



Issue 13/4

ECONOMIC OUTLOOK

ECONOMICS RESEARCH CENTRE

October 2013

SUMMARY

Recession in the Cyprus economy is forecasted to deepen in the second half of 2013 and in 2014. Real GDP growth for the third and fourth quarter of 2013 is forecasted at -7.0% and -8.1% respectively. GDP growth for the whole of 2013 is projected at -6.5%. Further contraction in activity is forecasted for 2014, as GDP growth for the whole year is projected at -8.0%. Downside risks, however, are dominant at present, especially as economic confidence is still fragile and the restructuring of the banking sector is underway. More specifically, downside risks that could lead to a worse outcome than that forecasted relate to the following factors.

- The current tight financial conditions marked by limited liquidity and credit as well as by relatively high interest rates: (a) could have profound consequences on investment and employment; and (b) could lead to higher than anticipated corporate and household default rates, given the deterioration of the real economy, creating further capitalisation needs for banks.
- The substantial loss of confidence in the domestic banking system weighs on overall economic sentiment in the country, posing risks to the outlook in the following quarters.
- Additional fiscal consolidation measures (e.g. reduction in social transfers, allowances, public sector payroll and/or increase in taxes) in the event of missed fiscal targets in subsequent quarters will have negative effects on disposable income and demand.
- Weaker external environment especially in the euro area and Russia could further depress activity in Cyprus through weak exports.

The possibility of upside risks for growth remains remote. Any investment decision directly or indirectly related to the hydrocarbon exploitation process and the tourism sector (e.g. casino licence and resort) will primarily boost economic confidence and subsequently improve growth prospects. Stronger growth of the United Kingdom economy is conducive to improved export performance in Cyprus, especially with respect to tourism.

Overall, the projections here indicate a slightly larger contraction in GDP (of about 14.5%) for the period 2013–2014 than that forecasted in the Economic Adjustment Programme (i.e. 12.6%). The method and data employed here generate a less negative forecast for 2013 than the projections published by the European Commission and the IMF. Furthermore, the dynamic models and data used in our forecasts suggest a more severe real GDP contraction in 2014 than that forecasted by the two organisations. This follows from the dynamic relationship between real output growth and other economic variables. Our results show that even though a good deal of the correction process is underway, the largest part of the adjustment is likely to be shifted to 2014. More specifically, the ongoing deterioration in a number of series relating to the domestic labour market and financial sector conditions, as well as to economic confidence, has persistent negative effects on growth. The resulting GDP growth forecasts are therefore markedly negative even for the second half of 2014.

A worse recession than that forecasted in the Economic Adjustment Programme will have negative implications for fiscal targets, debt sustainability, the repayment ability of highly leveraged businesses and households and, possibly, for banks' capital needs. Additional pressure on the banking system (which is heavily exposed to real estate loans) could be caused if the recession is accompanied by a larger than anticipated decline in property prices in the following years.

The implementation of structural reforms is, therefore, more pressing now, in order to ensure the long-run sustainability of public finances, improve efficiency and market competition and enhance the stability and governance of the banking sector. The introduction of structural reforms (government payroll, state and local governance, privatisation, pensions, labour and product market (de)regulation, education, health, etc.) at this critical juncture for the economy will strengthen country's credibility and investors' confidence and will ultimately improve its recovery prospects. Further austerity measures based on accounting principles and designed to balance the government books can only have a short-lived effect and can do very little to stop the economy from slipping deeper into recession.

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1. Recent developments

The worsening of the economic conditions in Cyprus intensified during the second quarter of 2013, as real GDP contracted by 5.8% compared to the same quarter in 2012. Real economic activity declined in all sectors apart from real estate activities which registered feeble growth. Consumption shrank further as a result of private agents' and public sector's ongoing adjustment efforts. The unprecedented fall in gross capital formation in the second quarter was driven by the reduction in both fixed investment and inventories. The positive contribution of net exports to output was due to a disproportionate reduction in imports compared to the decline in exports.

Economic confidence has been rebounding from the shock caused by the banking crisis in March, as indicated by the rising Economic Sentiment Indicator since May. Firms' perceptions and expectations (in services, retail trade, manufacturing and construction) about their activity picked up slightly during the third quarter following the drop in the second quarter. Firms' employment expectations were less negative than in the previous three quarters (Figure 1). At the same time consumer confidence remains at extraordinary low levels despite the marginal improvement in the third quarter (Figure 2). Thus, it not yet clear whether the less negative economic sentiment recorded in the third quarter marks the beginning of a recovery process in confidence. Given the volatile nature of survey data, this outcome may simply mark the beginning of a period when economic sentiment will fluctuate around historically low levels suggesting the persistence of the adverse conditions in real economy for a long period.

The deterioration in the labour market conditions continued as the unemployment rate (Eurostat) approached 17% in August; and registered unemployed increased by 36% in the third quarter of 2013 compared to the same quarter of 2012. Since June, however, vacancies have been shrinking at a slower rate compared to previous months in 2013 and 2012. The contraction in the registration of motor vehicles and new companies decelerated in July and August compared to previous months. The contraction of credit card usage (value) slowed down during the same period. Nevertheless in the case of credit card usage and registrations of new companies this pattern was reversed in August.

Available monthly data for manufacturing production and cement sales indicate that currently the worsening of the situation in the manufacturing and construction sectors is more or less as severe as it was in the second quarter. The contraction of loans to domestic (non-financial) firms and households accelerated in July and August manifesting the shortage of liquidity in the domestic banking system and, to some extent, the ongoing deleveraging.

Figure 1: Business Confidence Indicator (CypERC), Employment Expectations Indicator (CypERC) and gross value added growth (services, retail trade, construction, manufacturing)

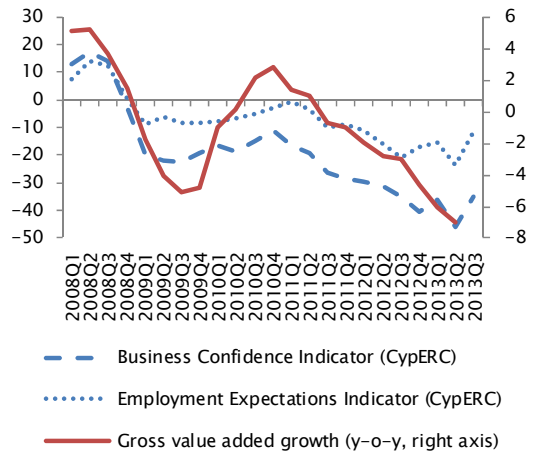
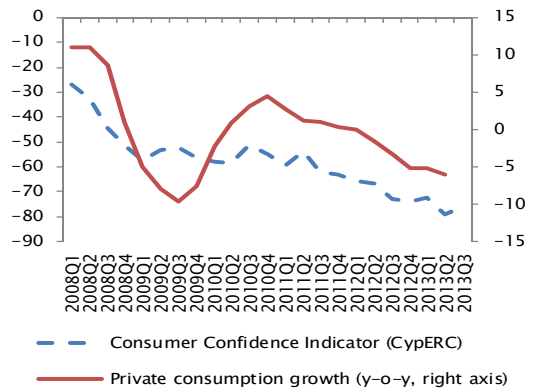


Figure 2: Consumer Confidence Indicator (CypERC) and private consumption growth



Despite the disappointing picture of tourist arrivals in 2013, the latest data on tourism revenue indicate improved performance during February – July 2013 compared to the same period in 2012. The increase in the general government expenditure in the second quarter resulted in a

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widening of the public sector deficit in spite of the increase in government revenue in the second quarter.

As a result of the recessionary conditions in Cyprus CPI inflation was negative for a second consecutive quarter although international oil prices were increasing during the same period. CPI was down by -0.8% in the third quarter of 2013 compared to the same period last year. The negative inflation in the third quarter was mainly driven by lower prices in the categories of food and beverages, housing, water, electricity and gas, household goods and health.

2. Forecasts

Projections for GDP growth and CPI inflation for 2013 and 2014 are constructed using quarterly data available up to the second quarter of 2013. Monthly indicators released by 9 October 2013, which contain information referring to September 2013, at best, are also used.

All forecasts presented in this Bulletin are based solely on published data, thus they only incorporate effects already captured by leading indicators used in the estimation of the forecasts.

The forecasts for the year-on-year (y-o-y) growth rate of real GDP for the third and fourth quarter of 2013 and all the quarters of 2014 are shown in Table 1.¹

- Recession in the Cyprus economy is forecasted to deepen in the second half of 2013 and in 2014. In particular, real GDP growth for the third and fourth quarter of 2013 is forecasted at -7.0% and -8.1% respectively. GDP growth for the whole of 2013 is projected at -6.5%.
- Based solely on the historical relationships between growth and numerous macroeconomic indicators further contraction in activity is forecasted for 2014. Real GDP growth for the whole year is projected at -8.0%. The first quarter of 2014 is projected as the most negative of the forecasting horizon as GDP is estimated to contract by

8.9%. During the second, third and last quarter of 2014 real GDP is forecasted at -8.2%, -8.0% and -6.7%, respectively.

Table 1 also shows the contribution of different components (groups of models) in shaping the final forecast. *Real economy* factors (domestic and international activity and labour market) and components in the group *other than real economy* have a negligible effect on the formation of the forecast in all quarters (less than 10%).² However, *real economy jointly with other* components plays a key role in determining the forecasts.

Table 1: Contribution of components to y-o-y GDP growth forecast¹

	2013 Quarters		2014 Quarters			
	3	4	1	2	3	4
FORECAST	-7.0	-8.1	-8.9	-8.2	-8.0	-6.7
COMPONENTS						
<i>Real economy</i>	-0.1	0.0	-0.1	-0.1	-0.1	-0.1
<i>Excluding real economy</i>	-0.5	-0.1	-0.2	-0.2	-0.2	-0.1
<i>Real economy & other aspects</i>	-6.5	-7.9	-8.7	-7.9	-7.8	-6.5
Fiscal	-0.1	-0.1	-0.2	-0.3	-0.3	-0.2
Prices	-0.3	-0.1	-0.4	-0.6	-0.5	-0.4
Exchange rates	-0.1	-0.2	-0.3	-0.4	-0.3	-0.2
Interest rates and spreads	-3.2	-2.9	-2.6	-2.4	-2.1	-1.7
Stock markets	-0.5	-2.2	-2.5	-1.7	-1.8	-1.8
Economic sentiment	-1.8	-2.3	-2.6	-2.3	-2.4	-2.0
Loans, deposits, reserves	-0.5	-0.2	-0.3	-0.4	-0.3	-0.2

Notes:

¹ Table 1 is presented in the Appendix (Table A1) in greater detail by showing the forecast resulting from each component together with the weight assigned in the computation of the final forecast. The weight of each component is determined by the number of relevant models used in the estimation and their historical forecasting performance.

² Differences between the forecasts and the sum of the components are due to rounding.

The forecasts in all quarters are mainly formed by models that include interest rates or spreads, economic sentiment or stock market indicators (and their monthly leads); as well as real economy factors and monthly values of series contained in the factors, such as the unemployment rate, registered unemployed, vacancies, arrivals of tourists, etc.

¹ The forecasts for the year-on-year growth rate of real GDP presented are obtained via the estimation of a large number of alternative models embracing various aspects of the economy. The final forecasts presented here are computed as the average across forecasts from models that historically outperform a simple univariate model. National Accounts data published on 9 October 2013 are used.

² The group 'other than real economy' includes: interest rates and spreads, stock market indicators, economic sentiment indicators, exchange rates, domestic and foreign price (sub)indices, international commodity prices, fiscal and banking-related series.

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For the third and fourth quarter of 2013, the forecasts from the various models are fairly concentrated around the mean, i.e. the forecasts shown in Table 1. The substantial negative carryover from the contraction in domestic activity in the previous quarters and the weak economic environment in the euro area exert further negative pressure on GDP growth in Cyprus during the third quarter. The weak economic conditions in the euro area are represented by the low level of European interest rates (Euribor), the spreads of countries in the periphery, and the deterioration in the services and construction confidence indicators in the second quarter. Moreover, the fragile economic confidence in Cyprus – alone and its interaction with the adverse situation in the real economy – suggests a worse outcome for the final quarter of the year than the mean forecast from all models.

Factors summarising the real side of the economy in the absence of other economy aspects, but also in connection with the rather volatile domestic sentiment indicators, tend to yield more negative projections for real activity throughout 2014 than the forecasts in Table 1. Apart from the quarterly information on the domestic and foreign real activity and labour market, models with real economy factors are augmented with up-to-date monthly values recorded during the third quarter of 2013. Thus the models capture the continuous downturn and the deterioration in the labour market conditions via a number of indicators such as the unemployment rate, registered unemployed, tourist arrivals, vehicle registrations, cement sales, etc.

The tight credit conditions in Cyprus, reflected by the relatively high domestic interest rates, aggravate the contraction in GDP projected for the first three quarters of 2014. Other variables relating to the banking sector – such as loans, deposits (as well as broader measures of banks' assets and liabilities) and international reserves – jointly with real economy factors forecast deeper recession in the second, third and final quarter of 2014 than the mean forecast. More specifically, the negative impacts of deposit outflows and of the rapid reduction of loans (caused by both reduced liquidity and deleveraging) on real output are likely to become more evident in the next year.

Recent and current fiscal conditions, namely large reductions in the expenditure of general government, decline/slowdown of government revenue and a rising public deficit are expected to amplify the contraction in real GDP (through lagged effects) in the last three quarters of 2014.

The subdued domestic and foreign inflation, the fairly stable international oil prices and declining international non-energy commodity prices seem to ease to some extent the negative pressure on GDP growth in the second half on 2014. Furthermore, the improved performance of international stock markets in the last few quarters and, to a smaller degree, the recovery of the euro area economic sentiment are found to ameliorate domestic downturn after the second quarter of 2014.

Forecasts are constructed using econometric techniques and, therefore, are associated with forecast errors determined by the historical performance (forecast error) of the method applied. Table 2 presents the different forecast ranges for GDP growth.

The quarterly profiles of the forecasts suggest that the Cyprus economy will incur the largest part of the adjustment in 2014. Furthermore, recession in 2013 is projected less severe than in the macroeconomic scenario of the Cyprus's economic adjustment programme; but the opposite is forecasted for 2014 ([1], [2]). The projections for 2013 and 2014 underpinning the economic adjustment programme do not fall within the forecast ranges given in Table 2. The programme's projection for 2013 is more negative than the lower endpoint (min), while the forecast for 2014 is less negative than the upper endpoint (max) presented here.

Table 2: GDP growth forecast, mean value and forecast range

2013					
	Quarters				
	1 ¹	2 ¹	3	4	1-4
Forecast	-5.0	-5.8	-7.0	-8.1	-6.5
<i>Forecast range²</i>					
Min	-5.0	-5.8	-7.6	-9.1	-6.9
Max	-5.0	-5.8	-6.5	-7.2	-6.1
2014					
	Quarters				
	1	2	3	4	1-4
Forecast	-8.9	-8.2	-8.0	-6.7	-8.0
<i>Forecast range²</i>					
Min	-10.5	-10.4	-10.8	-10.1	-10.4
Max	-7.4	-6.0	-5.2	-3.4	-5.5

Note: ¹ Published data (Quarterly National Accounts, Seasonally Adjusted Data, Statistical Service, 09/10/2013).

² The ranges are computed as \pm root mean squared forecast error around the forecasts which correspond to 68% confidence interval.

The downside risks that have been accompanying previous forecasts persist throughout the current forecast horizon. Such downside risks relate to the following:

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- The restructuring and recapitalisation of the banking sector coupled with the deposit outflows triggered by the March banking crisis have put strain on the supply of credit and liquidity in the system. Depending on its duration, the current credit crunch could have profound consequences on investment, employment and growth, even in the medium run.
- The current tight financial conditions (relatively high interest rates, limited liquidity/credit) together with the worsening of the real economy could lead to higher than anticipated corporate and household default rates creating further capitalisation needs for banks and accentuating recessionary conditions.
- Despite considerable easing in transaction restrictions, confidence in the Cypriot banking system has not rebounded. The substantial loss of confidence in the domestic banking system weighs on overall economic sentiment in the country posing risks to the outlook in the following quarters.
- To the extent that the effects of already legislated fiscal measures with effect in 2014 are not captured by available data (e.g. consumption indicators), their implementation will have further negative, albeit short-term, impacts on activity in 2014.
- Additional fiscal consolidation measures (e.g. reduction in social transfers, allowances, public sector payroll and/or increase in taxes) required for the achievement of fiscal targets in subsequent quarters, will have negative effects on disposable income and demand.
- Deterioration of the external environment, especially in the euro area and Russia, could depress activity in Cyprus further through weak exports – IMF projected feeble growth in the euro area in 2014 and revised Russia's growth forecasts for 2013 and 2014 downwards [1].

The possibility of upside risks for growth remains remote. However, any investment decision directly or indirectly related to the hydrocarbon exploitation process and the tourism sector (e.g. casino licence and resort) may initially boost economic confidence and subsequently improve growth prospects. Stronger growth in the United Kingdom is conducive to an improved export performance in Cyprus, especially tourism – IMF revised growth forecasts for 2013 and 2014 for the United Kingdom upwards [1].

CPI inflation in 2013 is projected at around 0.0%, with the final quarter of 2013 (compared to the same quarter of 2012) forecasted at -0.6%. CPI inflation in 2014 is projected at 1.6%.³ The forecast for 2014 reflects, to a large extent, base effects of low inflation in 2013. The recessionary conditions in the economy, that are projected to worsen, pose considerable downside risks to inflation, especially in 2014. The increase in the VAT rate and in the tax on motoring fuels in 2014 can be viewed as upside risks to inflation, as they are not directly incorporated in the 2014 forecast. Further rise in indirect taxes and/or in regulated prices to meet fiscal targets, increases in international commodity prices and the weakening of euro against the US dollar are likely to put upward pressure on inflation.

Comparison with previous forecasts

The current forecasts for the year-on-year growth rate of real GDP are revised downwards (i.e. they are more negative) for all quarters compared to the forecasts presented in the July issue of this bulletin. Consequently, the forecasts for 2013 and 2014 are revised from -5.7% to -6.5% and from -4.9% to -8.0%, respectively. The revision is caused by the deepening of the recession during the second quarter of 2013, which was reflected in the National Accounts data for the second quarter, but also in the downward revision of GDP figure for the first quarter. Furthermore, the severe worsening of almost all domestic indicators in the second quarter of 2013 resulted in more negative growth projections for the entire forecast horizon. The main drivers of the more pessimistic forecasts are the unusually adverse domestic financial conditions (limited liquidity, deposit 'haircut', transaction restrictions, etc.) and the confidence loss registered in the second quarter; together with the worsening domestic and weak euro area real economy conditions.

As recession deepened and CPI inflation turned negative during the second and third quarter of 2013, inflation projections for 2013 and 2014 are revised downwards from 1.0% to 0.0% and from 2.5% to 1.6% respectively.

³ CPI inflation forecasts are constructed from dynamic models that include lags and monthly leads of sub-indices of CPI and domestic and foreign Harmonised Index of Consumer Prices, international commodity prices, as well as factors summarizing real economic activity and leads of variables included in the factors (e.g. registered unemployed, unemployment rate, motor vehicle registrations, etc.).

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3. Concluding remarks

Quarterly data available up to the second quarter of 2013 and monthly indicators released early in October 2013 are employed together with dynamic econometric models to construct forecasts for GDP growth and CPI inflation. Historical relationships and recent data point *currently* to GDP growth of -6.5% and -8.0% for 2013 and 2014, respectively. Downside risks, however, are dominant at present, especially as economic confidence is still fragile and the restructuring of the banking sector is underway. CPI inflation is expected to remain subdued because of the recessionary conditions and the limited upward pressure on oil prices.

Overall the projections here indicate a slightly larger contraction in GDP (of about 14.5%) for the period 2013–2014 than that forecasted in the economic adjustment programme (i.e. 12.6%); the distribution of the output contraction between 2013 and 2014 presented in this issue is also somewhat different. The method and data employed here generate a less negative forecast for 2013 than the projections published by the European Commission and the IMF in relation to the Cyprus economic adjustment programme. Furthermore, the dynamic models and data used here suggest a more severe real GDP contraction in 2014 than that forecasted by the two organisations ([1], [2], [3]). Our results show that even though a great deal of the correction process is underway, the largest part of the adjustment is likely to be shifted to 2014. This follows from the dynamic relationship between real output growth and other economic variables. More specifically, the ongoing deterioration in a number of series relating to the domestic labour market and financial sector conditions as well as to

economic confidence, has persistent negative effects on growth. The resulting GDP growth forecasts are therefore quite negative even for the second half of 2014.

A worse recession than that forecasted in the adjustment programme will have negative implications for fiscal targets, debt sustainability, the repayment ability of highly leveraged businesses and households and possibly for banks' capital needs. Additional pressure on the banking system (which is heavily exposed to real estate loans) could be caused if the recession is accompanied by larger than anticipated declines in property prices in the following years.

In view of uncertain economic outlook the need for structural reforms is now more pressing in order to ensure the sustainability of public finances, improve efficiency and market competition and enhance the stability and governance of the banking sector. The introduction of reforms at this critical point for the economy, will strengthen country's credibility and investors' confidence and will ultimately improve the recovery prospects.

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APPENDIX

**Table A1: GDP growth forecasts
(components of forecasts, weights and forecast by component)**

COMPONENTS	CONTRIBUTION BY COMPONENT						WEIGHT						FORECAST BY COMPONENT					
	2013		2014				2013		2014				2013		2014			
	Quarters		Quarters		Quarters		Quarters		Quarters		Quarters		Quarters		Quarters			
	3	4	1	2	3	4	3	4	1	2	3	4	3	4	1	2	3	4
Real economy	-0.1	0.0	-0.1	-0.1	-0.1	-0.1	1.0	0.5	0.6	0.9	0.7	0.7	-6.7	-8.0	-9.5	-9.1	-9.1	-7.7
Excluding real economy	-0.5	-0.1	-0.2	-0.2	-0.2	-0.1	6.9	1.6	1.8	2.2	2.3	2.4	-7.3	-8.5	-9.1	-8.1	-7.3	-5.6
Real economy and other aspects	-6.5	-7.9	-8.7	-7.9	-7.8	-6.5	92.1	97.9	97.5	96.9	97.0	96.9	-7.0	-8.1	-8.9	-8.2	-8.0	-6.7
Fiscal	-0.1	-0.1	-0.2	-0.3	-0.3	-0.2	1.5	0.7	1.7	3.0	3.5	2.9	-7.0	-7.9	-9.1	-9.0	-8.7	-7.1
Prices	-0.3	-0.1	-0.4	-0.6	-0.5	-0.4	4.4	1.1	3.9	6.4	6.4	5.7	-7.0	-7.9	-9.2	-8.9	-7.8	-6.6
Exchange rates	-0.1	-0.2	-0.3	-0.4	-0.3	-0.2	1.0	2.2	2.9	4.0	4.1	3.8	-7.1	-8.2	-9.3	-9.0	-8.2	-6.4
Interest rates and spreads	-3.2	-2.9	-2.6	-2.4	-2.1	-1.7	45.3	35.0	28.9	29.3	27.7	26.2	-7.1	-8.3	-8.9	-8.1	-7.7	-6.5
Stock markets	-0.5	-2.2	-2.5	-1.7	-1.8	-1.8	6.9	28.0	27.5	23.6	24.5	28.7	-6.9	-8.0	-8.9	-7.0	-7.4	-6.3
Economic sentiment	-1.8	-2.3	-2.6	-2.3	-2.4	-2.0	26.1	28.8	28.9	26.1	26.8	26.9	-7.0	-8.1	-8.9	-8.9	-8.8	-7.4
Loans, deposits, reserves	-0.5	-0.2	-0.3	-0.4	-0.3	-0.2	6.9	2.1	3.7	4.6	3.9	2.8	-6.9	-8.0	-9.1	-9.0	-9.0	-7.9
	FORECAST						NUMBER OF MODELS											
	-7.0	-8.1	-8.9	-8.2	-8.0	-6.7	203	2144	7287	9259	8854	7286						



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The Economics Research Centre (CypERC) of the University of Cyprus is an independent, non-profit organization with the aim of promoting scientific knowledge in economics, especially in matters concerning Cyprus.

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