



Issue 14/4

ECONOMIC OUTLOOK

ECONOMICS RESEARCH CENTRE

October 2014

SUMMARY

During the second half of 2014 the recession in Cyprus is forecasted to moderate further; as a result real GDP growth for 2014 is projected at -2.4%. In the third quarter of 2014 real GDP is estimated to contract (y-o-y) by 1.9% and in the fourth quarter real activity is forecasted to decline by 1.4%. The recession is forecasted to persist in 2015 but the contraction of real GDP is estimated to decelerate considerably, at -0.4%. Real output is projected to fall (y-o-y) by 1.0% in the first quarter of 2015 and by 0.2% in the remaining quarters.

The forecasts for the growth rate of real GDP for 2014 and 2015 presented in this bulletin are less negative compared to the projections in the previous issue. The revisions are driven by the slowdown of real GDP contraction in Cyprus in the second quarter, the positive growth rate in the euro area for a third consecutive quarter and robust growth in the United Kingdom. Domestic leading indicators associated with real activity and the labour market continued to improve in the second and third quarter, adding to the less negative forecasts compared to the previous issue. Other economic developments that contributed to the upward revisions include: (i) the levels of economic confidence around the long-run average in Cyprus and the EU, (ii) the favourable performance of stock markets, (iii) further reductions in the spreads of the stressed economies of the euro area, and (iv) the strengthening of the stabilisation process in the banking system.

The downside risks accompanying the projections given in this bulletin include the following:

- The rising level of non-performing loans together with delays in the reform of the relevant legal framework and in the effective management of such loans could threaten banks' capital buffers, reinforce tight credit conditions and undermine the fragile confidence. A prolonged period of tight credit conditions could have adverse effects on both actual and potential growth.
- Delays in the advancement of agreed structural reforms and, in general, weaker commitment to the implementation of the economic adjustment programme could damage economic confidence and create risks to fiscal targets and activity.
- Further slowdown of the Russian economy in combination with the enforcement of sanctions by the EU and the weakening of the rouble against the euro could affect negatively international business activities and tourism revenues in Cyprus. Further weakening of the recovery momentum in the euro area could impact negatively on domestic activity
- Increased geopolitical tensions in the Middle East and Eastern Mediterranean could trigger adverse spillovers to economic confidence, tourism and consequently to activity.

Robust growth in the United Kingdom combined with the weakening of the euro against the British pound could benefit exports. The accommodative monetary policy stance announced by the ECB, and in particular the programme of asset backed security purchases is expected to improve liquidity in the domestic banking system with positive effects on the real economy. Finally, investment decisions related mainly to the sectors of energy and tourism could improve the medium-term prospects of the economy.

The projections in this bulletin indicate a milder recession for 2014 compared to the contraction of real GDP by 3.2% forecasted recently by the IMF. For 2015 the projections given here suggest that activity will continue to decline, albeit at a slower rate than in 2014, while weak growth at 0.4% is forecasted by the IMF. Although the error surrounding the projections for 2015 presented here is relatively large, the evidence for a more protracted activity contraction is associated with external factors (e.g. slower growth in the euro area and Russia) as well as with domestic dynamics (e.g. tight credit conditions, high private and public sector indebtedness levels and elevated unemployment). Factors relating to the external environment are expected to impact domestic activity with a delay, while domestic conditions are likely to generate more persistent adverse effects on growth.

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1. Recent developments

The recession in Cyprus moderated further in the second quarter of 2014 as real GDP declined by 2.5% year-on-year (y-o-y). The largest sector of the economy namely trade, transport, accommodation and food services has registered positive growth in the second quarter after about 2½ years of downturn; real estate activities expanded marginally. During the second quarter of 2014 the decline of the gross value added (y-o-y) in the sectors of industry, information and communication, public administration, education and health was more severe than in the first quarter of the year, while in the remaining sectors the contraction of real activity decelerated. Nevertheless, financial and insurance services as well as construction continued to shrink at much faster rates than other sectors. The decline (y-o-y) in consumption in the second quarter slowed down; it resulted from the lower government expenditure and stagnant private consumption. Gross capital formation increased compared to the second quarter of 2013, in spite of the contraction of fixed investment, which was, however, slower than in previous quarters. During the second quarter, exports exhibited weak growth, while imports increased (y-o-y) rather strongly after a long slump; net exports continued to contribute positively to GDP.

The Economic Sentiment Indicator (ESI) increased only marginally in the third quarter as a result of confidence improvements in services and among consumers; economic sentiment in retail trade, manufacturing and construction stalled over the third quarter. As shown by the Business Confidence Index, firms' activity perceptions and expectations remained unchanged between the second and third quarter, while employment expectations picked up further (Figure 1). The Consumer Confidence Indicator continued its gradual recovery during the third quarter (Figure 2). The current trends in economic sentiment data suggest that private consumption (demand side) and services (supply side) are likely to contribute the most towards easing the recession in the short run.

The unemployment rate (Eurostat) in the second quarter stood just below 16%; the recent data for July–August indicate that unemployment has been receding slowly. After a flat (y-o-y) second quarter, the decline in the the number of registered unemployed has gained momentum in the third quarter. Moreover, the growth of the number of vacancies strengthened considerably during the second quarter of 2014 and remained positive in July–August.

A number of monthly leading indicators available for some or all of the months of the third quarter continued to grow (y-o-y); such indicators include credit card usage, registrations of motor vehicles, volume and value index of retail trade, registration of new companies, tourist arrivals and the Cyprus stock exchange index. Over the same period, other indicators such as revenue from tourism, cement sales and industrial production decreased.

The contraction of the stock of domestic loans has been exhibiting signs of slowdown as smaller rates were registered in July–August compared to the previous months. The decline in both domestic and foreign deposits continued to decelerate in July–August. Nevertheless, non-performing loans relating to local operations rose further in August reaching 47.7% of total credit facilities. Lending rates have been declining, albeit sluggishly, suggesting that adverse credit conditions are still in place and that challenges for the banking system remain.

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

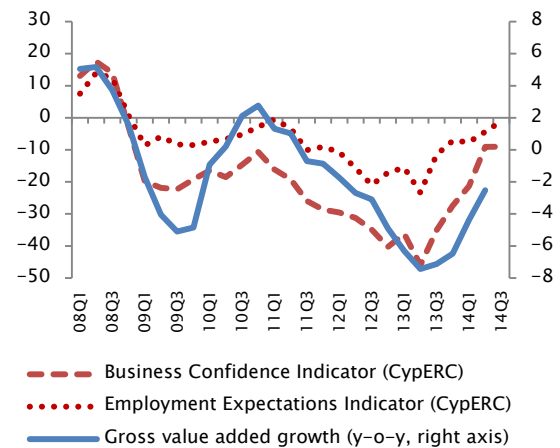
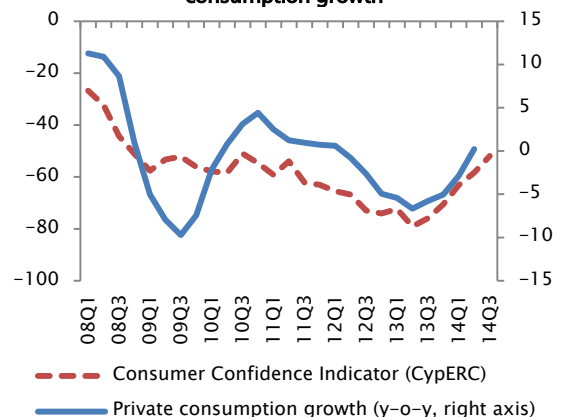


Figure 2: Consumer Confidence Indicator (CypERC) and private consumption growth



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On the fiscal front, a surplus for the general government was recorded over January–July 2014; public debt peaked in the second quarter followed by a slight decrease in July.

Negative inflation measured by the Consumer Price Index (CPI) persisted during the third quarter as CPI declined by 0.7% (y–o–y), due to weak domestic activity and the absence of upward pressures in international oil prices. However, the decline of the aggregate price level moderated in the third quarter.

2. Forecasts

Projections for GDP growth and CPI inflation are constructed using quarterly data available up to the second quarter of 2014. Monthly indicators released by 6 October 2014 that contain information covering the first months of the third quarter of 2014 are also used. All forecasts presented in this bulletin are based solely on published data; thus, they only incorporate effects already captured by quarterly series and monthly leading indicators used in estimation.

The forecasts for the (y–o–y) growth rate of real GDP for the third and final quarter of 2014 as well as for the four quarters of 2015 are shown in Table 1; projections for 2014 and 2015 are also provided using the forecasted y–o–y growth rates.¹

- Based on the historical relationships between growth and numerous macroeconomic indicators, the recession is forecasted to moderate in the second half of 2014. Real GDP growth for the whole year is projected at –2.4%. During the third quarter of 2014 real GDP is estimated to contract by 1.9%, and in the fourth quarter real activity is forecasted to decline by 1.4%.
- The recession is forecasted to persist in 2015, but the contraction of real activity is estimated to decelerate considerably, with real GDP growth projected at –0.4%. Real output is forecasted to fall by 1.0% in the first quarter; for the remaining of 2015 real GDP is projected at –0.2%.

Table 1 presents also the forecast errors associated with the estimated y–o–y growth rates in each quarter; apparently

forecasts computed for 2015 are accompanied by larger errors than those for 2014. Furthermore, Table 1 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 which *excludes real economy* factors have a minor effect on the formation of the forecast in all quarters (about 3% to 4%).² However, *real economy jointly with other* components plays a key role in determining the forecasts.

Table 1: GDP growth forecasts, forecast errors and contribution of components to forecasts¹

| YEAR | 2014 | | 2015 | | | |
|---|--------------|--------------|--------------|--------------|--------------|--------------|
| FORECAST² | –2.4 | | –0.4 | | | |
| Quarter | 3 | 4 | 1 | 2 | 3 | 4 |
| FORECAST (y–o–y) | –1.9 | –1.4 | –1.0 | –0.2 | –0.2 | –0.2 |
| Forecast error³ | 0.7 | 1.3 | 2.0 | 3.2 | 3.9 | 4.6 |
| COMPONENTS⁴ | | | | | | |
| <i>Real economy</i> | –0.02 | –0.01 | –0.01 | 0.00 | 0.00 | –0.01 |
| <i>Excluding real economy</i> | –0.04 | –0.02 | 0.00 | 0.03 | 0.03 | 0.02 |
| <i>Real economy & other aspects</i> | –1.83 | –1.33 | –0.96 | –0.24 | –0.19 | –0.24 |
| Fiscal | –0.05 | –0.04 | –0.03 | –0.02 | –0.02 | –0.02 |
| Prices | –0.18 | –0.13 | –0.08 | 0.00 | –0.01 | –0.02 |
| Exchange rates | –0.10 | –0.07 | –0.05 | –0.03 | –0.02 | –0.03 |
| Interest rates, spreads | –0.45 | –0.32 | –0.25 | –0.11 | –0.11 | –0.12 |
| Stock markets | –0.39 | –0.29 | –0.24 | –0.12 | –0.10 | –0.11 |
| Econ. sentiment | –0.46 | –0.33 | –0.21 | 0.01 | 0.01 | –0.02 |
| Loans and deposits | –0.22 | –0.15 | –0.10 | 0.02 | 0.06 | 0.07 |

¹ Table 1 is presented in the Appendix (Table A1 and A2) 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 inverse of the discounted mean squared forecast error of the relevant models (i.e. forecast errors in the more distant past are discounted more heavily).

² For the first and second quarter of 2014 the y–o–y growth rate of GDP obtained from published data is used (Quarterly National Accounts, Seasonally Adjusted Data, Statistical Service, 03/09/2014).

³ Pseudo out-of-sample root mean squared forecast error of the forecast method.

⁴ 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), banking sector series (e.g. loans, deposits) as well as domestic and

¹ The forecasts for the y–o–y growth rate of real GDP reported in the table are obtained via the estimation of a large number of alternative models embracing various aspects of the economy. The final forecast for each quarter presented here is computed as the weighted average of all model forecasts using weights based on the historical forecasting performance of each model.

² The group which excludes real economy factors includes: interest rates and spreads, stock market indicators, economic sentiment indicators, exchange rates, domestic and foreign price indices, international commodity prices, fiscal and banking-related series.



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international prices. Real economy factors and monthly values of series contained in the factors (e.g. unemployment rate, registered unemployed, vacancies, arrivals of tourists) are also included in the models. Historically such models have been generating relatively more accurate forecasts and, therefore, gain greater importance in the construction of the final forecast.

The decline in output for 2014 and 2015 is estimated to be less severe than that registered in the first half of this year, as the recession in Cyprus continued to moderate during the second quarter. Moreover, further improvements in a number of domestic leading indicators in the third quarter point towards a deceleration of GDP contraction in the second half of 2014 and further slowdown in 2015. More specifically, recession is estimated to abate in the last two quarters of 2014 and in 2015 as a result of the following:

- The contraction of domestic real economic activity and employment has been slowing down since the second half of 2013. Some activity leading indicators (e.g. volume/value index of retail trade, credit card usage, registration of motor vehicles, tourist arrivals, registration of new companies) continued their upturn in the first months of the third quarter.
- The decrease (y-o-y) in the number of registered unemployed that was recorded in the second quarter accelerated during the third quarter resulting in modest declines in the unemployment rate; furthermore job vacancies have been picking up.
- The Economic Sentiment Indicator for Cyprus continued to rise, although the improvement has been slower since May. The Cyprus stock exchange (general) index registered double-digit (y-o-y) returns in the second and third quarter of the year.
- Despite the challenges facing the banking system, stabilisation tendencies strengthened in the second quarter and during the first months of the third quarter, as deposits and loans contracted at a slower pace than previously.
- Low (negative) domestic inflation and suppressed international energy and non-energy prices are also found to be associated with less severe recession after the third quarter of 2014.

The recession is projected to ease also as a result of some favourable external factors such as the expansion of real activity in the euro area and the United Kingdom during the second quarter, the levels of economic confidence around

the long-run average registered in the European Union, the relatively good performance of the international stock markets and further reductions in the spreads of the stressed economies of the euro area. The weakening of the euro against the British pound is found to contain the recession in Cyprus, especially in 2015, through the effects on tourism services. However, at the moment, there are both external and domestic dynamics that weigh on growth, projecting a mild contraction of activity in 2015:

- The growth rate of real GDP in the euro area decelerated in the second quarter, and the low levels of European interest rates reflect weaknesses in the recovery of the euro area. Furthermore, the decline of the euro area economic sentiment indicator and the slowdown of European stock market indicators in the third quarter put a strain on output growth in Cyprus. Nevertheless, the pickup of domestic confidence indicators and Cyprus stock exchange affect positively real activity, limiting the depth of the recession.
- The slowdown of the Russian economy continued and the weakening of the rouble are estimated to put a drag on growth in Cyprus (mainly via the tourism channel) especially in 2015.
- The weakening of the euro against the US dollar is found to impact negatively on real GDP growth in 2015, mainly through the effects on energy prices.
- Despite the improvements in many domestic indicators in recent quarters, unemployment remains elevated, fixed investment continues to shrink, harming both actual and potential growth. The relatively high lending interest rates reflecting the tight domestic credit conditions, and the increased levels of public debt are also found to affect growth projections negatively.

Downside risks to the outlook include the following:

- The rising level of non-performing loans together with delays in the reform of the relevant legal framework and in the effective management of such loans, could threaten banks' capital buffers, reinforce tight credit conditions and undermine the fragile confidence. A prolonged period of tight credit conditions that leads to the contraction of fixed investment and employment could have adverse effects on both actual and long-run (potential) growth.
- Delays in the advancement of agreed structural reforms and, in general, weaker commitment to the implementation of the economic adjustment



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programme could damage economic confidence and create risks to fiscal targets and activity.

- Further slowdown of the Russian economy in combination with the enforcement of sanctions by the EU (as a result of the crisis in Ukraine) and the weakening of the rouble against the euro could affect negatively international business activities and tourism revenues in Cyprus (e.g. the IMF revised Russia's growth projections for 2015 downwards [2]).
- Further weakening of the recovery momentum in the euro area could impact negatively on domestic GDP (e.g. the euro area growth forecasts for 2014 and 2015 were revised downwards by the ECB and IMF ([1], [2])).
- Increased geopolitical tensions in the Middle East and Eastern Mediterranean could trigger adverse spillovers on economic confidence, tourism and thus on activity.

Robust growth in the United Kingdom combined with the weakening of the euro against the British pound could benefit exports. The accommodative monetary policy stance announced by the ECB, and in particular the programme of asset backed security purchases is expected to improve liquidity in the domestic banking system with positive effects on the real economy. Finally, investment decisions related mainly to the sectors of energy and tourism could improve the medium-term prospects of the economy.

CPI inflation in 2014 is projected at -1.1%.³ The negative inflation projection for 2014 is driven by the decelerating or negative rates of change in domestic price indices in the previous quarters, weak domestic demand, low foreign inflation rates, downward pressures in international oil prices and muted non-energy commodity prices. CPI inflation for 2015 is forecasted at 1.0% as a result of a pickup in consumer demand reflected in some leading indicators in recent months and the weakening of the euro against the US dollar which affects the price of imports, most notably of oil.

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, indicators relating to other aspects of the economy (e.g. exchange rates, interest rates, stock market and economic sentiment indicators) 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.).

Upside risks relate to increases in international commodity prices and further weakening of the euro against the US dollar. Downside risks to the projection stem from the recessionary conditions in the economy, which are forecasted to continue throughout 2014 and in 2015 and from weak external demand.

3. Concluding remarks

Quarterly data available up to the second quarter of 2014 and monthly indicators released early in October 2014 are employed in dynamic econometric models to construct forecasts for GDP growth and CPI inflation. The forecasts for real GDP growth for 2014 and 2015 presented in this bulletin are less negative compared to the projections in the previous issue. The forecasts for 2014 and 2015 are revised from -2.7% to -2.4% and from -0.7% to -0.4% respectively. The revisions are driven by the slowdown of real GDP contraction in Cyprus in the second quarter, the positive growth rate in the euro area for a third consecutive quarter and robust growth in the United Kingdom. Domestic leading indicators associated with real activity and the labour market continued to improve, adding to the less negative forecasts compared to the previous issue. Other economic developments that contributed to the upward revisions include: (i) the levels of economic confidence around the long-run average, (ii) the favourable performance of stock markets, (iii) further reductions in the spreads of the stressed economies of the euro area, and (iv) the strengthening of the stabilisation process in the banking system.

The projections in this bulletin indicate a milder recession for 2014 compared to the contraction of real GDP by 3.2% forecasted by the IMF. For 2015 the projections given here suggest that activity will continue to decline, albeit at a slower rate than in 2014, while weak growth at 0.4% is forecasted by the IMF ([2]). Although the error surrounding the projections for 2015 presented here is relatively large, the evidence for a more protracted activity contraction is associated with external factors (e.g. slower growth in the euro area and Russia) as well as with domestic dynamics (e.g. tight credit conditions, high private and public sector indebtedness levels and elevated unemployment). Factors relating to the external environment are expected to impact domestic activity with a delay, while domestic conditions are likely to generate more persistent adverse effects on growth.



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REFERENCES

1. European Central Bank (ECB) (2014), "ECB staff macroeconomic projections for the euro area", September 2014.
2. International Monetary Fund (IMF) (2014), "World Economic Outlook – Legacies, Clouds, Uncertainties", Washington (October).

APPENDIX

Table A1: GDP growth forecasts (components of forecasts, weights and forecast by component), 2014

| Quarter | CONTRIBUTION BY COMPONENT | | WEIGHT | | FORECAST BY COMPONENT | |
|------------------------------|---------------------------|-------------|-------------------------|-------|-----------------------|-------|
| | 2014 | | 2014 | | 2014 | |
| | 3 | 4 | 3 | 4 | 3 | 4 |
| COMPONENTS | | | | | | |
| Real economy | -0.02 | -0.01 | 0.81 | 0.72 | -1.94 | -1.34 |
| Excluding real economy | -0.04 | -0.02 | 2.34 | 2.13 | -1.79 | -0.97 |
| Real economy & other aspects | -1.83 | -1.33 | 96.85 | 97.15 | -1.89 | -1.37 |
| Fiscal | -0.05 | -0.04 | 2.32 | 2.38 | -1.99 | -1.52 |
| Prices | -0.18 | -0.13 | 9.80 | 9.97 | -1.86 | -1.32 |
| Exchange rates | -0.10 | -0.07 | 4.82 | 4.76 | -1.99 | -1.50 |
| Interest rates & spreads | -0.45 | -0.32 | 23.38 | 23.43 | -1.91 | -1.37 |
| Stock markets | -0.39 | -0.29 | 20.03 | 19.94 | -1.94 | -1.46 |
| Economic sentiment | -0.46 | -0.33 | 24.41 | 24.46 | -1.87 | -1.34 |
| Loans & deposits | -0.22 | -0.15 | 12.09 | 12.21 | -1.78 | -1.26 |
| FORECAST | | | NUMBER OF MODELS | | | |
| | -1.9 | -1.4 | 20332 | 20332 | | |

Table A2: GDP growth forecasts (components of forecasts, weights and forecast by component), 2015

| Year | CONTRIBUTION BY COMPONENT | | | | WEIGHT | | | | FORECAST BY COMPONENT | | | |
|------------------------------|---------------------------|-------------|-------------|-------------|-------------------------|-------|-------|-------|-----------------------|-------|-------|-------|
| | 2015 | | | | 2015 | | | | 2015 | | | |
| | 1 | 2 | 3 | 4 | 1 | 2 | 3 | 4 | 1 | 2 | 3 | 4 |
| COMPONENTS | | | | | | | | | | | | |
| Real economy | -0.01 | 0.00 | 0.00 | -0.01 | 0.71 | 0.68 | 0.76 | 0.81 | -0.92 | -0.24 | -0.37 | -0.82 |
| Excluding real economy | 0.00 | 0.03 | 0.03 | 0.02 | 2.13 | 2.25 | 2.56 | 2.72 | 0.02 | 1.38 | 1.22 | 0.85 |
| Real economy & other aspects | -0.96 | -0.24 | -0.19 | -0.24 | 97.16 | 97.07 | 96.68 | 96.48 | -0.98 | -0.24 | -0.19 | -0.25 |
| Fiscal | -0.03 | -0.02 | -0.02 | -0.02 | 2.36 | 2.40 | 2.38 | 2.28 | -1.16 | -0.78 | -0.72 | -0.74 |
| Prices | -0.08 | 0.00 | -0.01 | -0.02 | 9.92 | 10.70 | 10.61 | 10.18 | -0.85 | 0.01 | -0.07 | -0.23 |
| Exchange rates | -0.05 | -0.03 | -0.02 | -0.03 | 4.57 | 4.74 | 4.69 | 4.63 | -1.14 | -0.53 | -0.47 | -0.61 |
| Interest rates & spreads | -0.25 | -0.11 | -0.11 | -0.12 | 22.70 | 21.65 | 21.15 | 20.04 | -1.08 | -0.52 | -0.51 | -0.58 |
| Stock markets | -0.24 | -0.12 | -0.10 | -0.11 | 19.77 | 18.72 | 19.10 | 19.97 | -1.19 | -0.62 | -0.53 | -0.56 |
| Economic sentiment | -0.21 | 0.01 | 0.01 | -0.02 | 25.14 | 26.70 | 25.92 | 25.27 | -0.85 | 0.04 | 0.04 | -0.07 |
| Loans & deposits | -0.10 | 0.02 | 0.06 | 0.07 | 12.69 | 12.17 | 12.82 | 14.11 | -0.77 | 0.18 | 0.47 | 0.50 |
| FORECAST | | | | | NUMBER OF MODELS | | | | | | | |
| | -1.0 | -0.2 | -0.2 | -0.2 | 20332 | 20332 | 20332 | 20332 | | | | |



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