



Issue 15/4

# ECONOMIC OUTLOOK

## ECONOMICS RESEARCH CENTRE

**October 2015**

### SUMMARY

The recovery of economic activity in Cyprus is forecasted to continue in the following quarters. Real GDP growth for 2015 is projected at 1.3%. Real output is estimated to expand (y-o-y) by 1.9% and 2.6% in the third and fourth quarter of 2015 respectively. The projected growth rates for the second half of 2015 should, of course, be interpreted in the light of the low levels of GDP reached during the corresponding period in 2014. Real GDP growth in 2016 is forecasted at 1.5%.

The main drivers of the projected increase in real activity are given below.

- Growth (y-o-y) in real GDP and employment accelerated in the second quarter. Notably, the pickup in a number of activity-related domestic leading indicators continued during the third quarter.
- Stronger growth in the euro area and steady growth in the UK during the second quarter, as well as further increases in European economic sentiment indicators in the third quarter, support the recovery in Cyprus.
- The recent reductions in domestic lending interest rates amid conditions of weak demand and elevated unemployment are found to facilitate economic recovery. Furthermore, the return of domestic economic confidence to pre-crisis levels and the good fiscal performance are estimated to contribute to growth.
- Lower international oil prices and inflation in the EU are expected to benefit economic activity in Cyprus through their effects on real incomes, and on both domestic and external demand.
- The weakening of the euro against key currencies, most notably against the British pound, is expected to boost domestic activity in the following quarters through exports, particularly tourism services.
- Further reductions in the European lending rates and in the borrowing costs of euro area governments (with the exception of Greece) reflect ECB's accommodative monetary policy stance, which is also backing the recovery process in Cyprus.

Downside risks to the growth projections are associated with the following:

- The high levels of non-performing loans pose major risks to the stability of the banking system and to the outlook for the economy. Ineffective implementation of the new insolvency and foreclosure legal framework and bottlenecks in the introduction of legislation for the sale of loans could delay the restoration of healthy credit conditions and economic growth.
- Delays in the implementation of structural reforms agreed in the economic adjustment programme (e.g. public administration, privatisations, health system) may create risks to public finances, Cyprus's market borrowing costs and, therefore, to economic activity.
- Deterioration of the external economic environment namely (i) the worsening of the outlook for the Greek economy, (ii) the downturn in Russia and (iii) weaker than expected growth in the euro area and the UK, as a result of a slowdown in emerging markets, especially in China, could pose risks to the recovery momentum in Cyprus.

Upside risks to the economic outlook relate to the following: (i) a longer period of lower oil prices with positive effects on consumption; (ii) limited negative spillovers from adverse economic developments in Greece due to the recent weakening of the connections between the Cypriot and Greek banking systems; and (iii) investment decisions linked mainly to tourism, energy and financial services as well as public investment efforts for the expansion/improvement of infrastructure.

CPI inflation in 2015 is projected at -2.1%. In 2016 CPI inflation is estimated to remain slightly below zero. The negative inflation projections are mainly driven by the lower international oil prices combined with sluggish domestic demand.





### October 2015

#### 1. Recent developments

The economic activity in Cyprus expanded faster in the second quarter of 2015 as real GDP increased by 0.8% year-on-year (y-o-y) compared to 0.1% in the first quarter. All sectors apart from construction, entertainment and other services, registered positive y-o-y growth rates in their gross value added. On the demand side, growth in the second quarter was backed by the expansion of private consumption and investment. The y-o-y contraction in exports and the increase in imports contributed negatively to the GDP growth rate in the second quarter.

The improvements registered in many domestic leading indicators in the second quarter continued during the third quarter (e.g. volume index of retail trade, registrations of motor vehicles, cement sales, registrations of new companies, tourist arrivals from the UK). Furthermore, a budget surplus for the general government was recorded over January–August. The Economic Sentiment Indicator (ESI) declined in the third quarter as a result of a drop in July caused by the developments in Greece; nevertheless the ESI in August–September returned to the levels reached in the second quarter, reflecting improvements in consumer confidence as well as firming confidence in services and construction.

Loans to non-financial corporations continued to grow in July–August, while lending interest rates declined marginally over the same period. Non-performing loans as a percentage of total loans and advances rose further in July, posing risks to the banking system and the economy at large. The unemployment rate (Eurostat) fell in the second quarter and the number of registered unemployed in the third quarter contracted faster compared to the previous quarters; however the unemployment rate which is currently hovering at 15% is amongst the highest in the euro area.

The decrease of the general price level (measured by the Consumer Price Index – CPI) accelerated in the third quarter as a result of declining energy costs driven by falling international oil prices, and lower prices for education and recreation services.

#### 2. Forecasts

Projections for GDP growth and CPI inflation are constructed using quarterly data available up to the second quarter of 2015. Monthly indicators released by 5 October 2015 that contain information covering at most all the months in the third quarter of 2015 are also used. All forecasts presented

in this bulletin are based solely on published data; thus, they only incorporate effects already captured by the quarterly series and the monthly leading indicators used in the estimations.

The forecasts for the (y-o-y) growth rate of real GDP for the third and final quarter of 2015 as well as for all the quarters of 2016 are shown in Table 1; projections for the whole of 2015 and 2016 are also provided.<sup>1</sup>

- Based on the historical relationships between growth and numerous macroeconomic indicators, growth in 2015 is forecasted at 1.3%. Growth is estimated to strengthen as real GDP is projected to increase y-o-y by 1.9% and 2.6% in the third and fourth quarter of the year respectively. These estimates reflect also base effects as the *level* of real GDP bottomed out in the second half of 2014.
- The recovery is expected to continue in 2016 at a moderate pace with the y-o-y growth rate estimated at 1.7% and 1.3% for the first and second quarter respectively, and at 1.5% for the second half of the year. Real GDP growth for the whole of 2016 is projected at 1.5%.
- The y-o-y growth rates given in Table 1 imply quarter-on-quarter (q-o-q) percentage changes which average about 0.4% for the second half of 2015. The q-o-q growth rate for the first and second half of 2016 is estimated at 0.2% and 0.6% respectively.

Table 1 presents also the forecast errors associated with the estimated y-o-y growth rates in each quarter; errors are larger for quarters closer to the end of the forecast horizon. Furthermore, Table 1 shows the contribution of different components (groups of models) towards 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 2%).<sup>2</sup> However, *real economy factors jointly with other economy aspects* play a key role in determining the forecasts.

<sup>1</sup> 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.

<sup>2</sup> 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, as well as fiscal and banking sector series.

### October 2015

**Table 1: GDP growth forecasts, forecast errors and contribution of components to forecasts<sup>1</sup>**

YEAR	2015			
<b>FORECAST<sup>2</sup></b>	<b>1.3</b>			
<b>Quarter</b>	<b>3</b>	<b>4</b>		
<b>FORECAST (y-o-y)</b>	<b>1.9</b>	<b>2.6</b>		
Forecast error <sup>3</sup>	0.8	1.4		
<b>COMPONENTS<sup>4</sup></b>				
<i>Real economy</i>	0.01	0.01		
<i>Excluding real economy</i>	0.03	0.04		
<i>Real economy &amp; other aspects</i>	1.82	2.52		
Fiscal	0.03	0.04		
Prices	0.12	0.17		
Exchange rates	0.07	0.08		
Interest rates, spreads	0.56	0.86		
Stock markets	0.29	0.46		
Economic sentiment	0.44	0.58		
Loans, deposits	0.30	0.34		
YEAR	2016			
<b>FORECAST</b>	<b>1.5</b>			
<b>Quarter</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>
<b>FORECAST (y-o-y)</b>	<b>1.7</b>	<b>1.3</b>	<b>1.5</b>	<b>1.6</b>
Forecast error <sup>3</sup>	2.1	3.0	3.5	4.0
<b>COMPONENTS<sup>4</sup></b>				
<i>Real economy</i>	0.01	0.01	0.01	0.01
<i>Excluding real economy</i>	0.02	0.02	0.03	0.03
<i>Real economy &amp; other aspects</i>	1.71	1.27	1.42	1.60
Fiscal	0.02	0.02	0.03	0.03
Prices	0.11	0.11	0.12	0.13
Exchange rates	0.06	0.05	0.05	0.06
Interest rates, spreads	0.68	0.49	0.54	0.59
Stock markets	0.29	0.22	0.22	0.26
Economic sentiment	0.35	0.27	0.28	0.30
Loans, deposits	0.18	0.12	0.18	0.22

<sup>1</sup> Table 1 is presented in the Appendix (Table A1) in greater detail by reporting the forecast resulting from each component together with the weight assigned to the component forecast for the computation of the final forecast.

<sup>2</sup> For the first and second quarter of 2015 the y-o-y growth rates of GDP obtained from published data are used (Quarterly National Accounts, Seasonally Adjusted Data, Statistical Service, 08/09/2015).

<sup>3</sup> Pseudo out-of-sample root mean squared forecast error of the forecast method.

<sup>4</sup> 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 (one at a time) interest rates, spreads, economic sentiment indicators, stock market indices, banking sector series (e.g. loans, deposits) and domestic or foreign/international prices. Real economy factors and monthly values of series contained in the factors (e.g. unemployment rate, registered unemployed, registrations of motor vehicles, arrivals of tourists) are also included in the models. Historically such models have been generating

relatively more accurate forecasts than other groups of models and therefore have been gaining greater importance in the construction of the final forecasts.

The main drivers of the projected increase of real economic activity are discussed below.

- Growth (y-o-y) in real GDP and employment accelerated in the second quarter of 2015 and unemployment fell below 16% over the same period. The pickup in a number of activity-related domestic leading indicators (e.g. volume index of retail trade, registrations of motor vehicles, cement sales, registrations of new companies, tourist arrivals from the UK) continued during the third quarter. The decline (y-o-y) in the number of registered unemployed speeded up further in the third quarter signalling less adverse labour market conditions.
- Stronger growth in the euro area and steady growth in the UK during the second quarter of 2015, and further increases in European economic sentiment indicators in the third quarter support the recovery in Cyprus by creating a less adverse external environment.
- The recent reductions in domestic lending interest rates amid conditions of weak demand and elevated unemployment are found to facilitate the economic recovery. Furthermore, the return of domestic economic confidence to pre-crisis levels well as the good fiscal performance are estimated to contribute to growth.
- Lower international oil prices as well as low inflation in the EU are expected to benefit economic activity in Cyprus through their effects on real incomes and both domestic and external demand.
- The weakening of the euro against key currencies, most notably the British pound, is expected to boost domestic activity in the following quarters through exports, particularly tourism services.
- Further reductions in the European lending rates and in the borrowing costs of euro area governments (with the exception of Greece) reflect ECB's accommodative monetary policy stance which is also backing the recovery process in Cyprus.

The recent volatility in international financial markets related to developments in Greece and in China does not seem to significantly affect the current growth projections for Cyprus. Although movements in stock market indicators are still informative about the future evolution of GDP in Cyprus,



### October 2015

their importance in the construction of the final forecasts has been declining lately.

Nevertheless, some domestic and external factors continue to put a drag on activity in the following quarters. The high levels of corporate and household indebtedness and the process of deleveraging as well as the stricter lending practices recently adopted by banks limit both demand for and supply of new loans with protracted effects on investment and output.

In spite of the agreement on a new financing programme for Greece, the outlook for the Greek economy has deteriorated as reflected in the worsening performance of various leading indicators during the second and third quarter (e.g. Athens stock exchange index, long-term interest rate on Greek government bonds, Greek confidence indicators). The recent performance of Greek leading indicators has generated some adverse effects on the outlook for the Cypriot economy due to the economic/trade links between the two countries; these effects, however, are not found to be dominant at the moment. Another external factor that weighs on the outlook is the economic downturn in Russia which has led to a significant decline in the arrivals of Russian tourists in Cyprus in 2015.

There are both downside and upside risks to the outlook some of which have remained broadly unchanged compared to the previous issue. Downside risks to the growth projections are discussed below.

- The high levels of non-performing loans pose major risks to the stability of the banking system and to the outlook for the economy. Ineffective implementation of the new insolvency and foreclosure legal framework and bottlenecks in the introduction of legislation for the sale of loans could delay the resumption of healthy credit conditions and economic growth.
- Delays in the implementation of structural reforms agreed in the economic adjustment programme (e.g. public administration, privatisations, health system) may create risks to public finances, Cyprus's market borrowing costs and, therefore, to activity.
- Deterioration of the external economic environment namely (i) the worsening of the outlook for the Greek economy, (ii) the downturn in Russia, and (iii) weaker than expected growth in the euro area and the UK, as a result of a slowdown in emerging markets, especially in

China, could pose risks to the recovery momentum in Cyprus.

The IMF is currently forecasting a recession in Greece, in both 2015 and 2016 [4]. The IMF revised Russia's growth forecasts for 2015 and 2016 downwards, estimating a larger contraction in output than in its previous release [4]. For the euro area the IMF revised its growth projection for 2016 downwards, while the ECB made downward revisions to GDP growth forecasts for both 2015 and 2016 [1], [4].

Upside risks to the outlook relate to both external and domestic factors. A longer period of lower oil prices leading to lower energy costs will have positive effects on consumption, through income and substitution effects. The recent weakening of the connections between the Cypriot and Greek banking systems could limit the negative spillovers in Cyprus due to adverse economic developments in Greece. On the domestic front, investment decisions linked mainly to tourism, energy or financial services as well as public investment efforts for the expansion and/or improvement of infrastructure could improve the medium-term prospects of the economy.

CPI inflation in 2015 is projected at -2.1%. In 2016 CPI inflation is estimated to remain slightly below zero (-0.4%).<sup>3</sup> The negative inflation projections are driven by the lower international oil prices and subdued foreign inflation in non-energy commodities combined with sluggish domestic demand. Upside risks to the forecasts relate to increases in international commodity prices, the weakening of the euro against the US dollar and stronger demand. Downside risks to the projections are associated with weaker than expected demand and further downward pressures in commodity prices.

### 3. Concluding remarks

Quarterly data available up to the second quarter of 2015 and monthly indicators for the third quarter released until 5 October 2015 are employed in dynamic econometric models to construct forecasts for GDP growth and CPI inflation.

The forecast for real GDP growth for 2015 is revised from 1.1% in the August issue to 1.3%; the growth forecast for 2016 is revised from 1.1% to 1.5%. The upward revisions to

<sup>3</sup> CPI inflation forecasts are constructed using a methodology similar to that for GDP growth forecasts (see footnote 1).

### October 2015

the forecasts resulted from the strengthening of y-o-y real GDP growth in the second quarter in Cyprus and in the EU as well as from further improvements registered in a number of domestic leading indicators during the third quarter.

The forecasts for CPI inflation are revised downwards from -1.7% and 0.7% for 2015 and 2016 respectively, in the August issue, to -2.1% and -0.4% for the current and next year respectively. The downward revisions resulted from a larger contraction of the general price level in the third quarter compared to the first half of the year, driven mainly by lower energy prices and subdued domestic demand.

The forecasts for 2015 and 2016 given here suggest that real activity will continue to improve. Stronger growth in the second half of 2015 reflects also base effects as the *level* of real GDP bottomed out in the second half of 2014. The European Commission and the IMF project weaker growth (0.5%) for 2015. The growth forecast for 2016 presented here is in line with the projection of the European Commission and the IMF [2], [3]. The forecasts given in this bulletin are

accompanied by upside and downside risks related to both external and domestic factors.

#### REFERENCES

1. European Central Bank (ECB), "September 2015 Eurosystem Staff Macroeconomic Projections for the Euro Area", September 2015.
2. European Commission, "The Economic Adjustment Programme, Cyprus 7<sup>th</sup> Review – Summer 2015", European Economy Institutional Paper 009, October 2015.
3. International Monetary Fund (IMF), "Eighth Review under the Extended Arrangement under the Extended Fund Facility and Request for Modification of Performance Criteria", IMF Country Report No. 15/271, September 2015.
4. IMF, "World Economic Outlook: Adjusting to Lower Commodity Prices", October 2015.

#### APPENDIX

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

CONTRIBUTION BY COMPONENT					WEIGHT				FORECAST BY COMPONENT			
Year	2015				2015				2015			
Quarter	3	4			3	4			3	4		
COMPONENTS												
Real economy	0.01	0.01			0.54	0.49			1.88	2.65		
Excluding real economy	0.03	0.04			1.22	1.19			2.19	3.00		
Real economy & other aspects	1.82	2.52			98.22	98.31			1.85	2.56		
Fiscal	0.03	0.04			1.74	1.56			1.77	2.40		
Prices	0.12	0.17			6.55	7.34			1.86	2.25		
Exchange rates	0.07	0.08			3.69	3.18			1.88	2.50		
Interest rates, spreads	0.56	0.86			29.66	31.42			1.89	2.73		
Stock markets	0.29	0.46			15.01	17.07			1.96	2.68		
Economic sentiment	0.44	0.58			23.60	22.08			1.86	2.63		
Loans, deposits	0.30	0.34			17.97	15.65			1.69	2.19		
<b>FORECAST</b>					<b>NUMBER OF MODELS</b>							
<b>1.9</b>					<b>16756</b>							
<b>2.6</b>												
CONTRIBUTION BY COMPONENT					WEIGHT				FORECAST BY COMPONENT			
Year	2016				2016				2016			
Quarter	1	2	3	4	1	2	3	4	1	2	3	4
COMPONENTS												
Real economy	0.01	0.01	0.01	0.01	0.40	0.47	0.46	0.42	1.98	1.80	1.99	2.36
Excluding real economy	0.02	0.02	0.03	0.03	1.16	1.35	1.46	1.69	2.08	1.63	1.77	1.69
Real economy & other aspects	1.71	1.27	1.42	1.60	98.43	98.16	98.06	97.87	1.73	1.29	1.45	1.63
Fiscal	0.02	0.02	0.03	0.03	1.08	1.31	1.44	1.25	1.92	1.59	1.95	2.57
Prices	0.11	0.11	0.12	0.13	6.90	6.92	6.24	5.55	1.66	1.52	1.91	2.26
Exchange rates	0.06	0.05	0.05	0.06	2.77	3.06	2.98	2.92	2.14	1.71	1.83	2.00
Interest rates, spreads	0.68	0.49	0.54	0.59	35.85	33.18	36.09	37.99	1.91	1.46	1.49	1.56
Stock markets	0.29	0.22	0.22	0.26	16.01	16.03	16.31	14.50	1.83	1.37	1.36	1.80
Economic sentiment	0.35	0.27	0.28	0.30	19.37	18.08	15.43	14.28	1.82	1.48	1.84	2.12
Loans, deposits	0.18	0.12	0.18	0.22	16.45	19.58	19.57	21.40	1.12	0.60	0.91	1.05
<b>FORECAST</b>					<b>NUMBER OF MODELS</b>							
<b>1.7</b>					<b>16756</b>							
<b>1.3</b>												
<b>1.5</b>												
<b>1.6</b>												



Issue 15/4

# ECONOMIC OUTLOOK

## ECONOMICS RESEARCH CENTRE

**October 2015**

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.

The "Economic Outlook" publishes the results of research in the Forecasting Sector of CypERC. The views expressed in this bulletin do not necessarily reflect either those of the Academic Advisors of the Forecasting Sector or those of the CypERC Council.

### Forecasting Sector at CypERC

Director:	Prof. Panos Pashardes
Research Coordinator:	Nicoletta Pashourtidou
Academic Advisors:	Prof. Elena Andreou Assoc. Prof. Andros Kourtellos
Research Officers:	Christos Papamichael Charalampos Karagiannakis

The material in this document can be copied, distributed, transmitted and otherwise disseminated, but the source must be acknowledged.

Economics Research Centre, University of Cyprus, P.O. box 20537, 1678 Nicosia, CYPRUS  
Telephone: 22893660, Fax: 22895027, Website: [www.erc.ucy.ac.cy](http://www.erc.ucy.ac.cy), Email: [erc@ucy.ac.cy](mailto:erc@ucy.ac.cy)