

E C O N O M I C O U T L O O K

April 2024

Summary

Real economic activity in Cyprus is expected to continue to expand at robust rates over 2024 – 2025. Real GDP growth is projected to reach 2.6% in 2024 and to strengthen to 3.3% in 2025. Compared to the January issue, the growth forecasts have been revised up, by 0.2 percentage points for 2024 and by 0.1 percentage point for 2025. Despite the relatively high borrowing costs and a significant slowdown in Cyprus's trading partner economies, domestic activity and the labour market have remained resilient, fuelling growth in the following quarters. Domestic activity has been supported by falling inflation, a relatively tight labour market, recent increases in employee earnings, and ample fiscal space.

Inflation (based on the Consumer Price Index) is projected to remain on a downward trajectory over 2024 – 2025. Inflation is forecast at 2.0% in 2024 and at 1.9% in 2025, lower by 0.1 percentage point in each year vis-à-vis the forecasts in the January issue, as domestic inflation eased further during the first quarter of the current year.

Risks to the outlook for growth and inflation stem primarily from increased geopolitical tensions, especially a possible escalation of the conflict in the Middle East, the economic performance of trading partner economies, and the future path of interest rates.

Απρίλιος 2024

Περίληψη

Η οικονομική δραστηριότητα στην Κύπρο εκτιμάται ότι θα συνεχίσει να αυξάνεται κατά την περίοδο 2024 – 2025, διατηρώντας την ανθεκτικότητά της. Ο ρυθμός μεγέθυνσης του πραγματικού ΑΕΠ προβλέπεται να φτάσει στο 2,6% το 2024 και να ενδυναμωθεί στο 3,3% το 2025. Σε σύγκριση με το τεύχος Ιανουαρίου, οι προβλέψεις έχουν αναθεωρηθεί προς τα πάνω κατά 0,2 ποσοστιαίες μονάδες για το 2024 και κατά 0,1 ποσοστιαία μονάδα για το 2025. Παρά τα σχετικά υψηλά επιτόκια και τη σημαντική επιβράδυνση στις οικονομίες των εμπορικών εταίρων της Κύπρου, η εγχώρια δραστηριότητα και η αγορά εργασίας έχουν παραμείνει ανθεκτικές, τροφοδοτώντας την ανάπτυξη κατά τα επόμενα τρίμηνα. Η εγχώρια δραστηριότητα τα τελευταία δύο τρίμηνα έχει επωφεληθεί από τη μείωση του πληθωρισμού, τις συνθήκες στενότητας στην αγορά εργασίας, την αύξηση των απολαβών και την ισχυρή δημοσιονομική θέση της χώρας.

Ο πληθωρισμός (με βάση τον Δείκτη Τιμών Καταναλωτή) προβλέπεται να παραμείνει σε πτωτική πορεία το 2024 και 2025. Ο πληθωρισμός προβλέπεται σε 2,0% το 2024 και σε 1,9% το 2025. Σε σύγκριση με το τεύχος Ιανουαρίου, οι προβλέψεις για τον πληθωρισμό έχουν αναθεωρηθεί προς τα κάτω κατά 0,1 ποσοστιαία μονάδα για κάθε έτος, κυρίως λόγω περαιτέρω επιβράδυνσης του εγχώριου πληθωρισμού κατά το πρώτο τρίμηνο του τρέχοντος έτους.

Πιθανές αποκλίσεις του ρυθμού μεγέθυνσης του ΑΕΠ και του πληθωρισμού από τις πιο πάνω προβλέψεις μπορεί να προκύψουν κυρίως λόγω αυξημένων γεωπολιτικών εντάσεων, ιδίως από τυχόν κλιμάκωση της σύγκρουσης στη Μέση Ανατολή, της οικονομικής επίδοσης των εμπορικών εταίρων της Κύπρου και της μελλοντικής πορείας των επιτοκίων.

1. Recent developments

Economic growth in Cyprus slowed to 2.5% in 2023, from 5.1% in 2022. In the final quarter of 2023, the year-on-year (y-o-y) growth rate of real GDP moderated to 2.2%, compared with 2.4% in the third quarter, but remained well above the EU average.

In the fourth quarter of 2023, real gross value added in financial and professional services continued to decline (y-o-y); the contraction for the third consecutive quarter reflects the effects of monetary tightening, and sanctions against Russia. In terms of real gross value added growth (y-o-y), the industrial and construction sectors accelerated, while the sector of trade, transportation, and hospitality slowed during the fourth quarter. Nevertheless, the sector of trade, transportation and hospitality has remained among the fastest-growing economic activities. In the fourth quarter, the remaining sectors expanded at about the same rates as in the third quarter of 2023.

Growth (y-o-y) in real consumption expenditure picked up slightly in the final quarter of 2023, driven by robust growth in household consumption. Growth (y-o-y) in gross capital formation accelerated markedly in the fourth quarter, largely owing to base effects from changes in transport equipment. Construction investment as well as investment in machinery and equipment (other than transport equipment) also generated a positive contribution to growth. Despite an improvement in service exports, net exports weighed on growth in the fourth quarter of 2023, as total imports rose, while total exports contracted.

In the first quarter of 2024, the Economic Sentiment Indicator (ESI) weakened further, falling to its long-term average in March; however, the ESI for Cyprus remained above the EU-wide ESI. During the first quarter of the year, business confidence weakened in all sectors, although firms' employment expectations strengthened; consumer confidence rose slightly, driven by improved expectations. In the first quarter, selling price expectations stayed on a downward trend (despite an increase in March), while consumer price expectations remained broadly stable at the levels recorded in the last two quarters of 2023. Economic uncertainty in Cyprus showed an uptick in the first quarter, mainly as a result of higher uncertainty among firms in services and retail trade.

Monthly hard data send mixed signals about domestic economic conditions during the first quarter of the year, similarly to the recent developments in survey indicators. Labour market indicators point to favourable conditions in the job market during the first quarter of 2024, as the number of registered unemployed continued to fall (y-o-y) at double-digit rates, and unemployment remained relatively low, despite an increase in January. Leading indicators suggest that domestic activity continued to expand in the first months of the year (e.g. use of credit cards, retail trade volume, registrations of motor vehicles, tourist arrivals), although some of them point to challenges to growth (e.g. tourist arrivals from the UK, property sale contracts, registrations of new companies).

The fiscal performance was strong throughout 2023, leading to a declining debt-to-GDP ratio; the debt ratio decreased to 77% in December 2023, from 86% at the end of 2022. In the first two months of 2024, the fiscal balance remained in surplus, and government revenues rose faster than expenditures. The long-term interest rate for Cyprus edged down in the last two months of 2023 and stood at just above 3% in March.

Domestic lending interest rates hovered at a decade high in February, reflecting the restrictive monetary policy stance in the euro area. After a year of declines, the stock of loans has been registering weak growth since December, driven by annual increases in loans to non-residents. Deposits continued to increase in January and February, albeit at slow rates. Growth (y-o-y) in new lending over the period January – February expanded at a modest pace, after it had stalled in 2023. The ratio of non-performing loans (NPLs) to total loans remained on a downward trend during 2023.

Inflation, measured by the Consumer Price Index (CPI) continued to ease in the first quarter of the year. Inflation decelerated from 2.3% in the final quarter of 2023 to 1.6% in the first quarter of 2024, mainly because of lower energy and food inflation. Nevertheless, services inflation has exceeded the overall inflation rate significantly, particularly in the categories of restaurants, insurance, rents, and home repairs.

2. Forecasts

Projections for GDP growth and CPI inflation are constructed using a dataset with numerous domestic and foreign indicators, and a large number of dynamic econometric models. Quarterly series available up to the fourth quarter of 2023 were employed. Monthly indicators that contain information about developments over January – March 2024 were also used. The cut-off date for the data used in the analysis was 17 April 2024.

Table 1 presents the forecasts for the growth rate of real GDP for 2024 and 2025. Real activity is expected to continue to expand at robust rates over 2024 – 2025. Real GDP growth is projected to reach 2.6% in 2024 and to strengthen to 3.3% in 2025. Compared to the January issue, the growth forecasts have been revised up, by 0.2 percentage points for 2024 and by 0.1 percentage point for 2025. Despite the relatively

high borrowing costs and declining growth in Cyprus’s trading partner economies, domestic activity and the labour market have remained resilient, fuelling growth in the following quarters. Domestic activity has been supported by falling inflation, a relatively tight labour market, increases in employee earnings, and ample fiscal space.

Table 1 also shows the forecasts obtained from the different components (groups of models) and the weights assigned to these forecasts in shaping the final forecasts. The real economy component (which is based on factors estimated from real activity and labour market indicators) and the component relating to economic aspects other than the real economy take very small weights.¹ The component that combines information on both the real economy and other economic aspects plays a key role in forming the final forecasts.²

Table 1: GDP growth forecasts and components

YEAR	2024		2025	
FORECAST	2.6		3.3	
	WEIGHT	FORECAST BY COMPONENT	WEIGHT	FORECAST BY COMPONENT
COMPONENTS				
I. Real economy	0.51	2.6	0.41	3.3
II. Aspects other than real economy	0.36	2.6	0.49	3.2
III. Real economy & other aspects	99.13	2.6	99.10	3.3
Fiscal	5.44	2.7	5.49	3.4
Prices	11.73	2.6	12.40	3.2
Exchange rates	3.18	2.6	3.29	3.3
Interest rates, spreads	16.46	2.5	18.86	3.3
Stock markets	14.72	2.9	13.89	3.6
Economic sentiment, uncertainty	38.69	2.5	36.11	3.2
Loans, deposits	8.90	2.6	9.07	3.5

Table 2: CPI inflation forecasts

YEAR	2024	2025
FORECAST	2.0	1.9

¹ Factors refer to a small number of principal components extracted from a large dataset of series relating to real domestic and foreign activity, and the labour market. The component concerning aspects other than the real economy is based on indicators such as interest rates, stock market returns, economic sentiment indicators, exchange rates, domestic and foreign price indices, international commodity prices, fiscal indicators, loans and deposits. Monthly information within the forecast horizon (monthly leads) is included in the models if available.

² Economic sentiment indicators refer to data obtained through the Joint Harmonised EU Programme of Business and Consumer Surveys conducted by the Directorate General for Economic and Financial Affairs. The Economics Research Centre acknowledges funding from the European Union, the Ministry of Finance, and the University of Cyprus for carrying out the project “Business and Consumer Surveys” in Cyprus.

The key factors that are expected to fuel growth in the following quarters, together with the latest developments that are found to weigh on the outlook, are discussed below.

- *Real economy.* In the final quarter of 2023, real economic activity in Cyprus grew again at a moderate pace, and the domestic labour market continued to perform strongly, with low unemployment, solid job vacancy growth and further increases in real employee earnings. Monthly data suggest that domestic activity in most sectors continued to expand, and labour market conditions in both Cyprus and trading partner economies (e.g. EU, UK) remained favourable during the first months of 2024. The above positive developments in domestic activity and labour markets support the growth prospects in Cyprus significantly. However, the slowdown in Cyprus's trading partner economies (e.g. euro area, UK) deepened in the final quarter of 2023, and monthly data on manufacturing production and retail trade turnover suggest that activity in the EU remained subdued in the first months of 2024. Moreover, weakening domestic leading indicators relating to real estate, construction and tourism, together with the slowdown in the EU and the UK, weigh on the outlook for Cyprus.
- *Fiscal position.* The strong fiscal performance in Cyprus throughout 2023 and during the first months of 2024 is found to boost the growth prospects considerably. The sizable budget surpluses registered in previous months, and the declining debt-to-GDP ratio in recent years have created fiscal space, enabling the implementation of support measures to ease cost-of-living and input cost pressures for households and businesses, while also preserving investor confidence.
- *Inflation.* Domestic inflation continued to decrease in the final quarter of 2023 and the first quarter of 2024, driven by past declines in international oil prices as well as by lower food inflation. The deceleration of inflation in Cyprus, facilitated also by policy measures, has eased pressures on real incomes, backing activity. The declines (y-o-y) in international energy and food prices registered in 2023 and in the first two months of 2024 have contributed to the deceleration of inflation in Cyprus's trading partner economies (e.g. euro area, UK), generating positive effects on the outlook by

rendering some support to external demand. Nevertheless, inflation in trading partner economies, particularly in the UK, remained above its medium-term target in March, and global oil prices registered noticeable y-o-y increases in March. Foreign inflation and renewed upward pressures on oil prices, together with the recent economic slowdown, are found to dampen the outlook.

- *Financial conditions.* In response to high inflation, the ECB tightened monetary policy, with the key rates on deposit facility and main refinancing operations reaching all-time high levels in September 2023. Although the key ECB rates have been kept unchanged since September, borrowing costs in the euro area have increased to very high levels by historical standards, cooling demand and limiting growth. Domestic lending interest rates increased further in the final quarter of 2023 and stood at a decade-high in the first months of 2024, weighing significantly on investment and the growth outlook for 2024. Also, the recent increases in interest rates for deposits with longer maturities and the steady growth in deposits in previous quarters are expected to somewhat limit activity growth in the next quarters. Nevertheless, growth in new business loans, albeit weak, as well as declining NPLs are expected to benefit the outlook. More importantly, the performance of domestic and international stock markets remained favourable during the last quarter of 2023 and the first quarter of 2024, with robust y-o-y gains and relatively low market volatility, boosting the growth prospects substantially.
- *Confidence and uncertainty.* Domestic economic sentiment, albeit weakening, continues to back growth in the short run. Employment expectations among firms in Cyprus have strengthened recently, economic uncertainty has remained at relatively low levels, and economic sentiment in the EU, as well as consumer confidence in the UK, has stabilised lately; these developments are found to generate positive effects on the growth outlook. However, some trends in EU survey data weigh on the domestic outlook; these include economic sentiment levels below their historical averages, and past downward revisions in employment expectations. Moreover, the sliding economic sentiment in Cyprus, especially business confidence

in the hospitality sector, as well as elevated disagreement among firms about selling price expectations cloud the outlook.

Risks to the growth outlook for Cyprus have remained tilted to the downside as in the January issue, mainly because of ongoing geopolitical tensions and weak growth prospects in trading partner economies.

Further escalation of the conflict in the Middle East could adversely affect growth prospects for Cyprus through lower external demand, especially for tourism services and investment. Increased geopolitical tensions (e.g. the Middle East region, Ukraine) could trigger new upward pressures on prices, including through possible disruptions in supply chains.

Downside risks to the growth outlook may also arise from weaker-than-expected activity in the EU and the UK, as well as from climate risks (e.g. extreme heatwaves). The increased borrowing costs have put a strain on the finances of heavily indebted businesses and households, raising default risks and clouding the outlook, especially if interest rates remain elevated for longer than expected. Moreover, investment and consumption decisions may weigh on growth if interest rates stay at high levels for longer than envisaged. Finally, delays in the implementation of reforms and/or in the completion of public investment projects, especially those relating to energy transition, could weigh on growth, primarily through higher energy cost.

Upside risks to the growth outlook could stem from stronger-than-expected external demand, particularly if cost-of-living pressures abate at a fast pace, and from the gradual normalization of monetary policy. Investment projects as well as reforms whose positive effects on employment and activity have not been reflected in published data could lead to higher-than-projected growth rates.

Inflation is projected to continue to ease over 2024 – 2025. CPI inflation is forecast at 2.0% in 2024 and at 1.9% in 2025 (Table 2).³ The inflation forecasts have been revised down by 0.1 percentage point for each year, compared to those in the January issue, as domestic inflation decelerated further during the first quarter of 2024. The declines in global

commodity prices during 2023, particularly in oil and food prices, and a significant deceleration of inflation over the last two quarters are expected to contribute to low inflation rates in the following quarters. At the same time, the tight financing conditions in both Cyprus and trading partner economies have dampened activity and lowered selling price expectations, pushing projected inflation towards the medium-term target. However, the increases in international commodity prices for oil and food during the first quarter of 2024, as well as above-target inflation rates in trading partner economies add to the inflation outlook.

There are both upside and downside risks to the inflation outlook. Upside risks to inflation, through upward pressures on international commodity prices and supply-chain disruptions, could arise as a result of increased geopolitical tensions. Higher-than-projected inflation could result from robust wage growth in Cyprus supported by a resilient labour market, and from stronger-than-expected external demand. The expiration of support measures in the form of consumption tax cuts, that had been previously adopted to ease cost-of-living pressures, could raise inflation temporarily. Climate change has created upside risks to inflation, especially through higher food prices.

Downside risks to the inflation outlook stem from lower-than-anticipated domestic demand, mainly because of relatively high interest rates. Negative external demand surprises, owing to economic slowdown in countries of origin, and geopolitical tensions could lead to lower inflation rates than the forecasts discussed in this issue.

3. Concluding remarks

Quarterly and monthly series released up until 17 April 2024 were used in dynamic econometric models to construct forecasts for GDP growth and CPI inflation.

In 2024, real activity growth in Cyprus is expected to continue at a similar pace as in 2023 and to gather momentum in 2025. Real GDP growth is projected at 2.6% in 2024 and at 3.3% in 2025. The growth forecasts have been revised up, by 0.2 percentage points for 2024 and by 0.1 percentage point for 2025,

³ CPI inflation forecasts are constructed using a methodology similar to that described for GDP growth forecasts.

relative to the January issue. Economic activity and the labour market in Cyprus remained resilient in the final quarter of 2024, fuelling growth in the following quarters. Over the last two quarters domestic activity has been backed by falling inflation, a relatively tight labour market, increases in earnings, and the strong fiscal position. However, the high levels of domestic interest rates, sliding domestic economic sentiment, and weak activity in trading partner economies weigh on the growth outlook.

Forecasts by other organisations point to a robust growth outlook in 2024 and 2025. Real GDP growth in Cyprus for 2024 is forecast at 2.8% by the Central Bank and the European Commission, and at 2.7% by the International Monetary Fund. Growth in 2025 is projected to pick up to around 3.0% by the above organisations (3.1%, 3.0% and 2.9% according to the Central Bank, the European Commission, and the International Monetary Fund, respectively).^{[1] - [3]}

Inflation is projected to remain on a downward trajectory over 2024 – 2025. CPI inflation is forecast at 2.0% in 2024 and at 1.9% in 2025, lower by 0.1 percentage point in each year vis-à-vis the forecasts

in the January issue, as domestic inflation eased further during the first quarter of the current year.

Risks to the outlook for growth and inflation stem primarily from increased geopolitical tensions, especially a possible escalation of the conflict in the Middle East, the economic performance of trading partner economies, and the future path of interest rates.

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