

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

July 2024

Summary

*Real activity growth in Cyprus is projected to gather momentum over 2024 – 2025, driven by robust demand and a tight labour market, the easing of inflationary pressures, as well as the gradual declines in interest rates because of monetary policy normalisation. Real GDP growth is forecast at 3.0% in 2024 and at 3.3% in 2025. Relative to the April issue, the growth forecast for 2024 has been revised up by 0.4 percentage points, as real GDP growth in the first quarter of 2024 surprised on the upside and labour market conditions improved further in the second quarter of the year. The forecast for 2025 has remained unchanged from that in the April issue.*

*Inflation (based on the Consumer Price Index) is projected to continue to decline in 2024 and 2025, driven by disinflation in previous quarters that was supported by the easing of price pressures from international commodities and tight financing conditions. Inflation is forecast at 2.1% in 2024 and at 2.0% in 2025, higher by 0.1 percentage point in each year relative to the April issue. The upward revisions resulted largely from an increase in domestic inflation in the second quarter of 2024 (mainly owing to a pickup in energy prices), persistently high inflation rates in services and robust economic activity.*

*The main risks to the outlook for growth and inflation are associated with the disinflation process, the pace of monetary policy normalisation, the external economic environment, geopolitical tensions, large investment projects, and climate hazards.*

Ιούλιος 2024

Περίληψη

*Η δυναμική της οικονομικής μεγέθυνσης στην Κύπρο εκτιμάται ότι θα ενισχυθεί κατά την περίοδο 2024 – 2025, λόγω της ανθεκτικής ζήτησης και της στενότητας στην αγορά εργασίας, της αποκλιμάκωσης των πληθωριστικών πιέσεων, αλλά και της σταδιακής μείωσης των επιτοκίων ως αποτέλεσμα της ομαλοποίησης της νομισματικής πολιτικής. Ο ρυθμός μεγέθυνσης του πραγματικού ΑΕΠ προβλέπεται στο 3,0% το 2024 και στο 3,3% το 2025. Σε σύγκριση με το τεύχος Απριλίου, η πρόβλεψη για το 2024 έχει αναθεωρηθεί προς τα πάνω κατά 0,4 ποσοστιαίες μονάδες, καθώς ο ρυθμός αύξησης του πραγματικού ΑΕΠ το πρώτο τρίμηνο του 2024 ήταν υψηλότερος από τον αναμενόμενο και οι συνθήκες στην αγορά εργασίας βελτιώθηκαν περαιτέρω κατά το δεύτερο τρίμηνο του έτους. Η πρόβλεψη για το 2025 έχει παραμείνει αμετάβλητη σε σχέση με το τεύχος Απριλίου.*

*Ο πληθωρισμός (με βάση τον Δείκτη Τιμών Καταναλωτή) προβλέπεται να συνεχίσει να μειώνεται το 2024 και το 2025, λόγω του αποπληθωρισμού σε προηγούμενα τρίμηνα που υποβοηθήθηκε από την αποκλιμάκωση των ανοδικών πιέσεων στις διεθνείς τιμές εμπορευμάτων και από τις αυστηρές χρηματοπιστωτικές συνθήκες. Ο πληθωρισμός προβλέπεται στο 2,1% το 2024 και στο 2,0% το 2025, υψηλότερος κατά 0,1 ποσοστιαία μονάδα για κάθε έτος σε σχέση με την έκδοση Απριλίου. Η προς τα πάνω αναθεώρηση των προβλέψεων ήταν αποτέλεσμα της ανόδου του εγχώριου πληθωρισμού κατά το δεύτερο τρίμηνο του 2024 (κυρίως λόγω αυξήσεων στις τιμές της ενέργειας), των παρατεταμένα υψηλών ρυθμών πληθωρισμού στις υπηρεσίες και της ανθεκτικής οικονομικής δραστηριότητας.*

*Οι σημαντικότεροι παράγοντες που πιθανόν να οδηγήσουν σε αποκλίσεις του ρυθμού μεγέθυνσης του ΑΕΠ και του πληθωρισμού από τις πιο πάνω προβλέψεις συνδέονται με τη διαδικασία του αποπληθωρισμού, τον ρυθμό ομαλοποίησης της νομισματικής πολιτικής, το εξωτερικό οικονομικό περιβάλλον, γεωπολιτικές εντάσεις, μεγάλα επενδυτικά έργα, καθώς και με κλιματικούς κινδύνους.*

## 1. Recent developments

In the first quarter of 2024, economic growth in Cyprus strengthened and labour market conditions remained favourable. The year-on-year (y-o-y) growth rate of real GDP accelerated from 2.3% in the final quarter of 2023 to 3.4% in the first quarter of 2024, surprising on the upside.

During the first quarter of 2024, growth (y-o-y) in real gross value added picked up markedly in the sectors of construction and professional services. Moreover, growth improved in the manufacturing sector, as well as in public administration, education and healthcare. Growth in the sector of trade, transport and hospitality has declined to its long-run average since the final quarter of 2023, while growth in the sector of information and communication has been slowing; nevertheless, both sectors have remained among the key drivers of growth in Cyprus. Real gross value added in financial services continued to decline (y-o-y) in the first quarter of 2024, reflecting the drag from high interest rates; however, the contraction was smaller compared to that in the second half of 2023.

On the expenditure side, growth (y-o-y) in real consumption expenditure improved further in the first quarter of 2024, driven by robust growth in household consumption and strengthening growth in government consumption. Although gross fixed capital formation contracted (y-o-y) during the first quarter due to lower investment in machinery and equipment, construction investment increased vigorously. The contribution of net exports to growth was positive in the first quarter, as imports of goods declined sharply, and exports of services rose.

Monthly hard data indicate that domestic economic conditions during the second quarter of 2024 remained favourable. Further declines (y-o-y) in the number of registered unemployed and in the unemployment rate signal a strong labour market performance during the second quarter. Positive developments in many leading indicators suggest that real activity in Cyprus has remained robust (e.g. industrial production, building permits, registrations of new companies). However, some indicators show signs of weakening demand (e.g. use of credit cards, tourist arrivals, property sale contracts).

The Economic Sentiment Indicator (ESI) improved slightly in the second quarter and remained above its long-term average. During the second quarter, business confidence rose in manufacturing and services, although confidence among firms in accommodation and food services continued to slide. Consumer confidence was flat between the first and second quarters, despite a marked pickup in June. Firms' employment expectations declined slightly in the second quarter but remained above their long-run average. Selling price expectations and consumer price expectations stabilised at relatively high levels over the first half of 2024. Economic uncertainty in Cyprus came down in the second quarter, owing to lower uncertainty among firms in services and construction, and among consumers.

Public finances continued to perform strongly during the first five months of 2024. Over the period January – May, government revenue rose (y-o-y) faster than expenditure, and the budget balance continued to register surpluses. The ratio of public debt to GDP has stayed on a downward trend, and the long-term interest rate for Cyprus has stood at just above 3% since December 2023.

Domestic lending interest rates remained significantly elevated in April – May, at levels last seen about a decade ago. Nevertheless, for some lending categories (e.g. new housing loans, new business loans up to 1 million euros), interest rates have registered small declines recently, moving down from their peaks reached in 2023 or in the first months of 2024. Following a contraction in 2023, the stock of loans rose during the first five months of 2024, driven by increases in loans to non-residents. The annual growth rate of deposits strengthened in April – May, owing to a pickup in domestic deposits. New lending over the period January – May 2024 decreased compared to the same period in 2023, because of a contraction in new business loans, despite an increase in new loans to households. The ratio of non-performing loans (NPLs) to total loans declined further in the first months of 2024, falling from 8% in December 2023 to 7% in March 2024.

Since April, inflation in Cyprus has shown an uptick, as increases in international commodity prices have gathered pace and domestic activity has remained robust. The expiration of some support measures (i.e. reintroduction of excise duty on fuel) in April has also affected inflation. Inflation, measured by the

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Consumer Price Index (CPI) increased from 1.6% in the first quarter of 2024 to 2.7% in the second quarter. The increase in inflation during the second quarter was driven by rising inflation in the categories of housing, water, energy and transport, as well as by persistently high inflation in some services (e.g. restaurants and hotels).

## 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 first quarter of 2024 were employed. Monthly indicators that contain information about developments over April – June 2024 were also used. The cut-off date for the data used in the analysis was 17 July 2024.

Table 1 presents the forecasts for the growth rate of real GDP for 2024 and 2025. Growth is expected to accelerate over 2024 – 2025 due to robust demand, supported by a tight labour market, around-target inflation rates, and gradual declines in interest rates.

Real GDP growth is projected to strengthen from 2.5% in 2023 to 3.0% in 2024 and 3.3% in 2025. Compared to the April issue, the growth forecast for 2024 has been revised up by 0.4 percentage points, while the forecast for 2025 has remained unchanged. The upward revision to the growth outlook for 2024 resulted mainly from higher-than-expected GDP growth in the first quarter of 2024, and further improvements in the labour market performance during the second quarter of the year.

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.<sup>1</sup> The component that combines information on both the real economy and other economic aspects plays a key role in forming the final forecasts.<sup>2</sup>

**Table 1: GDP growth forecasts and components**

YEAR	2024		2025	
FORECAST	3.0		3.3	
	WEIGHT	FORECAST BY COMPONENT	WEIGHT	FORECAST BY COMPONENT
COMPONENTS				
I. Real economy	0.41	2.9	0.45	3.2
II. Aspects other than real economy	0.42	2.7	0.75	2.9
III. Real economy & other aspects	99.17	3.0	98.80	3.3
Fiscal	5.28	3.1	5.58	3.4
Prices	12.83	3.3	13.02	3.2
Exchange rates	3.18	2.9	3.32	3.3
Interest rates, spreads	17.47	3.0	21.78	3.3
Stock markets	16.45	3.3	13.26	3.6
Economic sentiment (surveys)	35.97	2.9	33.52	3.1
Loans, deposits	8.01	2.9	8.33	3.4

<sup>1</sup> 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.

<sup>2</sup> 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.

Table 2: CPI inflation forecasts

YEAR	2024	2025
FORECAST	2.1	2.0

Recent developments reflected in hard and soft data suggest a strong growth outlook, although there are some challenges ahead, mostly associated with the external environment. The key factors that shape the outlook for 2024 and 2025 are discussed below.

- *Activity and the labour market.* In the first quarter of 2023, growth in Cyprus strengthened markedly, setting the stage for a robust economic performance in the following quarters. The labour market remained strong, as employment, vacancies and real employee earnings continued to rise in the first quarter. Positive developments on the domestic front were also reflected in data for the second quarter, as many activity-related leading indicators expanded, and unemployment approached its historic low in May. Moreover, in trading partner economies (e.g. EU, UK), growth picked up in the first quarter and unemployment remained at very low levels in the first five months of the year. Thus, the above improvements in domestic and external economic conditions are expected to support growth in Cyprus in the following quarters. Nevertheless, leading indicators on manufacturing production and retail trade turnover up until May point to subdued economic activity in trading partner economies, weighing on the growth prospects in Cyprus. Weaknesses in some domestic leading indicators over the first half of 2024 also reveal challenges for growth.
- *Public finances.* Over the period January – May 2024, growth in government revenue remained vigorous and higher than growth in government expenditure, the budget surplus rose (y-o-y), and the ratio of public debt to GDP decreased further. The strong fiscal position is expected to continue to back the growth prospects through increased investor confidence and fiscal buffers that could be used to mitigate the socioeconomic impact of adverse shocks.
- *Prices.* The easing of upward pressures on global commodity prices in 2023, together with tight financing conditions, put inflation on a declining path. The deceleration of inflation in both Cyprus and trading partner economies is expected to

alleviate the squeeze on real incomes, providing support to domestic and external demand. Nevertheless, in the second quarter of 2024, increases in energy prices (especially international oil prices) accelerated, and inflation in Cyprus registered an uptick, posing challenges to real economic activity in the next quarters.

- *Financial conditions.* After a series of interest rate hikes that had started in July 2022, the key policy rates in the euro area had been kept unchanged near historically high levels since September 2023. In June 2024, the ECB cut its policy rates. As interest rates in the euro area have declined from their peaks, their drag on demand is expected to gradually ease, benefiting the growth prospects. Nevertheless, in Cyprus, lending interest rates have remained elevated (despite small decreases for some loan categories, e.g. for house purchase), and the volume of new loans contracted over January – May 2024. The still elevated borrowing costs in Cyprus, as well as the relatively high interest rates for deposits with longer maturities continue to weigh on the growth prospects by limiting demand. Yet, the uptick in new loans for house purchase over the first five months of 2024 and the downward trend in NPLs are expected to back the outlook. Moreover, the outlook is significantly benefitted from positive developments in the domestic and international stock markets. During the first half of 2024, stock market indices continued to register y-o-y gains and market volatility fluctuated at low levels, pointing to favourable economic conditions in the following quarters.
- *Developments in survey indicators.* Small improvements in domestic economic sentiment in the second quarter of 2024, on the back of confidence gains in services and industry, are found to positively affect growth in the short run. Moreover, firms' employment expectations have stayed at relatively high levels and business uncertainty has fluctuated at relatively low levels, benefiting the outlook. Further improvements in consumer confidence in trading partner economies are also found to back growth in the short run.

However, some negative trends in domestic and foreign survey indicators have persisted, weighing on the growth prospects for Cyprus. Weakening business confidence in the domestic hospitality and retail trade sectors, and elevated disagreement among firms in Cyprus about selling price expectations are found to create challenges to growth. In the EU and the euro area, economic sentiment remained broadly stable at relatively low levels over the first half of 2024, while firms' employment expectations deteriorated in the second quarter, clouding the outlook for Cyprus.

Downside risks to the growth outlook for Cyprus could result from geopolitical tensions (particularly in the Middle East) through lower external demand and/or upward price pressures, especially on energy prices, as well as from weaker-than-expected growth in trading partner economies. Renewed inflationary pressures, driven by fast increases in global commodity prices and/or elevated inflation in services, could slow the pace of monetary policy normalisation. Thus, domestic and external demand could be adversely affected if interest rates remain at high levels for longer than anticipated.

Moreover, extreme weather (e.g. frequent heatwaves, drought) raises economic costs with negative effects on activity. Delays in the implementation of reforms and in the completion of infrastructure projects (especially those aiming at reducing energy costs) could deprive businesses and households of efficiency gains, weigh on public finances, undermine investor confidence, and limit both short- and long-term growth prospects.

Upside risks to the growth outlook could arise from stronger-than-expected domestic and external demand, particularly as monetary conditions gradually ease. Investment projects and reforms with positive effects on activity, that have not been reflected in the data until the cut-off date, could lead to higher-than-projected growth rates.

CPI inflation is projected to ease from 3.5% in 2023 to 2.1% in 2024 and 2.0% in 2025 (Table 2).<sup>3</sup> Compared to the April issue, the forecasts have been revised up by 0.1 percentage point for each year. The upward revisions were mainly driven by the higher-than-expected inflation rate in the second quarter of

2024 and the strengthening of the growth momentum in the first quarter of the year.

The declines in international commodity prices registered during 2023 and the deceleration of domestic inflation until the first quarter of 2024 are expected to facilitate disinflation in the following quarters. Similarly, the relatively high levels of retail interest rates, because of policy rate hikes in the euro area between July 2022 – September 2023, are projected to contribute towards the deceleration of inflation over 2024 – 2025, through dampening effects on investment and consumption. Past downward revisions in price expectations are also found to facilitate the disinflation process over 2024 – 2025; however, their effects on the outlook have waned, as price expectations registered small increases during the second quarter of 2024.

Several factors pushed inflation up in the second quarter, adding to the inflation outlook. These factors include the recent pickup in global commodity prices, especially the increases in oil prices in March – June, persistently elevated inflation in services, the tight labour market and robust economic activity in Cyprus.

Risks to the inflation outlook are tilted to the upside. Risks for higher-than-projected inflation stem from faster-than-expected increases in energy and food prices, because of geopolitical tensions and/or climate-related hazards. Higher inflation rates than the forecasts discussed above may result from upward wage pressures in Cyprus due to labour market tightness, and from stronger-than-expected demand. The expiration of support measures (e.g. zero VAT rate for basic goods) and the introduction of green taxation could raise inflation temporarily.

Downside risks to the inflation outlook could arise from lower-than-anticipated domestic demand as financing conditions may remain tight for longer than expected. Additional downside risks could result from weaker-than-expected external demand, owing to slow growth in trading partner economies and/or geopolitical tensions.

### 3. Concluding remarks

Quarterly and monthly series released up until 17 July 2024 were used in dynamic econometric models

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

to construct forecasts for GDP growth and CPI inflation.

Real activity growth in Cyprus is projected to gather momentum over 2024 – 2025, driven by robust demand, a tight labour market, the easing of inflationary pressures, and the gradual declines in interest rates as a result of monetary policy normalisation. Real GDP growth is forecast at 3.0% in 2024 and at 3.3% in 2025. Relative to the April issue, the growth forecast for 2024 has been revised up by 0.4 percentage points, as GDP growth in the first quarter of 2024 was stronger than expected and labour market conditions improved further in the second quarter of the year. The forecast for 2025 has remained unchanged from that in the April issue.

Forecasts by other organisations also point to a pickup in the economic momentum over 2024 – 2025. Real GDP growth in Cyprus for 2024 is forecast at 3.0%, 2.8% and 2.9% by the Central Bank, the European Commission, and the Ministry of Finance, respectively. Growth in 2025 is projected at 3.1% by the Central Bank and the Ministry of Finance, and at 2.9% by the European Commission. <sup>[1] - [3]</sup>

Inflation is projected to continue to decline in 2024 and 2025. CPI inflation is forecast at 2.1% in 2024 and at 2.0% in 2025, higher by 0.1 percentage point in each year compared to the forecasts in the April

issue. The upward revisions were largely driven by an increase in domestic inflation in the second quarter of 2024 (resulting mainly from a pickup in energy prices), persistently high inflation rates in services and robust economic activity.

The main risks to the outlook for growth and inflation are associated with the disinflation process, the pace of monetary policy normalisation, the external economic environment, geopolitical tensions, large investment projects, and climate hazards.

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