

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

October 2024

Summary

Growth in Cyprus is projected to accelerate in 2024 and to remain robust in 2025, supported by favourable labour market conditions, the return of inflation to around-target rates, and gradual declines in interest rates. Real GDP growth is forecast at 3.5% in 2024 and at 3.3% in 2025. Relative to the July issue, the forecast for 2024 has been revised up by 0.5 percentage points, as the growth momentum strengthened in the first half of 2024 and domestic economic conditions in the third quarter of the year remained favourable according to monthly data. The forecast for 2025 has stayed the same as in the July issue.

Inflation (based on the Consumer Price Index) is forecast at 2.1% in 2024, as in the July issue. Inflation is projected to remain at 2.1% in 2025, higher by 0.1 percentage point compared to the forecast in the July issue. The upward revision was driven by robust growth in the first half of 2024, higher food inflation in the third quarter and elevated inflation in some services categories.

The main risks to the outlook for growth and inflation stem from the external economic environment, (particularly the growth momentum in trading partner economies), the pace of monetary policy easing (especially the path of domestic borrowing costs), as well as from geopolitical tensions, cyberattacks and climate risks. Moreover, fiscal risks owing to pending infrastructure projects and incomplete reforms could lead to lower-than-projected growth. On the other hand, a stronger reform drive, new investments, and targeted measures to address cost-of-living pressures may result in better-than-forecast growth rates.

Οκτώβριος 2024

Περίληψη

Ο ρυθμός οικονομικής μεγέθυνσης στην Κύπρο εκτιμάται ότι θα επιταχυνθεί το 2024 και θα παραμείνει ισχυρός το 2025, λόγω των ευνοϊκών συνθηκών στην αγορά εργασίας, της υποχώρησης του πληθωρισμού κοντά στον στόχο της ΕΚΤ, και της σταδιακής μείωσης των επιτοκίων. Ο ρυθμός μεγέθυνσης του πραγματικού ΑΕΠ προβλέπεται στο 3,5% το 2024 και στο 3,3% το 2025. Σε σύγκριση με το τεύχος Ιουλίου, η πρόβλεψη για το 2024 έχει αναθεωρηθεί προς τα πάνω κατά 0,5 ποσοστιαίες μονάδες, καθώς η δυναμική της οικονομικής μεγέθυνσης ισχυροποιήθηκε κατά το πρώτο εξάμηνο του 2024 και οι εγχώριες οικονομικές συνθήκες κατά το τρίτο τρίμηνο παρέμειναν θετικές σύμφωνα με μηνιαίους δείκτες. Η πρόβλεψη για το 2025 έχει παραμείνει αμετάβλητη σε σχέση με το τεύχος Ιουλίου.

Ο πληθωρισμός (με βάση τον Δείκτη Τιμών Καταναλωτή) προβλέπεται στο 2,1% το 2024, όπως και στο τεύχος Ιουλίου. Το 2025, ο πληθωρισμός προβλέπεται να παραμείνει στο 2,1%, υψηλότερος κατά 0,1 ποσοστιαία μονάδα σε σχέση με το τεύχος Ιουλίου. Η προς τα πάνω αναθεώρηση ήταν αποτέλεσμα του ισχυρού ρυθμού μεγέθυνσης κατά το πρώτο εξάμηνο του 2024, της αύξησης του πληθωρισμού των τροφίμων το τρίτο τρίμηνο και των παρατεταμένα υψηλών ρυθμών πληθωρισμού σε ορισμένες υπηρεσίες.

Οι σημαντικότεροι παράγοντες που πιθανόν να οδηγήσουν σε αποκλίσεις του ρυθμού μεγέθυνσης του ΑΕΠ και του πληθωρισμού από τις πιο πάνω προβλέψεις συνδέονται με το εξωτερικό οικονομικό περιβάλλον (κυρίως τη δυναμική της μεγέθυνσης σε οικονομίες των εμπορικών εταίρων της Κύπρου), τον ρυθμό νομισματικής χαλάρωσης (ειδικότερα την πορεία των εγχώριων επιτοκίων), καθώς και με γεωπολιτικές συγκρούσεις, πιθανές κυβερνοεπιθέσεις και κλιματικούς κινδύνους. Επιπλέον, δημοσιονομικοί κίνδυνοι από εκκρεμή έργα και ελλείψεις μεταρρυθμίσεις θα μπορούσαν να οδηγήσουν σε χαμηλότερους ρυθμούς μεγέθυνσης από τους προβλεπόμενους. Από την άλλη, επιτάχυνση των μεταρρυθμίσεων, νέες επενδύσεις και στοχευμένα μέτρα για αντιμετώπιση του αυξημένου κόστους ζωής μπορεί να οδηγήσουν σε καλύτερες από τις αναμενόμενες προοπτικές ανάπτυξης.

1. Recent developments

In the second quarter of 2024, the Cypriot economy continued to expand at a solid pace, while inflation picked up, before slowing markedly in the third quarter. The year-on-year (y-o-y) growth rate of real GDP remained strong in the second quarter of 2024, at 3.4%, but slightly below the rate (3.8%) reached in the first quarter.

During the second quarter of 2024, real gross value added rose (y-o-y) at a robust rate in most sectors, most notably in construction, and information and communication. However, in the second quarter, growth (y-o-y) in the sector of trade, transport and hospitality decelerated further, while growth in arts and recreation remained weak and below the rates registered in other services sectors. Real gross value added in financial services declined (y-o-y) slightly in the second quarter of 2024, following an improvement in the first quarter.

Growth (y-o-y) in real consumption expenditure strengthened in the second quarter of 2024, driven by vigorous growth in both household and government consumption. In the second quarter, construction investment continued to increase and investment in machinery and equipment rose, resulting in a pickup in gross fixed capital formation. The contribution of net exports to growth remained positive in the second quarter, as imports contracted (y-o-y) further, and exports rose strongly.

Monthly data (e.g. card purchases, tourist arrivals, property sale contracts, registrations of new companies, registrations of motor vehicles) suggest that economic activity growth in Cyprus remained firm in the third quarter of 2024. Moreover, the number of registered unemployed continued to decline (y-o-y) at double-digit rates during the third quarter, and the unemployment rate (Eurostat) stayed at relatively low levels in July and August, despite an uptick recorded in July.

The declines in international oil prices in the third quarter of 2024 facilitated disinflation; CPI inflation slowed to 1.4% in the third quarter of the year (its lowest level in 3½ years) from 2.7% in the second quarter. Inflation declines between the second and third quarters were registered in most of the CPI categories, especially in transport and energy. Nevertheless, in the third quarter, food inflation accelerated significantly and inflation for hotel and

restaurant services remained elevated, with the inflation rates in the above categories standing well above headline inflation.

The Economic Sentiment Indicator (ESI) improved further in the third quarter, as a result of confidence gains in retail trade, construction and, to a smaller degree, manufacturing. Economic confidence among consumers and firms in services remained broadly unchanged between the second and third quarters. In the third quarter, business confidence strengthened in professional services but weakened further in accommodation and food services as well as in financial services. Firms' employment expectations picked up markedly, while selling price expectations eased in the third quarter. Economic uncertainty in Cyprus rose slightly in the third quarter, mainly owing to higher uncertainty among firms in services and among consumers.

Public finances continued to perform strongly during the first eight months of 2024. Over the period January – August, government revenue rose (y-o-y) faster than expenditure, and the budget balance registered a sizeable surplus. The ratio of public debt to GDP has remained on a downward trend, and the long-term interest rate for Cyprus has edged down recently.

In August, domestic lending interest rates for most categories stood below their peaks reached earlier in 2024. However, lending interest rates have not exhibited a clear downward trend and have stayed at relatively high levels, despite the change in the monetary policy stance in June. New lending over the period January – August 2024 registered weak growth, as new loans to both businesses and households rose. The stock of loans has been rising at a modest pace since February, driven by increases in the stock of non-resident loans. The annual growth rate of deposits improved further in July – August, owing to stronger growth in domestic deposits. The ratio of non-performing loans (NPLs) to total loans remained on a declining path, as it fell below 7% in June.

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

ECONOMIC OUTLOOK

October 2024

Issue 24/4

available up to the second quarter of 2024 were employed. Monthly indicators that contain information about developments over July – September 2024 were also used. The cut-off date for the data used in the analysis was 18 October 2024.

Table 1 presents the forecasts for the growth rate of real GDP for 2024 and 2025. Growth is projected to accelerate in 2024 and to remain robust in 2025, supported by favourable labour market conditions, the return of inflation to around-target rates, and gradual declines in interest rates.

Real GDP growth is projected to strengthen from 2.6% in 2023 to 3.5% in 2024. In 2025, growth is forecast at 3.3%. Compared to the July issue, the growth forecast for 2024 has been revised up by 0.5 percentage points, while the forecast for 2025 has remained unchanged. The upward revision to the

growth outlook for 2024 resulted mainly from the pickup in the growth momentum during the first half of 2024, as well as from further improvements in domestic activity and job market reflected in hard and soft data for the third quarter of 2024.

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	3.5		3.3	
	WEIGHT	FORECAST BY COMPONENT	WEIGHT	FORECAST BY COMPONENT
COMPONENTS				
I. Real economy	0.44	3.5	0.43	3.2
II. Aspects other than real economy	0.63	3.5	0.71	3.4
III. Real economy & other aspects	98.93	3.5	98.86	3.3
Fiscal	5.31	3.5	5.36	3.3
Prices	13.09	3.4	12.29	3.1
Exchange rates	3.27	3.5	3.22	3.2
Interest rates, spreads	18.15	3.5	19.80	3.3
Stock markets	13.80	3.5	13.19	3.5
Economic sentiment (surveys)	36.11	3.5	36.17	3.3
Loans, deposits	9.19	3.5	8.82	3.6

Table 2: CPI inflation forecasts

YEAR	2024	2025
FORECAST	2.1	2.1

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.

On the domestic front, positive developments over the last months reflected in hard and soft data point to a strong growth outlook for Cyprus. Moreover, external economic conditions continue to support domestic activity. However, uncertainties relating to the growth prospects in trading partner economies have remained, while geopolitical risks have increased. The key factors that shape the outlook for 2024 and 2025 are discussed below.

- *Activity and the labour market.* In the second quarter of 2023, real activity increased at a solid pace, and the labour market performance remained strong, with rising employment and job vacancies, and low unemployment. Monthly indicators over the period July – September show that domestic activity continued to expand at robust rates and the number of registered unemployed declined further. The above improvements are expected to significantly fuel growth in the following quarters. The domestic outlook is also supported by developments in trading partner economies (e.g. EU, euro area, UK), namely the low levels of unemployment and a pickup in growth during the first half of 2024. Nevertheless, the growth prospects in Cyprus are found to be limited by weaknesses in trading partner economies, as growth has remained low and leading indicators on manufacturing production and retail trade turnover have not signalled significant improvements ahead.
- *Financial conditions.* The monetary policy in the euro area has entered its easing cycle, with policy rate cuts in June, September and October 2024. After about a year around historically high levels, interest rates in the euro area have started following a declining path since June. The recent declines in euro area interest rates are expected to facilitate the growth momentum in Cyprus by pushing down domestic borrowing costs, and by bolstering activity growth in trading partner economies. Although domestic lending interest rates have not yet shown a clear downward trend, the rates for some loan categories (e.g. new loans to non-financial corporations) have registered some declines recently that are expected to support economic activity in the following quarters. Moreover, growth in new loans over January – August 2024, as well as new decreases in NPLs are found to support the outlook, particularly in 2025.

Despite a hike in financial market volatility in August 2024 (which reflected, among other things, uncertainties about the growth momentum in the United States), the domestic and international stock market indices continued to register positive returns (y-o-y) in the third quarter. The favourable performance of stock markets over the first three quarters of 2024 is found to generate pronounced positive effects on the growth outlook.

- *Economic sentiment.* In the third quarter of 2024, employment expectations in Cyprus strengthened markedly and domestic economic confidence improved again, pointing to robust activity growth in the following quarters. Growth prospects also benefit from the relatively low levels of business uncertainty (reflected in survey measures) in Cyprus, as well as from a gradual improvement in consumer confidence in trading partner economies (despite a deterioration in the UK in September). However, declines in economic confidence in the financial services sector in Cyprus during the second and third quarters of 2024 are found to weigh on the outlook. In the EU and the euro area, economic sentiment remained broadly stable (but below its long-term average) over the first three quarters of 2024, while firms' employment expectations signalled some weaknesses during the third quarter, dampening the growth prospects for Cyprus.
- *Prices.* Following the double-digit increases in international commodity prices during the second quarter of 2024, global oil prices decreased (y-o-y) and inflation slowed in the third quarter. The deceleration of inflation in both Cyprus and trading partner economies is expected to partly back domestic and external demand. Nevertheless, the recent upward pressures on food prices, as well as the increases in energy prices during the second quarter of 2024 weigh on the outlook.
- *Public finances.* Cyprus's fiscal position improved markedly over the period January – August 2024, as budget surpluses continued to rise and the ratio of public debt to GDP declined further. The growth outlook benefits from the continuation of the strong fiscal performance that has improved investor confidence and strengthened the economy's resilience to external shocks.

Downside risks to the growth outlook for Cyprus could result from weaker-than-expected growth in trading partner economies, particularly in large euro area countries. Moreover, concerns about the global growth prospects reflected in spikes in market volatility and uncertainty, as well as in lower economic sentiment, may cloud the outlook for Cyprus. Renewed upward pressures on the cost of living and input costs as a result of geopolitical conflicts or extreme weather events may adversely affect the growth outlook. The domestic financing conditions, which have remained restrictive despite the recent cuts in the key ECB interest rates, could weigh on demand, leading to lower-than-anticipated activity growth. Downside risks may arise from delays in the implementation of reforms, as well as from possible cyberattacks. Pressures on public finances, owing to, for example, pending infrastructure projects and incomplete reforms, could weigh on economic confidence and uncertainty, and adversely affect growth.

Upside risks to the growth outlook could arise from stronger-than-expected domestic and external demand, particularly as monetary conditions gradually ease. A stronger reform momentum, new investments, and targeted measures to address cost-of-living pressures (e.g. high energy and housing costs) 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 2025 (Table 2).³ Inflation is projected to pick up somewhat over the final quarter of 2024 and the first quarter of 2025, because of base effects resulting from large declines in inflation during the last months of 2023 and the first months of 2024. Subsequently, inflation is forecast to decline and to stabilise around 2% by the end of the horizon. Compared to the July issue, the forecast for 2024 has remained unchanged, whereas the forecast for 2025 has been revised up by 0.1 percentage point. The upward revision was driven by the strong growth momentum in the first half of the year, the acceleration of food inflation in the third quarter, and the persistently high inflation rates in some services categories.

The recent declines in international oil prices and the deceleration of inflation, particularly during the third quarter of 2024 are expected to keep inflation close to 2% in the following quarters. Despite the recent change in the monetary policy stance, domestic lending interest rates have remained at relatively high levels, continuing to limit inflationary pressures in the next quarters through their dampening effects on demand. Easing selling price expectations, most notably the declines registered in the third quarter of 2024 across all sectors, contribute towards keeping price pressures in check over the next quarters.

Nevertheless, factors that add to the inflation outlook include strong growth and low unemployment in Cyprus during the first half of 2024, upward pressures in international and more importantly domestic food prices in the third quarter of the year, and the high services inflation in Cyprus.

There are both upside and downside risks to the inflation outlook. Geopolitical tensions may trigger faster-than-expected increases in international oil prices. Geopolitical conflicts could disrupt global trade and/or commodity production, renewing upward price pressures. Extreme weather events could exert upward pressures on food prices, while cyberattacks and cybersecurity investments could increase business costs. In addition, fast wage growth in Cyprus due to tight labour market conditions, and stronger-than-expected demand may result in higher-than-projected inflation. Finally, the introduction of green taxes 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, because of weak growth and low economic confidence in trading partner economies.

3. Concluding remarks

Quarterly and monthly series released up until 18 October 2024 were used in dynamic econometric models to construct forecasts for GDP growth and CPI inflation.

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

Real activity growth in Cyprus is projected to gather momentum in 2024 and to remain solid in 2025. The outlook is supported by a strong labour market in both Cyprus and trading partner economies, the return of inflation to rates near its target, and gradually easing monetary policy. Real GDP growth is forecast at 3.5% in 2024 and at 3.3% in 2025. Relative to the July issue, the growth forecast for 2024 has been revised up by 0.5 percentage points, as the growth momentum strengthened markedly in the first half of 2024 and domestic economic conditions in the third quarter remained favourable according to monthly indicators.

Forecasts by other organisations also point to a strengthening of the economic momentum in 2024 and robust growth in 2025. Real GDP growth in Cyprus for 2024 is forecast at 3.5%, 3.3% and 3.7% by the Central Bank, the International Monetary Fund, and the Ministry of Finance, respectively. Growth in 2025 is projected at 3.1% by the above organisations. ^{[1] - [3]}

CPI inflation is forecast at 2.1% in 2024, as in the July issue. Inflation is projected to stay at 2.1% in 2025, higher by 0.1 percentage point compared to the forecast in the July issue. The upward revision was driven by strong growth in the first half of 2024, as well as by high food and services inflation.

The main risks to the outlook for growth and inflation stem from the external economic environment (particularly the growth momentum in trading partner economies), the pace of monetary policy easing (especially the path of domestic borrowing costs), as well as from geopolitical tensions, cyberattacks and climate risks. Moreover, fiscal risks owing to pending infrastructure projects and incomplete reforms could lead to lower-than-projected growth. On the other hand, a stronger reform momentum, new investments, and targeted measures to address cost-of-living pressures may result in better-than-expected growth rates.

REFERENCES

1. Central Bank of Cyprus. 2024. Macroeconomic Projections for the Economy of Cyprus - September 2024. October (in Greek). Available at: <https://www.centralbank.cy/el/announcements/projections-02-10-2024>.
2. International Monetary Fund. 2024. World Economic Outlook: Policy Pivot, Rising Threats. Washington, DC. October.
3. Ministry of Finance. 2024. Economic Developments and Government Budget 2025 - 2027. October (in Greek). Available at: <https://www.gov.cy/mof/about/d-nsi-proypologismoy-kai-dimosionimikoy-elegchoy/kratikos-proypologismos/>

Economics Research Centre
University of Cyprus

Website: <https://www.ucy.ac.cy/erc/en/>

The bulletin reflects only the authors' views*

* Research team:

Vasiliki Bozani (email: bozani.vasiliki@ucy.ac.cy)

Niki Demosthenous (email: demosthenous.niki@ucy.ac.cy)

Anastasia Dimiski (email: dimiski.c.anastasia@ucy.ac.cy)

Nicoletta Pashourtidou (email: pashourtidou.nicoletta@ucy.ac.cy)

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