

ECONOMIC OUTLOOK

October 2022

Summary

Real GDP growth in 2022 is projected at 4.9%, up by 2.0 percentage points compared to the forecast in the July issue. The upward revision resulted from strong activity growth in the second quarter and robust demand during the third quarter, especially external demand for tourist services. However, the negative effects of the ongoing war in Ukraine on economic activity appear to be unfolding more slowly than previously thought, impacting the outlook for 2023. Real GDP growth in 2023 is forecast at 2.4%, down by 0.4 percentage points relative to the forecast in the July issue. The downward revision was driven by several factors, including sustained upward price pressures, the deterioration of economic sentiment in the EU, the weakening of business confidence in services in Cyprus, and the uptick of lending interest rates in the euro area.

The risks to the growth outlook are currently on the downside. As monetary and fiscal policies normalise, the adverse effects of the ongoing war in Ukraine on activity may build up. Further escalation of Russia's war in Ukraine could amplify upward pressures on commodity prices, prolong high inflation and deepen the energy crisis in Europe, increasing the cost of living further and negatively affecting growth. Lower-than-projected growth rates in Cyprus may arise if the slowdown in the EU and the UK turns out to be more severe than expected. The tightening of monetary policy may pose risks to the domestic outlook, if the increases in sovereign borrowing costs and debt servicing costs for firms and households are steeper than anticipated. In view of the tightening financial conditions, universal (instead of targeted) fiscal measures to counter the effects of high inflation, may undermine the fiscal position and cloud the growth prospects. Also, new COVID-19 outbreaks in Cyprus and abroad may hamper economic activity through possible containment measures and renewed supply chain disruptions.

CPI inflation is forecast at 8.6% and 3.4% for 2022 and 2023, respectively. The inflation outlook is mainly driven by the recent acceleration of inflation, as a result of strong increases in international prices of energy and food in combination with robust economic activity. The depreciation of the euro against the US dollar and upward revisions in selling price expectations in services have also influenced the inflation outlook.

Οκτώβριος 2022

Περίληψη

Το πραγματικό ΑΕΠ προβλέπεται να αυξηθεί κατά 4,9% το 2022. Η πρόβλεψη είναι αυξημένη κατά 2,0 ποσοστιαίες μονάδες σε σχέση με την προηγούμενη έκδοση, ως αποτέλεσμα του υψηλού ρυθμού μεγέθυνσης το δεύτερο τρίμηνο και της ισχυρής ζήτησης κατά το τρίτο τρίμηνο, κυρίως λόγω αυξημένου τουριστικού ρεύματος προς την Κύπρο. Ωστόσο, οι αρνητικές επιπτώσεις του συνεχιζόμενου πολέμου στην Ουκρανία πάνω στην οικονομική δραστηριότητα φαίνεται να εκτυλίσσονται πιο αργά απ' ό,τι αναμενόταν προηγούμενων, επηρεάζοντας τις προοπτικές για το 2023. Το πραγματικό ΑΕΠ προβλέπεται να αυξηθεί κατά 2,4% το 2023. Σε σχέση με την προηγούμενη έκδοση, η πρόβλεψη είναι μειωμένη κατά 0,4 ποσοστιαίες μονάδες, λόγω διαφόρων παραγόντων όπως οι συνεχιζόμενες ανοδικές πιέσεις στις τιμές, η επιδείνωση του οικονομικού κλίματος στην ΕΕ, η αποδυνάμωση της επιχειρηματικής εμπιστοσύνης στον τομέα των υπηρεσιών και η άνοδος των επιτοκίων στην ευρωζώνη.

Οι κίνδυνοι για δυσμενέστερες προοπτικές από τις προβλεπόμενες κυριαρχούν. Καθώς οι νομισματικές και δημοσιονομικές πολιτικές εισέρχονται σε φάση ομαλοποίησης (μετά την πανδημική κρίση), οι αρνητικές επιπτώσεις του συνεχιζόμενου πολέμου στην Ουκρανία πάνω στην δραστηριότητα ενδέχεται να ενταθούν. Περαιτέρω κλιμάκωση του πολέμου στην Ουκρανία θα μπορούσε να ενισχύσει τις ανοδικές πιέσεις στις διεθνείς τιμές των εμπορευμάτων (π.χ. πετρελαίου, τροφίμων), να παρατείνει τον υψηλό πληθωρισμό και να εντείνει την ενεργειακή κρίση στην Ευρώπη, αυξάνοντας περαιτέρω το κόστος ζωής και επηρεάζοντας αρνητικά την ανάπτυξη. Χαμηλότεροι ρυθμοί μεγέθυνσης από τους προβλεπόμενους θα μπορούσαν να προκύψουν αν η επιβράδυνση της δραστηριότητας στην ΕΕ και το Ηνωμένο Βασίλειο αποδειχθεί πιο σοβαρή από την αναμενόμενη. Η νομισματική σύσφιξη (για καταπολέμηση του υψηλού πληθωρισμού) θα μπορούσε να επηρεάσει αρνητικά τις εγχώριες προοπτικές αν οι αυξήσεις στο κόστος δανεισμού του κράτους και στο κόστος εξυπηρέτησης του χρέους επιχειρήσεων και νοικοκυριών είναι πιο απότομες από τις αναμενόμενες. Λόγω της σύσφιξης των χρηματοοικονομικών συνθηκών, τυχόν δημοσιονομικά μέτρα για αντιμετώπιση των επιπτώσεων του υψηλού πληθωρισμού καθολικής αντίστοιχης φύσης, ενδέχεται να υπονομεύσουν τη δημοσιονομική θέση και τις προοπτικές μεγέθυνσης. Επίσης, νέα έξαρση της πανδημίας COVID-19 στην Κύπρο και στο εξωτερικό ενδέχεται να επηρεάσει αρνητικά την οικονομική δραστηριότητα μέσω πιθανών περιοριστικών μέτρων και ενδεχόμενων διαταραχών στην εφοδιαστική αλυσίδα.

Ο πληθωρισμός (με βάση τον Δείκτη Τιμών Καταναλωτή) προβλέπεται στο 8,6% και 3,4% για το 2022 και το 2023 αντίστοιχα. Οι προοπτικές για τον πληθωρισμό επηρεάζονται από τα υψηλά επίπεδα πληθωρισμού που καταγράφηκαν πρόσφατα, ως αποτέλεσμα των μεγάλων αυξήσεων στις διεθνείς τιμές της ενέργειας και των τροφίμων, σε συνδυασμό με την ισχυρή οικονομική δραστηριότητα. Η υποτίμηση του ευρώ έναντι του δολαρίου και η άνοδος των προσδοκίων για τις τιμές πώλησης στις υπηρεσίες, επίσης, συνέβαλαν στη διαμόρφωση των προοπτικών για τον πληθωρισμό.

1. Recent developments

In the second quarter of 2022, the Cypriot economy continued to perform strongly, despite rising inflation and uncertainties relating to the ongoing war in Ukraine. Following strong year-on-year (y-o-y) growth in the first quarter of 2022 (6.0%), real GDP rose by 6.1% in the second quarter, as COVID-19 infections subsided and almost all containment measures were lifted.

During the second quarter of 2022, real gross value added expanded (y-o-y) in all sectors of economic activity, except construction. In the second quarter, growth in most sectors weakened, while the contraction in the construction sector intensified. However, in the second quarter, growth in the sector of trade, transportation, accommodation and food service activities (the largest sector in terms of gross value added) strengthened, and output exceeded its pre-pandemic level.

In the second quarter of 2022, the increase (y-o-y) in consumption expenditure (in real terms) accelerated, driven by a pickup in household consumption growth; government consumption growth slowed in the above period. Gross fixed capital formation rose vigorously in the second quarter, as a result of higher investment in transport equipment and intellectual property products, despite a contraction in construction investment. Imports of goods and services rose much faster than exports in the second quarter, pushing net exports further into negative territory.

Leading indicators, available for July – August 2022, show that domestic activity continued to improve in the third quarter of the year, driven by both domestic and external demand; these indicators relate to the volume of retail trade, the use of local and foreign credit cards in Cyprus, tourist arrivals, the number of property sale contracts (including contracts for foreign buyers). However, compared to previous months, most indicators registered smaller improvements; a small number of indicators showed signs of deterioration (e.g. registrations of motor vehicles, industrial production, number of building permits).

Uncertainties about the growth momentum are reflected in recent survey data. The Economic Sentiment Indicator (ESI) rose slightly in the third quarter vis-à-vis the second quarter of 2022, as a

result of confidence gains in the sectors of industry and construction, and among consumers; business confidence in services declined in the third quarter. In September, the ESI for Cyprus stood just above its long-run average and above the EU-wide ESI. Between the second and third quarters of 2022, the Employment Expectations Indicator remained broadly stable at its long-run average, while uncertainty among firms and consumers declined slightly. In the third quarter, price expectations were revised downwards in retail trade, industry and among consumers, but selling price expectations in services moved up.

The number of registered unemployed continued to decline (y-o-y) in the third quarter but at a slower rate compared to that registered in the previous two quarters of 2022. In July and August 2022, the unemployment rate in Cyprus (Eurostat) rose, exceeding 8%.

Over the period January – August 2022, government revenue increased strongly (y-o-y), while expenditure rose marginally (y-o-y), resulting in a budget surplus compared to a deficit over the same period in 2021. Public debt declined to EUR 24.0 billion in August. The long-term interest rate for Cyprus reached a five-year high in June – July to decline slightly in August.

Following the rise in the European Central Bank key interest rates in July, domestic lending interest rates showed a small uptick. New lending during July – August contracted (y-o-y), but growth in new credit over the period January – August remained strong compared to the same period in 2021. In July – August, the stock of loans and deposits increased at slower annual rates compared to the growth rates registered in April – June. The ratio of non-performing loans (NPLs) decreased from 11.4% in March to 11.2% in June.

In the third quarter of 2022, inflation (measured by the Consumer Price Index - CPI) increased further, reaching 9.5% compared with 9.2% in the second quarter. The high inflation in the third quarter was mainly driven by double-digit price increases in the categories of electricity, petroleum products, home repair services and imported agricultural products.

2. Forecasts

Projections for GDP growth and CPI inflation are constructed using an extensive dataset of domestic and foreign indicators, as well as a large number of dynamic econometric models. Quarterly series available up to the second quarter of 2022 were employed. Monthly indicators that contain information about some or all the months in the third quarter of 2022 were also used. The cut-off date for the data used in the analysis was 7 October 2022.

Table 1 presents the forecasts for the growth rate of real GDP for 2022 and 2023. The outlook for 2022 is expected to remain strong thanks to buoyant growth in the first half of the year, although output growth is projected to slow in the second half of 2022. The deceleration of growth is forecast to continue in 2023. Real GDP growth is projected at 4.9% in 2022 and 2.4% in 2023.

Compared to the forecast in the July issue, the growth forecast for 2022 has been revised up by 2.0 percentage points. The upward revision to the 2022 growth forecast resulted from the higher-than-anticipated activity growth in the second quarter and robust demand during the third quarter, especially external demand for tourist services, despite rising inflation. The previously assumed negative effects on the outlook due to the loss of tourist arrivals from Russia have not materialised, as increased tourist inflows from other countries have supported domestic activity. The negative effects of the ongoing war in Ukraine on economic activity appear to be unfolding more slowly than previously thought, impacting the outlook for 2023. The growth forecast for 2023 has been revised down by 0.4 percentage points vis-à-vis the forecast in the July issue. The downward revision to the outlook for 2023 was driven by several factors whose dampening effects on growth have intensified in recent months. These include, among others, sustained upward price pressures, the deterioration of economic sentiment in the EU, the weakening of business confidence in services in Cyprus and the uptick of lending interest rates in the euro area.

Table 1: GDP growth forecasts and components

Year	2022		
FORECAST	4.9		
	CONTRIBUTION	WEIGHT	FORECAST BY COMPONENT
COMPONENTS			
I. Real economy	0.02	0.49	5.0
II. Aspects other than real economy	0.03	0.57	5.0
III. Real economy & other aspects	4.90	98.95	4.9
Fiscal	0.27	5.35	5.0
Prices	0.59	12.56	4.7
Exchange rates	0.16	3.22	5.0
Interest rates, spreads	0.89	17.53	5.1
Stock markets	0.73	14.49	5.0
Economic sentiment, uncertainty	1.79	36.27	4.9
Loans, deposits	0.47	9.53	5.0
Year	2023		
FORECAST	2.4		
	CONTRIBUTION	WEIGHT	FORECAST BY COMPONENT
COMPONENTS			
I. Real economy	0.01	0.45	2.9
II. Aspects other than real economy	0.01	0.54	2.6
III. Real economy & other aspects	2.40	99.01	2.4
Fiscal	0.15	5.71	2.7
Prices	0.14	12.20	1.1
Exchange rates	0.09	3.45	2.7
Interest rates, spreads	0.50	18.66	2.7
Stock markets	0.40	14.18	2.8
Economic sentiment, uncertainty	0.89	36.35	2.5
Loans, deposits	0.22	8.45	2.6

Table 1 also shows the contribution of different components (groups of models) towards shaping the final forecasts. The real economy component—based on factors estimated from real activity and labour market indicators—and the component relating to economic aspects other than the real economy, have

a minor contribution to the overall forecasts.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

The main factors that are expected to support growth in the following quarters and the challenges to the outlook are discussed below.

- *Recent economic performance in Cyprus.* In the first half of 2022, real economic activity and job vacancies registered strong growth, and employment continued to rise at a solid pace. Moreover, the fiscal performance over the first eight months of 2022 improved compared to the same period in 2021. The above positive developments with respect to the real economy and public finances are expected to support growth in the coming quarters. However, during the third quarter of 2022, some monthly activity indicators weakened and labour market indicators signalled a reversal of the downward trend in unemployment, dampening the outlook.
- *Economic sentiment in Cyprus.* Economic sentiment in Cyprus improved slightly in the third quarter, after the significant deterioration registered in the spring, as a result of Russia's invasion of Ukraine. The recent confidence gains among consumers and firms in industry and construction, albeit small, have positive effects on the outlook. Economic confidence in services continued to weaken in the third quarter, weighing on the growth prospects, particularly for 2023.
- *Economic activity and expectations in trading partner economies.* GDP growth (y-o-y) in the EU, the euro area and the UK remained strong in the second quarter of 2022, but slowed vis-à-vis the growth rate in first quarter. Strong growth and declines in unemployment in the second quarter in Cyprus's trading partners create positive effects on the outlook. Nevertheless, further weakening of the growth momentum in the EU, the euro area and the

UK in the third quarter, and lower expectations about future activity in the above economies have been reflected in recently published hard indicators and survey data. Monthly indicators for the EU and the euro area show that the volume of manufacturing production fell in July, and retail trade turnover (in real terms) contracted in July and August. Moreover, a composite leading indicator for the UK registered faster declines in July and August compared to those observed in previous months. Economic sentiment in the EU and the euro area has been declining since March; consumer confidence in the EU, the euro area and the UK dropped to historic lows in September. The weakening growth momentum in trading partner economies weighs heavily on the outlook for Cyprus, especially for 2023.

- *Financial conditions.* In response to high inflation, financial conditions in the euro area have been tightening, with the key ECB interest rates on the rise as of July. The recent and upcoming increases in borrowing costs in the euro area (including Cyprus) are expected to lower inflation by reducing demand and therefore limit growth in 2023. However, interest rates are currently low by historical standards and together with favourable conditions in the domestic banking system (deposit growth, declining NPLs) are expected to continue to back growth in the very near term. The recent negative performance of international stock markets (mainly reflecting tighter financial conditions and expectations of a global slowdown) has not weighed on the outlook for Cyprus considerably, because of the strong performance of the domestic economy in the first half of the year.
- *Inflation.* Russia's invasion of Ukraine and the sanctions that followed have pushed international commodity prices up significantly; these upward pressures, combined with pre-existing inflationary pressures due to the strong recovery in 2021, have

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 conducting the "Business and Consumer Surveys" project in Cyprus.

led to fast and persistent increases in the general price level in Cyprus and abroad. The acceleration of inflation in the second and third quarters of 2022 (inflation reached historically high levels in the summer) is found to negatively affect the growth outlook, most notably for 2023. The effects of inflation on real incomes are expected to be partly mitigated by recent fiscal measures. Nevertheless, the persistently high inflation has taken a heavy toll on real incomes, weighing on the outlook significantly.

The risks to the growth outlook are currently on the downside. As monetary and fiscal policies normalise, the adverse effects of the ongoing war in Ukraine on activity may build up. An escalation of Russia's war in Ukraine could amplify upward pressures on commodity prices, prolong high inflation and deepen the energy crisis in Europe, raising the cost of living further and negatively affecting growth. Lower-than-projected growth rates in Cyprus may arise, if the slowdown in the EU and the UK turns out to be more severe than expected. The tightening of monetary policy (in response to high inflation) may pose risks to the domestic outlook, if the increases in sovereign borrowing costs and debt servicing costs for firms and households are steeper than anticipated. In view of the tightening financial conditions, universal (instead of targeted) fiscal measures to counter the effects of increasing energy costs and rising cost of living, may undermine the fiscal position and cloud the growth prospects. Also, new COVID-19 outbreaks in Cyprus and abroad may hamper economic activity through possible containment measures and renewed supply chain disruptions.

Upside risks to the outlook could stem from investments and reforms in Cyprus (whose positive effects have not been reflected in published data), as well as from stronger-than-expected economic activity in the EU, supported by e.g. the pandemic recovery plan NextGenerationEU.

CPI inflation is projected to increase from 2.4% in 2021 to 8.6% in 2022. Inflation in 2023 is forecast to decline to 3.4%.³ The inflation forecasts have been revised upwards compared to the forecasts in the July issue (7.5% for 2022 and 3.3% for 2023). During the first half of 2022, international commodity

prices, especially energy and food prices, rose rapidly as a result of the war in Ukraine, leading to fast-rising inflation rates. In the third quarter of 2022, international oil and food prices continued to rise, but at somewhat slower rates compared to those seen in the second quarter; nevertheless, CPI inflation peaked in July and moderated only slightly in August and September.

The inflation outlook is mainly driven by the recent high rates of inflation, as a result of strong increases in international prices of energy and food in combination with robust economic activity. Other developments in the third quarter that influenced inflation forecasts include the depreciation of the euro against the US dollar and upward revisions in selling price expectations in services. The higher price expectations in services reflect the expected pass through of higher costs, especially for energy, to consumer prices in the following quarters.

There are upside and downside risks to the inflation outlook. Further increases in international commodity prices, particularly in oil and food prices, as a result of an escalation of the war in Ukraine, could prolong inflationary pressures and keep inflation expectations elevated for longer. Other upside risks to the inflation outlook include: further weakening of the euro (especially against the US dollar), new universal fiscal support to counter the effects of increasing energy costs and rising cost of living, faster-than-expected wage increases, and supply bottlenecks due to new COVID-19 outbreaks. Downside risks to the inflation outlook may arise if domestic and global demand turn out to be weaker than anticipated, as a result of the tightening of financial conditions, an escalation of the war in Ukraine or a deeper-than-expected energy crisis in Europe.

3. Concluding remarks

Quarterly and monthly series released up until 7 October 2022 were employed in dynamic econometric models to construct forecasts for GDP growth and CPI inflation.

In the second quarter of 2022, economic activity in Cyprus continued to grow strongly, despite rising

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

inflation and uncertainties triggered by the war in Ukraine. Leading indicators show that domestic activity continued to improve in the third quarter, albeit at a somewhat slower pace compared to the second quarter. The recent strong economic performance is expected to support growth in the second half of 2022 and in 2023.

Real GDP growth in 2022 is projected at 4.9%, up by 2.0 percentage points compared to the forecast in the July issue. The upward revision resulted from strong activity growth in the second quarter and robust demand during the third quarter, especially external demand for tourist services. The previously assumed negative effects on the outlook due to the loss of tourist arrivals from Russia have not materialised, as increased tourist inflows from other countries have supported domestic activity.

However, the negative effects of the ongoing war in Ukraine and sanctions against Russia on activity appear to be unfolding more slowly than previously thought, impacting the outlook for 2023. Real GDP growth in 2023 is forecast at 2.4%, down by 0.4 percentage points relative to the forecast in the July issue. The downward revision was driven by several factors, including sustained upward price pressures, the deterioration of economic sentiment in the EU, the weakening of business confidence in services in Cyprus and the uptick of lending interest rates in the euro area.

Other organisations also forecast that growth in Cyprus will remain strong in 2022, but will decelerate in 2023. The Central Bank, the International Monetary Fund and the Ministry of Finance forecast real GDP growth for 2022 at 5.5%, 3.5% and 5.7%, respectively. For 2023, the growth projections by the Central Bank, the International Monetary Fund and the Ministry of Finance are 2.5%, 2.5% and 3.0%, respectively ([1]-[3]).

CPI inflation is forecast at 8.6% and 3.4% for 2022 and 2023, respectively. The inflation forecasts have been revised upwards relative to the forecasts in the July issue (7.5% for 2022 and 3.3% for 2023). The current inflation outlook is mainly driven by the recent high rates of inflation, as a result of strong increases in international prices of energy and food in combination with robust economic activity. The depreciation of the euro against the US dollar and upward revisions in selling price expectations in services have also influenced the inflation outlook.

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