



Issue 18/2

# ECONOMIC OUTLOOK

## ECONOMICS RESEARCH CENTRE

May 2018

Summary

*The Cypriot economy is expected to continue to grow at a solid pace in 2018 and 2019. In 2018, real GDP is forecasted to increase by 3.8%. In 2019, growth is projected to moderate slightly, as real GDP is forecasted to expand by 3.5%.*

*The key drivers of the strong outlook in 2018 and 2019 are the following:*

- *further improvements in real economic activity and labour market conditions during the final quarter of 2017 and the first quarter of 2018;*
- *historically high levels of domestic economic sentiment;*
- *steady growth in Cyprus's trading partner countries, and strong economic sentiment in the EU;*
- *favourable external financial conditions and supportive domestic lending conditions.*

*Downside risks to the projections are given below.*

- *The high stock of non-performing exposures in combination with delays in streamlining the current insolvency and foreclosure frameworks, may create risks to financial stability and discourage future investors.*
- *Fiscal slippage may render the economy vulnerable to shocks and lead to higher borrowing costs for Cyprus.*
- *Delays in the implementation of structural reforms (e.g. public administration, judicial system, local authorities), given the high level of public debt, may weaken business and investor confidence, the sustainability of public finances and growth prospects.*
- *Slower-than-expected growth in the UK and a weaker pound due to Brexit negotiations as well as geopolitical risks may negatively affect the outlook.*

*Upside risks to the outlook are associated with public investment and large-scale private construction projects. Moreover, stronger growth momentum in the EU may lead to faster growth rates than the current forecasts.*

Μάιος 2018

Περίληψη

*Η Κυπριακή οικονομία εκτιμάται ότι θα συνεχίσει να αναπτύσσεται με γοργούς ρυθμούς κατά το 2018 και 2019. Το 2018, το πραγματικό ΑΕΠ προβλέπεται να αυξηθεί κατά 3,8%. Το 2019, η ανάπτυξη αναμένεται να σημειώσει μικρή επιβράδυνση, καθώς το πραγματικό ΑΕΠ προβλέπεται να αυξηθεί κατά 3,5%.*

*Οι κυριότεροι παράγοντες που συμβάλλουν στη διαμόρφωση των ισχυρών προοπτικών είναι οι ακόλουθοι:*

- *περαιτέρω βελτίωση της πραγματικής οικονομικής δραστηριότητας καθώς και των συνθηκών στην αγορά εργασίας κατά το τελευταίο τρίμηνο του 2017 και το πρώτο τρίμηνο του 2018·*
- *ιστορικά υψηλά επίπεδα εγχώριας οικονομικής εμπιστοσύνης·*
- *σταθεροί ρυθμοί ανάπτυξης στις οικονομίες των κυριότερων εμπορικών εταίρων της Κύπρου και ψηλά επίπεδα οικονομικής εμπιστοσύνης στην ΕΕ·*
- *ευνοϊκές εξωτερικές χρηματοπιστωτικές συνθήκες και υποβοηθητικές συνθήκες δανεισμού στην Κύπρο.*

*Κίνδυνοι για χαμηλότερη από την προβλεπόμενη ανάπτυξη περιγράφονται πιο κάτω.*

- *Το ψηλό επίπεδο μη εξυπηρετούμενων δανείων σε συνδυασμό με καθυστερήσεις στη βελτίωση του υφιστάμενου πλαισίου εκποιήσεων και αφερεγγυότητας, ενδεχομένως να δημιουργήσει κινδύνους στη χρηματοπιστωτική σταθερότητα και να αποθαρρύνει μελλοντικούς επενδυτές.*
- *Η δημοσιονομική χαλάρωση καθιστά την οικονομία ευάλωτη σε τυχόν αρνητικές εξελίξεις και πιθανόν να οδηγήσει σε υψηλότερο κόστος δανεισμού για την Κύπρο.*
- *Καθυστερήσεις στην προώθηση διαρθρωτικών μεταρρυθμίσεων σε συνδυασμό με το ψηλό επίπεδο δημόσιου χρέους, ενδεχομένως να αποδυναμώσουν την επιχειρηματική και επενδυτική εμπιστοσύνη, τη βιωσιμότητα των δημόσιων οικονομικών και τις προοπτικές ανάπτυξης.*
- *Χαμηλότερους ρυθμούς ανάπτυξης από τους αναμενόμενους στο Ηνωμένο Βασίλειο και υποτίμηση της στερλίνας, λόγω των διαπραγματεύσεων για έξοδο της χώρας από την ΕΕ, καθώς και γεωπολιτικοί κίνδυνοι ίσως να επηρεάσουν αρνητικά τις προοπτικές.*

*Καλύτερες προοπτικές από τις προβλεπόμενες θα μπορούσαν να διαμορφωθούν λόγω: δημόσιων επενδύσεων, ιδιωτικών κατασκευαστικών έργων μεγάλης κλίμακας και ισχυρότερης ανάπτυξης από την αναμενόμενη στην ΕΕ.*

UNIVERSITY OF CYPRUS



### 1. Recent developments

The Cypriot economy continued to grow robustly as real GDP increased by 3.9% year-on-year (y-o-y) in the final quarter of 2017. Growth in Cyprus gained further momentum in 2017, as real activity expanded by 3.9% compared with 3.4% in 2016.

In the fourth quarter of 2017, most sectors of economic activity continued to expand strongly in terms of their real gross value added, while activity contraction in financial and insurance services decelerated. Both household and government consumption increased vigorously in the final quarter. Growth (y-o-y) in gross fixed capital formation doubled compared with the third quarter of 2017, driven by investment in equipment and construction. Net exports weighed on growth in the final quarter as the increase in imports was fivefold that in exports.

Many leading indicators of domestic activity (e.g. credit card use, index of industrial production, registrations of motor vehicles, tourist arrivals, registrations of new companies, property sale contracts, building permits) continued to pick up in the first quarter of 2018. The Economic Sentiment Indicator (ESI) strengthened further in the first quarter of the year and exceeded the levels of the EU- and euro area-wide sentiment indicators. The improvement in domestic economic sentiment was driven by confidence gains in all sectors, particularly in services and industry.

The number of registered unemployed declined at a faster pace in the first quarter of 2018 vis-à-vis previous quarters and the unemployment rate (Eurostat) stood just below 10% in January – February 2018. Nevertheless, unemployment in Cyprus is still above the euro area average.

The fiscal position improved further in 2017 as the increase in government revenue far exceeded the rise in expenditure, leading to higher surpluses compared with 2016. The strong fiscal performance continued in January – February 2018; however the downward trajectory of public debt is currently at risk.

Deposits held in Cyprus by domestic and other euro area residents continued to rise in the final quarter of 2017 and in January – February 2018, although at slower rates compared to the first three quarters of 2017. Deleveraging and weak new lending pushed the stock of loans down further; nevertheless loans to non-financial corporations have been registering weak growth since September 2017.

Interest rates remain at historically low levels. Throughout 2017, the stock of non-performing exposures has been declining steadily; however the ratio of non-performing loans to GDP exceeds 100%, rendering the economy vulnerable.

Negative inflation (measured by the Consumer Price Index – CPI) persisted for a third consecutive quarter. CPI declined by 0.5% in the first quarter of 2018, mainly driven by negative inflation in the categories of food, clothing, household equipment, communication and miscellaneous goods and services.

### 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 final quarter of 2017 are employed. Monthly indicators released by 17 April 2018 that contain information covering all the months in the first quarter of 2018 at the most, are also used. All forecasts presented in this bulletin are based solely on published data; thus, they only incorporate effects captured by the quarterly series and the monthly leading indicators used in the estimations.

The forecasts for the y-o-y growth rate of real GDP for the four quarters of 2018 and 2019 are shown in Table 1; the projections for the whole of 2018 and 2019 are also provided.

Based on the historical relationships between growth and numerous macroeconomic and financial indicators, real economic activity in Cyprus is estimated to continue to expand at a solid pace in 2018 and 2019. Real GDP growth is forecasted to increase by 3.8% in 2018 and 3.5% in 2019.

- Real GDP is estimated to have increased by 3.7% (y-o-y) in the first quarter of 2018; real activity is forecasted to expand by 3.8% and 4.1% in the second and third quarters respectively. Growth is projected to edge down to 3.6% in the final quarter of 2018. The corresponding q-o-q projections are 0.8%, 0.9%, 1.0% and 0.8% for the first, second, third and final quarters, respectively.
- Growth is estimated to continue at solid rates in 2019, albeit slightly lower than those projected for 2018. Real GDP is forecasted to rise by about 3.5% (y-o-y) in each quarter. On a q-o-q basis, real activity is forecasted to

expand by 0.8% in the first half and 0.9% in the second half of 2019.

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

YEAR	2018			
<b>FORECAST</b>	<b>3.8</b>			
<b>Quarter</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>
<b>FORECAST (y-o-y)</b>	<b>3.7</b>	<b>3.8</b>	<b>4.1</b>	<b>3.6</b>
Forecast error <sup>2</sup>	0.7	1.2	1.9	2.8
<b>COMPONENTS <sup>3</sup></b>				
<b>I. Real economy</b>	<b>0.02</b>	<b>0.02</b>	<b>0.02</b>	<b>0.02</b>
<b>II. Aspects other than real economy</b>	<b>0.04</b>	<b>0.04</b>	<b>0.04</b>	<b>0.03</b>
<b>III. Real economy &amp; other aspects</b>	<b>3.66</b>	<b>3.76</b>	<b>4.00</b>	<b>3.57</b>
Fiscal	0.11	0.11	0.10	0.08
Prices	0.55	0.51	0.50	0.46
Exchange rates	0.13	0.12	0.11	0.10
Interest rates, spreads	0.93	1.05	1.15	1.00
Stock markets	0.59	0.63	0.67	0.62
Economic sentiment	1.07	1.10	1.19	1.05
Loans, deposits	0.29	0.25	0.27	0.27
YEAR	2019			
<b>FORECAST</b>	<b>3.5</b>			
<b>Quarter</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>
<b>FORECAST (y-o-y)</b>	<b>3.5</b>	<b>3.5</b>	<b>3.4</b>	<b>3.5</b>
Forecast error <sup>3</sup>	3.1	3.6	4.0	4.4
<b>COMPONENTS <sup>4</sup></b>				
<b>I. Real economy</b>	<b>0.01</b>	<b>0.01</b>	<b>0.01</b>	<b>0.02</b>
<b>II. Aspects other than real economy</b>	<b>0.03</b>	<b>0.03</b>	<b>0.03</b>	<b>0.03</b>
<b>III. Real economy &amp; other aspects</b>	<b>3.49</b>	<b>3.45</b>	<b>3.40</b>	<b>3.48</b>
Fiscal	0.07	0.07	0.07	0.08
Prices	0.44	0.42	0.47	0.50
Exchange rates	0.10	0.10	0.11	0.12
Interest rates, spreads	1.05	1.22	1.12	1.06
Stock markets	0.60	0.51	0.48	0.48
Economic sentiment	0.93	0.83	0.80	0.88
Loans, deposits	0.30	0.30	0.33	0.36

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

<sup>2</sup> Pseudo out-of-sample root mean squared forecast error of the forecast method.

<sup>3</sup> Differences between the forecasts and the sum of the components are due to rounding.

Table 1 also presents the forecast errors associated with the estimated y-o-y growth rates in each quarter. As expected, the errors are larger for quarters closer to the end of the forecast horizon. Furthermore, Table 1 shows the contribution of different components (groups of models) towards shaping the final forecasts. The real economy component—based on factors estimated from domestic and international real activity and labour market indicators—and the component relating to economic aspects other than the real economy, have a minor contribution (of about 1.4%) to

the overall forecasts in all quarters.<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. More specifically, the forecasts are mainly formed by dynamic models that include real economy factors (one at a time) together with leading indicators (one at a time), such as interest rates, spreads, economic sentiment indicators, domestic or foreign/international prices and stock market returns.<sup>2, 3</sup>

The main drivers of the strong outlook in 2018 and 2019 are discussed below.

- *Further improvements in the real economy in Cyprus.* Real GDP growth remained robust throughout 2017 with private consumption and investment in construction and machinery as the main steady contributors. Employment continued to increase and unemployment continued to fall in 2017. Leading indicators of consumption, investment and exports, as well as recent data on the number of registered unemployed and firms' employment expectations, indicate that activity and labour market conditions improved further in the first quarter of 2018.
- *Historically high levels of domestic economic sentiment.* The ongoing confidence gains that have been recorded in all sectors and among consumers in 2017 and during the first months of 2018 contribute significantly to the favourable outlook.

<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 relating to aspects other than the real economy is based on indicators such as interest rates and spreads, stock market returns, economic sentiment indicators, exchange rates, domestic and foreign price indices, international commodity prices, as well as fiscal and banking sector series (loans, deposits).

<sup>2</sup> Monthly leads of leading indicators (e.g. interest rates, economic sentiment) and monthly leading values of series used in extracting the factors (e.g. unemployment rate, registered unemployed, arrivals of tourists, registrations of motor vehicles) are also included in the models.

<sup>3</sup> Economic sentiment indicators refer to data obtained through the Harmonised Business and Consumer Surveys Programme conducted by the Directorate General for Economic and Financial Affairs. The Economics Research Centre acknowledges funding from the European Commission and the Ministry of Finance for conducting the Business and Consumer Survey Project in Cyprus.

- *Steady growth in Cyprus's trading partner countries, and strong economic sentiment in the EU.* In 2017, the EU and the euro area registered solid growth rates. Economic sentiment remained at high levels in the first quarter of 2018, suggesting that the favourable economic conditions in Europe will continue in the following quarters. The UK economy expanded at a rate just below 2% in 2017, and the recovery of the Russian economy continued throughout 2017. Nevertheless, some confidence losses registered by the UK ESI in the first quarter of 2018, and the recent weakening of the rouble against the euro are found to weigh on the outlook but only slightly.
- *Favourable external financial conditions and supportive domestic lending conditions.* Despite the recent losses, the past favourable performance of the international stock markets, especially when combined with the positive developments in the real economy, points towards strong growth rates in the following quarters. The low levels of European and domestic lending interest rates also contribute to the favourable projections.

The low or negative inflation rates in the previous quarters will continue to support growth in the short run, but their effects on future growth are expected to wane as international commodity prices rebound and demand firms up.

Downside risks to the projections are given below.

- The high stock of non-performing exposures in combination with delays in streamlining the current insolvency and foreclosure frameworks, may create risks to financial stability and discourage future investors.
- Fiscal slippage may render the economy vulnerable to shocks and lead to higher borrowing costs for Cyprus.
- Delays in the implementation of structural reforms (e.g. public administration, judicial system, local authorities), given the high level of public debt, may weaken business and investor confidence, the sustainability of public finances and growth prospects.
- Slower-than-expected growth in the UK and a weaker pound due to Brexit negotiations as well as geopolitical risks may negatively affect the outlook.

Upside risks to the outlook are associated with public investment and large-scale private construction projects in the sectors of tourism and real estate. Moreover, stronger

growth momentum in the EU may lead to faster growth rates than the current forecasts.

In 2018, CPI inflation is forecasted to remain muted at 0.6% due to negative inflation in the previous three quarters, despite the pick-up of energy prices. Inflation is projected to gradually increase to 1.5% in 2019 mainly driven by stronger demand, increases in international commodity prices and upward pressures on domestic wages.<sup>4</sup> Upside risks to the forecast relate to stronger demand and faster wage growth, and more rapid increases in international commodity prices. Downside risks to the projections are associated with weaker demand.

### 3. Concluding remarks

Quarterly and monthly series released until 17 April 2018, are employed in dynamic econometric models to construct forecasts for growth and inflation.

The forecast for real GDP growth in 2018 has been revised from 3.6% in the January issue to 3.8%. The stronger outlook in this issue resulted mainly from further improvements in domestic macroeconomic and leading indicators, and the favourable external economic conditions in the final quarter of 2017 and in the first quarter of 2018. The CPI inflation projection for 2018 has been revised from 1.0% in the previous issue to 0.6%, as negative inflation persisted in the first quarter of 2018.

The forecasts presented in this issue suggest that real activity will continue to expand at robust rates in 2018, while growth is projected to decelerate slightly in 2019. The growth forecasts for 2018 and 2019 presented here are more conservative than the projected rates of 4% – 4¼% (during 2018 – 2019) announced by the IMF [1], but the former are in line with the forecasts published by the Ministry of Finance, namely 3.8% and 3.6% in 2018 and 2019, respectively [2].

### REFERENCES

1. International Monetary Fund (IMF), "Cyprus: Staff Concluding Statement of the Second Post-Program Monitoring Mission", March 2018.
2. Ministry of Finance, "Stability Programme 2018–2021", April 2018.

<sup>4</sup> CPI inflation forecasts are constructed using a methodology similar to that for GDP growth forecasts (see footnote 1).

### APPENDIX

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

CONTRIBUTION BY COMPONENT					WEIGHT				FORECAST BY COMPONENT			
YEAR	2018				2018				2018			
QUARTER	1	2	3	4	1	2	3	4	1	2	3	4
<b>COMPONENTS</b>												
<b>I. Real economy</b>	<b>0.02</b>	<b>0.02</b>	<b>0.02</b>	<b>0.02</b>	<b>0.56</b>	<b>0.56</b>	<b>0.49</b>	<b>0.49</b>	<b>3.6</b>	<b>3.7</b>	<b>3.8</b>	<b>3.2</b>
<b>II. Aspects other than real economy</b>	<b>0.04</b>	<b>0.03</b>	<b>0.03</b>	<b>0.03</b>	<b>0.98</b>	<b>0.93</b>	<b>0.87</b>	<b>0.92</b>	<b>3.7</b>	<b>3.8</b>	<b>3.9</b>	<b>3.5</b>
<b>III. Real economy &amp; other aspects</b>	<b>3.66</b>	<b>3.76</b>	<b>4.00</b>	<b>3.57</b>	<b>98.46</b>	<b>98.51</b>	<b>98.64</b>	<b>98.59</b>	<b>3.7</b>	<b>3.8</b>	<b>4.1</b>	<b>3.6</b>
Fiscal	0.11	0.11	0.10	0.08	2.96	2.85	2.73	2.51	3.7	3.7	3.8	3.2
Prices	0.55	0.51	0.50	0.46	14.68	13.90	12.38	13.02	3.7	3.7	4.0	3.5
Exchange rates	0.13	0.12	0.11	0.10	3.56	3.07	2.84	2.93	3.7	3.8	4.0	3.4
Interest rates, spreads	0.93	1.05	1.15	1.00	25.34	27.54	28.59	28.36	3.7	3.8	4.0	3.5
Stock markets	0.59	0.63	0.67	0.62	15.73	16.37	16.52	16.77	3.7	3.8	4.1	3.7
Economic sentiment	1.07	1.10	1.19	1.05	28.43	28.14	29.02	28.14	3.8	3.9	4.1	3.7
Loans, deposits	0.29	0.25	0.27	0.27	7.76	6.65	6.55	6.86	3.7	3.8	4.2	3.9
<b>FORECAST</b>	<b>3.7</b>	<b>3.8</b>	<b>4.1</b>	<b>3.6</b>								
CONTRIBUTION BY COMPONENT					WEIGHT				FORECAST BY COMPONENT			
YEAR	2019				2019				2019			
QUARTER	1	2	3	4	1	2	3	4	1	2	3	4
<b>COMPONENTS</b>												
<b>I. Real economy</b>	<b>0.01</b>	<b>0.01</b>	<b>0.01</b>	<b>0.02</b>	<b>0.43</b>	<b>0.41</b>	<b>0.45</b>	<b>0.49</b>	<b>3.2</b>	<b>3.3</b>	<b>3.3</b>	<b>3.4</b>
<b>II. Aspects other than real economy</b>	<b>0.03</b>	<b>0.03</b>	<b>0.03</b>	<b>0.03</b>	<b>0.90</b>	<b>0.91</b>	<b>0.90</b>	<b>0.86</b>	<b>3.5</b>	<b>3.4</b>	<b>3.4</b>	<b>3.4</b>
<b>III. Real economy &amp; other aspects</b>	<b>3.49</b>	<b>3.45</b>	<b>3.40</b>	<b>3.48</b>	<b>98.67</b>	<b>98.68</b>	<b>98.65</b>	<b>98.65</b>	<b>3.5</b>	<b>3.5</b>	<b>3.4</b>	<b>3.5</b>
Fiscal	0.07	0.07	0.07	0.08	2.26	2.20	2.41	2.49	3.2	3.0	3.1	3.0
Prices	0.44	0.42	0.47	0.50	12.46	12.03	13.51	14.17	3.5	3.5	3.5	3.5
Exchange rates	0.10	0.10	0.11	0.12	2.95	2.99	3.31	3.42	3.4	3.4	3.4	3.6
Interest rates, spreads	1.05	1.22	1.12	1.06	31.23	36.72	34.30	31.30	3.4	3.3	3.3	3.4
Stock markets	0.60	0.51	0.48	0.48	16.80	14.41	14.11	13.96	3.6	3.6	3.4	3.4
Economic sentiment	0.93	0.83	0.80	0.88	25.56	23.18	23.32	24.89	3.7	3.6	3.5	3.5
Loans, deposits	0.30	0.30	0.33	0.36	7.42	7.15	7.70	8.41	4.0	4.2	4.3	4.3
<b>FORECAST</b>	<b>3.5</b>	<b>3.5</b>	<b>3.4</b>	<b>3.5</b>								



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