

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

May 2023

Summary

Despite a weakening in the growth momentum in the final quarter of 2022, Cyprus's economic performance has remained strong, creating favourable conditions for activity in the near term. In 2023, growth is forecast to decelerate further, but it is expected to remain robust. The tightening in the financial conditions is expected to limit growth prospects in Cyprus, through lower domestic and external demand. The high inflation experienced during 2022 also weighs on the outlook. Real GDP growth is projected at 3.0% in 2023 and at 3.1% in 2024. The growth forecasts for 2023 and 2024 have been revised up by 0.4 and 0.3 percentage points, respectively, relative to those in the January issue. The upward revisions are mainly driven by better-than-expected growth in the final quarter of 2022, moderating inflation, improvements in economic confidence, as well as by a favourable stock market performance, despite the recent turmoil in the international banking sector. Nevertheless, downside risks to the growth outlook are currently dominant. The risks are mainly associated with the rising interest rates, as a result of monetary policy tightening.

Inflation (based on the Consumer Price Index) is forecast to decline in 2023 and 2024, as a result of lower pressures on international commodity prices and tighter financial conditions. Inflation is projected at 3.0% in 2023 and at 2.4% in 2024. The 2023 inflation forecast has been revised marginally downwards (by 0.2 percentage points) compared to that in the January issue, mainly because of the recent deceleration of inflation on the back of lower international commodity prices. However, the inflation forecast for 2024 is higher than that in the January issue (by 0.4 percentage points), as robust domestic activity as well as past price pressures are expected to add to inflation persistence.

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Περίληψη

Παρά την αποδυνάμωση της δυναμικής της μεγέθυνσης το τελευταίο τρίμηνο του 2022, οι επιδόσεις της κυπριακής οικονομίας παρέμειναν ισχυρές, δημιουργώντας ευνοϊκές συνθήκες για την οικονομική δραστηριότητα βραχυπρόθεσμα. Το 2023, ο ρυθμός μεγέθυνσης προβλέπεται να επιβραδυνθεί περαιτέρω, αλλά αναμένεται να παραμείνει ανθεκτικός. Η σύσφιξη των χρηματοοικονομικών συνθηκών εκτιμάται ότι θα περιορίσει τις προοπτικές ανάπτυξης στην Κύπρο λόγω μειωμένης εσωτερικής και εξωτερικής ζήτησης. Οι επιπτώσεις του υψηλού πληθωρισμού που είχε καταγραφεί το 2022 επίσης επιβαρύνουν τις προοπτικές. Ο ρυθμός μεγέθυνσης του πραγματικού ΑΕΠ προβλέπεται σε 3,0% για το 2023 και σε 3,1% για το 2024. Οι προβλέψεις για το 2023 και το 2024 έχουν αναθεωρηθεί προς τα πάνω (κατά 0,4 και 0,3 ποσοστιαίες μονάδες αντίστοιχα), συγκριτικά με τις προβλέψεις στο τεύχος Ιανουαρίου. Οι θετικότερες προοπτικές οφείλονται κυρίως στον υψηλότερο ρυθμό μεγέθυνσης από τον αναμενόμενο κατά το τέταρτο τρίμηνο του 2022, στην πρόσφατη επιβράδυνση του πληθωρισμού και στην ενδυνάμωση της οικονομικής εμπιστοσύνης στην Κύπρο και στην ΕΕ. Οι ευνοϊκές επιδόσεις των χρηματιστηριακών αγορών, παρά την πρόσφατη αναταραχή στον διεθνή τραπεζικό τομέα, έχουν επίσης συμβάλει στις θετικότερες προοπτικές. Ωστόσο, οι κίνδυνοι για δυσμενέστερες προοπτικές από τις προβλεπόμενες κυριαρχούν. Οι κίνδυνοι συνδέονται κυρίως με τα αυξανόμενα επιτόκια λόγω της νομισματικής σύσφιξης.

Ο πληθωρισμός (με βάση τον Δείκτη Τιμών Καταναλωτή) προβλέπεται να μειωθεί το 2023 και το 2024, ως αποτέλεσμα αποκλιμάκωσης των πιέσεων στις διεθνείς τιμές εμπορευμάτων (π.χ. πετρελαίου, τροφίμων) και της σύσφιξης των χρηματοπιστωτικών συνθηκών. Ο πληθωρισμός προβλέπεται σε 3,0% το 2023 και σε 2,4% το 2024. Η πρόβλεψη για τον πληθωρισμό του 2023 έχει αναθεωρηθεί οριακά προς τα κάτω (κατά 0,2 ποσοστιαίες μονάδες) σε σύγκριση με την έκδοση Ιανουαρίου, κυρίως λόγω της πρόσφατης επιβράδυνσης του πληθωρισμού, ως αποτέλεσμα μειώσεων στις διεθνείς τιμές εμπορευμάτων. Ωστόσο, η πρόβλεψη για τον πληθωρισμό του 2024 είναι υψηλότερη από αυτή στην έκδοση Ιανουαρίου (κατά 0,4 ποσοστιαίες μονάδες), αφού η ισχυρή εγχώρια δραστηριότητα, καθώς και οι ανοδικές πιέσεις στις τιμές που είχαν καταγραφεί κατά το 2022 εκτιμάται ότι θα επιτείνουν κάπως τον πληθωρισμό.

1. Recent developments

In 2022, economic activity in Cyprus remained strong, despite negative pressures on services exports as a result of Russia's invasion of Ukraine, lingering pandemic effects, and high energy and food inflation. Real GDP increased by 5.6% in 2022, compared with 6.6% in 2021. In the fourth quarter of 2022, year-on-year (y-o-y) GDP growth slowed to 4.5% from 5.3% in the third quarter.

In the final quarter of 2022, real gross value added expanded (y-o-y) in all sectors of economic activity, except construction, where value added contracted for the fourth quarter in a row. In the final quarter of 2022, growth slowed in the industrial, trade, financial and recreation sectors; growth picked up in the sectors of information and communication, real estate activities, public administration, education and health.

Consumption expenditure (in real terms) continued to rise (y-o-y) in the final quarter of 2022, but at a slower pace compared to the third quarter, as a result of a contraction in government consumption, while private consumption growth remained strong. Gross fixed capital formation contracted (y-o-y) in the fourth quarter of 2022, primarily driven by a decline in the category of transport equipment. Net exports contributed negatively to growth in the final quarter of 2022, as imports of goods and services rose (y-o-y) faster than exports.

Many leading indicators (e.g. volume of retail trade, use of credit cards, tourist arrivals, number of property sale contracts, registrations of motor vehicles) suggest that domestic activity remained robust in the first quarter of 2023. Nevertheless, the slowing growth momentum has been reflected in some activity indicators (e.g. registrations of new companies, industrial production, value of real estate transactions) and labour market data (e.g. registered unemployed, job vacancies). In February, the unemployment rate in Cyprus (Eurostat) stood at around 7.0%, about one percentage point higher than the rate in February 2022.

Survey indicators for January – March echoed favourable domestic economic conditions and short-term prospects, and declining uncertainty. The Economic Sentiment Indicator (ESI) rose further in the first quarter of 2023, as a result of confidence gains in services, retail trade, manufacturing, and

among consumers. In March, the ESI for Cyprus remained well above its long-term average and the EU-wide ESI. In March, economic uncertainty in Cyprus, measured through survey data, declined substantially, registering one of its lowest values in the post-pandemic period. During the first quarter, firms' employment expectations improved further, while firms' expectations about short-term price changes moved down; however, selling price expectations in services, construction and retail trade have stayed at very high levels relative to historical data.

The fiscal performance remained strong during the first two months of 2023. Over the period January – February, government revenue increased (y-o-y) much faster than expenditure, resulting in a budget surplus. The ratio of public debt to GDP declined to 87% in December 2022, from just above 100% in December 2021. As a result of monetary policy tightening, the long-term interest rate for Cyprus rose slightly in March, more than doubling in size since March 2022.

Domestic lending interest rates continued to increase in January and February, driven by further increases in the European Central Bank key interest rates. New lending over the period January – February declined (y-o-y), driven by a contraction in new housing loans, despite an expansion in new business loans. The stock of loans has been declining since December 2022, after a two-year period of growth. Over the period January – February, total deposits remained almost flat compared to the corresponding period in 2022. The stock of non-performing loans (NPLs) in the banking sector declined further; the ratio of NPLs to total loans decreased to 9.5% in December 2022 from 10.5% in October 2022.

In the first quarter of 2023, inflation, measured by the Consumer Price Index (CPI) eased to 6.5%, from 8.5% in the final quarter of 2022, mainly because of lower inflation in the categories of food, transport, and housing, water and energy. Despite the recent declines, inflation has remained high, especially in the categories of food and energy, and for services such as home maintenance, restaurants and hotels.

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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 2022 were employed. Monthly indicators that contain information about some or all the months in the first quarter of 2023 were also used. The cut-off date for the data used in the analysis was 21 April 2023.

Table 1 presents the forecasts for the growth rate of real GDP for 2023 and 2024. Despite a weakening in the growth momentum in the final quarter of 2022, Cyprus's economic performance has remained strong, creating favourable conditions for activity in the near term. In 2023, growth is forecast to continue to decelerate, but it is expected to remain robust. The tightening in the financial conditions is expected to limit growth prospects in Cyprus, through lower domestic and external demand. The high inflation experienced during 2022 also weighs on the outlook.

Real GDP growth is projected at 3.0% in 2023 and at 3.1% in 2024. The growth forecasts for 2023 and 2024 have been revised up by 0.4 and 0.3 percentage points, respectively, relative to those in the January issue. The upward revisions are mainly driven by better-than-expected growth in the final quarter of 2022, moderating inflation, improvements in economic confidence, as well as by a favourable stock market performance, despite the recent turmoil in the international banking sector.

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 minor 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	2023		2024	
FORECAST	3.0		3.1	
	WEIGHT	FORECAST BY COMPONENT	WEIGHT	FORECAST BY COMPONENT
COMPONENTS				
I. Real economy	0.42	3.0	0.45	3.2
II. Aspects other than real economy	0.55	3.2	0.62	3.1
III. Real economy & other aspects	99.03	3.0	98.93	3.1
Fiscal	5.74	2.7	5.74	3.1
Prices	12.38	2.1	12.31	2.1
Exchange rates	3.23	2.9	3.32	3.4
Interest rates, spreads	17.15	2.8	18.55	2.6
Stock markets	15.07	3.6	14.54	3.5
Economic sentiment, uncertainty	36.29	3.2	37.14	3.5
Loans, deposits	9.18	3.0	7.34	3.2

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 main factors that shape the outlook for 2023 and 2024 are discussed below.

- *Real economy.* Despite the slowdown in Cyprus and in trading partner economies (e.g. EU, euro area, UK), the conditions in the real economy during the final quarter of 2022 have remained favourable. In the fourth quarter of 2022, growth in Cyprus remained vigorous, and employment continued to rise, while unemployment in trading partner economies remained very low, despite slower growth. Many domestic leading indicators suggest that domestic activity has remained robust during the first quarter of 2023. Monthly data for January and February show that manufacturing production in the EU and the euro area expanded (y-o-y), following a contraction in December. The above positive developments are expected to support growth in the coming quarters. However, challenges to short-term prospects are reflected in movements in some indicators during the first quarter (e.g. new increases in the number of registered unemployed in Cyprus, and further declines in the EU retail trade turnover and in the UK composite leading indicator).
- *Economic confidence.* The improvements registered in survey indicators on economic confidence and employment expectations during the first quarter of the year influence the growth outlook significantly. In the first quarter, the ESI for Cyprus strengthened further, and the ESI for the EU and the euro area picked up, after four quarters of confidence losses. Moreover, improvements in consumer confidence were recorded in Cyprus, the EU and the UK, especially in February and March. Firms' short-term employment expectations in Cyprus, the EU and the euro area strengthened in the first quarter, generating positive effects on the outlook.
- *Financial conditions.* The tightening of monetary policy in the euro area in response to high inflation continued, with further increases in the key ECB interest rates in the first quarter of 2023. Higher sovereign and private sector borrowing costs in the euro area are found to weigh on the outlook. Most notably, the rising lending interest rates for businesses and households in Cyprus are found to have dampening effects on growth, which are estimated to be more prominent after the first half

of 2023 and in 2024. Nevertheless, the favourable conditions in the domestic banking system (e.g. growth in domestic deposits, declining NPLs), and the credit expansion recorded in 2022 are expected to continue to support domestic activity in the following quarters. Moreover, the recent positive performance of domestic and international stock market indices has positive effects on the outlook, despite a spike in volatility in March, as a result of the turmoil in the international financial sector triggered by the collapse of banks abroad.

- *Price pressures.* As of the final quarter of 2022, pressures on international commodity prices, especially oil and food prices, have eased and domestic inflation has moderated. Nevertheless, the strong upward pressures on international commodity prices registered in 2022 and elevated inflation, continue to weigh heavily on the growth outlook, through adverse effects on real incomes. Moreover, past fluctuations in firms' and consumers' price expectations point to increased (survey-based) inflation uncertainty that clouds the outlook. Fiscal support measures to mitigate the effects of high inflation, and moderate increases in nominal wages are expected to support activity.
- *Fiscal performance.* In 2022 and in the first months of 2023, public finances in Cyprus were marked by budget surpluses and declining public debt ratio. The recent strong fiscal performance is expected to continue to back growth prospects, by creating buffers, amid conditions of slowing growth and rising borrowing costs, and by preserving confidence.

The risks to the growth outlook are predominantly to the downside. Downside risks to the outlook for Cyprus could arise from monetary policy tightening, particularly if high inflation in the euro area proves more persistent than expected. Despite the robust capital and liquidity position of the domestic banking sector, the rising borrowing and debt servicing costs for businesses and households could lead to a new wave of NPLs and tighter domestic credit conditions (especially as uncertainties around the implementation of the foreclosure law remain), with adverse effects on activity. A new turmoil in the international financial sector could dent domestic confidence, particularly in conditions of slowing growth, negatively affecting credit supply and the outlook. Higher government borrowing costs may

pose challenges to public finances and confidence, as the economic momentum is slowing.

Furthermore, downside risks to the growth outlook could emerge from the effects of lower-than-expected growth rates in Europe and lower-than-expected external demand (especially for tourist services), as well as from the impact of new sanctions against Russia on certain professional service activities in Cyprus. Finally, new pressures on international commodity prices (e.g. as a result of the war in Ukraine or other geopolitical shocks) could weigh on real incomes and growth prospects.

Upside risks to the outlook could result from the positive effects of investments in Cyprus which have not been reflected in published data, and stronger-than-expected external demand, especially for tourist services.

CPI inflation is forecast to decrease from 8.4% in 2022 to 3.0% in 2023 and to 2.4% in 2024, mainly driven by the easing of international commodity prices and the tightening of financial conditions.³ The 2023 inflation forecast has been revised marginally downwards compared to that in the January issue (3.2%), mainly because of the recent deceleration of inflation on the back of lower international commodity prices. However, the inflation forecast for 2024 is higher than that in the January issue (by 0.4 percentage points), as robust domestic activity as well as past price pressures are expected to add to inflation persistence.

The upward pressures on domestic consumer prices are expected to ease further in the following quarters, mainly as a result of the decline in international commodity prices (especially oil prices) during the first quarter of 2023. Other developments in the first quarter of the year that contribute to the projected moderation of inflation include monetary policy tightening (reflected in rising interest rates and weaker growth momentum), the slower depreciation of the euro against the US dollar, and downward revisions in consumers' and firms' price expectations.

Nevertheless, the lagged effects of past increases in international commodity prices and inflation, the depreciation of the euro against the US dollar, particularly in 2022, and the recent strong economic

performance in Cyprus tend to push inflation projections up.

Upside risks to the inflation outlook include new upward pressures on international commodity prices, as a result of the ongoing war in Ukraine or other geopolitical shocks, and a faster depreciation of the euro against the US dollar. Stronger-than-expected economic activity, universal support measures (against inflation effects) while price pressures are easing, and strong wage growth may also result in higher-than-projected inflation. Downside risks to the inflation outlook may arise from weaker-than-anticipated demand because of tightening financial conditions, faster declines in international commodity prices, and an appreciation of the euro.

3. Concluding remarks

Quarterly and monthly series released up until 21 April 2023 were employed in dynamic econometric models to construct forecasts for GDP growth and CPI inflation.

In the final quarter of 2022, economic activity in Cyprus registered robust growth; however, the economy expanded at a slower pace compared to the first three quarters of 2022. Many leading indicators suggest that domestic activity remained vigorous in the first quarter of 2023, although some leading indicators, particularly for the labour market, point to a further weakening of the growth momentum.

Real GDP growth is forecast to decelerate from 5.6% in 2022 to 3.0% in 2023. Growth in 2024 is projected at 3.1%. The growth forecasts for 2023 and 2024 have been revised up by 0.4 and 0.3 percentage points, respectively, relative to the January issue. The upward revisions are mainly driven by better-than-expected growth in the final quarter of 2022, moderating inflation and improvements in economic confidence, as well as a favourable stock market performance, despite the recent turmoil in the international banking sector.

Forecasts by other organisations also point to a growth slowdown in 2023. Real GDP growth in Cyprus for 2023 is forecast at 1.6% by the European Commission, while the growth projection by the International Monetary Fund is at 2.5%. For 2024,

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

the European Commission and the International Monetary Fund project growth at 2.1% and 2.8%, respectively ([1], [2]).

CPI inflation is forecast to decrease from 8.4% in 2022 to 3.0% in 2023 and to 2.4% in 2024, driven by lower pressures on international commodity prices and tighter financial conditions. The inflation forecast for 2023 has been revised marginally downwards compared to that in the January issue (3.2%), mainly because of the recent decline in inflation on the back of lower international commodity prices. However, the inflation forecast for 2024 is somewhat higher than that in the January issue (2.0%), as past price pressures and robust domestic activity are expected to add to inflation persistence.

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