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Summary

The growth momentum of the Cypriot economy is expected to moderate in 2019 and 2020. Real GDP growth is projected to slow from 3.9% in 2018 to 3.4% in 2019 and to remain at 3.4% in 2020. The outlook is forecast to remain favourable due to domestic and external factors, such as robust activity and employment growth in Cyprus in the previous quarters, higher-than-expected growth in the euro area and the UK in the first quarter of 2019, supportive external financial conditions, low inflation, strong fiscal performance in Cyprus, and further progress in the domestic banking sector. Recent developments in business and consumer survey data reflect lower expectations of activity growth in the euro area and the UK, as well as the absence of broad-based confidence gains in Cyprus, weakening the growth momentum in the following quarters.

Downside risks to the projections may stem from slower progress with private sector deleveraging and slower progress with the reduction of NPLs. The newly proposed changes to the law on foreclosures are expected to cause delays in the foreclosure procedures and limit the effectiveness of the legal tools. Such amendments may intensify downside risks to the outlook by renewing instability in the banking system, undermining Cyprus' credibility, denting investor and depositor confidence, and weakening repayment discipline. The high level of public debt together with the strong link between bank and sovereign risk, poses risks to the outlook, especially if amendments to the law on foreclosures similar to those recently proposed are enacted. Also, upward pressures on public expenditure (e.g. from the public sector wage bill and/or the newly introduced General Health System) may weaken the outlook.

Downside risks could arise from higher uncertainty surrounding the UK's exit from the EU, weaker-than-expected growth in the UK and the euro area, and geopolitical tensions in the Eastern Mediterranean.

Upside risks to the outlook are associated with a higher degree of materialisation of investment plans (e.g. investments relating to tourism, property developments, shipping) than that reflected in the predictors.

Ιούλιος 2019

Περίληψη

Η δυναμική της οικονομικής μεγέθυνσης στην Κύπρο αναμένεται να μετριαστεί το 2019 και 2020. Ο ρυθμός μεγέθυνσης του πραγματικού ΑΕΠ προβλέπεται να επιβραδυνθεί από 3,9% το 2018 σε 3,4% το 2019 και να παραμείνει στο 3,4% το 2020. Οι προοπτικές της οικονομίας προβλέπονται να παραμείνουν ευνοϊκές λόγω εγχώριων και εξωτερικών παραγόντων, όπως οι ικανοποιητικοί ρυθμοί αύξησης της δραστηριότητας και της απασχόλησης στην Κύπρο τα προηγούμενα τρίμηνα, ο ψηλότερος από τον αναμενόμενο ρυθμό μεγέθυνσης στην ευρωζώνη και το Ηνωμένο Βασίλειο το πρώτο τρίμηνο του 2019, οι υποβοηθητικές χρηματοπιστωτικές συνθήκες στο εξωτερικό, ο χαμηλός πληθωρισμός, η ισχυρή δημοσιονομική επίδοση στην Κύπρο και η περαιτέρω πρόοδος στον εγχώριο τραπεζικό τομέα. Η πρόσφατη πορεία των δεικτών από τις έρευνες οικονομικής συγκυρίας (ανάμεσα σε επιχειρήσεις και καταναλωτές), αποτυπώνει χαμηλότερες προσδοκίες για την οικονομική δραστηριότητα στην ευρωζώνη και το Ηνωμένο Βασίλειο καθώς και την απουσία βελτιώσεων ευρείας κλίμακας στην εγχώρια εμπιστοσύνη, αποδυναμώνοντας τη δυναμική ανάπτυξης τα επόμενα τρίμηνα.

Κίνδυνοι για χαμηλότερους από τους προβλεπόμενους ρυθμούς μεγέθυνσης θα μπορούσαν να προκύψουν από βραδύτερη πρόοδο στην απομόχλευση του ιδιωτικού τομέα και στη μείωση των μη εξυπηρετούμενων δανείων. Οι αλλαγές στον νόμο των εκποιήσεων που προτάθηκαν πρόσφατα αναμένεται να προκαλέσουν καθυστερήσεις στις διαδικασίες εκποιήσεων και να περιορίσουν την αποτελεσματικότητα του νομικού πλαισίου. Τέτοιες τροποποιήσεις ενδέχεται να αυξήσουν τους κινδύνους επιδείνωσης των προοπτικών αφού κλονίζουν τη σταθερότητα του τραπεζικού συστήματος και την αξιοπιστία της Κύπρου, αποδυναμώνουν την εμπιστοσύνη επενδυτών και καταθετών, και ενθαρρύνουν στρατηγικούς κακοπληρωτές. Το ψηλό δημόσιο χρέος σε συνάρτηση με την ισχυρότερη διασύνδεση μεταξύ τραπεζικού τομέα και κράτους ενέχει κινδύνους για τις προοπτικές, ειδικότερα αν τροποποιήσεις παρόμοιες με τις προτεινόμενες ενσωματωθούν στη νομοθεσία. Αυξητικές πιέσεις στις δημόσιες δαπάνες (π.χ. από το κρατικό μισθολόγιο ή/και την εφαρμογή του ΓΕΣΥ), επίσης, ενδέχεται να επηρεάσουν αρνητικά τις προοπτικές.

Επιπρόσθετα, κίνδυνοι για τις προοπτικές ενδεχομένως να προκύψουν από μεγαλύτερη αβεβαιότητα σχετικά με την έξοδο του Ηνωμένου Βασιλείου από την ΕΕ, χαμηλότερους από τους αναμενόμενους ρυθμούς μεγέθυνσης στην ευρωζώνη και στο Ηνωμένο Βασίλειο, καθώς και από γεωπολιτικές εντάσεις στην περιοχή της ανατολικής Μεσογείου.

Θετικότερες από τις προβλεπόμενες προοπτικές μπορούν να διαμορφωθούν από μεγαλύτερο βαθμό υλοποίησης επενδύσεων από ό,τι ανατακλάται στους οικονομικούς δείκτες.

UNIVERSITY OF CYPRUS



1. Recent developments

In the first quarter of 2019, growth in Cyprus eased but remained robust. Real GDP increased by 3.4% year-on-year (y-o-y) in the first quarter of 2019 vis-à-vis 3.8% in the final quarter of 2018.

In the first quarter of 2019, the sector of financial and insurance services, continued to contract in terms of its real gross value added (y-o-y), while all other sectors of economic activity registered positive growth rates. The sectors of construction, information and communication as well as arts, entertainment and other services posted the highest growth rates. Nevertheless, real activity in construction increased at a slower pace in the first quarter of 2019 compared to 2018. Growth in the largest sector of economic activity, namely trade, transportation, accommodation and food services, also decelerated in the first quarter of this year.

Consumption growth edged down in the first quarter of 2019 due to a smaller increase in the consumption expenditure of the general government; private consumption continued to increase steadily. Gross fixed capital formation rose strongly (y-o-y) in the first quarter driven by rapid growth in construction investment, particularly in dwellings investment. Imports of goods and services increased (y-o-y), while exports fell (y-o-y) resulting in a negative contribution of net exports to growth in the first quarter.

The performance of different leading indicators of domestic activity in the second quarter of 2019 vis-à-vis the same period in 2018, varied. Available data for some or all of the months of the second quarter show a pickup in the y-o-y growth rates of some indicators (e.g. volume index of retail trade, number of property sale contracts, number of property sale contracts by foreign buyers, number of building permits), while improvements in other indicators slowed (e.g. overall credit card use, credit card use by tourists). Another group of leading indicators continued to decline (y-o-y) in the second quarter, but at slower rates compared to the first quarter of the year (e.g. tourist arrivals, registrations of motor vehicles, registrations of new companies).

The Economic Sentiment Indicator (ESI) in the second quarter of 2019 remained broadly unchanged compared to the first quarter as business confidence in retail trade, construction and industry improved, while confidence in services and among consumers weakened. Firms' employment

expectations also remained at about the same positive level as in the first quarter. The ESI for Cyprus is currently standing above its long-run average and above the euro area ESI.

In the second quarter of the year, the number of registered unemployed decreased at much faster rates vis-à-vis those reported in the first quarter 2019. Over the same period, the unemployment rate (Eurostat) declined to just below 7% and below the euro area average.

In January – May 2019, government revenue increased (y-o-y) much faster than government expenditure, resulting in higher surplus compared to the same period in 2018. Although public debt increased in May, long-term interest rates for Cyprus declined at historically low levels in the second quarter of the year.

In January – May 2019, the volumes of new loans exceeded the amounts granted over the same period in 2018. Over the period January – May 2019, the stock of total loans has been declining at steady rates (annual growth rates). In the first five months of the year, total deposits continued to post positive annual growth rates driven by domestic deposits, but growth decelerated in April – May 2019. Domestic lending interest rates remain at historically low levels. The most recent data show that the stock of non-performing loans (NPLs) decreased in February, to just above 30% of total facilities.

Inflation (measured by the Consumer Price Index – CPI) decelerated further, declining from 1.5% in the first quarter of 2019 to 0.4% in the second quarter of the year. The decrease in inflation was largely driven by lower inflation in the categories of food, and housing, water, electricity and gas, as well as negative inflation in the category of clothing and footwear. Negative inflation in the category of transport persisted in the second quarter, though a milder rate was recorded compared to the first quarter.

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 first quarter of 2019 are employed. Monthly indicators released by 17 July 2019 that contain information about some or all the months in the second quarter of 2019 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 second, third and fourth quarters of 2019 as well as all the quarters of 2020 are given in Table 1; the projections for the whole of 2019 and 2020 are also shown. Based on the historical relationships between growth and numerous macroeconomic and financial indicators, real economic activity in Cyprus is expected to continue to increase at robust rates in both 2019 and 2020.

Real GDP growth is projected to slow from 3.9% in 2018 to 3.4% in 2019 and to remain at 3.4% in 2020.

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 1.3%) to the overall forecasts in all quarters.¹ 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 price indices and stock market returns.^{2, 3}

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 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).

² 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.

³ Economic sentiment indicators refer to data obtained through the Harmonised Programme of Business and Consumer Surveys conducted by the Directorate General for Economic and Financial Affairs. The Economics Research Centre acknowledges funding

Table 1: GDP growth forecasts, forecast errors and contribution of components to forecasts ¹

YEAR		2019			
FORECAST ²		3.4			
Quarter		2	3	4	
FORECAST (y-o-y)		3.4	3.4	3.4	
Forecast error ³		0.7	1.4	2.1	
COMPONENTS ⁴					
I. Real economy		0.02	0.02	0.02	
II. Aspects other than real economy		0.03	0.03	0.02	
III. Real economy & other aspects		3.36	3.38	3.36	
Fiscal		0.19	0.20	0.19	
Prices		0.48	0.52	0.49	
Exchange rates		0.11	0.11	0.10	
Interest rates, spreads		0.87	0.92	0.91	
Stock markets		0.54	0.52	0.55	
Economic sentiment		0.90	0.85	0.87	
Loans, deposits		0.27	0.27	0.25	
YEAR		2020			
FORECAST		3.4			
Quarter		1	2	3	4
FORECAST (y-o-y)		3.5	3.4	3.5	3.4
Forecast error ³		3.0	3.2	3.6	4.0
COMPONENTS ⁴					
I. Real economy		0.02	0.02	0.02	0.02
II. Aspects other than real economy		0.02	0.02	0.02	0.02
III. Real economy & other aspects		3.47	3.37	3.42	3.34
Fiscal		0.18	0.17	0.19	0.17
Prices		0.52	0.51	0.51	0.50
Exchange rates		0.11	0.10	0.11	0.11
Interest rates, spreads		0.94	0.86	0.88	0.84
Stock markets		0.59	0.58	0.53	0.53
Economic sentiment		0.88	0.85	0.84	0.80
Loans, deposits		0.26	0.31	0.37	0.38

¹ 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.

² For the first quarter of 2019 the y-o-y growth rate of GDP obtained from published data is used (Gross Domestic Product, Quarterly, Chain-linked Volume Measures (Seasonally Adjusted), Statistical Service, 07/06/2019).

³ Pseudo out-of-sample root mean squared forecast error of the forecast method.

⁴ Differences between the forecasts and the sum of the components are due to rounding.

The main drivers of the outlook are discussed below.

- *Robust activity and employment growth in Cyprus.* Although real GDP and employment growth rates eased, particularly in the first quarter of 2019, real activity and employment continued to increase robustly. Labour market leading indicators for the second quarter of 2019 point to further

from the European Union, the Ministry of Finance and the University of Cyprus for conducting the “Business and Consumer Surveys” project in Cyprus.

reductions in unemployment. The signals from activity-related leading indicators in the second quarter have been mixed, with some indicators suggesting firming activity growth, while others pointing to weaker growth momentum.

- *Favourable growth outcome in the euro area and the UK.* In the first quarter of 2019, q-o-q GDP growth in the EU and the euro area strengthened, and growth in the UK accelerated compared to the performance in the final quarter of 2018. Although this recent pickup in the growth rates is attributed to temporary factors, it has positive effects on the outlook for the Cypriot economy. Nevertheless, recent survey data show that economic sentiment in the EU and the euro area declined further in the second quarter of 2019, reflecting lower expectations of activity growth in the bloc. In the second quarter, the ESI for the UK fell below its long-run average, reflecting expectations of lower economic activity in the following quarters due to political uncertainty. The weakening of European survey indicators weighs on the outlook for Cyprus as these indicators are currently projecting growth rates of around 3%.
- *Low inflation.* The declines in domestic inflation in the first half of 2019 and the absence of upward pressures in international commodity prices (e.g. oil and food prices) support real activity, influencing the outlook favourably, particularly in 2020.
- *Further progress in the domestic banking sector.* The recent reductions in the stock of NPLs and further improvements in the loan-to-deposit ratio are found to boost growth, especially after the first half of 2019.
- *Supportive external financial conditions.* European interest rates have remained at low levels and interest rates for long-term government bonds in euro area countries have declined in the first half of 2019. Moreover, in the first half of 2019, the performance of international stock markets has been recovering from the negative returns registered in the final quarter of 2018. Both the current levels of European interest rates and the performance of foreign stock markets contribute to favourable external economic conditions facilitating growth.
- *Other domestic factors.* The strong fiscal performance and the low levels of domestic lending interest rates suggest that robust growth will continue in the following quarters. Domestic economic sentiment remained well-above its long-run average in the first half of the year contributing to a robust outlook. However, no significant broad-based confidence gains (i.e. across all sectors, and consumers)

were achieved in the first half of 2019. As a result, domestic survey indicators forecast a slightly more conservative outlook for 2020 than other indicators.

There are downside and upside risks to the outlook that are not fully reflected in the published predictors employed in the computation of the forecasts. Downside risks, however, have become more dominant compared to the previous issue.

Downside risks to the projections may stem from slower progress with private sector deleveraging and slower progress with the reduction of NPLs. The newly proposed changes to the law on foreclosures are expected to cause delays in the foreclosure procedures and limit the effectiveness of the legal tools. Such amendments may intensify downside risks to the outlook by renewing instability in the banking system, undermining Cyprus' credibility, denting investor and depositor confidence, and weakening repayment discipline. The high level of public debt together with the strong link between bank and sovereign risk, poses risks to the outlook, especially if amendments to the law on foreclosures similar to those recently proposed are enacted. Also, upward pressures on public expenditure (e.g. from the public sector wage bill and/or the newly introduced General Health System) may weaken the outlook.

Downside risks could arise from higher uncertainty surrounding the UK's exit from the EU, weaker-than-expected growth in the UK and the euro area, and geopolitical tensions in the Eastern Mediterranean.

Upside risks to the outlook are associated with a higher degree of materialisation of investment plans (e.g. investments relating to tourism, property developments, shipping) than that reflected in the predictors.

In 2019, CPI inflation is projected at 0.7%, as international oil prices remained subdued and inflation decelerated further in the second quarter of 2019.⁴ Inflation for 2020 is projected to rise to 1.8% driven by robust activity growth and rising incomes. Upside risks to the forecasts relate to stronger demand and faster wage growth, faster increases in international commodity prices, and a weakening of the euro vis-à-vis the US dollar. Downside risks to the forecast are associated with weaker demand and downward pressures in international commodity prices.

⁴ CPI inflation forecasts are constructed using a methodology similar to that for GDP growth forecasts.

3. Concluding remarks

Quarterly and monthly series released until 17 July 2019, are employed in dynamic econometric models to construct forecasts for growth and inflation.

The forecast for real GDP growth for 2019 has been revised marginally from 3.5% in the May issue to 3.4%, mainly as a result of deceleration in domestic activity growth in the first quarter of the year. The growth forecast for 2020 has remained unchanged from the previous issue.

The CPI inflation forecast for 2019 has been revised marginally from 0.8% to 0.7%, and the inflation forecast for 2020 has been revised from 2.4% to 1.8%. The downward revisions are mainly driven by further

deceleration in inflation in the second quarter of 2019, and subdued international oil prices.

The forecasts presented in this issue suggest that real activity in Cyprus will continue to increase at robust rates in 2019 and 2020, albeit at a slower pace vis-à-vis 2018. The GDP growth forecast for 2019 presented here is in line with the projection published by the Central Bank (3.5%), but higher than the growth forecast given by the European Commission (2.9%), [1] – [2]. The growth forecast for 2020 is more optimistic than the projections released by the Central Bank (3.1%) and the European Commission (2.6%), [1] – [2].

REFERENCES

1. European Commission, “European Economic Forecast, Summer 2019 (Interim)”, European Economy, Institutional Paper 108, July 2019.
2. Central Bank of Cyprus, “Economic Bulletin – June 2019”, Nicosia – Cyprus (in Greek), June 2019.

APPENDIX

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

YEAR	CONTRIBUTION BY COMPONENT			WEIGHT			FORECAST BY COMPONENT					
	2019			2019			2019					
QUARTER	2	3	4	2	3	4	2	3	4			
COMPONENTS												
I. Real economy	0.02	0.02	0.02	0.56	0.65	0.52	3.4	3.4	3.4			
II. Aspects other than real economy	0.03	0.03	0.02	0.92	0.95	0.73	3.4	3.3	3.1			
III. Real economy & other aspects	3.36	3.38	3.36	98.52	98.40	98.75	3.4	3.4	3.4			
Fiscal	0.19	0.20	0.19	5.68	5.90	5.61	3.4	3.5	3.4			
Prices	0.48	0.52	0.49	14.03	14.76	13.96	3.5	3.5	3.5			
Exchange rates	0.11	0.11	0.10	3.12	3.10	2.98	3.4	3.4	3.4			
Interest rates, spreads	0.87	0.92	0.91	25.46	26.95	27.22	3.4	3.4	3.4			
Stock markets	0.54	0.52	0.55	15.41	14.46	15.11	3.5	3.6	3.6			
Economic sentiment	0.90	0.85	0.87	27.06	25.81	27.25	3.3	3.3	3.2			
Loans, deposits	0.27	0.27	0.25	7.75	7.43	6.61	3.5	3.6	3.8			
FORECAST	3.4	3.4	3.4									
YEAR	CONTRIBUTION BY COMPONENT				WEIGHT				FORECAST BY COMPONENT			
	2020				2020				2020			
QUARTER	1	2	3	4	1	2	3	4	1	2	3	4
COMPONENTS												
I. Real economy	0.02	0.02	0.02	0.02	0.54	0.51	0.48	0.53	3.5	3.4	3.4	3.3
II. Aspects other than real economy	0.02	0.02	0.02	0.02	0.76	0.74	0.69	0.73	3.3	3.3	3.3	3.3
III. Real economy & other aspects	3.47	3.37	3.42	3.34	98.70	98.75	98.83	98.74	3.5	3.4	3.5	3.4
Fiscal	0.18	0.17	0.19	0.17	5.14	5.02	5.46	5.12	3.5	3.4	3.5	3.4
Prices	0.52	0.51	0.51	0.50	14.03	14.38	14.54	14.86	3.7	3.5	3.5	3.4
Exchange rates	0.11	0.10	0.11	0.11	3.03	3.09	3.23	3.30	3.5	3.4	3.4	3.3
Interest rates, spreads	0.94	0.86	0.88	0.84	27.34	26.33	26.77	26.46	3.4	3.3	3.3	3.2
Stock markets	0.59	0.58	0.53	0.53	15.35	15.86	14.67	15.13	3.8	3.6	3.6	3.5
Economic sentiment	0.88	0.85	0.84	0.80	27.60	26.80	26.00	25.34	3.2	3.2	3.2	3.2
Loans, deposits	0.26	0.31	0.37	0.38	6.20	7.27	8.15	8.54	4.2	4.2	4.5	4.4
FORECAST	3.5	3.4	3.5	3.4								



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