

ECONOMIC OUTLOOK

July 2022

Summary

Real GDP is projected to increase by 2.9% in 2022 and by 2.8% in 2023. Compared to the previous issue, the growth forecast for 2022 has been revised up (0.3 percentage points), while the forecast for 2023 has been revised down (0.3 percentage points). The revisions are small, as there are opposing forces at play. On the one hand, the recent strong performance of activity and labour market indicators is expected to support the outlook, particularly in 2022. On the other hand, the recent strong inflationary pressures are projected to have lagged adverse effects on real activity, dampening the outlook for 2023. Moreover, the weakening of economic confidence is found to weigh on the outlook for both 2022 and 2023, while the loss of tourist arrivals, due to Russia's invasion of Ukraine and sanctions against Russia, affects the 2022 growth projection negatively.

The growth outlook is accompanied by both downside and upside risks. The war in Ukraine could lead to lower-than-expected exports of services from Cyprus, as well as to slower-than-anticipated growth in the EU, mainly because of the EU's high dependency on Russian energy. The war could prolong upward pressures on commodity prices and lead to a protracted period of high inflation, with negative effects on purchasing power and real activity. Risks to the outlook could arise if the tightening of financial conditions, in response to high inflation, is faster and/or stronger than expected, adversely affecting sovereign and corporate borrowing costs. Moreover, changes that weaken the foreclosure framework could undermine policy credibility and progress in reducing non-performing loans, with negative effects on growth. Downside risks to the outlook as a result of new COVID-19 waves have remained. Upside risks to the outlook could stem from stronger-than-anticipated external demand, especially demand for tourist services in Cyprus from markets other than Russia. Also, investments and reforms, particularly through the Recovery and Resilience Plan for Cyprus are expected to support growth.

CPI inflation is forecast at 7.5% and 3.3% for 2022 and 2023, respectively. The current inflation outlook is mainly driven by the acceleration of domestic and foreign inflation in the second quarter of 2022, as a result of rapid increases in international energy and food prices in combination with robust economic activity.

Ιούλιος 2022

Περίληψη

Το πραγματικό ΑΕΠ προβλέπεται να αυξηθεί κατά 2,9% το 2022 και κατά 2,8% το 2023. Σε σύγκριση με την προηγούμενη έκδοση, η πρόβλεψη για το 2022 έχει αναθεωρηθεί προς τα πάνω (0,3 ποσοστιαίες μονάδες), ενώ η πρόβλεψη για το 2023 έχει αναθεωρηθεί προς τα κάτω (0,3 ποσοστιαίες μονάδες). Οι αναθεωρήσεις είναι μικρές, καθώς στη διαμόρφωση των προοπτικών επενεργούν αντιτιθέμενοι παράγοντες. Από τη μια πλευρά, οι πρόσφατες ισχυρές επιδόσεις δεικτών οικονομικής δραστηριότητας και οι ευνοϊκές συνθήκες στην αγοράς εργασίας αναμένεται να στηρίξουν τις προοπτικές, ιδιαίτερα το 2022. Από την άλλη πλευρά, οι πρόσφατες ισχυρές πληθωριστικές πιέσεις αναμένεται να έχουν αρνητικές επιπτώσεις στην πραγματική δραστηριότητα με υστέρηση, επηρεάζοντας την πρόβλεψη για το 2023. Επιπλέον, η αποδυνάμωση της οικονομικής εμπιστοσύνης φαίνεται να επιβαρύνει τις προοπτικές για το 2022 και το 2023, ενώ η απώλεια τουριστικών αφίξεων, λόγω της εισβολής της Ρωσίας στην Ουκρανία και των κυρώσεων, επηρεάζει αρνητικά την πρόβλεψη για το 2022.

Η συνέχιση του πολέμου στην Ουκρανία ενδέχεται να οδηγήσει σε δυσμενέστερες προοπτικές από τις προβλεπόμενες μέσω (α) χαμηλότερων εξαγωγών υπηρεσιών από τις αναμενόμενες, και (β) ασθενέστερου ρυθμού μεγέθυνσης στην ΕΕ από τον αναμενόμενο, κυρίως λόγω της υψηλής εξάρτησης της ΕΕ από τη ρωσική ενέργεια. Ο πόλεμος μπορεί να παρατείνει τις ανοδικές πιέσεις στις διεθνείς τιμές εμπορευμάτων (π.χ. ενέργειας, τροφίμων) και να οδηγήσει σε μια παρατεταμένη περίοδο υψηλού πληθωρισμού, με αρνητικές επιπτώσεις στην αγοραστική δύναμη και την πραγματική δραστηριότητα. Κίνδυνοι για τις προοπτικές πιθανόν να προκύψουν και αν η σύσφιξη των χρηματοοικονομικών συνθηκών (για αντιμετώπιση του υψηλού πληθωρισμού), είναι ταχύτερη ή/και ισχυρότερη από την αναμενόμενη, επηρεάζοντας δυσμενώς το κόστος δανεισμού του κράτους, των επιχειρήσεων και των νοικοκυριών. Ως εκ τούτου, αλλαγές που αποδυναμώνουν το πλαίσιο εκποιήσεων θα μπορούσαν να υπονομεύσουν την αξιοπιστία και να δυσχεραίνουν τη μείωση των μη εξυπηρετούμενων δανείων, με αρνητικές επιπτώσεις στην ανάπτυξη. Κίνδυνοι για χειρότερες προοπτικές από τις προβλεπόμενες ως αποτέλεσμα νέων κυμάτων λοιμώξεων COVID-19 συνεχίζουν να υφίστανται. Καλύτερες προοπτικές από τις προβλεπόμενες θα μπορούσαν να προκύψουν λόγω ισχυρότερης εξωτερικής ζήτησης από την αναμενόμενη, ιδίως λόγω αυξημένου τουριστικού κύματος στην Κύπρο από αγορές εκτός της ρωσικής. Επίσης, επενδύσεις και μεταρρυθμίσεις, ιδιαίτερα μέσω του Σχεδίου Ανάκαμψης και Ανθεκτικότητας για την Κύπρο αναμένεται να στηρίξουν την ανάπτυξη.

Ο πληθωρισμός (με βάση τον Δείκτη Τιμών Καταναλωτή) προβλέπεται στο 7,5% και στο 3,3% για το 2022 και το 2023, αντίστοιχα. Οι προβλέψεις για υψηλό πληθωρισμό είναι κυρίως αποτέλεσμα της επιτάχυνσης του πληθωρισμού στην Κύπρο και στο εξωτερικό κατά το δεύτερο τρίμηνο του 2022, λόγω των ραγδαίων αυξήσεων στις διεθνείς τιμές της ενέργειας και των τροφίμων, σε συνδυασμό με την ισχυρή οικονομική δραστηριότητα.

1. Recent developments

In the first quarter of 2022, the Cypriot economy continued to register strong growth, despite a surge in COVID-19 infections, inflationary pressures, and a rise in uncertainty as a result of Russia's invasion of Ukraine and sanctions against Russia. Real GDP increased by 5.6% year-on-year (y-o-y) in the first quarter of the year, compared to 5.9% in the final quarter of 2021.

During the first quarter of 2022, all sectors of economic activity expanded (y-o-y) in terms of real gross value added, with the exception of the construction sector that contracted (y-o-y) for the third consecutive quarter. Trade, transportation, accommodation and food service activities, as well as entertainment, recreation and other services posted the highest growth rates in the first quarter; however, output in these sectors has remained below the pre-pandemic levels.

In the first quarter of 2022, consumption expenditure (in real terms) decreased (y-o-y) because of a decline in household consumption, despite a small increase in government consumption. Gross capital formation rose (y-o-y) vigorously, mainly driven by inventory accumulation. Moreover, construction investment other than dwellings, as well as investment in machinery and equipment, except transport equipment, contributed to growth in the first quarter. Both exports and imports increased strongly in the first quarter, resulting in a negative contribution to growth from net exports.

Russia's invasion of Ukraine and sanctions imposed on Russia are expected to negatively impact the Cypriot economy through higher inflation and lower service exports. Monthly survey data published after February have pointed to challenges for domestic activity in the near future. Since March, firms' expectations about activity have weakened and consumers' expectations about their financial situation have worsened. Following a steep decline in March, the Economic Sentiment Indicator (ESI) has fluctuated just below its long-run average. Between the first and second quarters of the year, the largest confidence losses were registered in services. Compared to the lows reached in March, confidence in June improved in services and construction, whereas confidence deteriorated

further in retail trade, industry and among consumers. Nevertheless, during the second quarter there was an uptick in firms' employment expectations and a decline in economic uncertainty; moreover, price expectations showed signs of stabilisation, albeit at high levels.

Monthly hard data, available for April – May 2022 and in some cases for June 2022, gave mixed signals about developments in domestic activity. Leading indicators that signalled improvements in real activity during the second quarter relate to the use of local and foreign credit cards in Cyprus, tourist arrivals, the number of property sale contracts (including contracts for foreign buyers) and motor vehicle registrations. On the other hand, monthly data on industrial production, building permits, dishonoured cheques and registrations of new companies paint a less bright picture.

The number of registered unemployed continued to decline at a fast pace in the second quarter of the year. In May 2022, the unemployment rate in Cyprus (Eurostat) fell to 4.8% and below the euro area average.

Over the period January – May 2022, government revenue registered a strong increase (y-o-y), while expenditure decreased (y-o-y), resulting in a budget surplus compared to a deficit over the same period in 2021. Public debt declined to EUR 24.2 billion in May. The long-term interest rate for Cyprus continued to rise in April and May, reaching levels observed in 2018.

In April and May, the stock of domestic loans continued to grow at robust rates, while the annual growth rate of deposits decelerated. Over the period January – May, new lending registered double-digit growth (y-o-y), driven by strong increases in loans for house purchase and business loans, despite a contraction in the former category during April – May. Despite marginal increases in May, domestic lending interest rates have remained at low levels. Progress in reducing non-performing loans (NPLs) stalled as the ratio of NPLs to total loans stood at 11.4% in March 2022 compared to 11.1% in December 2021.

During the second quarter of 2022, inflation (measured by the Consumer Price Index - CPI) accelerated significantly, reaching levels that had last been observed in the early 1980s. Inflation increased

from 6.4% in the first quarter the year to 9.2% in the second quarter. The acceleration of inflation in the second quarter mainly resulted from large price increases in the categories of electricity, petroleum products, home repair services and 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 first quarter of 2022 are employed. Monthly indicators that contain information about some or all the months in the second quarter of 2022 are also used. The cut-off date for the data used in the analysis is 8 July 2022.

The forecasts presented in this bulletin are based on published data up to the cut-off date. In addition to the observed effects of recent developments in leading indicators, the 2022 growth projection also incorporates the impact of reduced external demand for tourist services on economic activity, as a result of the war in Ukraine and sanctions against Russia. This effect has been incorporated in the forecast because of insufficient information in published leading indicators, and the importance of tourism services for the economy, particularly the significance of the Russian market.¹ Other direct and indirect effects of the war and sanctions on domestic activity (through e.g. external demand for professional services, inflation, economic confidence) have been captured by movements in leading indicators used for forecasting.

Table 1 presents the forecasts for the growth rate of real GDP for 2022 and 2023. Following the strong growth rate registered in the first quarter of 2022, output growth in Cyprus is expected to slow for the rest of the year. In 2022, real GDP is projected to increase by 2.9%. In 2023, real GDP is forecast to expand by 2.8%.

¹ The influx of visitors from Russia and Ukraine accounted for 23% of tourist arrivals in Cyprus over 2015 – 2019 and exceeded 30% in 2021. The growth projection for 2022 incorporates the impact of the expected loss of tourist arrivals from Russia and

Table 1: GDP growth forecasts and components

Year	2022		
FORECAST	2.9		
	CONTRIBUTION	WEIGHT	FORECAST BY COMPONENT
COMPONENTS			
I. Real economy	0.01	0.36	3.4
II. Aspects other than real economy	0.00	0.23	1.9
III. Real economy & other aspects	2.84	99.41	2.9
Fiscal	0.16	5.50	2.8
Prices	0.49	12.37	4.0
Exchange rates	0.11	3.32	3.2
Interest rates, spreads	0.59	17.10	3.5
Stock markets	0.43	15.18	2.8
Economic sentiment, uncertainty	0.78	37.29	2.1
Loans, deposits	0.28	8.66	3.3
Year	2023		
FORECAST	2.8		
	CONTRIBUTION	WEIGHT	FORECAST BY COMPONENT
COMPONENTS			
I. Real economy	0.02	0.45	3.4
II. Aspects other than real economy	0.01	0.58	2.6
III. Real economy & other aspects	2.81	98.97	2.8
Fiscal	0.18	5.82	3.1
Prices	0.20	11.13	1.8
Exchange rates	0.13	3.47	3.8
Interest rates, spreads	0.63	19.34	3.2
Stock markets	0.45	14.38	3.1
Economic sentiment, uncertainty	0.96	37.05	2.6
Loans, deposits	0.26	7.79	3.4

Compared to the forecasts in the May issue, the growth forecast for 2022 has been revised up by 0.3 percentage points, while the forecast for 2023 has been revised down by 0.3 percentage points. The

Ukraine for the period June – December 2022, taking into account that the loss could be partly offset by increased numbers of visitors from other countries, as indicated by recent data.

revisions to the growth forecasts are small, as there are opposing forces at play. On the one hand, the recent strong performance of activity and labour market indicators is expected to support the outlook, particularly in 2022. On the other hand, the recent strong inflationary pressures are projected to have lagged adverse effects on real activity, dampening the outlook for 2023. Moreover, the weakening of economic confidence is found to weigh on the outlook for both 2022 and 2023, while the loss of tourist arrivals due to the war in Ukraine affects the 2022 growth projection negatively.

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.² The component that combines information on both the real economy and other economic aspects plays a key role in forming the final forecasts.^{3, 4}

The main features of the growth outlook are discussed below.

- *Recent strong economic performance and signs of slowdown.* In both Cyprus and its trading partner economies (e.g. EU, euro area, UK), real GDP registered strong growth and unemployment declined further in the first quarter of 2022. The positive developments in the first quarter are found to fuel growth considerably in both 2022 and 2023. The signals from domestic hard indicators in the second quarter were mixed. Some indicators continued to register positive developments, backing activity, while others revealed challenges for growth. The loss of tourist arrivals from Russia and Ukraine, especially during the peak season, is expected to directly limit growth prospects for Cyprus. The weakening growth momentum in

trading partner economies weighs on the outlook; hard data on manufacturing production and retail turnover in the EU and the euro area, as well as a composite leading indicator for the UK pointed to weakening activity in April – May 2022.

- *Tightening but still favourable financial conditions.* In the second quarter of 2022, the performance of international stock markets deteriorated and volatility remained elevated, reflecting tightening external financial conditions and slowing global growth. However, the adverse impact of the recent stock market developments on domestic outlook is moderated by the strong performance of the domestic economy, especially in the first quarter. Despite further increases in long-term interest rates for euro area countries in May, financial conditions in the euro area have remained supportive. The current low levels of lending interest rates in the euro area, and the strong pickup in new loans in Cyprus are projected to facilitate growth in 2022 and 2023. However, the expected change in the monetary stance in the euro area, as the pandemic and the war in Ukraine continue, may weigh on domestic growth prospects through high public debt and deteriorating asset quality in the banking system.
- *Weaker economic sentiment.* Economic sentiment in Cyprus, the EU and the euro area continued to worsen during the second quarter of the year, after the sharp drop in March, as a result of Russia's invasion of Ukraine. The war has intensified inflationary pressures and led to higher uncertainty and lower confidence, especially among consumers. The recent deterioration in domestic and European confidence indicators is found to negatively affect growth prospects, particularly in 2022; survey data suggest a weaker outlook than that projected by other indicators.

² 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, as well as fiscal and banking sector series.

³ Monthly leads of leading indicators (e.g. interest rates, economic sentiment) and 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.

⁴ 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.

• *Higher inflation.* The strong recovery of activity from the pandemic-induced downturn and supply chain bottlenecks put upward pressures on inflation in the second half of 2021. Russia's invasion of Ukraine and the sanctions that followed pushed international commodity prices up, particularly energy and food prices. Thus, inflationary pressures strengthened markedly in the first half of 2022, impacting firms' and consumers' price expectations. The loss of real incomes as a result of high inflation, has been mitigated by strong growth in previous quarters and the recent introduction of fiscal measures. Both universal measures to alleviate households' rising energy costs and targeted aid to limit the effects of inflation on vulnerable groups have been introduced. Savings built up over 2020 – 2021 and pandemic-related policy support have also propped up disposable incomes. Nevertheless, a prolonged period of high inflation that dents real incomes is expected to significantly limit growth prospects, especially in 2023.

The growth outlook is accompanied by both downside and upside risks. The war in Ukraine and sanctions against Russia could lead to lower-than-expected exports of services from Cyprus, as well as to slower-than-anticipated growth in the EU, mainly because of the EU's high dependency on Russian natural gas. The continuation of the war could prolong upward pressures on commodity prices, especially energy and food prices and lead to a protracted period of high inflation, with negative effects on purchasing power and real activity.

Risks to the outlook could arise if the tightening of financial conditions, in response to high inflation, is faster and/or stronger than expected; higher sovereign borrowing costs in view of elevated public debt, and higher debt servicing costs for firms and households could weigh on growth. Furthermore, changes that weaken the foreclosure framework could undermine policy credibility and progress in reducing NPLs, with negative effects on growth.

Downside risks to the outlook as a result of new COVID-19 waves have remained. New infection waves may limit economic activity through new

containment measures and renewed supply chain disruptions.

Upside risks to the outlook could stem from stronger-than-anticipated external demand, especially demand for tourist services in Cyprus from markets other than Russia. Also, investments and reforms, particularly through the Recovery and Resilience Plan for Cyprus are expected to support growth.

CPI inflation is projected to reach 7.5% in 2022 and to ease to 3.3% in 2023.⁵ The inflation forecasts have been revised upwards compared to the forecasts (4.8% for 2022 and 2.2% for 2023) in the May issue. Russia's invasion of Ukraine and sanctions against Russia led to rapid increases in international commodity prices, especially energy and food prices, during the second quarter of 2022. The recent sharp increases in energy and food prices have intensified the inflationary pressures of the previous quarters, caused by the strong recovery from the pandemic downturn and pandemic-related supply bottlenecks. The inflation outlook is driven by the acceleration of domestic and foreign inflation in the second quarter of 2022, as a result of strong increases in international energy and food prices in combination with robust economic activity. Other developments in the first half of 2022 that contributed to the high inflation forecasts include the depreciation of the euro, as well as upward revisions in firms' selling price expectations and consumers' expectations about price trends.

There are upside and downside risks to the inflation outlook. Additional increases in international commodity prices, particularly in oil and food prices, as a result of the war in Ukraine and sanctions on Russia, could prolong inflationary pressures and drive up inflation expectations further. Other upside risks to the inflation outlook include faster-than-expected wage increases, additional universal (non-targeted) measures to cushion the effects of high inflation, further weakening of the euro, and renewed supply bottlenecks. Downside risks to the inflation outlook may arise if domestic and/or global demand turn out to be weaker than anticipated, and if the tightening of financial conditions occurs faster or more forcefully than expected.

⁵ CPI inflation forecasts are constructed using a methodology similar to that described for GDP growth forecasts.

3. Concluding remarks

Quarterly and monthly series released up until 8 July 2022 are employed in dynamic econometric models to construct forecasts for GDP growth and CPI inflation.

In the first quarter of 2022, economic activity expanded strongly, while unemployment declined further; some leading indicators continued to record improvements in activity and the labour market during the second quarter. The recent strong economic performance is expected to support growth in 2022 and 2023. However, the loss of tourist arrivals, as a result of the war in Ukraine and sanctions against Russia, adversely affects the growth projection for 2022. Also, the war and sanctions triggered rapid increases in international commodity prices (e.g. energy, food) in the first half of the year, that added to pre-existing inflationary pressures. The recent acceleration of inflation, which puts downward pressure on real incomes, is found to dampen growth in 2023. Economic confidence in Cyprus and the EU continued to deteriorate in the second quarter, following the sharp drop in March as a result of Russia's invasion of Ukraine. The recent sizable confidence losses weigh heavily on growth prospects. As a result of the above recent developments real GDP growth in 2022 is projected at 2.9%, up by 0.3 percentage points compared to the forecast in the May issue. Real GDP growth in 2023 is forecast at 2.8%, a downward revision by 0.3 percentage points relative to the previous issue.

The growth forecast for 2022 presented in this bulletin is close to the forecasts released by the European Central Bank (2.7%) and the European Commission (3.2%). The range of forecasts for 2023 is wider, with the forecast by the European Central Bank (3.6%) being more optimistic and that by the European Commission (2.1%) being lower than the growth forecast given in this bulletin [1], [2].

CPI inflation is forecast at 7.5% and 3.3% for 2022 and 2023, respectively. The inflation forecasts have been revised upwards significantly relative to the forecasts in the May issue (4.8% for 2022 and 2.2% for 2023). The current inflation outlook is driven by the acceleration of domestic and foreign inflation in the second quarter of 2022, as a result of rapid increases in international energy and food prices in combination with robust economic activity. The depreciation of the euro and upward revisions in price expectations expressed by firms and consumers in the first half of 2022 also contributed to the high inflation forecasts.

REFERENCES

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2. European Commission (2022), European Economic Forecast, Summer 2022, Institutional Paper 183, July 2022.

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