

October 2018

Summary

The Cypriot economy is forecasted to continue to grow at robust rates in 2018 and 2019. In 2018, real GDP is projected to increase by 3.9%. In 2019, growth is forecasted to edge down as real GDP is projected to grow by 3.5%. The main drivers of the outlook in 2018 and 2019 include the vigorous growth in domestic activity, the ongoing improvements in the domestic labour market, the strong fiscal performance in Cyprus and the supportive domestic financial conditions (e.g. low lending interest rates, deleveraging, expansion of domestic deposits and credit). The moderation in the growth rate projected for 2019 is driven by the recent declines in economic sentiment in Cyprus, the pickup of energy inflation, the recent slowdown in the EU and the euro area, and European interest rates and spreads which reflect EU and euro area uncertainties.

Downside risks to the outlook are given below.

- The high levels of private debt and non-performing loans (NPLs), despite recent progress, pose risks to the soundness of the banking system, economic confidence and growth prospects.
- The high level of public debt together with the stronger connection between bank and sovereign risk, after the resolution of the Cyprus Cooperative Bank, renders Cyprus vulnerable to shocks. Moreover, a failure to maintain fiscal discipline could add to the economy's vulnerabilities.
- Delays in the implementation of structural reforms (e.g. judicial system, public administration), given the high level of public debt and problematic loans, may dent economic confidence, the sustainability of public finances and growth.
- Other downside risks to the outlook include: higher uncertainty in the euro area due to Italy's deviation from EU budget rules, with possible negative effects on the borrowing costs of other vulnerable euro area countries; slower-than-expected growth in the euro area; higher uncertainty and weaker-than-expected growth in the UK due to a failure of Brexit negotiations; competitiveness pressures on the Cypriot tourist product from other destinations.

Upside risks to the outlook are associated with faster-than-forecasted growth in Russia as well as with the implementation of private investment projects (e.g. investments relating to tourism, property developments, energy) and public investments.

Οκτώβριος 2018

Περίληψη

Η Κυπριακή οικονομία εκτιμάται ότι θα συνεχίσει να καταγράφει ισχυρούς ρυθμούς ανάπτυξης κατά το 2018 και 2019. Το 2018, το πραγματικό ΑΕΠ προβλέπεται να αυξηθεί κατά 3,9%. Το 2019, ο ρυθμός ανάπτυξης αναμένεται να μετριαστεί, καθώς το πραγματικό ΑΕΠ προβλέπεται να αυξηθεί κατά 3,5%. Ανάμεσα στους κυριότερους παράγοντες που συμβάλλουν στη διαμόρφωση των προοπτικών για το 2018 και 2019 περιλαμβάνονται: η αύξηση της εγχώριας οικονομικής δραστηριότητας, η συνεχής βελτίωση των συνθηκών στην εγχώρια αγορά εργασίας, η ισχυρή δημοσιονομική επίδοση της χώρας και οι υποβοηθητικές χρηματοοικονομικές συνθήκες στην Κύπρο (π.χ. χαμηλά επιτόκια δανεισμού, απομόχλευση, αύξηση εγχώριων καταθέσεων και νέου δανεισμού). Η πρόβλεψη λιγότερο ισχυρού ρυθμού ανάπτυξης για το 2019 συγκριτικά με το 2018 συνδέεται με την πρόσφατη υποχώρηση του οικονομικού κλίματος στην Κύπρο, την επιτάχυνση του πληθωρισμού ενεργειακών αγαθών, την πρόσφατη επιβράδυνση της ανάπτυξης στην ΕΕ και στην ευρωζώνη καθώς και τα ευρωπαϊκά επιτόκια και αποδόσεις ομολόγων που αντανακλούν αβεβαιότητες στην ΕΕ και στην ευρωζώνη.

Κίνδυνοι για χαμηλότερους από τους προβλεπόμενους ρυθμούς ανάπτυξης περιλαμβάνουν: τα ψηλά επίπεδα ιδιωτικού χρέους και μη εξυπηρετούμενων δανείων· το ψηλό δημόσιο χρέος, μαζί με την ισχυρότερη πλέον διασύνδεση μεταξύ τραπεζικού τομέα και κράτους, μετά την πύλωση της Κυπριακής Συνεργατικής Τράπεζας· τυχόν αποκλίσεις από τη δημοσιονομική πειθαρχία· καθυστερήσεις στην εφαρμογή διαρθρωτικών μεταρρυθμίσεων (π.χ. δικαστικό σύστημα, δημόσια διοίκηση), δεδομένου του ψηλού δημόσιου χρέους και μη εξυπηρετούμενων δανείων. Άλλοι κίνδυνοι για τις προοπτικές περιλαμβάνουν: (α) μεγαλύτερη αβεβαιότητα στην ευρωζώνη λόγω απόκλισης της Ιταλίας από τους δημοσιονομικούς κανόνες της ΕΕ, με πιθανές αρνητικές συνέπειες στο κόστος δανεισμού και άλλων ευάλωτων οικονομιών της ευρωζώνης· (β) βραδύτερη από την αναμενόμενη ανάπτυξη στην ευρωζώνη· (γ) μεγαλύτερη αβεβαιότητα και ασθενέστερη από την αναμενόμενη ανάπτυξη στο Ηνωμένο Βασίλειο λόγω πιθανής αποτυχίας των διαπραγματεύσεων για έξοδο της χώρας από την ΕΕ· (δ) πιέσεις στην ανταγωνιστικότητα του Κυπριακού τουριστικού προϊόντος από άλλους προορισμούς.

Θετικότερες από τις προβλεπόμενες προοπτικές μπορούν να διαμορφωθούν λόγω μεγαλύτερων από τους αναμενόμενους ρυθμούς ανάπτυξης στη Ρωσία καθώς και από την υλοποίηση δημόσιων και ιδιωτικών επενδυτικών έργων.



1. Recent developments

In the second quarter of 2018, the Cypriot economy continued to register robust growth as real GDP increased by 3.9% year-on-year (y-o-y), just below the rate recorded in the first quarter. All sectors of economic activity, except information-communication services and financial activities, continued to expand in terms of their real gross value added. In the sector of information-communication services, real activity remained almost unchanged (y-o-y). The financial sector has shrunk (y-o-y) for an eighth consecutive quarter, although the decline in the gross value added in the first half of 2018 has decelerated. In the first half of the year, construction, arts and entertainment as well as professional services were the fastest-growing sectors, in terms of real gross value added (y-o-y).

In the second quarter of 2018, consumption growth (y-o-y) accelerated driven by a strong increase in household consumption, while government consumption declined. Gross fixed capital formation expanded strongly (y-o-y) in the second quarter, mainly due to a large increase in transport equipment investment. Investment in dwellings and other buildings continued to grow strongly in the second quarter of 2018. Net exports turned negative in the second quarter of 2018 as exports increased weakly while imports rose vigorously.

In the third quarter of 2018, many leading indicators of domestic activity (e.g. credit card use by locals and tourists, registrations of motor vehicles, property sale contracts, building permits) continued to register growth rates similar to or stronger than those recorded in the second quarter. Other leading indicators, such as tourist arrivals and registrations of new companies, performed less strongly in the third quarter of 2018 vis-à-vis the second quarter. The Economic Sentiment Indicator (ESI) eased further in the third quarter as consumer confidence weakened and business confidence declined in all sectors except in construction. Nevertheless, the ESI for Cyprus is currently above its long-run average and at about the same level as the euro area ESI. In the third quarter, firms' employment expectations reached their highest point in the post-crisis period.

The number of registered unemployed declined rapidly at rates of above 20% in both the second and third quarters of 2018. The unemployment rate (Eurostat) has been declining throughout January – August 2018; in July – August 2018, unemployment in Cyprus dropped below the euro area average of 8%.

The fiscal position has strengthened significantly over January – August 2018, mainly due to rapid growth in government revenue vis-à-vis moderate increases in expenditure. The overall and primary fiscal surpluses over January – August 2018 exceeded significantly the performance over the corresponding period in 2017. Support to the banking sector resulted in two sizeable increases in public debt in April and July 2018. Nevertheless, the interest rates for long-term government bonds declined in July – August 2018.

Deposits increased in July – August 2018 at about the same rate as in the second quarter, driven by robust growth in domestic deposits. The decline in the total stock of loans decelerated in July – August 2018 as the growth rate of loans to non-financial corporations picked up, while the decrease in housing loans slowed down significantly. Interest rates declined to new lows in July – August 2018. The stock of non-performing loans (NPLs) dropped markedly in June 2018, mainly as a result of a sizeable reduction in the NPLs of non-financial corporations. In June 2018, the ratio of NPLs to total loans was at 40% and 39% for the total and non-financial corporations, respectively. The NPLs of households have declined at a slower pace over January – June 2018 and their ratio to total household loans has remained above 50%.

Inflation (measured by the Consumer Price Index – CPI) accelerated to 2.7% in the third quarter of 2018 compared with 1.1% in the second quarter. The higher inflation rate in the third quarter resulted mainly from more rapid price increases in the categories of food, transport and housing-water-electricity-gas.

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 2018 are employed. Monthly indicators released by 17 October 2018 that contain information covering some or all the months in the third quarter of 2018 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 third and fourth quarters of 2018 and all the quarters of

2019 are shown in Table 1; the projections for the whole of 2018 and 2019 are also provided.

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

YEAR	2018			
FORECAST ²	3.9			
Quarter	3	4		
FORECAST (y-o-y)	3.7	3.7		
Forecast error ³	0.7	1.3		
COMPONENTS ⁴				
I. Real economy	0.02	0.02		
II. Aspects other than real economy	0.03	0.03		
III. Real economy & other aspects	3.67	3.64		
Fiscal	0.21	0.22		
Prices	0.50	0.51		
Exchange rates	0.11	0.11		
Interest rates, spreads	0.97	1.02		
Stock markets	0.53	0.51		
Economic sentiment	1.05	0.98		
Loans, deposits	0.30	0.28		
YEAR	2019			
FORECAST	3.5			
Quarter	1	2	3	4
FORECAST (y-o-y)	3.5	3.6	3.4	3.3
Forecast error ³	2.1	3.1	3.3	3.7
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	3.44	3.60	3.37	3.25
Fiscal	0.20	0.20	0.17	0.19
Prices	0.47	0.50	0.47	0.44
Exchange rates	0.10	0.11	0.11	0.11
Interest rates, spreads	0.98	0.98	0.90	0.87
Stock markets	0.51	0.56	0.53	0.51
Economic sentiment	0.94	0.98	0.87	0.81
Loans, deposits	0.23	0.27	0.32	0.33

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 and second quarters of 2018 the y-o-y growth rates of GDP obtained from published data are used (Quarterly National Accounts, Seasonally Adjusted Data, Statistical Service, 10/09/2018).

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.

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 is forecasted to increase by 3.9% in 2018 and 3.5% in 2019.

- Real GDP is estimated to have increased by 3.7% (y-o-y) in the third quarter of 2018; GDP growth is forecasted to remain at 3.7% in the final quarter of the year. The

corresponding quarter-on-quarter (q-o-q) projections are 0.9% for both the third and fourth quarters of 2018.

- Growth is projected to moderate in 2019 but, nonetheless, to remain robust. In the first half of 2019, real GDP growth is forecasted at about 3.6% (y-o-y), and in the second half of the year growth is projected to moderate to 3.4%. On a q-o-q basis, real activity is forecasted to expand by 0.9% in the first half and 0.7% in the second half of 2019.

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 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, the Ministry of Finance and the University of Cyprus for conducting the Business and Consumer Survey Project in Cyprus.

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

- *Strong economic performance in Cyprus.* In the second quarter of 2018, real GDP growth remained robust, despite a slight moderation compared to the first quarter; employment growth accelerated across sectors. In general, leading indicators point to further improvements in domestic activity and labour market conditions during the third quarter of the year.
- *Strong fiscal performance.* Despite the recent increases in public debt, revenue growth has remained vigorous while expenditure growth has been modest, generating surpluses and contributing towards a sustainable growth path.
- *Supportive domestic financial conditions.* The outlook is benefitting from the low levels of lending interest rates, deleveraging, the recent upswing of the Cyprus stock market and the expansion of domestic deposits and credit.
- *Supportive external environment.* All quarterly and monthly indicators on external economic conditions point towards robust growth rates in the following quarters, but provide mixed signals regarding the growth momentum in Cyprus, particularly in 2019. Although international stock market returns and European confidence indicators weakened in the second and third quarters, they still reflect a favourable external environment with positive effects on domestic outlook. In the second quarter, growth in the EU and the euro area eased further, UK growth remained modest at about 1% as in the previous two quarters, while growth in Russia accelerated. European interest rates remain at historically low levels and sovereign spreads of euro area countries, except Italy, remain compressed. Both foreign real economy factors and European interest rates suggest a less strong growth momentum for 2019 relative to other foreign indicators.

Other recent developments in indicators that limit the growth momentum for 2019, include the following:

- the declines in domestic economic confidence indicators in the second and third quarters from their peaks reached in previous quarters, moderate the projected growth rates;

- the faster increases in international oil prices in the second and third quarters of 2018 led to higher inflation rates with some dampening effects on the forecasts.

There are downside and upside risks to the outlook associated with both domestic factors and the external environment; the risks are not fully reflected in the published predictors employed in the computation of the forecasts.

- The high levels of private debt and NPLs, despite recent progress, pose risks to the soundness of the banking system, economic confidence and growth prospects.
- The high level of public debt together with the stronger connection between bank and sovereign risk, after the resolution of the Cyprus Cooperative Bank, renders Cyprus vulnerable to shocks. Moreover, a failure to maintain fiscal discipline could add to the economy's vulnerabilities.
- Delays in the implementation of structural reforms (e.g. judicial system, public administration), given the high level of public debt and NPLs, may dent economic confidence, the sustainability of public finances and growth.
- Other downside risks to the outlook include:
 - higher uncertainty in the euro area due to Italy's deviation from EU budget rules, with possible negative effects on the borrowing costs of other vulnerable euro area countries;
 - slower-than-expected growth in the euro area;
 - higher uncertainty and weaker-than-expected growth in the UK due to a failure of Brexit negotiations;
 - competitiveness pressures on the Cypriot tourist product from other destinations.

Upside risks to the outlook are associated with faster-than-forecasted growth in Russia as well as with the implementation of private investment projects (e.g. investments relating to tourism, property developments, energy) and public investments not yet captured by leading indicators.

In 2018 and 2019, CPI inflation is forecasted at 1.7% and 2.6%, respectively, as international oil prices continue to increase and demand strengthens.⁴ Upside risks to the forecasts relate to faster wage growth and stronger demand, more rapid increases in international commodity prices and

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

a weakening of the euro vis-à-vis the US dollar. Downside risks to the projections are associated with weaker demand.

3. Concluding remarks

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

The forecast for real GDP growth in 2018 has remained unchanged, at 3.9%, relative to that in the July issue. The growth forecast for 2019 has been revised from 3.3% in the July issue to 3.5%, mainly as a result of the strong performance of domestic activity and labour market indicators in the second and third quarters of 2018.

The CPI inflation forecasts for 2018 and 2019 have been revised from 1.3% and 1.4% in the previous issue to 1.7% and 2.6%, respectively. The large upward revisions were

driven by faster increases in international oil prices in the second and third quarters, and a pickup in domestic inflation in the third quarter.

The forecasts presented in this issue suggest that real activity will continue to increase at strong rates in 2018, while growth is projected to edge down in 2019. The growth forecast for 2018 presented here is in line with the projections of 4% released by the IMF and the Ministry of Finance [1], [2]. For 2019, the growth forecast in this bulletin is more conservative than the projected rates of 4.2% and 3.8% given by the IMF and the Ministry of Finance, respectively [1], [2].

REFERENCES

1. International Monetary Fund (IMF), "World Economic Outlook: Challenges to Steady Growth", Washington, DC, October 2018.
2. Ministry of Finance, "Cyprus Draft Budgetary Plan 2019", October 2018.

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	3	4		3	4		3	4				
COMPONENTS												
I. Real economy	0.02	0.02		0.58	0.66		3.7	3.7				
II. Aspects other than real economy	0.03	0.03		0.86	0.85		3.7	3.6				
III. Real economy & other aspects	3.67	3.64		98.56	98.50		3.7	3.7				
Fiscal	0.21	0.22		5.70	6.00		3.7	3.7				
Prices	0.50	0.51		13.34	13.83		3.8	3.7				
Exchange rates	0.11	0.11		3.03	3.11		3.7	3.6				
Interest rates, spreads	0.97	1.02		25.89	27.70		3.7	3.7				
Stock markets	0.53	0.51		14.25	13.58		3.7	3.8				
Economic sentiment	1.05	0.98		28.57	26.90		3.7	3.6				
Loans, deposits	0.30	0.28		7.78	7.38		3.8	3.8				
FORECAST	3.7	3.7										
CONTRIBUTION BY COMPONENT				WEIGHT				FORECAST BY COMPONENT				
YEAR	2019				2019				2019			
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	0.49	0.51	0.50	0.48	3.4	3.5	3.4	3.3
II. Aspects other than real economy	0.02	0.02	0.02	0.02	0.67	0.72	0.71	0.71	3.4	3.5	3.4	3.4
III. Real economy & other aspects	3.44	3.60	3.37	3.25	98.84	98.77	98.79	98.81	3.5	3.6	3.4	3.3
Fiscal	0.20	0.20	0.17	0.19	5.94	5.53	5.21	5.76	3.4	3.5	3.3	3.2
Prices	0.47	0.50	0.47	0.44	13.45	13.75	14.12	13.65	3.5	3.6	3.3	3.2
Exchange rates	0.10	0.11	0.11	0.11	3.03	3.08	3.16	3.26	3.4	3.6	3.5	3.4
Interest rates, spreads	0.98	0.98	0.90	0.87	28.22	27.95	27.76	28.92	3.5	3.5	3.3	3.0
Stock markets	0.51	0.56	0.53	0.51	14.15	14.40	14.71	14.51	3.6	3.9	3.6	3.5
Economic sentiment	0.94	0.98	0.87	0.81	27.95	27.96	26.42	25.20	3.4	3.5	3.3	3.2
Loans, deposits	0.23	0.27	0.32	0.33	6.10	6.11	7.41	7.50	3.8	4.4	4.3	4.4
FORECAST	3.5	3.6	3.4	3.3								



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