



# ECONOMIC OUTLOOK

## ECONOMICS RESEARCH CENTRE

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### Summary

*Real GDP growth is projected at 5.4% in 2021 and 4.1% in 2022. The growth forecasts for 2021 and 2022 have been revised upwards relative to the forecasts in the previous issue. The upward revisions were mainly driven by the strengthening recovery during the second quarter of 2021, further improvements in leading indicators in the third quarter, as well as by upward revisions in National Accounts data.*

*Downside risks to the outlook could stem from new waves of COVID-19 infections because of new virus variants and relatively lower vaccination coverage among younger age groups. Pandemic-induced supply disruptions and sustained upward pressures in international commodity prices may dampen growth prospects, as Cyprus's import dependency, especially on oil, is very high. Moreover, downside risks could emerge as a result of the high levels of public and private debt that may render the Cypriot economy vulnerable to tightening financial conditions and changes in investor sentiment. Despite continued progress, the stock of NPLs in the economy is still relatively high, clouding the outlook. Fiscal pressures may arise, for example, because of the persistence of the pandemic, increased financing needs relating to the General Healthcare System and the State Health Services Organisation, as well as inflationary pressures.*

*On the upside, investments and reforms, particularly through the Recovery and Resilience Plan for Cyprus are expected to positively affect output and employment. A stabilisation of COVID-19 infections and further progress in vaccination coverage globally, may further improve external and domestic economic conditions. More specifically in Cyprus, a higher vaccination coverage among younger age groups and a better-than-anticipated tourist season could result in a stronger-than-projected outcome.*

*In 2021 and 2022, CPI inflation is projected at 2.3% and 1.8%, respectively.*

Οκτώβριος 2021

### Περίληψη

*Ο ρυθμός μεγέθυνσης του πραγματικού ΑΕΠ εκτιμάται σε 5,4% για το 2021 και σε 4,1% για το 2022. Οι προβλέψεις έχουν αναθεωρηθεί προς τα πάνω κυρίως λόγω της ενδυνάμωσης της ανάκαμψης κατά το δεύτερο τρίμηνο του 2021, περαιτέρω βελτιώσεων στη δραστηριότητα και την αγορά εργασίας κατά το τρίτο τρίμηνο (που αποτυπώνονται σε προπορευόμενους δείκτες) και προς τα πάνω αναθεωρήσεων στα στοιχεία των Εθνικών Λογαριασμών.*

*Κίνδυνοι για δυσμενέστερες από τις προβλεπόμενες προοπτικές πηγάζουν από πιθανά νέα κύματα της πανδημίας λόγω νέων παραλλαγών του ιού και σχετικά μικρότερης εμβολιαστικής κάλυψης των νεαρότερων ηλικιακών ομάδων. Διαταραχές στην εφοδιαστική αλυσίδα λόγω της πανδημίας και συνεχιζόμενες ανοδικές πιέσεις στις διεθνείς τιμές αγαθών μπορεί να επηρεάσουν αρνητικά τις προοπτικές, αφού η εξάρτηση της Κύπρου από τις εισαγωγές, κυρίως του πετρελαίου, είναι πολύ μεγάλη. Επιπλέον, ενδέχεται να προκύψουν κίνδυνοι για τις προοπτικές ως αποτέλεσμα του υψηλού δημόσιου και ιδιωτικού χρέους που μπορεί να καταστήσουν την κυπριακή οικονομία ευάλωτη στο ενδεχόμενο λιγότερο χαλαρών χρηματοοικονομικών συνθηκών και σε αλλαγές στην εμπιστοσύνη των επενδυτών. Παρά τη συνεχιζόμενη πρόοδο, το μέγεθος των μη εξυπηρετούμενων δανείων στην οικονομία παραμένει σχετικά υψηλό, επιβαρύνοντας τις προοπτικές. Δημοσιονομικές πιέσεις πιθανόν να προκύψουν, για παράδειγμα, από παρατεταμένη πανδημία, αυξημένες δαπάνες που σχετίζονται με το Γενικό Σύστημα Υγείας και τον Οργανισμό Κρατικών Υπηρεσιών Υγείας, καθώς και από πληθωριστικές πιέσεις.*

*Καλύτερες προοπτικές από τις προβλεπόμενες μπορούν να διαμορφωθούν από επενδύσεις και μεταρρυθμίσεις, ιδίως μέσω του Σχεδίου Ανάκαμψης και Ανθεκτικότητας για την Κύπρο, που αναμένεται να επηρεάσουν θετικά την παραγωγή και την απασχόληση. Σταθεροποίηση της επιδημιολογικής κατάστασης και αύξηση στην εμβολιαστική κάλυψη παγκοσμίως, θα βελτίωναν περαιτέρω τις εξωτερικές και εγχώριες οικονομικές συνθήκες. Ειδικότερα στην Κύπρο, η αύξηση της εμβολιαστικής κάλυψης σε νεαρότερες ηλικιακές ομάδες και μία καλύτερη από την αναμενόμενη τουριστική σεζόν θα μπορούσαν να οδηγήσουν σε ισχυρότερες προοπτικές από τις προβλεπόμενες.*

*Ο πληθωρισμός για το 2021 και 2022 προβλέπεται στο 2,3% και 1,8% αντίστοιχα.*

UNIVERSITY OF CYPRUS



### 1. Recent developments

The recovery of economic activity in Cyprus accelerated in the second quarter of 2021, against the backdrop of broader vaccination coverage in the country. Following a year-on-year (y-o-y) contraction of 2.1% in the first quarter of 2021, real GDP increased (y-o-y) vigorously, by 13.3%, in the second quarter of the year.

The hardest-hit sectors by the pandemic crisis, namely trade, transportation and hospitality, as well as arts and entertainment, registered strong growth rates in the second quarter of 2021, in both y-o-y and quarter-on-quarter terms. Moreover, during the second quarter, real gross value added continued to recover in industry, construction, and professional and administrative services, while real activity in financial and insurance services declined (y-o-y) slightly. The remaining services sectors continued to expand in the second quarter of the year.

All expenditure components of GDP registered double-digit growth rates (y-o-y) in the second quarter of 2021. Gross fixed capital formation growth (y-o-y) accelerated markedly, as a result of the rebound in investment in dwellings, other buildings and transport equipment. In the second quarter, the y-o-y increase in imports exceeded the y-o-y rise in exports, which was driven by strong services exports, resulting in a negative contribution of net exports to growth.

Leading indicators for domestic activity continued to improve in the third quarter of 2021, reflecting a broad-based recovery that has involved domestic and external demand, as well as various sectors of economic activity. Indicators that continued to improve in July – September 2021 (subject to data availability) include retail trade and industrial production indices, the number of property sale contracts, particularly for foreign buyers, as well as tourism-related indicators (arrivals, revenue, foreign credit card use in Cyprus). A small number of leading indicators (e.g. purchases with domestic credit cards, motor vehicle registrations, value of property transactions) showed some softening in the third quarter.

The Economic Sentiment Indicator (ESI) increased further in the third quarter of 2021, as a result of stronger business confidence in services, retail trade and industry; in the third quarter, significant confidence gains were recorded among firms in the hospitality subsector. Following a strong pickup in the second quarter of 2021, consumer confidence declined slightly in the third quarter. Overall, during the third quarter, economic sentiment fluctuated just above its

historical average, while firms' employment expectations continued to pick up.

The decline in the number of registered unemployed accelerated significantly in the third quarter. In August 2021, the unemployment rate (Eurostat) fell to under 5% and decreased below the euro area average.

Over the period January – August 2021, government revenue registered stronger growth (y-o-y) than expenditure, and the general government deficit narrowed vis-à-vis the same period in 2020. Following the peak reached in March 2021, public debt slowly returned to a downward trend; however, the debt-to-GDP ratio remained particularly high in August. The long-term interest rates for Cyprus declined to historical lows in the third quarter of 2021.

The stock of domestic loans registered steady growth over the period January – August 2021, while the ratio of non-performing loans (NPLs) to total loans declined to 17.6% in June 2021 from 17.9% in March 2021. New lending, especially loans for house purchase, registered a strong pickup during the period January – August 2021, supported by low interest rates and policy measures to counteract the economic effects of the pandemic. After March 2021, the annual growth rate of deposits accelerated for the category of domestic residents, and turned positive for the category of other euro area residents, following a long period of declines.

Inflation (measured by the Consumer Price Index – CPI) rose in the third quarter of 2021, reaching 4.4% vis-à-vis 2.4% in the second quarter. In the third quarter of 2021, the highest inflation rates were recorded in the categories of housing, water and energy, transport, and food. The acceleration of inflation was driven by large increases in international commodity prices, especially for oil and food, in the second and third quarters of 2021, as well as by the recovery of demand from the pandemic shock.

### 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 2021 are employed. Monthly indicators that contain information about some or all the months in the third quarter of 2021 are also used. The cut-off date for the data used in the analysis is 20 October 2021. All forecasts presented in

this bulletin are based solely on published data; thus, they only incorporate effects captured by the indicators used in the estimations.

Table 1 presents the forecasts for the growth rate of real GDP for 2021 and 2022. Based on the historical relationships between growth and numerous macroeconomic and financial indicators, real economic activity in Cyprus is expected to register a strong recovery in 2021, following the downturn in 2020 as a result of the COVID-19 pandemic. Growth in 2022 is projected to remain vigorous, as conditions normalise further, partly because of vaccine access. Real GDP growth is projected at 5.4% in 2021 and 4.1% in 2022. The growth forecasts for 2021 and 2022 have been revised upwards relative to the forecasts in the previous issue. The upward revisions were mainly driven by the strengthening recovery during the second quarter of 2021, further improvements in leading indicators in the third quarter of the year, as well as by upward revisions in National Accounts data.

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 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 to the overall forecasts.<sup>1</sup> The component that combines information on both the real economy and other economic aspects plays a key role in forming the final forecasts.<sup>2, 3</sup>

The drivers of the outlook are discussed below.

- *Further strengthening of recovery.* Real economic activity in Cyprus, the EU and in other trading partner economies (e.g. the UK, Russia) registered a strong pickup in the second quarter of 2021, as vaccine rollouts advanced and economies reopened. Domestic and foreign leading indicators suggest that economic activity continued to expand in the third quarter; however, some monthly data point to a weakening in the recovery momentum. Data on registered unemployed reveal that labour market

conditions in Cyprus improved significantly during the third quarter of 2021; moreover, the increase in employee earnings and the strong upturn in job vacancies in the second quarter of 2021 are expected to support growth in the following quarters.

- *Further gains in economic confidence.* Economic confidence in Cyprus, the EU and the euro area continued to rise in the third quarter, favouring the outlook considerably, particularly in 2021. Although economic sentiment in the EU and the euro area has softened somewhat in recent months, it has stood well above its historical average since April. In Cyprus, economic sentiment has fluctuated slightly above its long-run average since June 2021, but has remained below the EU and euro area-wide sentiment. Nevertheless, survey data continue to point to strong growth, particularly for 2021.
- *Supportive policy environment and financial conditions.* In the euro area, sovereign and private sector borrowing costs have remained very low, reflecting the accommodative monetary policy stance. Despite signs of rising volatility in September, international stock markets performed strongly in the third quarter, suggesting further improvements in external economic conditions that back the recovery. In Cyprus, new lending has been increasing since February, facilitated by low interest rates and fiscal measures to counteract the economic effects of the pandemic. Domestic credit growth, together with the recent declines in NPLs and the acceleration in deposit growth, is expected to benefit the outlook, especially for 2022. Moreover, the supportive fiscal policy stance is expected to continue mitigating the impact of the pandemic and to positively affect the outlook.

The rapid increases in international commodity prices, particularly for energy and food, during the second and third quarters of 2021 have pushed inflation up, creating also rising inflation uncertainty as suggested by survey data. The recent increases in international commodity prices and inflation are found to weigh on the outlook, as they dent real incomes. Moreover, upward pressures on input costs, as a result of rising international commodity prices and supply-

<sup>1</sup> Factors refer to a small number of principal components extracted from a large dataset of series relating to real domestic and foreign activity, and the labour market. The component 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.

<sup>2</sup> 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.

<sup>3</sup> 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.

chain bottlenecks, weaken growth prospects for both 2021 and 2022.

**Table 1: GDP growth forecasts and components**

Year	2021		
FORECAST	5.4		
	CONTRIBUTION	WEIGHT	FORECAST BY COMPONENT
<b>COMPONENTS</b>			
<b>I. Real economy</b>	0.02	0.48	5.0
<b>II. Aspects other than real economy</b>	0.02	0.46	3.7
<b>III. Real economy &amp; other aspects</b>	5.33	99.06	5.4
Fiscal	0.30	5.62	5.3
Prices	0.53	10.84	4.9
Exchange rates	0.18	3.41	5.2
Interest rates, spreads	0.99	18.43	5.4
Stock markets	0.84	16.20	5.2
Economic sentiment, uncertainty	2.07	36.00	5.8
Loans, deposits	0.43	8.57	5.0
Year	2022		
FORECAST	4.1		
	CONTRIBUTION	WEIGHT	FORECAST BY COMPONENT
<b>COMPONENTS</b>			
<b>I. Real economy</b>	0.02	0.47	4.1
<b>II. Aspects other than real economy</b>	0.02	0.55	3.6
<b>III. Real economy &amp; other aspects</b>	4.07	98.98	4.1
Fiscal	0.23	5.56	4.1
Prices	0.41	11.11	3.7
Exchange rates	0.14	3.39	4.1
Interest rates, spreads	0.82	19.92	4.1
Stock markets	0.60	13.26	4.5
Economic sentiment, uncertainty	1.46	36.36	4.0
Loans, deposits	0.41	9.38	4.4

As the COVID-19 pandemic persists, uncertainty regarding growth outlook remains high; there are both downside and upside risks to the outlook, with downside risks likely to intensify towards the end of the forecast horizon.

Downside risks to the outlook may stem from new waves of COVID-19 infections because of new virus variants and relatively lower vaccination coverage among younger age groups. Supply disruptions due to the pandemic and sustained upward price pressures may dampen growth prospects, as Cyprus's import dependency, especially on oil, is very high. Moreover, downside risks could emerge as a result of the high levels of public and private debt that may render the Cypriot economy vulnerable to tightening financial conditions and changes in investor sentiment. Despite continued progress, the stock of NPLs in the economy has remained relatively high, clouding the outlook; for example, the ratio of NPLs to total loans is still high, particularly among households. Fiscal pressures may intensify as a result of several reasons, including the persistence of the pandemic, increased financing needs relating to the General Healthcare System and the State Health Services Organisation, as well as inflationary pressures.

On the upside, investments and reforms, particularly through the Recovery and Resilience Plan for Cyprus are expected to positively affect output and employment, as well as to enhance the country's growth potential and competitiveness. A stabilisation of COVID-19 infections and further progress in vaccination coverage globally, may further improve external and domestic economic conditions. More specifically in Cyprus, a higher vaccination coverage among younger age groups and a better-than-anticipated tourist season could result in a stronger-than-projected outcome.

CPI inflation is projected at 2.3% in 2021 and at 1.8% in 2022.<sup>4</sup> The inflation projections reflect the strong recovery in demand, as well as the fast increases in international commodity prices (particularly for oil and food) and in inflation during the second and third quarters of the year. Survey data for the third quarter of 2021 incorporated in the forecasts show that firms' selling price expectations and consumers' expectations about price trends exceeded their long-run averages significantly. Moreover, inflation uncertainty among firms (indicated by disagreement in expectations) has increased in recent months. The recent pickup in price expectations has put upward pressure on inflation projections.

Currently, risks for higher-than-projected inflation are dominant. Upside risks to the inflation outlook include faster

<sup>4</sup> CPI inflation forecasts are constructed using a methodology similar to that described for GDP growth forecasts.

increases in international commodity prices, particularly in oil and food prices, supply-chain bottlenecks caused by the pandemic and stronger-than-expected demand. Downside risks to the inflation outlook are associated with a weaker-than-anticipated recovery in domestic and global activity, and an easing of upward pressures on international commodity prices.

### 3. Concluding remarks

Quarterly and monthly series released up until 20 October 2021, are employed in dynamic econometric models to construct forecasts for GDP growth and CPI inflation. Following strong output growth in the second quarter of 2021, leading indicators suggest that domestic economic activity and labour market conditions continued to improve in the third quarter of the year, as progress in vaccinations continued and international travel restrictions were relaxed. Nevertheless, during the third quarter inflationary pressures intensified and some monthly indicators point to softening growth momentum.

Real GDP growth is projected at 5.4% in 2021 and 4.1% in 2022. The growth forecasts have been revised upwards compared to those in the July issue (3.7% and 3.8% for 2021 and 2022, respectively). The upward revisions were mainly driven by the strengthening recovery during the second quarter of 2021, further improvements in leading indicators in the third quarter of the year, as well as by upward revisions in National Accounts data.

CPI inflation is projected at 2.3% in 2021 and 1.8% in 2022. The inflation forecast for 2021 has been revised upwards, while the forecast for 2022 has remained unchanged relative to the projections in the July issue (1.6% and 1.8% for 2021 and 2022, respectively). The upward revision in the 2021 forecast resulted primarily from the rapid increases in international commodity prices, particularly for energy and food, during the second and third quarters of 2021

The growth forecasts for 2021 and 2022 presented in this bulletin are very close to the forecasts released by the Ministry of Finance (5.5% and 4.0% for 2021 and 2022, respectively), but slightly higher than the projections published by the International Monetary Fund (4.8% and 3.6% for 2021 and 2022, respectively), [1], [2]. The forecasts in this issue were computed using the revised National Accounts data published by the Statistical Service of Cyprus on 15 October 2021.

### REFERENCES

1. International Monetary Fund, “World Economic Outlook: Recovery during a Pandemic—Health Concerns, Supply Disruptions, Price Pressures”, October 2021.
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