



Issue 19/4

ECONOMIC OUTLOOK

ECONOMICS RESEARCH CENTRE

November 2019

Summary

Real economic activity in Cyprus is expected to continue to increase at robust rates in 2019 and 2020, albeit at a slower pace compared to 2018. The growth rate of real GDP is projected to slow from 4.1% in 2018 to 3.6% in 2019. Growth is projected to decelerate further in 2020 as real GDP is forecast to increase by 3.1%. The drivers of the outlook include a mixture of domestic and external factors, such as robust activity and employment growth in Cyprus in the previous quarters, low domestic lending interest rates and supportive external financial conditions, subdued inflation, and Cyprus' sound fiscal position.

A key element of the strong growth rates projected, especially for 2019, is the revision to the GDP time series. In particular, the upward revision to the GDP growth rates for the first quarter of 2019 and 2018 as a whole created stronger carryover effects, affecting the outlook favourably.

Downside risks to the projections may stem from slower progress with private sector deleveraging and slower progress with the reduction of NPLs, especially as the response to the "Estia" scheme for vulnerable borrowers has been limited, raising concerns about the extent of strategic defaults and the effectiveness of the foreclosure framework. The high level of public debt together with the strong link between bank and sovereign risk, and potential pressures to public finances (e.g. court rulings on the reversal of past public sector pay cuts, the newly introduced General Health System), continue to pose risks to the outlook. Other downside risks could arise from the prolonged uncertainty regarding the Brexit deal, weaker-than-expected growth in the euro area, the UK and Russia, and geopolitical tensions. Upside risks to the outlook are associated with a higher degree of materialisation of investments than that reflected in the predictors.

Νοέμβριος 2019

Περίληψη

Η πραγματική οικονομική δραστηριότητα στην Κύπρο εκτιμάται ότι θα συνεχίσει να αυξάνεται με ικανοποιητικούς ρυθμούς το 2019 και 2020, αν και κάπως χαμηλότερους συγκριτικά με το 2018. Ο ρυθμός μεγέθυνσης του πραγματικού ΑΕΠ προβλέπεται να επιβραδυνθεί από 4,1% το 2018 σε 3,6% το 2019. Ο ρυθμός μεγέθυνσης αναμένεται να επιβραδυνθεί περαιτέρω το 2020, καθώς το πραγματικό ΑΕΠ προβλέπεται να αυξηθεί κατά 3,1%. Οι ευνοϊκές προοπτικές οφείλονται σε συνδυασμό εγχώριων και εξωτερικών παραγόντων, όπως οι ικανοποιητικοί ρυθμοί αύξησης της δραστηριότητας και της απασχόλησης στην Κύπρο τα προηγούμενα τρίμηνα, τα χαμηλά εγχώρια επιτόκια δανεισμού και οι υποβοηθητικές χρηματοπιστωτικές συνθήκες στο εξωτερικό, ο υποτονικός πληθωρισμός και η ισχυρή δημοσιονομική επίδοση της Κύπρου.

Βασικό στοιχείο των σχετικά ψηλών ρυθμών μεγέθυνσης που προβλέπονται, κυρίως για το 2019, είναι η αναθεώρηση των στοιχείων για το ΑΕΠ. Συγκεκριμένα, η ανοδική αναθεώρηση των ρυθμών αύξησης του ΑΕΠ για το πρώτο τρίμηνο του 2019 και για το 2018 συνολικά δημιούργησε ισχυρότερη δυναμική, επηρεάζοντας ευνοϊκά τις προοπτικές.

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, ειδικότερα καθώς η ανταπόκριση στο σχέδιο Εστία φαίνεται να είναι περιορισμένη, προκαλώντας προβληματισμό για την έκταση του φαινομένου των στρατηγικών κακοπληρωτών και την αποτελεσματικότητα του νομικού πλαισίου των εκποιήσεων. Το ψηλό δημόσιο χρέος σε συνάρτηση με την ισχυρότερη διασύνδεση μεταξύ τραπεζικού τομέα και κράτους, επίσης, ενέχει κινδύνους για τις προοπτικές. Επιπρόσθετα, αυξητικές πιέσεις στις δημόσιες δαπάνες (π.χ. από δικαστικές αποφάσεις σχετικά με παλαιότερες αποκοπές μισθών και συντάξεων στον δημόσιο τομέα, από την εφαρμογή του ΓΕΣΥ) ενδέχεται να επηρεάσουν αρνητικά τις προοπτικές.

Άλλοι κίνδυνοι για τις προοπτικές ενδεχομένως να προκύψουν από την παρατεταμένη αβεβαιότητα σχετικά με την συμφωνία για έξοδο του Ηνωμένου Βασιλείου από την ΕΕ, χαμηλότερους από τους αναμενόμενους ρυθμούς μεγέθυνσης στην ευρωζώνη, το Ηνωμένο Βασίλειο και τη Ρωσία, καθώς και από γεωπολιτικές εντάσεις.

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

UNIVERSITY OF CYPRUS



1. Recent developments

Based on revised National Accounts data released on 21 October 2019, growth in Cyprus eased in the second quarter of the year but remained robust. Real GDP increased by 3.2% year-on-year (y-o-y) in the second quarter of 2019 vis-à-vis 3.4% in the first quarter.

In the second 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. As in the first quarter of the year, the fastest-growing sectors were construction, information and communication as well as arts, entertainment and other services. Moreover, growth in the largest sector of economic activity, namely trade, transportation, accommodation and food services, picked up in the second quarter. Although real activity in construction continued to post double-digit growth (y-o-y) in the first half of the year, the rates are lower compared to those in 2018.

In the second quarter of 2019, consumption continued to rise strongly as a result of steady growth in private consumption expenditure and a double-digit increase (y-o-y) in the consumption expenditure of the general government. Growth in gross fixed capital formation remained strong in the second quarter, driven by higher investment in dwellings and other buildings as well as in transport equipment. The decrease (y-o-y) in exports of goods and services was larger than the decline (y-o-y) in imports, resulting in a negative contribution of net exports to growth in the second quarter.

In the third quarter of 2019, the performance of leading indicators of domestic activity was mixed. Available data for some or all of the months in the third quarter show a pickup in the y-o-y growth rates of a number of leading indicators vis-à-vis the second quarter of 2019 (e.g. volume index of retail trade, index of industrial production, registrations of motor vehicles, tourist arrivals, use of foreign credit cards in Cyprus). On the other hand, some leading indicators relating to real estate and professional services (e.g. number of property sale contracts, number of property sale contracts by foreign buyers, registrations of new companies) worsened in the third quarter of 2019.

The Economic Sentiment Indicator (ESI) in the third quarter of 2019 remained broadly unchanged compared to the first half of the year. In the third quarter, consumer confidence improved slightly, while business confidence in retail trade and services weakened. Business confidence in services has

been weighed down by deteriorating perceptions and expectations among firms in accommodation and food services. Firms' employment expectations also remained at about the same positive level as in the first half of the year. The ESI for Cyprus continues to stand above its long-run average and above the euro area ESI.

In the third quarter of the year, the number of registered unemployed decreased at slightly slower rates vis-à-vis those reported in the second quarter of 2019. Over the same period, the unemployment rate (Eurostat) declined to about 6.5%, which is below the euro area average.

During the period January - August 2019, government revenue increased (y-o-y) much faster than expenditure, resulting in a higher surplus compared to the same period in 2018. Although public debt remains elevated without showing a downward trend, long-term interest rates for Cyprus declined to historically low levels in the third quarter of the year.

In January - August 2019, the stock of total loans has been registering negative annual growth rates, while total deposits have been posting positive growth, driven by domestic deposits. The volume of pure new loans in January - August 2019 rose vis-à-vis the same period in 2018. Domestic lending interest rates remain at historically low levels. Recent data show that the stock of non-performing loans (NPLs) decreased further in May but remains high relative to the size of the economy. The ratios of NPLs to total exposures are currently at 31% and 38% for non-financial corporations and households, respectively.

Inflation (measured by the Consumer Price Index - CPI) declined further and turned negative in the third quarter of 2019. Inflation fell from 0.4% in the second quarter of 2019 to -0.6% in the third quarter of the year. The decrease in inflation was largely driven by negative inflation in the categories of food and transport, and lower inflation in the category of housing, water, electricity and 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 2019 are employed. Monthly indicators that contain information about some or all the months in the third quarter of 2019 are also used. The cut-off date for the data used in the analysis is 21 October 2019. 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 2019, and 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 2019 and 2020.

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

YEAR	2019			
FORECAST ²	3.6			
Quarter	3	4		
FORECAST (y-o-y)	3.6	4.0		
Forecast error ³	0.9	1.7		
COMPONENTS ⁴				
I. Real economy	0.02	0.02		
II. Aspects other than real economy	0.03	0.03		
III. Real economy & other aspects	3.59	3.98		
Fiscal	0.24	0.26		
Prices	0.49	0.51		
Exchange rates	0.13	0.13		
Interest rates, spreads	0.93	1.06		
Stock markets	0.55	0.59		
Economic sentiment	0.92	1.07		
Loans, deposits	0.34	0.37		
YEAR	2020			
FORECAST	3.1			
Quarter	1	2	3	4
FORECAST (y-o-y)	3.2	3.1	3.1	3.1
Forecast error ³	2.4	3.5	3.8	4.1
COMPONENTS ⁴				
I. Real economy	0.02	0.02	0.02	0.02
II. Aspects other than real economy	0.03	0.02	0.02	0.02
III. Real economy & other aspects	3.16	3.08	3.04	3.06
Fiscal	0.20	0.19	0.20	0.21
Prices	0.43	0.42	0.42	0.39
Exchange rates	0.10	0.10	0.10	0.09
Interest rates, spreads	0.85	0.83	0.81	0.83
Stock markets	0.47	0.49	0.48	0.45
Economic sentiment	0.84	0.82	0.79	0.80
Loans, deposits	0.27	0.23	0.26	0.28

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 2019 the GDP growth rates are obtained from published data (Gross Domestic Product, Quarterly, Chain-linked Volume Measures (Seasonally Adjusted), Statistical Service, 21/10/2019).

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 growth rate of real GDP is projected to slow from 4.1% in 2018 to 3.6% in 2019. Growth is projected to decelerate further in 2020 but to remain robust; real GDP is forecast to increase by 3.1% in 2020. The drivers of the outlook include a mixture of domestic and external factors. A key element of the strong growth rates projected, especially for the second half of 2019, is the revision to the GDP time series. In particular, the upward revision to the GDP growth rates for the first quarter of 2019 and 2018 as a whole created stronger carryover effects, affecting the outlook favourably.

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 1.4%) 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 from the European Union, the Ministry of Finance and the University of Cyprus for conducting the “Business and Consumer Surveys” project in Cyprus.

Growth is expected to remain solid in the following quarters, mainly as a result of the recent strong economic performance in Cyprus and supportive external financial conditions. Specifically:

- *Robust activity and employment growth in Cyprus.* Real GDP and employment continued to rise at robust rates in the second quarter of 2019, although at a rather slower pace compared to previous quarters. Leading indicators pointed to further improvements in the labour market conditions in the third quarter of the year. Moreover, some activity-related leading indicators registered stronger growth rates in the third quarter of 2019 vis-à-vis the second quarter.
- *Low lending interest rates.* Lending interest rates in Cyprus have declined to historically low levels, which, in combination with the favourable conditions in the real economy, are expected to facilitate growth well into 2020.
- *Subdued inflation.* Domestic inflation has been declining since the final quarter of 2018 and international oil prices in the first nine months of 2019 have been fluctuating below the levels registered in the corresponding period in 2018. These conditions of low inflation are found to support growth in the short run.
- *Sound fiscal position.* The fiscal performance has remained strong throughout January – August 2019 and Cyprus' borrowing costs have declined to historically low levels, contributing to sustainable growth.
- *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 further in the third quarter of 2019. Moreover, in the third quarter of 2019, the performance of European stock markets was less adverse compared to the first half of the year. Both the current levels of European interest rates and the recent performance of foreign stock markets contribute to favourable financial conditions, facilitating growth.

Although some domestic and foreign factors continue to support growth, recent developments associated with these factors weigh on growth prospects, especially for 2020:

- *Broad-based gains in domestic economic confidence have stalled.* During January – September 2019, domestic economic sentiment has fluctuated well-above its long-run average, supported by some confidence gains in construction and high levels of confidence in services. However, in January – September 2019, confidence indicators for services, retail trade, industry and consumers

have declined below the levels registered over the same period in 2018.

- *Growth in Cyprus' trading partner countries has decelerated.* In the second quarter of 2019, GDP growth in the EU, the euro area, the UK and Russia slowed. Moreover, survey data for the third quarter of the year show that economic sentiment in the EU, the euro area and the UK continued to decline, reflecting expectations of a further slowdown.
- *Some domestic leading indicators relating to real estate, professional services, and tourism have worsened.* Indicators such as the number of property sale contracts by foreign buyers, registrations of new companies and a confidence indicator for firms in accommodation and food services, have deteriorated, especially after May 2019.

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 remain dominant.

Downside risks to the projections may stem from slower progress with private sector deleveraging and slower progress with the reduction of NPLs, especially as the response to the “Estia” scheme for vulnerable borrowers has been limited, raising concerns about the extent of strategic defaults and the effectiveness of the foreclosure framework. The high level of public debt together with the strong link between bank and sovereign risk, and potential pressures to public finances (e.g. court rulings on the reversal of past public sector pay cuts, the newly introduced General Health System), continue to pose risks to the outlook. Other downside risks could arise from the prolonged uncertainty regarding the Brexit deal, weaker-than-expected growth in the euro area, the UK and Russia, and geopolitical tensions. Upside risks to the outlook are associated with a higher degree of materialisation of investments than that reflected in the predictors.

In 2019, CPI inflation is projected at 0.3%, as international oil prices declined further and inflation turned negative in the third quarter of 2019.⁴ Inflation for 2020 is projected to rise to 1.2%, driven by robust activity growth and rising incomes. Upside risks to the forecasts relate to stronger demand and higher wage growth, and faster increases in international commodity prices. Downside risks to the inflation outlook

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

are associated with weaker demand and downward pressures in international commodity prices.

3. Concluding remarks

Quarterly and monthly series released up until 21 October 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 from 3.4% in the July issue to 3.6%, mainly as a result of revisions in the National Accounts. The growth forecast for 2020 has been revised from 3.4% in the July issue to 3.1%. The downward revision resulted mostly from the moderation of the growth momentum (in Cyprus and in Cyprus' trading partner countries), the deterioration in some domestic leading indicators, the absence of broad-based gains in domestic economic confidence and a further worsening of European confidence indicators.

The CPI inflation forecast for 2019 has been revised from 0.7% in the July issue to 0.3%, and the inflation forecast for 2020 has been revised from 1.8% to 1.2%. The downward revisions are mainly driven by the drop of inflation to negative territory and the decline in international oil prices in the third quarter of 2019.

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 more optimistic than the projections given by the IMF (3.1%) and the Ministry of Finance (3.2%), [1] – [2]. The growth forecast for 2020 is close to the projections released by the IMF (2.9%) and the Ministry of Finance (2.9%), [1] – [2].

REFERENCES

1. International Monetary Fund (IMF), "World Economic Outlook: Global Manufacturing Downturn, Rising Trade Barriers", Washington, DC, October 2019.
2. Ministry of Finance, "Macroeconomic Outlook", September 2019, available at:
http://mof.gov.cy/assets/modules/wnp/articles/201909/499/docs/macroeconomic_outlook_sep19.pdf

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	3	4		3	4		3	4		3	4
COMPONENTS												
I. Real economy	0.02		0.02		0.60		0.60		3.7		4.0	
II. Aspects other than real economy	0.03		0.03		0.85		0.85		3.6		4.0	
III. Real economy & other aspects	3.59		3.98		98.55		98.55		3.6		4.0	
Fiscal	0.24		0.26		6.48		6.31		3.7		4.1	
Prices	0.49		0.51		13.43		12.78		3.7		4.0	
Exchange rates	0.13		0.13		3.47		3.26		3.6		4.0	
Interest rates, spreads	0.93		1.06		25.36		25.87		3.7		4.1	
Stock markets	0.55		0.59		14.77		14.24		3.7		4.1	
Economic sentiment	0.92		1.07		25.50		26.76		3.6		4.0	
Loans, deposits	0.34		0.37		9.55		9.32		3.6		4.0	
FORECAST	3.6		4.0									
YEAR	CONTRIBUTION BY COMPONENT				WEIGHT				FORECAST BY COMPONENT			
	2020				2020				2020			
	QUARTER	1	2	3	4	1	2	3	4	1	2	3
COMPONENTS												
I. Real economy	0.02	0.02	0.02	0.02	0.61	0.58	0.56	0.53	3.2	3.2	3.1	3.0
II. Aspects other than real economy	0.03	0.02	0.02	0.02	0.81	0.73	0.83	0.84	3.1	3.0	2.9	2.9
III. Real economy & other aspects	3.16	3.08	3.04	3.06	98.58	98.68	98.61	98.63	3.2	3.1	3.1	3.1
Fiscal	0.20	0.19	0.20	0.21	6.15	5.86	6.04	6.52	3.3	3.3	3.2	3.3
Prices	0.43	0.42	0.42	0.39	13.23	13.48	13.52	12.88	3.2	3.1	3.1	3.1
Exchange rates	0.10	0.10	0.10	0.09	3.28	3.30	3.29	3.18	3.1	3.1	3.0	2.8
Interest rates, spreads	0.85	0.83	0.81	0.83	25.72	25.94	25.37	25.83	3.3	3.2	3.2	3.2
Stock markets	0.47	0.49	0.48	0.45	14.23	14.65	14.77	14.39	3.3	3.3	3.2	3.2
Economic sentiment	0.84	0.82	0.79	0.80	27.21	27.66	27.27	27.41	3.1	3.0	2.9	2.9
Loans, deposits	0.27	0.23	0.26	0.28	8.76	7.80	8.35	8.41	3.1	2.9	3.1	3.4
FORECAST	3.2	3.1	3.1	3.1								



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