

## **Newsletter Issue 24 – March 2012**

The topics addressed in this issue of Economic Research are the following: (i) The Borrowing Behaviour of Households in Cyprus: Evidence from the Cyprus Family Expenditure Surveys, (ii) House Price Indices in Cyprus (iii) Foreign Direct Investments in Cyprus and (iv) Macroeconomic Forecasts and the Council of Experts of the Economics Research Centre of the University of Cyprus.

The first study investigates how various factors affect households demand for borrowing in Cyprus using data from the Family Expenditure Surveys for the years 2002/03 and 2008/09. The descriptive statistics show that middle income households with a younger age head have relatively high gross debt-to-income ratios; whereas upper income households with an older age head tend to have relatively high gross deposits-to-income ratios. The econometric analysis uses smooth (over the life cycle) income to investigate the extent to which household borrowing at a given point in time conforms to long term expectations about future income. The results conform to theoretical expectation insofar as demand for loans is determined by smooth, not current, income. Nevertheless, the results need to be confirmed by further analysis to also account for the dynamics of the borrowing-saving behavior of households. This will be possible when the Household Finance and Consumption Survey is available in Cyprus, hopefully in the near future.

Monitoring house and real estate markets is now considered an integral part of macro-financial surveillance given that, as we have witnessed during the recent “Great Recession”, large movements in prices in these markets can have considerable repercussions in an economy. In addition, there appear to be also considerable cross-country spillovers which have been identified and which policy makers need to monitor closely. In this study we construct a quarterly house/flat price index in order to provide accurate and timely information on developments of price levels in the Cypriot housing market. We construct a hedonic price index based on sale ads published in local newspapers. To construct such an index we take into account a number of relevant characteristics for each property type (e.g., no. of bedrooms, size, location etc). The database was developed by CypERC and the sample starts from the first quarter of year 2000. CypERC plans to frequently update the database and publish the quarterly index together with a historic annual index, periodically. The results reveal an average annual increase in the price per square meter of the order of 14% from 2000 to 2008. Since 2009 residential house prices have been falling, and in 2011 they have declined by some 11% compared to the previous year.

The third work provides evidence on the net inflow of Foreign Direct Investments (FDI) in Cyprus and it focuses on the contribution of the FDI to the economic growth of Cyprus. The results indicate that FDI originating from the European Union have a positive effect on the growth of the economy. A similar effect is exhibited by the FDI that targets Financial Institutions, Real Estate and Other Business Activities. However, the influence foreign investments have on the economic growth is relatively small suggesting an increase in the effort of attracting foreign capital. Nevertheless, in a globalised economy, where competition for funds is fierce, ensuring the inflow of foreign capital requires a continuous, intensive, systematic and coordinated effort.

Following the recent crisis which we are still experiencing in the EU, economic surveillance has acquired additional significance. Early detection of macroeconomic vulnerabilities can help prevent crises, by adopting early and timely policy responses. The ERC, conscious of the need to beef up economic surveillance in Cyprus, has launched a new initiative in the area of macroeconomic forecasting. Since late 2011 it has set up the Council of Experts of the Economics Research Centre (ERC). The aim of CEERC is to provide high level, independent, analysis of the economy of Cyprus and its outlook. The analysis and forecasts of CEERC will be based on research undertaken by the ERC, which will also provide the Secretariat support and technical resources to this new body. The CEERC's aim is to help provide credible, independent, analysis and advice and thus help in the formulation of sensible economic policies in Cyprus, ones that ultimately help achieve macroeconomic stability and long-term growth. The publication of the analyses of CEERC will be undertaken bi-annually in the ERC's Economic Outlook, as well as in other separate ad hoc publications covering topics of wider interest.