

E C O N O M I C O U T L O O K

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Summary

Real GDP growth in Cyprus is forecast to slow from 5.1% in 2022 to 2.4% in 2023, before picking up to 2.8% in 2024. GDP growth in Cyprus decelerated further in the second quarter of 2023, resulting in a lower-than-expected growth rate. Consequently, the growth forecasts for 2023 and 2024 have been downgraded by 0.6 and 0.1 percentage points, respectively, compared to the July issue. Tighter credit conditions, elevated prices, and the slowdown in Cyprus's trading partner economies weigh on domestic growth prospects considerably. Moreover, third quarter indicators, mainly relating to external demand, suggest that domestic activity has softened further. Nevertheless, there are factors that support the growth outlook; these factors include: favourable labour market conditions, resilient business confidence in Cyprus, growth in new business loans, further improvements in stock market indices, and a strong fiscal performance.

Inflation (based on the Consumer Price Index) is forecast to decrease from 8.4% in 2022 to 3.9% in 2023 and 2.6% in 2024, mainly as a result of tighter credit conditions, and past declines in international commodity prices and domestic inflation. The decline in CPI inflation in Cyprus between the second and third quarters was marginal. Moreover, price developments have shown an uptick recently (particularly in September). Therefore, inflation forecasts for 2023 and 2024 have been revised upwards by 0.9 and 0.6 percentage points, respectively, relative to those in the July issue.

The outlook for growth and inflation is accompanied by downside and upside risks. Moreover, geopolitical uncertainty has increased considerably compared to the July issue, with possible effects on economic activity and prices in Cyprus over the following quarters.

Οκτώβριος 2023

Περίληψη

Ο ρυθμός μεγέθυνσης του πραγματικού ΑΕΠ προβλέπεται να επιβραδυνθεί από 5,1% το 2022 σε 2,4% το 2023 και να φτάσει στο 2,8% το 2024. Κατά το δεύτερο τρίμηνο του 2023 ο ρυθμός μεγέθυνσης του ΑΕΠ στην Κύπρο επιβραδύνθηκε περαιτέρω, με αποτέλεσμα χαμηλότερο ρυθμό από τον αναμενόμενο. Ως εκ τούτου, οι προβλέψεις για το 2023 και το 2024 έχουν αναθεωρηθεί προς τα κάτω κατά 0,6 και 0,1 ποσοστιαίες μονάδες αντίστοιχα, σε σύγκριση με το τεύχος Ιουλίου. Οι αυστηρότερες πιστωτικές συνθήκες, οι αυξημένες τιμές και η επιβράδυνση στις οικονομίες των εμπορικών εταίρων της Κύπρου, ιδίως της ευρωζώνης, επιβαρύνουν σημαντικά τις εγχώριες προοπτικές μεγέθυνσης. Επιπλέον, στοιχεία για το τρίτο τρίμηνο του έτους (που σχετίζονται κυρίως με την εξωτερική ζήτηση) δείχνουν περαιτέρω μείωση στη δυναμική της μεγέθυνσης. Ωστόσο, υπάρχουν παράγοντες που στηρίζουν τις προοπτικές, ανάμεσα στους οποίους περιλαμβάνονται οι ακόλουθοι: ευνοϊκές συνθήκες στην αγορά εργασίας, ανθεκτική επιχειρηματική εμπιστοσύνη στην Κύπρο, άνοδος σε νέα επιχειρηματικά δάνεια, περαιτέρω βελτιώσεις σε χρηματιστηριακούς δείκτες και ισχυρές δημοσιονομικές επιδόσεις.

Ο πληθωρισμός (με βάση τον Δείκτη Τιμών Καταναλωτή) προβλέπεται να μειωθεί από 8,4% το 2022 σε 3,9% το 2023 και σε 2,6% το 2024, κυρίως εξαιτίας αυστηρότερων πιστωτικών συνθηκών και ως αποτέλεσμα προηγούμενων μειώσεων στις διεθνείς τιμές εμπορευμάτων (ειδικότερα του πετρελαίου) και στον εγχώριο πληθωρισμό. Η μείωση του πληθωρισμού στην Κύπρο μεταξύ του δεύτερου και του τρίτου τριμήνου ήταν οριακή και η πρόσφατη πορεία των τιμών κατέγραψε ανοδικές τάσεις (ιδιαίτερα τον Σεπτέμβριο). Επομένως, οι προβλέψεις για τον πληθωρισμό για το 2023 και το 2024 έχουν αναθεωρηθεί προς τα πάνω κατά 0,9 και 0,6 ποσοστιαίες μονάδες αντίστοιχα, σε σχέση με εκείνες στο τεύχος Ιουλίου.

Οι προοπτικές για τον ρυθμό μεγέθυνσης και τον πληθωρισμό συνοδεύονται από κινδύνους. Επιπλέον, η γεωπολιτική αβεβαιότητα έχει αυξηθεί σημαντικά σε σύγκριση με το τεύχος Ιουλίου, με πιθανές συνέπειες στην οικονομική δραστηριότητα και στις τιμές στην Κύπρο κατά τα επόμενα τρίμηνα.

1. Recent developments

Economic growth in Cyprus decelerated further in the second quarter of 2023, but the economy continued to show resilience, as the labour market and economic sentiment remained robust. In the second quarter, real GDP expanded by 2.3%, year-on-year (y-o-y), compared with 3.3% in the first quarter.

On the output side, the slowdown in the second quarter was mainly driven by the contraction in real gross value added in professional services, as well as in financial activities. In the sector of information and communication, growth (y-o-y) continued to slow but remained strong. In the second quarter of the year, growth (y-o-y) remained vigorous in the sector of trade and hospitality, while it picked up in industry, construction, and entertainment; in the remaining sectors, growth was modest (as in the first quarter).

On the expenditure side, the sharp decline in gross capital formation and the decrease in exports weighed on GDP growth in the second quarter. The contraction in capital formation was mainly due to lower investment in the categories of transport equipment and intellectual property products; the decrease in exports was driven by a reduction in service exports. Private and government consumption continued to expand (y-o-y) in the second quarter, but at slower rates compared to the first quarter. A large drop in imports in the second quarter, which significantly exceeded the contraction in exports, generated a positive contribution of net exports to growth.

Recent developments in leading indicators suggest that economic activity in Cyprus continued to expand in the third quarter of 2023 (e.g. volume of retail trade, registrations of motor vehicles, registrations of new companies). Labour market data on registered unemployed for the third quarter point to favourable labour market conditions. However, several monthly indicators suggest that domestic activity has softened further recently (e.g. use of credit cards, tourist arrivals, number of property sale contracts), amid elevated prices and tighter credit conditions.

In the third quarter of 2023, the Economic Sentiment Indicator (ESI) rose marginally, as a result of small confidence gains among businesses. The largest

confidence gains in the third quarter were observed in services, owing to improvements in financial services sentiment; confidence in hospitality and professional services weakened. Consumer confidence registered further losses during the third quarter. However, the ESI for Cyprus remained above its long-term average and the EU-wide ESI throughout the third quarter. Moreover, firms' employment expectations stayed above their long-term average in the third quarter, despite a new deterioration. In the third quarter, economic uncertainty in Cyprus declined further in services, retail trade and construction, but increased in industry and among consumers. During the third quarter, selling price expectations eased somewhat in industry, retail trade and services, while consumer price expectations were revised upwards. Selling price expectations in all sectors except industry have remained elevated by historical standards.

The fiscal performance over the period January – August was strong; compared with the same period in 2022, government revenue rose faster than expenditure, and the budget surplus increased. Public debt decreased from EUR 24.5 billion in May to EUR 23.5 billion in August. The long-term interest rate for Cyprus in the third quarter stayed broadly unchanged vis-à-vis the second quarter, at around 4%.

Domestic lending interest rates increased again during July - August because of further monetary policy tightening. Growth (y-o-y) in new lending remained positive over the period January – August, supported by a strong expansion in new business loans, despite a contraction in new housing loans. In July and August, the stock of loans registered further declines, while deposits continued to grow steadily. The ratio of non-performing loans (NPLs) to total loans continued its downward trend in June.

In the third quarter of 2023, inflation, measured by the Consumer Price Index (CPI), declined only marginally, to 2.7%, from 2.9% in the second quarter. This decline was mainly driven by the lower inflation rates registered in the categories of housing, water and energy, household goods, and recreation. Nevertheless, in the third quarter, food inflation accelerated, significantly contributing to headline inflation.

2. Forecasts

Projections for GDP growth and CPI inflation are constructed using a dataset with numerous domestic and foreign indicators, and a large number of dynamic econometric models. Quarterly series available up to the second quarter of 2023 were employed. Monthly indicators that contain information about some or all the months in the third quarter of 2023 were also used. The cut-off date for the data used in the analysis was 20 October 2023.

Table 1 presents the forecasts for the growth rate of real GDP for 2023 and 2024. Based on revised national accounts data, real GDP growth is forecast to slow from 5.1% in 2022 to 2.4% in 2023, before picking up to 2.8% in 2024. The forecasts for 2023 and 2024 have been revised down by 0.6 and 0.1 percentage points, respectively, in relation to those in the July issue.

The growth outlook has been downgraded as a result of the lower-than-expected growth rate in Cyprus in the second quarter of 2023. Tighter credit conditions, elevated prices, and slower growth in Cyprus’s trading partner economies, especially the

euro area, weigh on the domestic outlook considerably, while some leading indicators (July – September) signal further loss of growth momentum. The lower-than-expected growth rate incorporated in the forecast revision also reflects the materialisation of downside risks relating to the impact of sanctions against Russia on external demand for services in Cyprus, despite strong tourist inflows. However, the outlook is supported by favourable domestic developments over the past months, marked by robust economic sentiment, a resilient labour market, a strong fiscal performance, and increases in new business loans.

Table 1 also shows the forecasts obtained from the different components (groups of models) and the weights assigned to these forecasts in shaping the final forecasts. The real economy component (which is based on factors estimated from real activity and labour market indicators) and the component relating to economic aspects other than the real economy take very small weights.¹ The component that combines information on both the real economy and other economic aspects plays a key role in forming the final forecasts.²

Table 1: GDP growth forecasts and components

YEAR	2023		2024	
FORECAST	2.4		2.8	
	WEIGHT	FORECAST BY COMPONENT	WEIGHT	FORECAST BY COMPONENT
COMPONENTS				
I. Real economy	0.49	2.4	0.40	2.9
II. Aspects other than real economy	0.58	2.4	0.46	2.9
III. Real economy and other aspects	98.94	2.4	99.14	2.8
Fiscal	5.33	2.4	5.34	2.8
Prices	12.26	2.4	12.40	2.7
Exchange rates	3.15	2.5	3.23	3.1
Interest rates, spreads	17.09	2.4	18.16	2.4
Stock markets	14.04	2.5	12.80	3.2
Economic sentiment, uncertainty	37.95	2.4	37.63	2.9
Loans, deposits	9.11	2.5	9.59	2.9

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 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, fiscal indicators, loans and deposits. Monthly information within the forecast horizon (monthly leads) is included in the models if available.

² 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 carrying out the project “Business and Consumer Surveys” in Cyprus.

The main factors that shape the outlook for 2023 and 2024 are broadly similar to those that influenced the forecasts in the July issue.

- *Real economy.* In the second quarter of 2023, real activity and employment in Cyprus continued to expand (y-o-y), but at slower rates compared to those registered in previous quarters. Several domestic leading indicators for the period July - September suggest that economic activity and the labour market have remained robust. Moreover, unemployment in trading partner economies (e.g. EU, UK) has stayed at very low levels. Amid the global economic slowdown, the above developments are expected to support growth in Cyprus in the short run. However, growth prospects have been adversely affected by the slowdown in trading partner economies in the first half of 2023, as well as by further weakening in EU activity during the third quarter, as signalled by indicators on manufacturing production and retail trade turnover. Similarly, the softening in domestic activity, mainly reflected in third quarter data relating to external demand (e.g. foreign credit cards used in Cyprus, tourist arrivals, property sales to foreign buyers), has also dampened the outlook, especially for 2023.
- *Economic confidence.* During the second quarter, domestic economic sentiment remained strong and survey-based uncertainty was relatively low, generating positive effects on growth. Moreover, improvements in business confidence registered in the third quarter of 2023, which kept the overall economic sentiment at high levels, are expected to benefit short-term growth. However, recent survey data for Cyprus reveal that challenges to the domestic outlook have intensified in recent months, as confidence among consumers and firms in the sectors of hospitality and professional services has slid. Weakening economic sentiment in the EU and the euro area has weighed on the growth prospects significantly, while recent improvements in consumer confidence in the UK have positively affected the outlook.
- *Financial conditions.* Monetary policy in the euro area continued to tighten, with new increases in the key ECB interest rates in August and September, to bring inflation back to its medium-term target. Consequently, higher sovereign and private sector borrowing costs in the euro area have pushed the

growth forecasts down. The rise in domestic lending interest rates over the past months has produced particularly dampening effects on growth throughout the forecast horizon. On the other hand, y-o-y increases in new business loans, and favourable conditions in the domestic banking sector (e.g. declining NPLs, steady deposit growth) are expected to back growth, especially in 2024. Also, improvements in domestic and international stock market indices, and relatively low market volatility during the second and third quarters have generated positive effects on the outlook.

- *Fiscal performance.* The strong fiscal performance in Cyprus continued over the period January – August, as the fiscal balance remained in surplus, and the debt-to-GDP ratio stayed on a downward trend. The above positive developments in public finances are expected to benefit growth, by creating fiscal space amid the global slowdown, and by supporting domestic economic sentiment and investor confidence.
- *Price developments.* Since the beginning of 2023, international oil and food prices have been registering y-o-y declines. The deceleration of inflation in the first half of 2023, mainly because of lower energy prices, is projected to facilitate growth through positive effects on real incomes. However, price developments during the third quarter seem to cloud the outlook. The y-o-y declines in international oil and food prices moderated in the third quarter, as oil and food monthly prices started rising in July and September, respectively. Domestic inflation moved up in August and September, while inflation uncertainty (reflected in changes in price expectations) remained elevated in the third quarter. Although inflation in trading partner economies (e.g. euro area, UK) has registered steady declines in the first three quarters of 2023, it remains well above target, weighing on real incomes. Wage growth in Cyprus (which exceeded inflation in the first half of 2023), as well as past and newly introduced fiscal measures to mitigate the effects of inflationary pressures, are expected to benefit economic activity.

There are both downside and upside risks to the growth outlook. Geopolitical uncertainty has increased considerably compared to the July issue, with possible effects on economic activity in Cyprus

over the following quarters. Downside risks to the outlook for Cyprus could arise from lower-than-expected growth in trading partner economies, especially the euro area, and lower external demand (e.g. tourism and investment demand) as a result of the Israel – Gaza war. Renewed upward pressures on international commodity prices, triggered by increased geopolitical tensions, will negatively impact real incomes and weigh on growth prospects. Although the key ECB interest rates have remained unchanged in October, downside risks to the outlook for Cyprus continue to stem from tighter credit conditions. The past increases in interest rates which have raised debt servicing costs considerably, could lead to higher credit risk, amid slowing growth and ongoing uncertainties around the implementation of the foreclosure law. A reversal of the declining trend in NPLs could dent the capital position of the domestic banking sector, and negatively affect economic confidence and activity.

Moreover, pressures on public finances, with adverse effects on confidence and growth, may arise from spending that reduces fiscal space (e.g. increases in public sector wage bill, universal or not effectively targeted measures to alleviate the rising cost of living), particularly in conditions of slowdown.

Upside risks to the outlook could result from the positive effects of public and private investment projects in Cyprus which have not been reflected in published data. Fiscal measures to address the rising cost of living, especially those targeted to vulnerable households and measures promoting the green transition, are expected to support activity, without adding to inflation pressures. Moreover, the recently announced measures to tackle the housing problem in Cyprus are expected to positively influence the growth prospects. Also, stronger-than-expected external demand may lead to higher-than-projected growth rates, especially if Cyprus is viewed as a safe haven in the Middle East region.

CPI inflation is forecast to decrease from 8.4% in 2022 to 3.9% in 2023 and 2.6% in 2024. The main drivers of the projected inflation deceleration include the declines in international oil (and to a smaller extent food) prices, especially those

registered during the first half of 2023, the drop in domestic inflation between the first and second quarters, and tighter credit conditions.³ However, compared to the forecasts in the July issue, the inflation outlook for 2023 and 2024 has been lifted by 0.9 and 0.6 percentage points, respectively. The large upward revisions have resulted from developments during the third quarter of 2023. In the third quarter, global oil and food prices remained below their peaks reached in the spring of 2022; but compared to the second quarter, oil prices rose, and food prices stayed almost flat because of increases in September. After one year on a declining path, domestic inflation rose in August and September, contributing significantly to the upward revisions. Moreover, domestic economic sentiment and the labour market remained robust, while consumer price expectations moved up during the third quarter, adding to the inflation forecasts.

There are both upside and downside risks to the inflation outlook. Increased geopolitical uncertainty as a result of the Israel – Gaza war and the ongoing war in Ukraine may intensify upward pressures on international commodity prices, leading to higher-than-projected inflation. Upward pressures on commodity prices, especially food prices, may stem from climate risks. Other factors that could lead to higher-than-forecast inflation include the following: stronger-than-expected demand; strong wage growth driven by a robust labour market and the Cost-of-Living Allowance; universal fiscal measures that reduce prices through tax cuts.

Downside risks to the inflation outlook may result from the impact of tighter credit conditions on domestic and global activity, and weaker-than-anticipated demand, mainly because of geopolitical tensions in the Middle East. Also, downside risks to the inflation forecasts are associated with faster declines in international commodity prices, and a further appreciation of the euro.

3. Concluding remarks

Quarterly and monthly series released up until 20 October 2023 were employed in dynamic econometric models to construct forecasts for GDP growth and CPI inflation.

³ CPI inflation forecasts are constructed using a methodology similar to that described for GDP growth forecasts.

GDP growth in Cyprus decelerated further in the second quarter of 2023, resulting in a lower-than-expected growth rate. Consequently, the growth outlook has been downgraded. Real GDP growth is forecast to decelerate from 5.1% in 2022 to 2.4% in 2023, a downward revision by 0.6 percentage points in relation to the July issue. Growth in 2024 is projected at 2.8%, down by 0.1 percentage point compared to the July issue. Tighter credit conditions, elevated prices, and the slowdown in Cyprus's trading partner economies (especially the euro area) weigh on domestic growth prospects considerably. Moreover, third quarter indicators, mainly relating to external demand, suggest that domestic activity has softened further. Nevertheless, there are factors that support the growth outlook; these factors include: favourable labour market conditions, resilient business confidence in Cyprus, growth in new business loans, further improvements in stock market indices, and a strong fiscal performance.

Forecasts by other organisations also point to a growth slowdown in 2023, followed by a small improvement in 2024. Real GDP growth in Cyprus for 2023 is forecast at 2.4% by the Central Bank and the Ministry of Finance. For 2023, the International Monetary Fund forecasts growth in Cyprus at 2.2%. For 2024, the Central Bank and the International Monetary Fund project growth in Cyprus at 2.7%, while the growth forecast by the Ministry of Finance is 2.9%. [1] - [3]

CPI inflation is forecast to decrease from 8.4% in 2022 to 3.9% in 2023 and 2.6% in 2024, mainly as a result of tighter credit conditions, and past declines

in international commodity prices and domestic inflation. The decline in CPI inflation in Cyprus between the second and third quarters was marginal. In August and September, domestic inflation showed an uptick and the annual declines in global oil prices moderated significantly. The above price developments have pushed inflation forecasts for 2023 and 2024 higher by 0.9 and 0.6 percentage points, respectively, relative to those in the July issue.

The outlook for growth and inflation is accompanied by downside and upside risks. Moreover, geopolitical uncertainty has increased considerably compared to the July issue, with possible effects on economic activity and prices in Cyprus over the following quarters.

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