



ECONOMIC OUTLOOK

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Summary

Real GDP growth is projected at 3.3% in 2021, accelerating to 3.6% in 2022. The growth forecast for 2021 has been revised downwards relative to the forecast in the previous issue, reflecting the milder-than-expected contraction in 2020, but also the stricter pandemic containment measures implemented in January.

Uncertainty about the outlook remains elevated because of pandemic-related factors, namely the fast rise in COVID-19 infections following the reopening of economic sectors in March, the presence of new virus variants, and the pace of vaccinations. Downside risks stem from setbacks to the reopening of economic activities and renewed pandemic containment measures. Downside risks are also associated with the path of external demand for tourist services that depends on the epidemiological conditions, including vaccinations, in Cyprus and abroad. A slower vaccination pace in Cyprus and abroad, as well as new infection waves due to new variants may adversely affect domestic and external economic conditions. Additional downside risks relate to pressures on public finances and a possible re-escalation in NPLs as the pandemic persists. Slow progress in implementing structural reforms and uncertainties around the foreclosure framework may undermine the country's credibility, renew vulnerabilities and weigh on the growth prospects.

On the upside, a faster-than-expected vaccination pace in Cyprus and the EU, leading to a steady improvement in the epidemiological conditions could boost confidence and demand. The positive effects of domestic and EU pandemic-related support programmes on activity may turn out stronger than those reflected in published data. In 2021 and 2022, CPI inflation is projected at 0.9% and 1.5%, respectively, as activity is expected to recover.

Απρίλιος 2021

Περίληψη

Η οικονομική δραστηριότητα στην Κύπρο προβλέπεται να ανακάμψει το 2021, μετά την απότομη συρρίκνωσή της το 2020 ως αποτέλεσμα της πανδημίας COVID-19. Ο ρυθμός μεγέθυνσης εκτιμάται ότι θα ενδυναμωθεί το 2022, καθώς αναμένεται σταδιακή επιστροφή στην κανονικότητα. Ο ρυθμός μεγέθυνσης του πραγματικού ΑΕΠ εκτιμάται σε 3,3% για το 2021 και σε 3,6% για το 2022. Η πρόβλεψη για το 2021 έχει αναθεωρηθεί προς τα κάτω αντικατοπτρίζοντας τη μικρότερη από την προβλεπόμενη συρρίκνωση το 2020 αλλά και την αυστηροποίηση των περιοριστικών μέτρων κατά της πανδημίας τον Ιανουάριο.

Η αβεβαιότητα σχετικά με τις οικονομικές προοπτικές παραμένει αυξημένη λόγω παραγόντων που σχετίζονται με την πανδημία, όπως η αύξηση των κρουσμάτων μετά την επαναδραστηριοποίηση οικονομικών τομέων τον Μάρτιο, η παρουσία νέων μεταλλάξεων του ιού και η πορεία των εμβολιασμών. Πιθανοί κίνδυνοι για δυσμενέστερες από τις προβλεπόμενες προοπτικές απορρέουν από ανατροπές στην επανεκκίνηση οικονομικών δραστηριοτήτων και νέα περιοριστικά μέτρα κατά της πανδημίας. Η πορεία της εξωτερικής ζήτησης για το κυπριακό τουριστικό προϊόν, επίσης, ελλοχεύει κινδύνους, αφού εξαρτάται από τις επιδημιολογικές συνθήκες, συμπεριλαμβανομένων των εμβολιασμών, στην Κύπρο και το εξωτερικό. Επιβράδυνση στον ρυθμό των εμβολιασμών στην Κύπρο και το εξωτερικό, καθώς και νέα κύματα λοιμώξεων ίσως να επιδεινώσουν τις οικονομικές προοπτικές. Άλλοι κίνδυνοι για τις προοπτικές σχετίζονται με ενδεχόμενες πιέσεις στα δημόσια οικονομικά και πιθανή εκ νέου κλιμάκωση των μη εξυπηρετούμενων δανείων ενόσω η πανδημία παραμένει. Βραδεία πρόοδος στην εφαρμογή διαρθρωτικών μεταρρυθμίσεων και αβεβαιότητα γύρω από το πλαίσιο των εκποιήσεων πιθανόν να υπονομεύσουν την αξιοπιστία της χώρας, να εντείνουν ευπάθειες της οικονομίας και να επηρεάσουν αρνητικά τις προοπτικές.

Καλύτερες προοπτικές από τις προβλεπόμενες μπορούν να διαμορφωθούν από ενίσχυση της οικονομικής εμπιστοσύνης και της ζήτησης λόγω επιτάχυνσης των εμβολιασμών στην Κύπρο και την ΕΕ και σταθερής βελτίωσης των επιδημιολογικών συνθηκών. Οι θετικές επιπτώσεις στη δραστηριότητα από εγχώρια και ευρωπαϊκά προγράμματα οικονομικής στήριξης ίσως να αποδειχθούν ισχυρότερες από αυτές που αποτυπώνονται στους διαθέσιμους δείκτες.

Ο πληθωρισμός για το 2021 και 2022 προβλέπεται να αυξηθεί στο 0,9% και 1,5% αντίστοιχα, καθώς η οικονομική δραστηριότητα αναμένεται να ανακάμψει.

UNIVERSITY OF CYPRUS



1. Recent developments

The COVID-19 pandemic has led to an abrupt decline in economic activity in Cyprus. Following an unprecedented contraction in the second quarter of 2020, activity started recovering in the second half of the year as the pandemic containment measures were relaxed. In 2020, real GDP contracted by 5.1%. However, in the final months of 2020, a new wave of COVID-19 infections resulted in stricter containment measures (extending into the first months of 2021), weakening the recovery momentum.

In the final quarter of 2020, the year-on-year (y-o-y) contraction of gross value added accelerated in the sectors of arts and entertainment, professional activities and construction; output declines slowed in the sector of trade, transportation, accommodation and food services, as well as in the industrial and financial sectors. The remaining services sectors posted weak growth in the fourth quarter of 2020.

Revised data show that real private consumption suffered a severe fall in the second quarter of 2020 because of the pandemic; despite a strong pickup in the third quarter, private spending remained below its pre-pandemic level in the last quarter of 2020. Real consumption expenditure of the general government registered strong growth throughout 2020. In the final quarter of 2020, gross fixed capital formation increased (y-o-y) vigorously, mainly as a result of higher investment in transport equipment, despite faster declines (y-o-y) in construction investment vis-à-vis the third quarter. Net exports worsened considerably in the final quarter of 2020, as the decline (y-o-y) in exports deepened further, while the decrease (y-o-y) in imports eased.

As a result of tighter pandemic containment measures introduced in December 2020 and January 2021, a number of domestic activity indicators worsened at the beginning of this year (e.g. retail trade volume/value index, building permits, value of property transactions). In the first quarter of 2021, few indicators continued to grow (e.g. registrations of new companies, local credit card use); some indicators registered smaller declines compared to the fourth quarter of 2020, because of improvements observed in March (e.g. number of property sale contracts, motor vehicle registrations).

The Economic Sentiment Indicator (ESI) declined in the first quarter of the year despite a strong pickup in March; the ESI stayed below both its historical average and the EU-wide ESI. In the first quarter, consumer confidence edged up, while business confidence in all sectors and firms' employment

expectations deteriorated. Confidence among firms in the hospitality sector has remained at historically low levels, despite a significant improvement in the overall services confidence indicator in March.

In the first quarter of 2021, registered unemployment continued to increase, but at a much slower pace compared to the final quarter of 2020. Following a peak in October 2020, the unemployment rate (Eurostat) has been steadily decreasing; in February it stood at 6.8%, which is below the euro area average.

As a result of the pandemic, the general government deficit widened considerably in 2020. In the first two months of 2021, government revenue continued to contract (y-o-y), while expenditure increased strongly, resulting in a negative fiscal balance. Public debt rose further in February; nevertheless, long-term interest rates for Cyprus remained at record-low levels over the period January – February.

Domestic deposits continued to register modest annual growth rates in the first two months of 2021. After November 2020, the annual growth rate of the domestic loan stock strengthened further. New lending over the period January – February decreased compared to the same period in 2020, as a result of declines in the volumes of large business loans (over 1 million EUR), despite strong growth in new small business loans and new housing loans. The low levels of lending interest rates, together with pandemic-related support measures (e.g. interest rate subsidisation of new business and housing loans), and the downward trend in non-performing loans (NPLs) recorded in 2020, facilitate credit growth.

Inflation (measured by the Consumer Price Index – CPI) remained negative in the first quarter of 2021, at –1.4% from –0.8% in the final quarter of 2020, mainly because of negative inflation in the categories of food, transport, communication, housing, water and energy.

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 fourth quarter of 2020 are employed. Monthly indicators that contain information about some or all the months in the first quarter of 2021 are also used. The cut-off date for the data used in the analysis is 9 April 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 projected to recover in 2021, following the abrupt contraction in 2020 as a result of the COVID-19 pandemic. Growth in 2022 is projected to pick up, as conditions are expected to gradually normalise. Real GDP growth is projected at 3.3% in 2021, accelerating to 3.6% in 2022. The current growth forecast for 2021 is somewhat lower than previously projected, reflecting the milder-than-expected contraction in 2020, but also the tighter pandemic containment measures taken in January.

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.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, 3}

The drivers of the outlook are discussed below.

- *Recovery of domestic activity.* Following the strong rebound in activity in the third quarter of 2020, output in Cyprus continued to recover in the final quarter, despite the rise in COVID-19 infections. Also, employment in the fourth quarter of 2020 registered a smaller decline vis-à-vis the third quarter. Leading indicators point to a deterioration in activity over January – February due to tighter pandemic containment measures. Nevertheless, monthly indicators suggest a pickup in activity in March, following the reopening of economic sectors. Moreover, labour market indicators signal some improvements during the first quarter of 2021.

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.

² Monthly leads of leading indicators (e.g. interest rates, economic sentiment) and monthly leading values of series used in extracting

Table 1: GDP growth forecasts and components

Year	2021		
FORECAST	3.3		
	CONTRIBUTION	WEIGHT	FORECAST BY COMPONENT
COMPONENTS			
I. Real economy	0.02	0.4	4.5
II. Aspects other than real economy	0.02	0.5	5.1
III. Real economy & other aspects	3.27	99.1	3.3
Fiscal	0.19	5.5	3.5
Prices	0.40	11.1	3.6
Exchange rates	0.12	3.1	3.8
Interest rates, spreads	0.65	19.5	3.3
Stock markets	0.45	14.2	3.2
Economic sentiment, uncertainty	1.22	39.3	3.1
Loans, deposits	0.23	6.5	3.6
Year	2022		
FORECAST	3.6		
	CONTRIBUTION	WEIGHT	FORECAST BY COMPONENT
COMPONENTS			
I. Real economy	0.02	0.4	3.8
II. Aspects other than real economy	0.02	0.4	5.6
III. Real economy & other aspects	3.53	99.2	3.6
Fiscal	0.20	5.5	3.6
Prices	0.52	12.5	4.2
Exchange rates	0.12	3.2	3.8
Interest rates, spreads	0.65	19.4	3.3
Stock markets	0.59	14.8	4.0
Economic sentiment, uncertainty	1.26	37.3	3.4
Loans, deposits	0.20	6.4	3.1

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 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.

- *Continuation of fiscal policy support.* A wide range of measures have been implemented to mitigate the economic effects of the pandemic, by supporting business liquidity and household incomes, and safeguarding jobs. Such measures together with the supportive fiscal policy stance at the EU-level (e.g. suspension of fiscal rules) are expected to continue to facilitate the recovery and limit the scarring effects of the COVID-19 shock.
- *Favourable financial conditions.* In the euro area, the interest rates for long-term government bonds have remained at record-low levels, reflecting continued monetary policy accommodation. International stock market indicators strengthened in the first quarter of 2021 and volatility declined in February – March, signalling improvements in external economic conditions. On the domestic front, conditions are conducive to credit growth that support the recovery. Domestic lending interest rates have remained at historically low levels, banks' balance sheets have significantly improved compared to the previous crisis, and schemes to support viable borrowers and new lending have been put into effect since the early stages of the pandemic. Nevertheless, vulnerabilities associated with the previous crisis, such as the high levels of indebtedness and NPLs, together with conditions of low bank profitability, could weigh on growth, particularly at longer horizons.
- *Improving economic conditions abroad.* In the fourth quarter of 2020, the contraction of real GDP accelerated in the EU and the euro area; nevertheless, output contraction was smaller than initially projected. Economic confidence in the EU and the euro area has been rising since the third quarter of 2020; economic sentiment rose markedly in March, pointing to a strengthening of the recovery momentum. In the UK, the decline in real GDP decelerated in the final quarter of 2020; a composite leading indicator for the first quarter does not signal a deterioration in economic activity vis-à-vis the fourth quarter of 2020, despite restrictions to contain the spread of COVID-19.
- *Pickup in domestic economic sentiment with reopening.* In January, economic sentiment in Cyprus deteriorated significantly due to the implementation of stricter pandemic containment measures. The gradual easing of the pandemic restrictions in March led to a strong pickup in economic sentiment, affecting the outlook favourably. Nevertheless, the ESI for Cyprus is currently standing well

below its long-run average, dampening the recovery momentum.

- *Muted price pressures.* CPI inflation in Cyprus turned negative after the onset of the pandemic, sliding further into negative territory in the first quarter of 2021. International oil prices as well as other commodity prices (e.g. food) increased strongly in the first quarter of 2021, but remained below their pre-pandemic levels; the recent increases in international prices reflect both the ongoing recovery and base effects from last year's low levels. The absence of inflation pressures and the past declines in energy prices are expected to continue to support the recovery in the following quarters.

Uncertainty about the outlook remains elevated because of pandemic-related factors, namely the fast rise in COVID-19 infections following the reopening of economic sectors in March, the presence of new virus variants, and the pace of vaccinations.

Downside risks to the outlook stem from setbacks to the reopening of economic activities and renewed pandemic containment measures, which could slow the recovery of domestic activity. Downside risks are also associated with the path of external demand for tourist services that depends on the epidemiological conditions, including vaccinations, in Cyprus and abroad. A slower vaccination pace in Cyprus and abroad, as well as new infection waves due to new variants may adversely affect domestic and external economic conditions. Additional downside risks relate to pressures on public finances and a possible re-escalation in NPLs as the pandemic persists. Slow progress in implementing structural reforms, and uncertainties around the foreclosure framework may undermine the country's credibility, renew vulnerabilities and weigh on the growth prospects.

On the upside, a faster-than-expected vaccination pace in Cyprus and the EU, leading to a steady improvement in the epidemiological conditions could boost confidence and demand. The positive effects of domestic and EU pandemic-related support programmes on activity may turn out stronger than those reflected in published data.

In 2021, CPI inflation is projected at 0.9%, as economic activity is expected to recover.⁴ The projection for muted inflation in 2021 is driven by the recent negative inflation rates in Cyprus and the significant fall in international oil prices in 2020. CPI inflation is projected to rise to 1.5% in 2022, as growth is expected to firm up. Upside risks to the forecasts include

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

faster increases in international commodity prices, particularly oil prices, and stronger-than-expected growth in Cyprus and abroad. Downside risks to the inflation outlook are associated with a weaker-than-anticipated recovery in domestic and global activity, as well as downward pressures on international commodity prices.

3. Concluding remarks

Quarterly and monthly series released up until 9 April 2021, are employed in dynamic econometric models to construct forecasts for GDP growth and CPI inflation. Leading indicators for the first quarter of 2021 reflect possible setbacks to the recovery because of tighter restrictions implemented in January to curb the transmission of COVID-19, but also improvements in activity with the reopening of economic sectors in March.

In 2021, real GDP growth in Cyprus is projected at 3.3%. The growth forecast for 2021 has been revised downwards relative to the forecast in the February issue (3.7%), as a result of the smaller-than-projected contraction in GDP in 2020 and impediments to economic activity caused by the lockdown in January. In 2022, growth is projected to strengthen to 3.6%.

In 2021, CPI inflation is projected at 0.9%; the forecast for inflation remained broadly unchanged compared to the February issue (0.8%). In 2022, inflation is forecast to accelerate to 1.5% as growth strengthens.

The growth forecast for 2021 presented in this bulletin is very close to the forecast published by the European Commission (3.2%) and slightly higher than the projection given by the IMF (3.0%). For 2022, the growth forecast shown here is more optimistic than that by the European Commission (3.1%), but slightly lower than the projection by the IMF (3.9%) [1] – [2].

The forecasts in this issue are accompanied by considerable uncertainty as economic outcomes hinge on the course of the pandemic and the pace of vaccinations, in Cyprus and abroad.

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