



Issue 20/1

# ECONOMIC OUTLOOK

## ECONOMICS RESEARCH CENTRE

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Summary

*Real economic activity in Cyprus is expected to continue to increase at robust rates in 2020, albeit at a slower pace compared to 2019. The growth rate of real GDP is estimated to have slowed from 4.1% in 2018 to 3.4% in 2019. Growth is projected to decelerate further in 2020 as real GDP is forecast to increase by 2.8%.*

*The drivers of the outlook include the recent robust economic performance in Cyprus, low inflation and supportive financial conditions. Nevertheless, the forecasts have been revised downwards compared to those in the November issue. The downward revisions reflect the moderation of the growth momentum in Cyprus and the EU, particularly after the second quarter of 2018, and the faltering of some leading indicators, especially domestic and European economic confidence indicators.*

*Downside risks to the projections may stem from slower progress with private sector deleveraging and slower progress with the reduction of NPLs; these risks could be accentuated in an environment of low profitability in the banking sector. The high level of public debt together with the strong link between bank and sovereign risk, and potential pressures to public finances continue to pose risks to the outlook. Fiscal pressures could be associated with court rulings on the reversal of past public sector pay cuts, rapid growth in the public sector wage bill and the newly introduced General Health System. Other downside risks could arise from weaker-than-expected growth in the euro area and the UK, as well as from rising geopolitical tensions in the Eastern Mediterranean. In particular, downside risks may result from weaker-than-expected demand for tourist services due to renewed Brexit-related uncertainty regarding the future relationship of the UK with the EU. Upside risks to the outlook are associated with a higher degree of materialisation of investments than that reflected in the predictors, as well as stronger-than-expected growth in Russia.*

Ιανουάριος 2020

Περίληψη

*Η πραγματική οικονομική δραστηριότητα στην Κύπρο εκτιμάται ότι θα συνεχίσει να αυξάνεται με ικανοποιητικούς ρυθμούς το 2020, αν και κάπως χαμηλότερους συγκριτικά με το 2019. Ο ρυθμός μεγέθυνσης του πραγματικού ΑΕΠ εκτιμάται ότι έχει επιβραδυνθεί από 4,1% το 2018 σε 3,4% το 2019. Ο ρυθμός μεγέθυνσης αναμένεται να επιβραδυνθεί περαιτέρω το 2020, καθώς το πραγματικό ΑΕΠ προβλέπεται να αυξηθεί κατά 2,8%.*

*Οι ευνοϊκές προοπτικές οφείλονται σε παράγοντες όπως οι πρόσφατες ικανοποιητικές οικονομικές επιδόσεις της Κύπρου, ο χαμηλός πληθωρισμός και οι υποβοηθητικές χρηματοπιστωτικές συνθήκες. Ωστόσο, οι προβλέψεις έχουν αναθεωρηθεί προς τα κάτω συγκριτικά με αυτές στο τεύχος Νοεμβρίου. Οι προς τα κάτω αναθεωρήσεις αντανακλούν τον μετριασμό της δυναμικής της οικονομικής μεγέθυνσης στην Κύπρο και στην ΕΕ, κυρίως μετά το δεύτερο τρίμηνο του 2018, καθώς και την αποδυνάμωση ορισμένων προπορευόμενων δεικτών, ειδικότερα εγχώριων και Ευρωπαϊκών δεικτών οικονομικής εμπιστοσύνης.*

*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 σε περιβάλλον χαμηλής κερδοφορίας στον τραπεζικό τομέα. 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 ψηλό ρυθμό επέκτασης του κρατικού μισθολογίου, από την εφαρμογή του ΓΕΣΥ) ενδέχεται να επηρεάσουν αρνητικά τις προοπτικές.*

*Άλλοι κίνδυνοι για τις προοπτικές ενδεχομένως να προκύψουν από χαμηλότερους από τους αναμενόμενους ρυθμούς μεγέθυνσης στην ευρωζώνη και στο Ηνωμένο Βασίλειο, καθώς και από αυξανόμενες γεωπολιτικές εντάσεις στην Ανατολική Μεσόγειο. Συγκεκριμένα, οι προοπτικές ίσως επηρεαστούν αρνητικά σε περίπτωση που η ζήτηση για τουριστικές υπηρεσίες είναι ασθενέστερη από την αναμενόμενη, λόγω αβεβαιότητας που σχετίζεται με τη διαμόρφωση της μελλοντικής σχέσης του Ηνωμένου Βασιλείου με την ΕΕ.*

*Θετικότερες από τις προβλεπόμενες προοπτικές μπορούν να διαμορφωθούν από μεγαλύτερο βαθμό υλοποίησης επενδύσεων από ό,τι ανατακλάται στους οικονομικούς δείκτες και ψηλότερους από τους αναμενόμενους ρυθμούς μεγέθυνσης στη Ρωσία.*

UNIVERSITY OF CYPRUS



### 1. Recent developments

Growth in Cyprus remained robust in the third quarter of 2019, as real GDP increased by 3.4% year-on-year (y-o-y) vis-à-vis 3.2% in the second quarter.

All sectors of economic activity registered positive growth rates in the third quarter of 2019, with the exception of the financial and insurance services sector, which continued to contract in terms of its real gross value added (y-o-y). Construction and information and communication have remained the fastest-growing sectors in the third quarter; however real activity growth in construction has decelerated further. Manufacturing, professional services, arts, entertainment and other services also registered strong growth rates in the third quarter of 2019.

Consumption continued to rise strongly in the third quarter of 2019, as a result of a large increase in the consumption expenditure of the general government and steady growth in private consumption expenditure. Growth in gross fixed capital formation decelerated further in the third quarter, but remained robust, driven by higher investment in dwellings and transport equipment. Net exports had a small positive contribution to growth in the third quarter as exports rose and imports declined (y-o-y).

In the final quarter of 2019, leading indicators of domestic activity gave mixed signals. Available data for some or all of the months in the fourth quarter of 2019 show that a number of leading indicators registered robust y-o-y growth rates (e.g. volume index of retail trade, sales by local and foreign credit cards in Cyprus, tourist arrivals, property sale contracts, building permits). Another group of leading indicators worsened in the final quarter of 2019 (e.g. registrations of new companies, property sale contracts by foreign buyers, registrations of motor vehicles).

The Economic Sentiment Indicator (ESI) in the final quarter of 2019 remained broadly unchanged compared to the third quarter. Business confidence in industry and construction rose, while confidence among firms in retail trade and services, and among consumers weakened slightly in the final quarter of 2019. Firms' employment expectations were revised downwards in the fourth quarter, falling to their lowest level in three years. Nevertheless, the ESI for Cyprus has remained above both its long-run average and the euro area ESI throughout 2019.

The number of registered unemployed continued to decrease at double-digit rates in the final quarter of 2019,

but at a somewhat slower pace compared with the previous two quarters. Revised unemployment data (Eurostat) show that the unemployment rate stood just above 7% in the third quarter of 2019 and rose slightly in October – November.

A large budget surplus was recorded during the period January – November 2019 compared to a deficit over the same period in 2018. In October – November 2019, both government revenue and expenditure rose rapidly, limiting surpluses. Public debt has declined slightly from its peak reached in May 2019, and long-term interest rates for Cyprus have remained to historically low levels in the second half of 2019.

In October – November 2019, the stock of total loans has registered positive annual growth rates for the first time since 2013. Moreover, in January – November 2019, new loans to firms and households have increased moderately compared with the same period in 2018, and domestic lending interest rates have remained at historically low levels. In January – November 2019, total deposits have posted positive growth, driven by domestic deposits. The most recent data show that the stock of non-performing loans (NPLs) decreased further in August, with the ratio of NPLs to total exposures currently standing at just above 29%.

Inflation (measured by the Consumer Price Index – CPI) remained negative in the final quarter of 2019 at –0.3% from –0.6% in the third quarter. Overall, inflation in 2019 fell to 0.3% from 1.4% in 2018, mainly driven by subdued inflation in the category of food and negative inflation in the categories of transport, communication and clothing.

### 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 third quarter of 2019 are employed. Monthly indicators that contain information about some or all the months in the fourth quarter of 2019 are also used. The cut-off date for the data used in the analysis is 21 January 2020. 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 fourth quarter 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 2020 but at a somewhat slower pace than in 2019. The growth rate of real GDP is estimated to have slowed from 4.1% in 2018 to 3.4% in 2019. Growth is projected to decelerate further in 2020 but to remain robust; real GDP is forecast to increase by 2.8% in 2020.

**Table 1: GDP growth forecasts, forecast errors and contribution of components to forecasts <sup>1</sup>**

Year	2019	2020			
<b>FORECAST <sup>2</sup></b>	<b>3.4</b>	<b>2.8</b>			
<b>Quarter</b>	<b>4</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>
<b>FORECAST (y-o-y)</b>	<b>3.5</b>	<b>2.8</b>	<b>2.5</b>	<b>3.0</b>	<b>2.9</b>
Forecast error <sup>3</sup>	0.9	1.5	2.2	3.3	3.6
<b>COMPONENTS <sup>4</sup></b>					
<b>I. Real economy</b>	<b>0.02</b>	<b>0.02</b>	<b>0.01</b>	<b>0.01</b>	<b>0.01</b>
<b>II. Aspects other than real economy</b>	<b>0.03</b>	<b>0.02</b>	<b>0.02</b>	<b>0.02</b>	<b>0.02</b>
<b>III. Real economy &amp; other aspects</b>	<b>3.44</b>	<b>2.72</b>	<b>2.49</b>	<b>2.97</b>	<b>2.83</b>
Fiscal	0.25	0.19	0.16	0.19	0.19
Prices	0.48	0.37	0.35	0.43	0.43
Exchange rates	0.11	0.09	0.08	0.09	0.08
Interest rates, spreads	0.86	0.68	0.58	0.73	0.69
Stock markets	0.50	0.39	0.38	0.45	0.43
Economic sentiment	0.92	0.74	0.69	0.81	0.74
Loans, deposits	0.32	0.26	0.24	0.27	0.27

<sup>1</sup> 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.

<sup>2</sup> For the first three quarters of 2019 the GDP growth rates are obtained from published data (Gross Domestic Product, Quarterly, Chain-linked Volume Measures (Seasonally Adjusted), Statistical Service, 09/12/2019).

<sup>3</sup> Pseudo out-of-sample root mean squared forecast error of the forecast method.

<sup>4</sup> Differences between the forecasts and the sum of the components are due to rounding.

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.<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. 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.<sup>2, 3</sup>

Growth is projected to continue at robust rates, mainly driven by the recent robust economic performance in Cyprus, low inflation and supportive financial conditions. Nevertheless, growth in 2020 is forecast to ease as a result of both domestic and external factors. Specifically:

- *Robust activity and employment growth in Cyprus.* In the first three quarters of 2019, real GDP and employment registered robust growth rates but lower than those recorded in 2018. A number of activity-related leading indicators continued to perform favourably in the final quarter of 2019, pointing to the continuation of solid growth rates in the following quarters. However, another group of leading indicators, based on hard data, weakened in the final quarter of 2019, weighing on growth in the next quarters.
- *Low inflation.* Inflation remained low throughout 2019, particularly in the second half of the year. The conditions of subdued domestic and foreign inflation are found to support growth in the short run.

<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 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).

<sup>2</sup> 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.

<sup>3</sup> 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.

- *Supportive external financial conditions.* International stock markets performed strongly in the last quarter of 2019 in view of lower uncertainty surrounding, among others, global trade and Brexit. Moreover, European interest rates and interest rates for long-term government bonds in euro area countries have declined to historically low levels in the second half of 2019, reflecting a more accommodative monetary policy stance. The recent positive performance of financial markets and the low borrowing costs in the euro area are found to affect short-term growth prospects positively.
- *Further progress in the domestic banking sector.* During 2019, the expansion of loans, albeit modest, together with the decline in the stock of NPLs, and steady growth in deposits, reflect further improvements in the domestic banking sector, contributing to favourable growth prospects.
- *Robust domestic economic sentiment.* Throughout 2019 economic sentiment in Cyprus remained above its long-run average; also, confidence in the construction sector improved significantly. The high levels of economic confidence are expected to continue to support growth in the following quarters. Nevertheless, confidence among consumers, and among firms in retail trade and services has weakened in 2019 vis-à-vis 2018, moderating the growth momentum.
- *Growth, albeit modest, in trading partner countries.* In the third quarter of 2019, real GDP in the EU and the euro area expanded by 1.4% and 1.2%, respectively (at the same rates as in the second quarter), while growth in Russia picked up to 1.6%. During the final quarter of 2019, economic sentiment indicators for the EU and the euro area declined to their long-run averages; however, confidence losses were smaller compared to previous quarters. Growth in the UK slowed to 1% in the third quarter of 2019, and economic sentiment in the UK continued to weaken well-below its long-run average in the fourth quarter. In spite of the tepid growth rates in trading partner countries, external economic conditions provide some support to domestic growth prospects. Nevertheless, the evolution of European survey indicators during 2019 is found to weigh on the growth momentum in Cyprus in 2020.

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 as in the previous issue.

Downside risks to the projections may stem from slower progress with private sector deleveraging and slower progress with the reduction of NPLs; these risks could be accentuated in an environment of low profitability in the banking sector. The high level of public debt together with the strong link between bank and sovereign risk, and potential pressures to public finances continue to pose risks to the outlook. Fiscal pressures could be associated with court rulings on the reversal of past public sector pay cuts, rapid growth in the public sector wage bill and the newly introduced General Health System. Other downside risks could arise from weaker-than-expected growth in the euro area and the UK, as well as from rising geopolitical tensions in the Eastern Mediterranean. In particular, downside risks may result from weaker-than-expected demand for tourist services due to renewed Brexit-related uncertainty regarding the future relationship of the UK with the EU.

Upside risks to the outlook are associated with a higher degree of materialisation of investments than that reflected in the predictors, and stronger-than-expected growth in Russia.

In 2020, CPI inflation is projected to rise to 0.8% from 0.3% in 2019, driven by solid activity growth and rising incomes.<sup>4</sup> Upside risks to the forecasts relate to faster increases in international commodity prices, stronger demand and higher wage growth. Downside risks to the inflation outlook are associated with slower growth and downward pressures in international commodity prices.

### 3. Concluding remarks

Quarterly and monthly series released up until 21 January 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 3.6% in the November issue to 3.4%, and the growth forecast for 2020 has been revised from 3.1% to 2.8%. The downward revisions reflect the moderation of the growth momentum in Cyprus and the EU, particularly after the second quarter of 2018, and the faltering of some leading indicators, especially domestic and European economic confidence indicators.

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

The CPI inflation forecast for 2020 has been revised from 1.2% in the November issue to 0.8%. The downward revision is mainly driven by the negative inflation rates in the second half of 2019.

The forecasts presented in this issue suggest that real economic activity will continue to expand at robust rates in 2020, albeit at a slower pace vis-à-vis 2019. The growth forecast for 2020 is close to the projections released by the Central Bank of Cyprus, the IMF and the Ministry of Finance (2.9%), but slightly more optimistic than the projection published by the European Commission (2.6%) [1] – [4].

### REFERENCES

1. Central Bank of Cyprus, “Economic Bulletin – December 2019”, Nicosia – Cyprus (in Greek), December 2019.
2. European Commission, “European Economic Forecast, Autumn 2019”, European Economy, Institutional Paper 115, November 2019.
3. International Monetary Fund (IMF), “Cyprus, 2019 Article IV Consultation— Press Release; Staff Report; and Statement by the Executive Director for Cyprus”, IMF Country Report No. 19/362, December 2019.
4. Ministry of Finance, “Cyprus Draft Budgetary Plan 2020”, in accordance to regulation (EU) No 473/2013, October 2019.

### 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	2020				2019	2020				2019	2020			
Quarter	4	1	2	3	4	4	1	2	3	4	4	1	2	3	4
<b>COMPONENTS</b>															
<b>I. Real economy</b>	0.02	0.02	0.01	0.01	0.01	0.58	0.59	0.56	0.53	0.50	3.5	2.7	2.4	2.8	2.6
<b>II. Aspects other than real economy</b>	0.03	0.02	0.02	0.02	0.02	0.84	0.85	0.82	0.73	0.75	3.5	2.8	2.5	3.0	2.9
<b>III. Real economy &amp; other aspects</b>	3.44	2.72	2.49	2.97	2.83	98.58	98.56	98.62	98.73	98.75	3.5	2.8	2.5	3.0	2.9
Fiscal	0.25	0.19	0.16	0.19	0.19	7.25	7.18	6.72	6.85	7.01	3.5	2.7	2.4	2.8	2.7
Prices	0.48	0.37	0.35	0.43	0.43	13.91	13.49	13.56	13.98	14.74	3.4	2.8	2.6	3.1	2.9
Exchange rates	0.11	0.09	0.08	0.09	0.08	3.28	3.15	3.13	3.10	3.07	3.5	2.7	2.4	2.8	2.6
Interest rates, spreads	0.86	0.68	0.58	0.73	0.69	24.33	24.40	23.92	24.55	23.98	3.5	2.8	2.4	3.0	2.9
Stock markets	0.50	0.39	0.38	0.45	0.43	14.14	13.57	14.07	14.02	14.05	3.6	2.9	2.7	3.2	3.0
Economic sentiment	0.92	0.74	0.69	0.81	0.74	26.52	28.04	28.94	28.86	27.89	3.5	2.6	2.4	2.8	2.6
Loans, deposits	0.32	0.26	0.24	0.27	0.27	9.15	8.74	8.26	7.38	8.00	3.5	3.0	2.9	3.6	3.4
<b>FORECASTS</b>	3.5	2.8	2.5	3.0	2.9										



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