



ECONOMIC OUTLOOK

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Summary

The Cypriot economy is projected to suffer a severe contraction in 2020 as a result of the COVID-19 pandemic. Real GDP is projected to drop by 6.9% in 2020, under the baseline scenario. The projection incorporates the following:

(i) the direct impact of containment measures enforced in Cyprus (e.g. business shutdowns), thereby reducing the production capacity in sectors of economic activity;

(ii) the impact of the COVID-19 pandemic relating to reduced capacity utilisation due to measures/restrictions (e.g. social distancing, increased hygiene requirements), which will remain in place after the relaxation of the initial containment measures;

(iii) the impact of reduced external demand, particularly demand for tourist services.

Due to the high uncertainty surrounding the outlook, two alternative scenarios are considered, a baseline and an adverse one. The scenarios differ with respect to the following: (a) the adjustment period experienced in each sector, following the complete lifting of containment measures in the particular sector; (b) the evolution of external demand. During the adjustment period, sectors are assumed to operate below their normal capacity utilisation levels due to supply and demand constraints (e.g. social distancing, increased hygiene requirements, disruption of supply chains, travel restrictions). The baseline scenario assumes an adjustment period of two months and a reduction in external demand for tourist services in Cyprus from April to August, translating into a decrease of 40% in annual tourist arrivals. The sector of retail trade, transportation, accommodation and food service activities and the sector of arts, entertainment, recreation and other service activities are associated with the largest output losses, amounting to around 20% of their gross value added. Significant output losses are also estimated for construction, manufacturing, as well as administrative and support service activities. In the adverse scenario, which assumes a longer adjustment period and a sharp reduction in external demand, the contraction in real GDP could be as severe as 13.1%.

Μάιος 2020

Περίληψη

Η οικονομική δραστηριότητα στην Κύπρο εκτιμάται ότι θα συρρικνωθεί σημαντικά το 2020 ως αποτέλεσμα της πανδημίας COVID-19. Το πραγματικό ΑΕΠ προβλέπεται να μειωθεί κατά 6,9% το 2020 κάτω από το βασικό σενάριο. Η πρόβλεψη ενσωματώνει τα ακόλουθα:

(i) την άμεση επίπτωση των μέτρων για παρεμπόδιση της εξάπλωσης του κορωνοϊού που εφαρμόστηκαν στην Κύπρο (π.χ. προσωρινό κλείσιμο επιχειρήσεων), τα οποία έχουν μειώσει την παραγωγική ικανότητα τομέων της οικονομίας·

(ii) την επίπτωση της πανδημίας που σχετίζεται με τη μειωμένη χρήση παραγωγικής ικανότητας (capacity utilisation) λόγω μέτρων/περιορισμών (π.χ. κοινωνική αποστασιοποίηση) που θα συνεχίσουν να υφίστανται μετά τη χαλάρωση των αρχικών περιοριστικών μέτρων·

(iii) την επίπτωση της μειωμένης εξωτερικής ζήτησης, ειδικότερα της ζήτησης για τουριστικές υπηρεσίες.

Λόγω της μεγάλης αβεβαιότητας σχετικά με τις προοπτικές, εξετάζεται ένα βασικό και ένα δυσμενές σενάριο. Τα σενάρια διαφέρουν ως προς τα ακόλουθα: (α) την περίοδο προσαρμογής σε κάθε τομέα της οικονομίας μετά την πλήρη άρση των περιοριστικών μέτρων στον συγκεκριμένο τομέα, και (β) την εξωτερική ζήτηση. Κατά τη διάρκεια της περιόδου προσαρμογής, οι τομείς θεωρείται ότι λειτουργούν κάτω από τα κανονικά επίπεδα χρήσης παραγωγικής ικανότητας λόγω περιορισμών από πλευράς προσφοράς και ζήτησης (π.χ. κοινωνική αποστασιοποίηση, αυξημένα μέτρα υγιεινής, διακοπές στις αλυσίδες εφοδιασμού, ταξιδιωτικοί περιορισμοί). Στο βασικό σενάριο η περίοδος προσαρμογής διαρκεί δύο μήνες και η μείωση στην εξωτερική ζήτηση για τουριστικές υπηρεσίες στην Κύπρο από τον Απρίλιο μέχρι τον Αύγουστο αντιστοιχεί σε υποχώρηση της τάξης του 40% στις επήσεις αφίξεις τουριστών. Ο τομέας λιανικού εμπορίου, μεταφορών, υπηρεσιών παροχής καταλύματος και εστίασης, καθώς και ο τομέας τεχνών, διασκέδασης, ψυχαγωγίας και άλλων υπηρεσιών εκτιμάται ότι θα καταγράψουν τις μεγαλύτερες απώλειες παραγωγής, που φτάνουν γύρω στο 20% της προστιθέμενης αξίας των τομέων. Σημαντικές απώλειες παραγωγής εκτιμάται ότι θα σημειώσουν και οι τομείς των κατασκευών και της μεταποίησης, καθώς και ο τομέας διοικητικών και υποστηρικτικών δραστηριοτήτων. Στο δυσμενές σενάριο, το οποίο υποθέτει μεγαλύτερη περίοδο προσαρμογής και μεγαλύτερη πτώση στην εξωτερική ζήτηση, η συρρίκνωση του πραγματικού ΑΕΠ το 2020 προβλέπεται στο 13,1%.



1. Recent developments

In 2019, real GDP in Cyprus increased by 3.2%, marking the fifth consecutive year of strong growth. However, the outbreak of the COVID-19 pandemic and the unprecedented containment measures have severely disrupted economic activity globally, including in Cyprus.

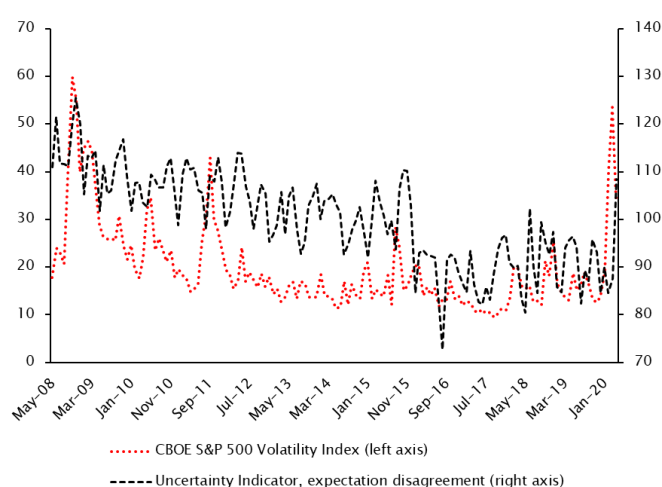
The pandemic hit Cyprus in the first week of March and by mid-March the first set of containment measures came into effect. Additional measures to curb the spread of the virus in Cyprus were enforced during the second half of March. The containment measures have included restrictions for entry to Cyprus (i.e. areas under the effective control of the Government of the Republic of Cyprus), suspension of operations of all non-essential business in the sectors of retail trade, construction and services (e.g. hotels, restaurants, sports/leisure facilities), restrictions on daily movements, as well as a range of social distancing measures (e.g. ban of public events and gatherings, school closures).

The outbreak of the pandemic in Cyprus and the containment measures that followed could be viewed as an exogenous shock to the economy that has primarily affected supply; the shock, however, could gradually impact demand. The lack of therapies and vaccines for COVID-19 makes shutdowns and lockdowns necessary given the capacity of the health system; at the same time, it creates enormous uncertainty about the magnitude and duration of the shock. The initial impact of the shock on the economy has been reflected in business and consumer survey data for March and April. Economic confidence plummeted as business and consumer expectations about activity and financial conditions were revised heavily downwards. In March, the Economic Sentiment Indicator (ESI) declined by the same amount as that recorded at the height of the 2013 economic crisis. In April, ESI suffered a historically large plunge, more than double the size of the drop in March. As a result, ESI fell to levels last seen in 2013 and well below its historical average. The largest confidence losses in March – April were registered in services and industry. Business confidence indicators for the industrial sector, and for accommodation and food services fell to all-time low levels. Consumer expectations about the economic conditions and unemployment in Cyprus are currently standing at levels similar to those registered during the 2013 crisis.

High uncertainty about the containment of the pandemic, the economic effects of the restrictive measures, and the reopening of the economy is prevalent. Uncertainty

measures derived using international stock market data such as the S&P 500 Volatility Index (VIX), increased sharply in February – March reaching levels similar to those registered during the international financial crisis. In Cyprus, uncertainty measured using the dispersion of firms' expectations rose significantly in April, after four years at very low levels (Figure 1).

Figure 1: Measures of uncertainty, financial markets and Cyprus



Source: Global Financial Data (CBOE S&P 500 Volatility Index) and CypERC calculations (Uncertainty Indicator).

However, economic policy at the EU and euro area level as well as in Cyprus has responded quickly to the highly uncertain economic environment due to COVID-19.

The strong fiscal performance in Cyprus in 2019 and in the first two months of 2020 created the space for a swift adoption of a fiscal package to alleviate the consequences of the pandemic in the country. The spending measures announced in mid-March amount to EUR 700 million (of which EUR 450 million have a direct budgetary impact) and aim at safeguarding employment, providing liquidity to businesses and avoiding company failures, supporting the self-employed, and strengthening the health care system. An additional package that includes subsidies to very small businesses affected by the pandemic and the injection of additional market liquidity through state-guaranteed bank loans is underway.

The conditions in the Cypriot banking system improved further in 2019 via better asset quality, steady growth of domestic deposits, as well as adequate capital and liquidity buffers. Domestic banks and the Cypriot economy will benefit from the accommodative monetary policy and regulatory flexibility in the euro area. Furthermore, the

Central Bank of Cyprus announced measures, such as the temporary release of about EUR 1.3 billion capital reserves to support businesses and households. The measures will allow banks to carry out short-term restructurings of loans and grant short-term loans to businesses for meeting working capital needs.

At the end of April, a four-phase plan for the gradual relaxation of the pandemic containment measures and the reopening of the economy was announced. The plan spans a period of over two months, beginning in 4 May and ending in mid-July, subject to the evolution of the epidemiological conditions in the country.

2. Forecasts

The pandemic has created extraordinary conditions locally and globally, leading to elevated uncertainty about the economic outlook. As the outbreak of the pandemic and the subsequent containment measures constitute an exogenous shock to an otherwise robustly growing economy, the standard forecasting procedures provide little insight about the impact of this shock on economic activity in the following quarters. The leading indicators published until 29 April 2020 used in the forecasting models capture the disruption in economic activity due to the pandemic only partially. However, these forecasting models are informative about the dynamic path of the economy and its different sectors up to the data cut-off date. Projections for the growth rate of GDP and its production-side components are constructed using an extensive dataset of domestic and foreign indicators, as well as a large number of dynamic econometric models.^{1,2} First, the projections incorporate the impact of containment measures enforced in Cyprus, thereby reducing the production capacity in sectors or sub-sectors of economic activity. This can be viewed as the direct impact of containment measures, such as business shutdowns, on activity. Second, the projections incorporate the impact of the COVID-19 pandemic relating to reduced capacity

utilisation in each sector due to measures/restrictions (e.g. social distancing, increased hygiene requirements), which will remain in place after the relaxation of the initial containment measures. Third, the impact of reduced external demand, particularly demand for tourist services, is taken into account. Tourist services make up a large part of economic activity in Cyprus and are expected to be heavily affected as the pandemic has restricted international travel significantly.

Two alternative scenarios are considered, a baseline and an adverse one. The scenarios differ with respect to the following: (a) the adjustment period experienced in each sector following the complete lifting of containment measures in the particular sector, and (b) the evolution of external demand. During the adjustment period and prior to the return to normality, sectors are assumed to operate below their normal capacity utilisation levels due to supply and demand constraints (e.g. social distancing, increased hygiene requirements, disruption of supply chains, travel restrictions).³ Specifically, the two scenarios rest on the following assumptions:

- Baseline scenario: (i) an adjustment period of two months after the complete lifting of containment measures in each sector, based on the reopening plan announced by the government; (ii) a reduction in external demand for tourist services in Cyprus from April to August, translating into a decrease of 40% in annual tourist arrivals.
- Adverse scenario: (i) an adjustment period of four months after the complete lifting of containment measures in each sector, based on the announced reopening plan; (ii) a reduction in external demand for tourist services in Cyprus from April to December, translating into a decrease of 80% in annual tourist arrivals.

Table 1 presents the forecasts under the two scenarios, together with the losses in terms of output for the economy and its sectors.

¹ The data used include indicators such as interest rates and spreads, stock market returns and volatility, economic sentiment indicators, uncertainty indicators, exchange rates, domestic and foreign price indices, international commodity prices, as well as fiscal and banking sector series. 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.

² The analysis has benefited from the project on the development of sectoral forecasts for the Cypriot economy, funded by the Central Bank of Cyprus and the Ministry of Finance (2019).

³ Information about capacity utilisation is obtained from Business Surveys carried out under the Joint Harmonised EU Programme of Business and Consumer Surveys.

Based on the above assumptions, real economic activity in Cyprus is forecast to suffer a severe contraction in 2020 as a result of the pandemic. The recession in 2020 is forecast at 6.9% under the baseline scenario; under the adverse scenario real activity is projected to contract by 13.1%.

Analysing the direct impact of the pandemic containment measures amounts to focusing solely on the period of decreed lockdowns, assuming that normal economic activity can resume immediately after the measures are lifted. Under this benign assumption, the output loss for the Cypriot economy is estimated at 5.8% of GDP and corresponds to a contraction of 3.6% in real GDP in 2020. The direct impact of the COVID-19 containment measures is larger in the sector of arts, entertainment, recreation and other service activities. Retail trade, transportation, accommodation and food service activities as well as construction are also associated with sizable output losses during the lockdown period.

Under the baseline scenario, real GDP in Cyprus is projected to drop by 6.9%, a contraction in real activity similar to that experienced during the 2013 crisis. Output losses due to the COVID-19 crisis are estimated at 9.1% of GDP. All sectors of economic activity are expected to incur output losses. The magnitude of these losses depends on the extent to which the sector has directly been affected by lockdown measures, the decline in sectoral capacity utilisation (reflecting supply and demand effects) during the adjustment period, as well as on the degree of the sector's reliance on external demand. Therefore, the sector of retail trade, transportation, accommodation and food service activities, and the sector of arts, entertainment, recreation and other service activities are associated with the largest losses, amounting to around 20% of their 2019 gross value added. Significant output losses are estimated for construction, manufacturing, as well as administrative and support service activities; the losses in the latter sector are mainly due to rental activities (e.g. car rentals) and travel agency / tour operator activities, which are closely linked to tourism.

Under the adverse scenario, real GDP is forecast to decline by 13.1%, nearly double the size of the 2013 recession. The economy is projected to suffer hefty losses under the adverse scenario, totalling 15.3% of GDP. Output losses in sectors that rely heavily on external demand through tourism may exceed 30% of the sectoral gross value added. When the direct effects of the lockdown are combined with the assumptions of the adverse scenario, the economic damage

in construction, professional and administrative services and industry, exceeds 10% of their gross value added.

Table 1: GDP growth projections for 2020 and output losses under alternative scenarios

Scenario	Direct impact of containment measures	Baseline	Adverse
GDP growth		-6.9	-13.1
Loss (% of 2019 output)			
Economy (GDP)	5.8	9.1	15.3
Agriculture	0.0	1.6	3.3
Industry	4.7	8.1	11.4
Construction	8.8	12.3	15.8
Wholesale and retail trade, transportation, accommodation and food service activities	12.0	18.5	35.9
Information and communication	1.5	1.5	1.5
Financial and insurance activities	1.4	2.2	3.0
Real estate activities	1.6	2.8	4.1
Professional, scientific, technical, administrative and support service activities	3.6	6.9	14.5
Public administration, education, health	1.8	2.9	3.9
Arts, entertainment, recreation and other service activities	16.7	21.5	33.6

The uncertainty surrounding any macroeconomic projection at this juncture is extremely high. The response of economic activity to the COVID-19 crisis does not only depend on mitigating economic policies and the economic fundamentals of the country, but also on the epidemiological outcomes in Cyprus and abroad in the following months. The pandemic hit Cyprus at a time of robust growth, positive budget balance and improved conditions in the banking sector, hence policy was able to respond promptly. However,

legacies from the previous crisis, such as the high level of public and private debt and the high stock of non-performing loans, render the economy less resilient to the shock. As a result of the current crisis the economy is faced with new challenges. In the short term, concerns relate to the uninterrupted resumption of economic activity, the effectiveness of policy measures in supporting employment and businesses, and the reaction of external demand, particularly tourism. Dealing with fiscal pressures arising from the current crisis while maintaining market access, avoiding a re-escalation of non-performing loans, and withstanding a possibly unfavourable external environment, will largely determine the balance of risks to the outlook, particularly in the medium term.

3. Concluding remarks

The outbreak of the COVID-19 pandemic has necessitated containment measures that have severely disrupted economic activity globally, including in Cyprus. Households, firms and policy makers are faced with extremely high uncertainty about future economic conditions. Consequently, forecasts need to not only incorporate the most recent developments through leading indicators, but also integrate the direct and indirect effects of the unprecedented measures taken to control the pandemic, which are not fully reflected in recent data. The forecasts for 2020, constructed under two scenarios, rely on assumptions about the adjustment period following the lifting of containment measures and the evolution of external demand.

Under both scenarios, real economic activity in Cyprus is projected to decline substantially in 2020, leading to a sizeable downward revision of the 2020 growth forecast compared to the January issue, as a result of the COVID-19 crisis. Under the baseline scenario, real GDP in Cyprus is projected to contract by 6.9% in 2020. The baseline growth forecast is close to the projections released by the European Commission, the IMF and the Ministry of Finance (around 7%) [1] – [3]. Nevertheless, due to the high uncertainty and the escalation of downside risks, an adverse scenario forecast is also necessary. Under the adverse scenario, the contraction in real GDP could be as severe as 13.1%.

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