



ECONOMIC OUTLOOK

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Summary

Real GDP growth in Cyprus is projected at -6.5% in 2020 as a result of the COVID-19 pandemic. In 2021, economic activity is expected to recover as real GDP growth is projected at 4.2%. The negative growth forecast for 2020 incorporates the disruption in economic activity due to the lockdown in Cyprus in the spring, captured by published data. Also, the growth forecasts for 2020 and 2021 reflect (through leading indicators) the resumption of economic activity with reopening, and, to a smaller extent, challenges to recovery due to ongoing or new measures and restrictions (e.g. social distancing, movement restrictions, partial lockdowns) to curb new outbreaks of COVID-19.

The contraction in real activity projected for 2020 is less severe than the forecast in the August issue. The upward revision is driven by the rebound in domestic activity and improvements in external economic conditions in the third quarter of the year as the economies reopened.

The CPI inflation forecast for 2020 has remained unchanged from the previous issue, at -0.7%. In 2021, CPI inflation is forecast at 1.0% as demand is expected to pick up.

The forecasts at this juncture are accompanied by elevated uncertainty as economic outcomes largely depend on the evolution of the pandemic, in particular controlling the new wave of infections in Cyprus and abroad.

Νοέμβριος 2020

Περίληψη

Ο ρυθμός μεταβολής του πραγματικού ΑΕΠ στην Κύπρο για το 2020 προβλέπεται σε -6,5%, ως αποτέλεσμα της πανδημίας COVID-19. Το 2021 η οικονομική δραστηριότητα στην Κύπρο αναμένεται να ανακάμψει με τον ρυθμό μεγέθυνσης του πραγματικού ΑΕΠ να εκτιμάται σε 4,2%. Η αρνητική πρόβλεψη για το 2020 ενσωματώνει τη διακοπή της ομαλής λειτουργίας της οικονομίας, λόγω των περιοριστικών μέτρων που λήφθηκαν την άνοιξη, η οποία αποτυπώνεται στους οικονομικούς δείκτες. Επίσης, οι προβλέψεις για το 2020 και 2021 αντανακλούν (μέσω προπορευόμενων δεικτών) την επανεκκίνηση της οικονομικής δραστηριότητας στην Κύπρο και στο εξωτερικό και, σε μικρότερο βαθμό, προκλήσεις στην ανάκαμψη λόγω συνεχιζόμενων ή νέων μέτρων/περιορισμών κατά της πανδημίας. Η συρρίκνωση στο πραγματικό ΑΕΠ που εκτιμάται για το 2020 είναι μικρότερη από την πρόβλεψη στο τεύχος Αυγούστου. Η προς τα πάνω αναθεώρηση προέρχεται από τη βελτίωση της εγχώριας δραστηριότητας και την καλύτερευση του εξωτερικού περιβάλλοντος με την επαναδραστηριοποίηση των οικονομιών το τρίτο τρίμηνο του έτους.

Σημαντικότερο κίνδυνο για τις προοπτικές αποτελεί η επιδείνωση των επιδημιολογικών συνθηκών στην Κύπρο και στο εξωτερικό και η λήψη πρόσθετων, αυστηρότερων μέτρων για περιορισμό της πανδημίας. Ευπάθειες της κυπριακής οικονομίας λόγω της προηγούμενης κρίσης όπως τα υψηλά επίπεδα δημόσιου και ιδιωτικού χρέους και το μεγάλο απόθεμα μη εξυπηρετούμενων δανείων, την καθιστούν λιγότερο ανθεκτική στη νέα κρίση. Συνεπώς, επιπρόσθετες δημοσιονομικές πιέσεις που ενδεχομένως να προκύψουν από την τρέχουσα κρίση, μια πιθανή εκ νέου κλιμάκωση των μη εξυπηρετούμενων δανείων, καθώς και καθυστερήσεις στη διαδικασία των εκποιήσεων επίσης, αποτελούν κινδύνους για τις προοπτικές. Περαιτέρω καθυστερήσεις στην εφαρμογή διαρθρωτικών μεταρρυθμίσεων (π.χ. δικαστικό σύστημα, δημόσια υπηρεσία, τοπική αυτοδιοίκηση) ενδέχεται να υπονομεύσουν την αξιοπιστία, να περιορίσουν την πρόσβαση σε κονδύλια του Μηχανισμού Ανάκαμψης και Ανθεκτικότητας της ΕΕ και να επιβαρύνουν τις προοπτικές ανάπτυξης. Ο θερμοκρασιολογικός προγραμματισμός πολιτογραφήσεων ενδεχομένως να επηρεάσει τις προοπτικές μέσω πιθανής μείωσης του όγκου κατασκευαστικών έργων.

Καλύτερες από τις προβλεπόμενες προοπτικές μπορούν να διαμορφωθούν από σταθερή βελτίωση των επιδημιολογικών συνθηκών στην Κύπρο και στο εξωτερικό και ταχύτερη από την αναμενόμενη ανάπτυξη και διάθεση ενός εμβολίου. Ισχυρότερη ανάκαμψη της δραστηριότητας από αυτή που αντανακλάται στα διαθέσιμα στοιχεία μπορεί να οδηγήσει σε καλύτερα από τα προβλεπόμενα αποτελέσματα. Επιπλέον, η επιτυχή απορρόφηση κονδυλίων της ΕΕ και η αξιοποίηση των διαθέσιμων εργαλείων της ΕΕ για μετριασμό των επιπτώσεων της πανδημίας αναμένεται να επηρεάσουν θετικά τις προοπτικές.

Ο πληθωρισμός το 2020 προβλέπεται να μειωθεί σε -0,7% από 0,3% το 2019. Ο πληθωρισμός για το 2021 προβλέπεται σε 1,0% καθώς η ζήτηση αναμένεται να ανακάμψει.



1. Recent developments

The COVID-19 pandemic and the unprecedented containment measures that followed affected the Cypriot economy deeply as real GDP contracted by 12.3% year-on-year (y-o-y) in the second quarter of 2020.

The largest sector in terms of gross value added, namely trade, transportation, accommodation and food service activities shrank at an unprecedented rate of over 30% (y-o-y) in the second quarter. Construction, arts and entertainment, the industrial sector and, to a smaller degree, professional, administrative and financial activities also suffered losses in the second quarter as a result of the pandemic. The remaining sectors continued to expand, limiting the effects of the downturn. Private consumption declined sharply in the second quarter, while the consumption expenditure of the general government continued to rise strongly, partly offsetting the effects of the downturn. In the second quarter, gross fixed capital formation contracted driven by significant declines in construction investment and transport equipment. Net exports contributed negatively to GDP growth in the second quarter as exports declined faster than imports.

Domestic leading indicators, particularly those relating to consumption, construction investment and real estate activities continued to recover in the third quarter, following the reopening of the economy. Tourism indicators remained depressed in the third quarter as the flow of international tourists was limited due to the pandemic.

In the third quarter, the Economic Sentiment Indicator (ESI) rose from the low levels registered during the lockdown; nevertheless, the ESI has remained below both its historical average and the EU-wide ESI. Business confidence in services, manufacturing and retail trade improved in the third quarter, while confidence in construction was relatively less affected by the pandemic. Firms' employment expectations strengthened in the third quarter, backed by the government schemes in place for supporting employment and businesses. Consumer confidence increased only marginally in the third quarter and consumer expectations for the economic conditions in the country and unemployment remained grim.

The number of registered unemployed continued to increase at double-digit rates in the third quarter; the largest increases were recorded in the sectors of trade, transportation, and hospitality. The unemployment rate

(Eurostat) increased to just above 7% in August but remained below the euro area average.

To alleviate the consequences of the pandemic in Cyprus generous fiscal measures were adopted as early as mid-March. The measures aim at safeguarding employment, providing liquidity to businesses and avoiding company failures, supporting the self-employed, and strengthening the health care system. In July - August, government expenditure continued to rise (y-o-y) and revenue continued to decline (y-o-y), but at a slower pace compared to that in April - June, narrowing the deficit. The measures to mitigate the impact of the pandemic increased public debt to about EUR 25bn; nevertheless, in the third quarter, long-term interest rates for Cyprus declined.

In the third quarter, domestic deposits continued to increase and domestic loans registered stronger annual growth rates, particularly loans for house purchase. Although new credit has remained subdued after the reopening, new lending for house purchase in June - August almost matched its level in the corresponding months in 2019. Domestic lending interest rates have remained at very low levels and various measures announced to counteract the economic effects of the pandemic (e.g. suspension of loan instalments, short-term restructurings of loans, interest rate subsidisation of new housing and business loans) are expected to support business liquidity, investment, as well as household incomes. The ratio of non-performing loans (NPLs) to total facilities declined to just below 27% in May, with the sectors of construction and trade, as well as households being the most exposed. Despite the downward trend, NPLs remain a significant vulnerability for the economy, particularly after the pandemic-induced measures to support viable borrowers come to an end.

Inflation (measured by the Consumer Price Index - CPI) in the third quarter stayed in negative territory, at -1.2% vis-à-vis -1.6% in the second quarter, mainly driven by negative inflation in the categories of housing, energy, transport and communication.

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 second quarter of 2020 are employed. Monthly indicators that contain information about some or all the months in the third quarter

of 2020 are also used. The cut-off date for the data used in the analysis is 20 October 2020. 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 2020 and 2021. Based on the historical relationships between growth and numerous macroeconomic and financial indicators, real economic activity in Cyprus is forecast to suffer a severe contraction in 2020 as a result of the COVID-19 pandemic. Real GDP is projected to contract by 6.5% in 2020. In 2021, activity is expected to recover as real GDP growth is forecast at 4.2%.

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 negative growth forecast for 2020 incorporates the disruption in economic activity due to the lockdown in Cyprus in the spring, captured by published data up to the cut-off date. Also, the growth forecasts for 2020 and 2021 reflect, through leading indicators, the resumption of economic activity with reopening, and, to a smaller extent, challenges to recovery due to ongoing or new measures and restrictions (e.g. social distancing, movement restrictions, partial lockdowns) to curb new outbreaks of COVID-19. The drivers of the outlook are discussed below.

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 (loans including NPLs, deposits).

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	2020		
FORECAST	-6.5		
	CONTRIBUTION	WEIGHT	FORECAST BY COMPONENT
COMPONENTS			
I. Real economy	-0.03	0.49	-5.8
II. Aspects other than real economy	-0.04	0.69	-5.6
III. Real economy & other aspects	-6.38	98.82	-6.5
Fiscal	-0.46	6.79	-6.7
Prices	-0.82	12.05	-6.8
Exchange rates	-0.25	3.77	-6.6
Interest rates, spreads	-1.40	20.92	-6.7
Stock markets	-1.08	16.13	-6.7
Economic sentiment, uncertainty	-1.81	30.76	-5.9
Loans, deposits	-0.57	8.40	-6.7
Year	2021		
FORECAST	4.2		
	CONTRIBUTION	WEIGHT	FORECAST BY COMPONENT
COMPONENTS			
I. Real economy	0.02	0.46	3.6
II. Aspects other than real economy	0.03	0.61	4.1
III. Real economy & other aspects	4.12	98.92	4.2
Fiscal	0.30	6.81	4.3
Prices	0.51	11.59	4.4
Exchange rates	0.16	3.67	4.2
Interest rates, spreads	0.93	22.70	4.1
Stock markets	0.65	16.09	4.1
Economic sentiment, uncertainty	1.29	30.90	4.2
Loans, deposits	0.28	7.18	3.9

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 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.

- *Drop and rebound in activity.* In the second quarter real GDP in Cyprus and the EU contracted severely as a result of the pandemic and lockdowns; however, the rise in unemployment was cushioned by policy measures to support employment and businesses. Second quarter GDP data show that Cyprus registered a smaller drop in activity compared to output declines in the EU and the euro area. Leading indicators (e.g. retail trade sales, manufacturing production) for the third quarter point to a rebound in activity in the EU as the economies reopened. In Cyprus, hard data, such as retail trade indices, building permits, property sale contracts and motor vehicle registrations signal to a strong pickup in domestic activity from May onward. These positive developments are expected to limit the depth of the recession in 2020 and fuel recovery in the following quarters. However, the rise in the number of registered unemployed in Cyprus accelerated in the third quarter, particularly in tourism-related sectors, and international tourism outturns in Cyprus were worse than envisaged, weighing on the outlook.
- *Rise in economic sentiment.* Economic confidence in Cyprus and the EU rose in the third quarter; the recovery of the ESI was particularly strong in the EU and the euro area, while the ESI in Cyprus increased moderately, recording a setback in September. The recent improvements in economic confidence, especially at the EU-level, are found to have positive effects on output in the following quarters. Nevertheless, the recovery momentum is dampened as confidence gains in Cyprus were rather modest in the third quarter.
- *Supportive monetary and fiscal and policies.* The low levels of both domestic and European interest rates, reflecting the supportive monetary policy conditions in the euro area, as well as the increased government spending to support households and businesses during the pandemic are expected to mitigate the downturn in 2020 and facilitate the recovery in the next quarters.
- *Low inflation.* Inflation in Cyprus remained negative in the third quarter. Moreover, international oil prices have remained subdued, despite some increases as economies reopened. Thus, the absence of upward price pressures supports real incomes and the economic recovery.
- *Improved conditions in international stock markets.* In the third quarter, international stock markets recovered from the low levels registered in the first half of the year and volatility declined further, pointing to a less adverse external environment.

Nonetheless, there are some factors that signal challenges to a strong recovery from the COVID-19 recession.

International stock market indices remain below their 2019 levels and volatility is still above the 2019 levels, reflecting uncertainties about the recovery momentum, especially in Europe as the pandemic continues to spread. Also, the high indebtedness levels in Cyprus may weigh on growth, even in conditions of record-low interest rates, while elevated uncertainty may increase precautionary saving, putting a drag on demand.

The uncertainty surrounding the projections is extremely high as the pandemic has been resurging. Significant downside risks to the outlook stem from the deterioration of the epidemiological conditions in Cyprus and abroad, and the introduction of new or additional measures to curb the spread of the virus (e.g. partial lockdowns, movement restrictions). Setbacks in the recovery of domestic and external demand due to new COVID-19 outbreaks affect the outlook negatively. Legacies from the previous crisis, such as the high levels of public and private debt, and the high stock of NPLs, render the economy less resilient to the COVID-19 crisis. Thus, additional risks relate to fiscal pressures arising from the current crisis, a possible re-escalation of NPLs (particularly after the expiry of the various support schemes) and setbacks in the foreclosure process. Further delays in the implementation of overdue structural reforms (e.g. judicial system, public administration, local authorities) may undermine credibility, limit access to the EU Recovery and Resilience Facility and weigh on the growth prospects. The termination of the citizenship-by-investment programme may affect the outlook through, for example, lower construction investment. Finally, geopolitical tensions in the Eastern Mediterranean may also weigh on the outlook.

Upside risks to the outlook include the steady improvement in the epidemiological conditions in Cyprus and abroad, and the faster-than-expected development and availability of a vaccine, which would positively affect demand. A stronger rebound in activity than that reflected in the predictors may lead to better outcomes than the projections. Moreover, successfully absorbing EU funds and making optimal use of the available EU instruments to mitigate the pandemic effects will positively affect the outlook, as well as the medium-term prospects.

In 2020, CPI inflation is projected to fall to -0.7% from 0.3% in 2019, driven by the sharp declines in international oil prices in the first half of the year and subdued demand due to the pandemic. In 2021, CPI inflation is forecast at 1.0% as demand is expected to strengthen; the low inflation forecast in 2021

is driven by past decreases in international oil prices and negative inflation in Cyprus in the second and third quarters of 2020.⁴ Upside risks to the forecasts include a faster rebound in international energy prices and demand. Downside risks to the inflation outlook are associated with a deeper and/or a more protracted downturn in domestic and global activity than that is currently foreseen, as well as downward pressures on international commodity prices.

3. Concluding remarks

The outbreak of the COVID-19 pandemic has necessitated containment measures that have severely disrupted economic activity globally, including in Cyprus. The economic disruptions induced by the pandemic, particularly in March – April, and the subsequent pickup in activity as the economies reopened are reflected in the data used for the construction of the forecasts.

Real GDP growth in Cyprus is forecast at –6.5% in 2020, a less severe decline than the projection presented in the August issue (–7.5%). The upward revision is driven by the rebound in domestic activity and improvements in external economic conditions in the third quarter as the economies reopened. In 2021, real economic activity in Cyprus is projected to grow at 4.2%. The CPI inflation forecast for 2020 remained unchanged from the previous issue, at –0.7%. In 2021, CPI inflation is forecast at 1.0% as demand is expected to pick up.

The growth forecast for 2020 presented in this bulletin is close to the projection published by the IMF (–6.4%), but somewhat more pessimistic than the forecast released by the Ministry of Finance (–5.5%). The growth forecast for 2021 is slightly lower than the projections published by the IMF (4.7%) and the Ministry of Finance (4.5%), [1] – [2].

The forecasts at this juncture are accompanied by elevated uncertainty as economic outcomes largely depend on the evolution of the pandemic, in particular controlling the new wave of infections in Cyprus and abroad.

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



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