

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

January 2023

Summary

Growth in 2022 is estimated to have remained strong, supported by the vigorous growth rates attained in the first three quarters of the year. In 2023, growth is forecast to decelerate. The upward pressures on energy prices and high inflation, as well as monetary policy tightening are expected to affect domestic activity both directly and indirectly through weaker global economic activity. Real GDP growth is projected at 5.6% and 2.6% for 2022 and 2023, respectively. Compared to the forecast in the October issue, the growth forecasts for 2022 and 2023 have been revised up by 0.7 and 0.2 percentage points, respectively. The upward revisions resulted mainly from the higher-than-projected growth rate in the third quarter of 2022 and upward revisions in GDP growth data for recent quarters. In 2024, real GDP growth is forecast at 2.8%.

The growth outlook is accompanied by risks, predominantly on the downside. Downside risks to the outlook for Cyprus could arise if the slowdown in trading partner economies turns out to be more severe than expected. Strong upward pressures on international commodity prices (especially energy prices), as a result of geopolitical tensions, particularly Russia's war in Ukraine, could sustain inflationary pressures and squeeze real incomes further, weighing on growth prospects. Moreover, downside risks to the outlook could stem from faster and/or steeper than expected increases in the borrowing costs faced by the government and the private sector, as a result of monetary policy tightening in the euro area, particularly if high inflation persists. The rising borrowing and debt service costs could increase credit risk in conditions of a global slowdown, and may pose challenges to public finances and the domestic banking system, particularly as the complete implementation of the foreclosure framework has been undermined by delays.

Inflation (based on the Consumer Price Index) is forecast to decrease from 8.4% in 2022 to 3.2% in 2023. In 2024, inflation is projected to fall to 2.0%.

Ιανουάριος 2023

Περίληψη

Ο ρυθμός οικονομικής μεγέθυνσης το 2022 εκτιμάται ότι παρέμεινε ισχυρός, υποστηριζόμενος από τους υψηλούς ρυθμούς αύξησης της οικονομικής δραστηριότητας που καταγράφηκαν κατά τα τρία πρώτα τρίμηνα του έτους. Το 2023, ο ρυθμός μεγέθυνσης της οικονομίας προβλέπεται να επιβραδυνθεί. Οι ανοδικές πιέσεις στις τιμές της ενέργειας και ο υψηλός πληθωρισμός, καθώς και η σύσφιξη της νομισματικής πολιτικής αναμένεται να επηρεάσουν την εγχώρια δραστηριότητα άμεσα, αλλά και έμμεσα μέσω της ασθενέστερης παγκόσμιας οικονομικής δραστηριότητας. Ο ρυθμός μεγέθυνσης του πραγματικού ΑΕΠ προβλέπεται σε 5,6% και 2,6% για το 2022 και το 2023 αντίστοιχα. Οι προβλέψεις για το 2022 και το 2023 έχουν αναθεωρηθεί προς τα πάνω κατά 0,7 και 0,2 ποσοστιαίες μονάδες αντίστοιχα, συγκριτικά με τις προβλέψεις στο τεύχος Οκτωβρίου. Οι θετικότερες προοπτικές είναι κυρίως αποτέλεσμα του υψηλότερου ρυθμού μεγέθυνσης από τον προβλεπόμενο κατά το τρίτο τρίμηνο του 2022, καθώς και των προς τα πάνω αναθεωρήσεων στα στοιχεία για τον ρυθμό αύξησης του ΑΕΠ για πρόσφατα τρίμηνα. Το 2024, η αύξηση του πραγματικού ΑΕΠ προβλέπεται στο 2,8%.

Οι κίνδυνοι για δυσμενέστερες προοπτικές από τις προβλεπόμενες κυριαρχούν. Χαμηλότεροι από τους προβλεπόμενους ρυθμούς μεγέθυνσης θα μπορούσαν να προκύψουν αν η επιβράδυνση στις οικονομίες των εμπορικών εταίρων της Κύπρου αποδειχθεί πιο σοβαρή από την αναμενόμενη. Περαιτέρω ανοδικές πιέσεις στις διεθνείς τιμές των εμπορευμάτων (κυρίως της ενέργειας), ως αποτέλεσμα γεωπολιτικών εντάσεων, ιδιαίτερα του συνεχιζόμενου πολέμου της Ρωσίας στην Ουκρανία, θα μπορούσαν να επιτείνουν τις πληθωριστικές πιέσεις και να συμπιέσουν περισσότερο τα πραγματικά εισοδήματα, επιβαρύνοντας τις προοπτικές. Επιπλέον, οι κίνδυνοι για δυσμενέστερες από τις προβλεπόμενες προοπτικές θα μπορούσαν να προκύψουν από ταχύτερες ή/και πιο απότομες από τις αναμενόμενες αυξήσεις στο κόστος δανεισμού του κράτους και του ιδιωτικού τομέα λόγω της σύσφιξης της νομισματικής πολιτικής στην ευρωζώνη, ιδιαίτερα αν ο πληθωρισμός παραμείνει σε υψηλά επίπεδα. Σε συνθήκες παγκόσμιας επιβράδυνσης, το αυξανόμενο κόστος δανεισμού και το αυξανόμενο κόστος εξυπηρέτησης χρέους θα μπορούσαν να οδηγήσουν σε άνοδο του πιστωτικού κινδύνου με συνεπακόλουθες προκλήσεις για τα δημόσια οικονομικά και το εγχώριο τραπεζικό σύστημα, ειδικότερα ενόσω η πλήρης εφαρμογή του πλαισίου των εκποιήσεων καθυστερεί.

Ο πληθωρισμός (με βάση τον Δείκτη Τιμών Καταναλωτή) προβλέπεται να μειωθεί από 8,4% το 2022 σε 3,2% το 2023. Το 2024, ο πληθωρισμός προβλέπεται να μειωθεί στο 2,0%.

1. Recent developments

The Cypriot economy continued to perform strongly in the third quarter of 2022 owing to buoyant domestic and external demand. Real GDP increased by 5.4% year-on-year (y-o-y) in the third quarter compared with 6.4% in the first half of 2022.

In the third quarter of 2022, real gross value added expanded (y-o-y) in all sectors of economic activity, except construction, where value added declined for the third consecutive quarter. In the third quarter, growth in the industrial, trade and most services sectors decelerated, while the contraction in the construction sector moderated.

In the third quarter of 2022, private consumption (in real terms) continued to increase (y-o-y) vigorously, but at a slower pace compared to the first half of the year, while government consumption growth picked up. Growth in gross fixed capital formation slowed sharply in the third quarter, as key components such as transport equipment, dwellings and other buildings registered declines; however, the decline in construction investment was less severe than the contraction in the first half of 2022. Exports and imports of goods and services continued to rise (y-o-y) at double-digit rates in the third quarter, resulting in a negative contribution of net exports to growth.

Domestic activity continued to improve in the final quarter of 2022, as signalled by leading indicators available for October – December (e.g. volume of retail trade, use of credit cards, tourist arrivals, number of property sale contracts, registrations of motor vehicles). However, the recent developments in most indicators suggest a slowing growth momentum. Labour market indicators showed signs of deterioration in labour market conditions. The number of registered unemployed increased (y-o-y) in the final quarter of 2022, after five consecutive quarters of declines. In November, the unemployment rate in Cyprus (Eurostat) rose to 7.5% from 6.3% at the beginning of 2022.

Survey indicators reflect favourable domestic economic conditions amid considerable uncertainty. The Economic Sentiment Indicator (ESI) increased in the fourth quarter of 2022, as a result of confidence gains in the sectors of services, retail trade and construction, as well as among consumers. In December, the ESI for Cyprus exceeded its long-run average and remained well above the EU-wide ESI.

Also, the Employment Expectations Indicator improved in the fourth quarter of 2022 and moved above its long-run average. Economic uncertainty in Cyprus, measured through survey data, rose in the last quarter of 2022, as a result of higher uncertainty among firms. In the fourth quarter of 2022, consumers and firms in retail trade, industry and construction revised their price expectations downwards, while selling price expectations in services rose.

Over the period January – November 2022, government revenue increased (y-o-y) much faster than expenditure, resulting in a budget surplus, compared to a deficit over the same period in 2021. Public debt declined to just below EUR 24.0 billion in November. The long-term interest rate for Cyprus increased further in October – November owing to monetary policy tightening.

Domestic lending interest rates continued to increase in October and November, driven by further increases in the European Central Bank key interest rates. New lending in October – November contracted (y-o-y), but growth in new credit over the period January – November expanded strongly compared to the same period in 2021. The annual growth rate of loans continued to slow down in October and November. The annual growth rate of total deposits turned negative in November for the first time in two years. Progress in the reduction of non-performing loans (NPLs) in the banking sector continued, as the ratio of NPLs decreased from 11.2% in June to 10.5% in October.

In the final quarter of 2022, inflation, measured by the Consumer Price Index (CPI) eased to 8.5%, from 9.5% in the third quarter, mainly because of lower inflation in the categories of housing and energy, transport, and clothing, despite a pickup in food inflation. In 2022, inflation reached 8.4%, the highest rate since 1981, primarily as a result of fast increases in energy and food prices.

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 2022 were employed. Monthly indicators that contain information about some or all the months in the final

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quarter of 2022 were also used. The cut-off date for the data used in the analysis was 12 January 2023.

Table 1 presents the forecasts for the growth rate of real GDP for 2022, 2023 and 2024. The year 2022 was marked by uncertainties caused by Russia's war in Ukraine, lingering pandemic effects and high energy and food inflation. Nevertheless, growth in 2022 is estimated to have remained strong, supported by the vigorous growth rates attained in the first three quarters of the year. In the final quarter of 2022, real GDP growth is estimated to have slowed down. In 2023, growth is forecast to decelerate further. The upward pressures on energy prices and high inflation, as well as monetary policy tightening are expected to affect domestic activity both directly and indirectly through weaker global economic activity. Real GDP growth is projected at 5.6% and 2.6% for 2022 and 2023, respectively. Compared to the forecasts in the October issue, the

growth forecasts for 2022 and 2023 have been revised up by 0.7 and 0.2 percentage points, respectively. The upward revisions resulted mainly from the higher-than-projected growth rate in the third quarter of 2022 and upward revisions in GDP growth data for recent quarters. For 2024, real GDP growth is forecast at 2.8%.

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, have a minor weight.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	2022		2023		2024	
FORECAST	5.6		2.6		2.8	
	WEIGHT	FORECAST BY COMPONENT	WEIGHT	FORECAST BY COMPONENT	WEIGHT	FORECAST BY COMPONENT
COMPONENTS						
I. Real economy	0.48	5.6	0.37	2.9	0.44	3.0
II. Aspects other than real economy	0.56	5.6	0.38	3.2	0.58	3.2
III. Real economy & other aspects	98.97	5.6	99.24	2.6	98.98	2.8
Fiscal	5.57	5.7	5.39	3.3	5.77	3.3
Prices	11.85	5.5	12.09	1.6	11.39	2.0
Exchange rates	3.25	5.6	3.22	2.8	3.43	2.8
Interest rates, spreads	17.20	5.6	18.81	2.5	18.75	2.5
Stock markets	14.12	5.6	13.26	3.0	13.89	3.3
Economic sentiment, uncertainty	37.26	5.6	37.15	2.7	38.25	3.0
Loans, deposits	9.71	5.6	9.33	2.9	7.52	3.1

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 are expected to support growth in the following quarters as well as the challenges to the growth prospects are discussed below.

- *Domestic real economy.* In the third quarter of 2022, employment growth strengthened, and real economic activity and job vacancies registered robust growth rates, albeit somewhat lower compared to the first half of the year. The recent favourable conditions in the real economy are projected to propel growth in the following quarters. However, in the final quarter of 2022, some activity indicators weakened and labour market indicators deteriorated, signalling some loss in the economic momentum in Cyprus.
- *Domestic sentiment and employment expectations.* Improvements in economic confidence and expectations influence positively the growth outlook. Economic sentiment in Cyprus strengthened further in the final quarter of 2022, mainly driven by gains in business confidence in services and retail trade. Smaller gains were registered in consumer confidence between the third and fourth quarters. Firms' employment expectations picked up in the fourth quarter, largely because of upward revisions in employment plans in services and retail trade.
- *Domestic financial conditions.* Despite the recent slowdown in the annual growth rate of domestic deposits and loans, the conditions in the domestic banking system have remained favourable, particularly as NPLs have continued declining. Credit expansion, albeit slowing, is expected to continue to facilitate economic activity in the next quarters. Moreover, the performance of the Cyprus Stock Exchange, which strengthened significantly in the final quarter of 2022, is projected to benefit the outlook. However, the rising borrowing costs, as a result of monetary policy tightening, are found to weigh on the outlook.
- *Fiscal performance.* The recent fiscal performance has been characterised by vigorous growth in revenues and a modest increase in expenditures, as well as a declining public debt ratio. The above positive developments in public finances help create fiscal buffers and improve the domestic economic environment, amid conditions of slowing

global growth, and therefore support growth prospects.

- *Economic activity and expectations in trading partner economies.* Although trading partner economies continued to grow in the third quarter of 2022, the weakening of the growth momentum in the EU, the euro area and the UK in the second half of 2022 (reflected in hard and soft data) clouds the outlook for the Cypriot economy. In the third quarter of 2022, GDP growth (y-o-y) decelerated further in the EU, the euro area and most notably in the UK. Monthly data for October and November show that retail trade turnover (in real terms) in the EU and the euro area contracted (y-o-y), while a composite leading indicator for the UK continued to decline at a fast pace. Economic sentiment in the EU and the euro area weakened further in the final quarter of 2022, although an uptick was recorded in December. Consumer sentiment in the EU and the UK remained weak in the fourth quarter, despite a pickup after the historically low levels registered in September.
- *External financial conditions.* Monetary policy in the euro area continued to tighten in response to high inflation, with further increases in the key ECB interest rates in the final quarter of 2022. Moreover, financial conditions in the euro area are expected to tighten further in the following quarters. The rising sovereign and private sector borrowing costs in the euro area are found to have dampening effects on growth (especially towards the end of the forecast horizon), as they are expected to cool down demand and reduce inflation. The tightening of financial conditions and the slowing global economy are reflected in the performance of international stock markets, as returns (y-o-y) remained mostly negative in the final quarter of 2022, despite a small decline in volatility. Nevertheless, international stock market indicators forecast a more optimistic outlook for Cyprus than that projected by other leading indicators.
- *Inflation.* The strong upward pressures on international commodity prices and the substantial increases in the general price level registered throughout 2022 are found to weigh heavily on the outlook, as inflation has dented the real incomes of households and businesses. The negative impact of inflation on real incomes and growth is expected to be mitigated to some extent by the recent fiscal

measures, the partial wage indexation for about 45% of employees and the implementation of the new national minimum wage. However, the effects of the recent fiscal measures are expected to gradually wane in the following quarters. Despite the deceleration of inflation in the final quarter of 2022, uncertainties about the high energy cost and its pass-through to other inflation components have remained, especially as Russia's war in Ukraine continues.

The growth outlook is accompanied by risks, predominantly on the downside, which are mainly associated with the external environment. The risks to the outlook from new COVID-19 outbreaks have gradually lessened.

Downside risks to the outlook for Cyprus could arise if the slowdown in trading partner economies turns out to be more severe than expected. Strong upward pressures on international commodity prices (especially energy prices), as a result of geopolitical tensions, particularly Russia's war in Ukraine, could sustain inflationary pressures and squeeze real incomes further, weighing on growth prospects.

Moreover, downside risks to the outlook could stem from faster and/or steeper than expected increases in the borrowing costs faced by the government and the private sector, as a result of monetary policy tightening in the euro area, particularly if high inflation persists. The rising borrowing and debt service costs could increase credit risk in conditions of a global slowdown, and may pose challenges to public finances and the domestic banking system, particularly as the complete implementation of the foreclosure framework has been undermined by delays.

Upside risks to the outlook could result from investments in Cyprus (whose positive effects have not been reflected in published data) and better-than-expected external economic environment, especially stronger-than-expected outturn in the EU. CPI inflation is projected to fall from 8.4% in 2022 to 3.2% in 2023.³ The 2023 inflation forecast has been revised marginally downwards compared to that in the October issue (3.4%), mainly because of the

deceleration of inflation in the final quarter of 2022. Inflation in 2024 is projected at 2.0%.

In the final quarter of 2022, the increases in international oil and food prices continued to moderate, most notably in December. Consequently, the upward pressures on domestic consumer prices are expected to ease further in the following quarters. Other developments in the fourth quarter of 2022 that contribute to the projected moderation of inflation include: the slower depreciation of the euro in November and December, the downward revisions in selling price expectations in retail trade and manufacturing, and further monetary policy tightening, reflected in gradually increasing interest rates. Moreover, base effects from the high price level registered in 2022 contribute to the lower inflation projected for 2023.

Nevertheless, the high inflation rates seen in previous quarters, the depreciation of the euro against the US dollar throughout 2022 and recent upward revisions in selling price expectations in services are expected to add to inflation in the following quarters.

Upside risks to the inflation outlook include: renewed upward pressures on international oil and food prices as a result of geopolitical tensions, faster depreciation of the euro (especially against the US dollar) and strong wage growth that could feed back into inflation. Downside risks to the inflation outlook may arise from weaker-than-anticipated demand because of the energy crisis and the normalisation of monetary and fiscal conditions in Europe, lower pressures on commodity prices and slower depreciation of the euro.

3. Concluding remarks

Quarterly and monthly series released up until 12 January 2023 were employed in dynamic econometric models to construct forecasts for GDP growth and CPI inflation.

In the third quarter of 2022, economic activity in Cyprus continued to grow, but at a rate somewhat slower compared to that registered in the first half of the year. In the final quarter of 2022, some activity

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

indicators weakened and labour market indicators deteriorated.

For 2022, real GDP growth is projected at 5.6%, up by 0.7 percentage points compared to the forecast in the October issue. For 2023, growth is forecast to decelerate to 2.6%, an upward revision by 0.2 percentage points relative to the October issue. The upward revisions resulted from the higher-than-projected growth rate in the third quarter of 2022 and upward revisions in GDP growth data for recent quarters. Real GDP growth for 2024 is projected at 2.8%.

Forecasts by other organisations also suggest that growth in Cyprus remained strong in 2022, but is expected to decelerate in 2023. The Central Bank of Cyprus and the European Commission forecast real GDP growth for 2022 at 5.8% and 5.6%, respectively. For 2023 and 2024, the growth projections by the Central Bank are 2.5%, and 3.1%, respectively. The European Commission projects growth in Cyprus at 1.0% and 1.9% for 2023 and 2024, respectively ([1], [2]).

CPI inflation is forecast to decrease from 8.4% in 2022 to 3.2% in 2023. In 2024, inflation is projected to fall to 2.0%. The inflation forecast for 2023 has been revised marginally downwards compared to that in the October issue (3.4%), mainly because of the deceleration of inflation in the final quarter of 2022, driven primarily by the moderation in international oil prices.

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