

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

January 2024

Summary

Real GDP growth in Cyprus is estimated to have slowed from 5.1% in 2022 to 2.4% in 2023. Growth is projected to stay at 2.4% in 2024 and to improve to 3.2% in 2025. Compared to the October issue, the growth forecast for 2023 has remained unchanged, while the forecast for 2024 has been revised down by 0.4 percentage points. The tightening of monetary policy that led to slowing growth during 2023, as well as geopolitical turmoil (conflict in the Middle East, ship attacks in the Red Sea, war in Ukraine), are expected to weigh on growth in 2024. Despite the slowdown in 2023, economic activity and the labour market in Cyprus have remained resilient, while inflation has gradually decelerated, supporting growth prospects. In addition, the growth outlook benefits from robust economic sentiment and strong public finances during 2023.

Inflation (based on the Consumer Price Index) is projected to decelerate further in 2024 and 2025, mainly driven by the recent easing of price pressures and the tight financing conditions. Inflation is forecast to decrease from 3.5% in 2023 to 2.1% in 2024 and 2.0% in 2025. Compared to the October issue, the inflation forecast for 2024 has been revised down by 0.5 percentage points, as international commodity prices eased in the final quarter of 2023 and domestic inflation decelerated substantially in November and December.

Risks to the growth outlook are tilted to the downside, while risks to the inflation outlook are skewed to the upside, mainly owing to increased geopolitical turmoil.

Ιανουάριος 2024

Περίληψη

Ο ρυθμός μεγέθυνσης του πραγματικού ΑΕΠ εκτιμάται ότι έχει επιβραδυνθεί από 5,1% το 2022 σε 2,4% το 2023. Ο ρυθμός μεγέθυνσης προβλέπεται να παραμείνει στο 2,4% το 2024 και να ενδυναμωθεί στο 3,2% το 2025. Σε σύγκριση με το τεύχος Οκτωβρίου, η πρόβλεψη για το 2023 έχει παραμείνει αμετάβλητη, ενώ η πρόβλεψη για το 2024 έχει αναθεωρηθεί προς τα κάτω κατά 0,4 ποσοστιαίες μονάδες. Η αυστηροποίηση της νομισματικής πολιτικής που οδήγησε σε επιβράδυνση της ανάπτυξης κατά το 2023, καθώς και οι γεωπολιτικές αναταράξεις (σύγκρουση στη Μέση Ανατολή, επιθέσεις κατά εμπορικών πλοίων στην Ερυθρά Θάλασσα, πόλεμος στην Ουκρανία), αναμένεται να επιβαρύνουν τον ρυθμό μεγέθυνσης το 2024. Παρά την επιβράδυνση της ανάπτυξης το 2023, η οικονομική δραστηριότητα και η αγορά εργασίας στην Κύπρο έχουν παραμείνει ανθεκτικές, ενώ ο πληθωρισμός έχει επιβραδυνθεί σταδιακά, υποστηρίζοντας τις προοπτικές μεγέθυνσης. Επιπλέον, οι εγχώριες προοπτικές επωφελούνται από τα σχετικά υψηλά επίπεδα οικονομικής εμπιστοσύνης στην Κύπρο και την ισχυρή δημοσιονομική επίδοση κατά το 2023.

Ο πληθωρισμός (με βάση τον Δείκτη Τιμών Καταναλωτή) προβλέπεται να επιβραδυνθεί περαιτέρω το 2024 και 2025, κυρίως εξαιτίας της πρόσφατης αποκλιμάκωσης των ανοδικών πιέσεων στις τιμές και των αυστηρότερων πιστωτικών συνθηκών. Ο πληθωρισμός προβλέπεται να μειωθεί από 3,5% το 2023 σε 2,1% το 2024 και σε 2,0% το 2025. Σε σύγκριση με το τεύχος Οκτωβρίου, η πρόβλεψη για τον πληθωρισμό του 2024 έχει αναθεωρηθεί προς τα κάτω κατά 0,5 ποσοστιαίες μονάδες, καθώς οι διεθνείς τιμές εμπορευμάτων σημείωσαν κάμψη το τελευταίο τρίμηνο του 2023 και ο εγχώριος πληθωρισμός επιβραδύνθηκε σημαντικά τον Νοέμβριο και τον Δεκέμβριο.

Οι προβλέψεις συνοδεύονται από κινδύνους για χαμηλότερους από τους προβλεπόμενους ρυθμούς μεγέθυνσης και υψηλότερο από τον προβλεπόμενο πληθωρισμό, κυρίως λόγω των αυξημένων γεωπολιτικών εντάσεων.

1. Recent developments

Economic growth in Cyprus remained solid in the third quarter of 2023, supported by a strong labour market performance. The year-on-year (y-o-y) growth rate of real GDP stayed unchanged at 2.2% between the second and third quarters of 2023, avoiding further slowdown.

In the third quarter of 2023, real gross value added in financial and professional services declined (y-o-y), for the second consecutive quarter, reflecting the effects of monetary tightening, and sanctions against Russia because of its war in Ukraine. The contraction in real activity during the third quarter intensified in financial services, but it moderated markedly in professional services. Real gross value added in the remaining sectors, except industry, continued to expand (y-o-y) in the third quarter, but at somewhat slower rates vis-à-vis the second quarter; in the industrial sector growth strengthened further.

On the expenditure side, private consumption and gross capital formation, notably machinery and equipment, were the main contributors to GDP growth in the third quarter. The contribution of construction investment to GDP growth has remained positive in the third quarter, but the y-o-y increase in the key component of fixed capital formation, namely dwellings, has weakened considerably, registering its lowest value since the final quarter of 2020. The y-o-y growth rate in government consumption fell again in the third quarter, whereas private consumption growth picked up. Net exports weighed on growth in the third quarter, as imports rebounded much more strongly than exports, after they had both contracted in the second quarter.

Monthly data signalled improvements in domestic activity in the last three months of 2023 (e.g. registrations of motor vehicles, use of local credit cards in Cyprus). Yet, recent developments in leading indicators suggest that activity growth continued to moderate over the past months (e.g. number of property sale contracts, tourist arrivals, use of foreign credit cards in Cyprus). Labour market conditions improved further in the final quarter of 2023, as the declines (y-o-y) in the number of registered unemployed accelerated, and the unemployment rate (Eurostat) followed a declining path over the period January - November.

In the fourth quarter of 2023, the Economic Sentiment Indicator (ESI) decreased marginally compared to the third quarter; however, the ESI for Cyprus remained above its long-term average. Consumer confidence continued to slide in the fourth quarter, despite a pickup registered in December. Business confidence in services, retail trade and manufacturing weakened in the fourth quarter, while confidence in construction improved, reaching its highest level since 2019. Firms' employment expectations stayed above their long-term average in the fourth quarter, despite a deterioration in December owing to downward revisions in services. In the fourth quarter, selling price expectations continued to gradually ease, while consumer price expectations rose slightly because of a large upward revision in October. Economic uncertainty in Cyprus remained at relatively low levels in 2023, although it increased abruptly in December, driven by higher uncertainty among firms in services, particularly in the financial sector.

Public finances continued to perform strongly over the period January – November 2023; compared with the same period in 2022, revenue rose faster than expenditure, and the budget surplus increased. In November, public debt stood at EUR 23.2 billion, down from EUR 23.5 billion in August, and the long-term interest rate for Cyprus fell just under 4%.

Domestic lending interest rates continued to trend upwards in October – November, reaching their highest point since 2014, reflecting the tightening of monetary policy in the euro area. Growth (y-o-y) in new lending remained positive over the period January – November, driven by the increase in new business loans, despite the decrease in new housing loans. Since the first months of 2023, the stock of loans has been contracting, while deposits have been expanding, but at a slowing pace especially in October and November. The ratio of non-performing loans (NPLs) to total loans remained on a downward trend during the period January – October 2023.

Inflation, measured by the Consumer Price Index (CPI) has been gradually easing since the final quarter of 2022, falling from 8.4% in 2022 to 3.5% in 2023. Inflation edged down from 2.7% in the third quarter of 2023 to 2.3% in the fourth quarter, mainly because of lower food inflation. Nevertheless, food inflation as well as inflation in the categories of restaurants and hotels, and miscellaneous

goods/services remained well above the overall inflation rate at the end of 2023.

2. Forecasts

Projections for GDP growth and CPI inflation are constructed using a dataset with numerous domestic and foreign indicators, and a large number of dynamic econometric models. Quarterly series available up to the third quarter of 2023 were employed. Monthly indicators that contain information about some or all the months in the final quarter of 2023 were also used. The cut-off date for the data used in the analysis was 17 January 2024.

Table 1 presents the forecasts for the growth rate of real GDP for 2023, 2024 and 2025. Real GDP growth is forecast to have slowed from 5.1% in 2022 to 2.4% in 2023. Growth is projected to stay at 2.4% in 2024 and to improve to 3.2% in 2025. The tightening of monetary policy that led to slowing growth during 2023, as well as geopolitical turmoil, because of the Israel – Hamas war, commercial ship attacks in the Red Sea region, and the ongoing war in Ukraine, are expected to weigh on the outlook in 2024. Despite

the slowdown in 2023, economic activity and the labour market in Cyprus have remained resilient, while inflation has gradually decelerated from its peak in July 2022, supporting the growth outlook. Compared to the October issue, the growth forecast for 2023 has remained unchanged, but the forecast for 2024 has been revised down by 0.4 percentage points. The downward revision was driven by tighter financing conditions, weaker economic growth in the EU, and softening domestic activity in the second half of 2023 reflected in hard and soft data.

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 take very small weights.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	2023		2024		2025	
FORECAST	2.4		2.4		3.2	
	WEIGHT	FORECAST BY COMPONENT	WEIGHT	FORECAST BY COMPONENT	WEIGHT	FORECAST BY COMPONENT
COMPONENTS						
I. Real economy	0.56	2.4	0.43	2.4	0.44	3.3
II. Aspects other than real economy	0.61	2.5	0.49	2.3	0.60	3.4
III. Real economy & other aspects	98.83	2.5	99.08	2.4	98.96	3.2
Fiscal	5.34	2.5	5.29	2.4	5.43	3.3
Prices	11.88	2.4	12.35	2.1	12.78	2.6
Exchange rates	3.10	2.4	3.19	2.6	3.35	3.4
Interest rates, spreads	17.37	2.4	17.87	2.1	18.81	3.1
Stock markets	13.62	2.4	13.48	2.5	14.28	3.3
Economic sentiment, uncertainty	38.37	2.4	37.51	2.5	36.00	3.3
Loans, deposits	9.15	2.4	9.38	2.5	8.31	3.4

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.

ECONOMIC OUTLOOK

January 2024

Issue 24/1

The main factors that affect the outlook are discussed below.

- *Activity and the labour market.* The economic slowdown in Cyprus's trading partner economies (e.g. EU, UK) intensified during the first three quarters of 2023, weighing on domestic activity. In the third quarter, GDP growth (y-o-y) almost stalled in the EU, while it remained feeble in the UK. Monthly indicators on manufacturing production and retail trade turnover suggest that activity in trading partner economies (especially in the euro area) was weak in the final quarter of 2023. Moreover, some domestic leading indicators relating to tourism and real estate signal further loss of growth momentum in Cyprus during the last quarter of 2023. The above developments impede domestic growth prospects considerably. Nevertheless, unemployment in trading partner economies has stayed at very low levels, while the domestic labour market has remained robust, with declines in unemployment and strong growth in job vacancies. The favourable labour market conditions (foreign and domestic), and solid economic growth in Cyprus during the third quarter influence the outlook positively.
- *Confidence and uncertainty.* The high levels of economic sentiment in Cyprus recorded throughout 2023, mainly driven by improvements in business confidence, as well as the relatively low levels of economic uncertainty are expected to benefit the outlook significantly. Moreover, improvements in consumer confidence in the EU and the UK registered in 2023, and the uptick of economic sentiment in the EU and the euro area during the final quarter of 2023 influence the domestic growth prospects positively. However, economic sentiment in the EU and the euro area has remained below its historical average since the second half of 2022, and domestic consumer confidence has almost stalled since the second quarter of 2023. In recent quarters, business confidence in financial services has exhibited large swings, while confidence among firms in the hospitality sector has weakened. The above developments in survey indicators weigh on the growth outlook.
- *Financial conditions.* After having reached a 15-year high in September, the key ECB rates have

been kept unchanged. The tight monetary policy stance in the euro area, to bring inflation back to its medium-term target, led to further tightening of financing conditions in the bloc during the second half of 2023. The recent increases in funding costs for households and businesses as well as in long-term interest rates for euro area member states are expected to continue limiting demand, dampening growth in the following quarters. Most notably, rising interest rates (for loans, and deposits with longer maturities) in Cyprus are found to significantly weigh on growth, through lower investment and consumption, especially in 2024. Although the increase (y-o-y) in new business loans and the decline in NPLs have slowed, they continue to support the outlook. Also, the strong performance of domestic and international stock markets in the second half of 2023, and relatively low market volatility boost growth prospects throughout the forecast horizon.

- *Public finances.* The fiscal performance in Cyprus over the period January – November 2023, was characterised by a substantial budget surplus and a downward trend in debt-to-GDP ratio. The positive fiscal outcome, for a second year in a row, has created fiscal space and strengthened investor confidence; it is thus expected to support activity amid economic slowdown and heightened geopolitical tensions.
- *Prices.* International oil and food prices continued to decline (y-o-y) in the second half of 2023, though at a slowing pace, contributing to inflation reduction. Inflation in Cyprus decelerated markedly in the second half of 2023, despite a setback in August – September (mainly driven by increases in energy prices and elevated food inflation). Inflation in Cyprus's trading partner economies (e.g. euro area, UK) has decreased gradually from its peak in October 2022. Therefore, the recent declines in international commodity prices, and the deceleration of domestic and foreign inflation are projected to back growth through positive effects on real incomes. Furthermore, activity in the following quarters is expected to benefit from strong wage growth in Cyprus, the recently introduced fiscal measures (extending in 2024) to mitigate the effects of inflationary pressures, and the Cost-of-Living Allowance for some employee categories. Nevertheless, foreign inflation in

combination with the recent economic slowdown in the EU and the UK is found to significantly weigh on the growth forecasts throughout the forecast horizon, as inflation in trading partner economies (particularly in the UK) has remained elevated, despite steady declines in 2023.

Downside risks to the growth outlook for Cyprus have increased compared to the October issue owing to geopolitical turmoil. Downside risks to the outlook could stem from lower external demand, especially for tourism services and investment, because of the conflict in the Middle East. New inflationary pressures with adverse effects on real incomes and activity could result from disruptions in global trade (longer delivery times, higher shipping costs) or new hikes in commodity prices because of increased geopolitical tensions. Lower-than-expected growth in trading partner economies (e.g. EU, UK) may lead to weaker growth outcomes in Cyprus than the forecasts presented in this issue.

The tightening of financing conditions continues to pose risks to the outlook, although the key ECB interest rates have remained unchanged after September. Higher lending interest rates could put a strain on the finances of firms and households, raising loan defaults, with adverse effects on economic confidence and activity. Pressures on public finances amid tight financial conditions may also create challenges to the outlook.

Better-than-forecast growth rates could result from the materialisation of public and private investment projects whose effects have not been reflected in published data. Moreover, the recently announced government measures that aim at promoting the green transition and increasing the housing supply are expected to positively affect growth prospects. Also, stronger-than-expected external demand may lead to higher-than-forecast growth rates.

CPI inflation is projected to continue declining in 2024 and 2025. CPI inflation is forecast to decelerate from 3.5% in 2023 to 2.1% in 2024 and 2.0% in 2025.³ The inflation forecast for 2024 has been revised down by 0.5 percentage points, compared to that in the October issue, as international commodity prices eased in the final quarter of 2023 and domestic inflation decelerated substantially in

November and December, following a setback in August – September. The main drivers of the projected inflation deceleration include the easing of pressures on international commodity prices in 2023, the recent declines in inflation, and tight financing conditions that cool demand. Also, the inflation outlook benefits from the easing of selling price expectations in 2023, fiscal measures aimed at containing price rises, and the appreciation of the euro against the US dollar, particularly in the second half of 2023.

Risks to the inflation outlook are tilted to the upside, although some downside risks remain. Upside risks to inflation, through upward pressures in international commodity prices, stem from increased geopolitical turmoil as a result of the Israel – Hamas war and further escalation of the conflict in the Middle East, as well as from the ongoing war in Ukraine. Moreover, the recent commercial ship attacks in the Red Sea which have been affecting global trade by disrupting supply-chains and driving up shipping costs, could renew inflationary pressures. Higher-than-projected inflation could result from strong wage growth in Cyprus supported by a robust labour market, as well as from wage increases based on the Cost-of-Living Allowance. Climate risks continue to pose a threat to food inflation.

Downside risks to the inflation outlook are associated with weaker-than-anticipated domestic and/or external demand because of tight financing conditions and geopolitical tensions, especially in the Middle East.

3. Concluding remarks

Quarterly and monthly series released up until 17 January 2024 were employed in dynamic econometric models to construct forecasts for GDP growth and CPI inflation.

Real GDP growth is forecast to have decelerated from 5.1% in 2022 to 2.4% in 2023, unchanged from the October issue. Growth in 2024 is projected at 2.4%, down by 0.4 percentage points compared to the October issue. GDP growth in Cyprus remained solid in the third quarter of 2023, avoiding further deceleration, while labour market conditions have

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

remained favourable. In addition, economic sentiment stayed above its long-run average, inflation slowed down, and public finances performed strongly during 2023. However, credit conditions in Cyprus continued to tighten in the second half of the year, growth in the EU declined again in the third quarter, and some leading indicators point to softening activity in the final quarter of 2023 in both Cyprus and the EU; these developments weigh on the outlook for 2024.

Forecasts by other organisations point to a growth slowdown in 2023, followed by improvements in 2024 and 2025. Real GDP growth in Cyprus for 2023 is forecast at 2.2% by the Central Bank and the European Commission. For 2024, the Central Bank and the European Commission project growth in Cyprus at 2.6%. Growth in 2025 is projected to pick up to 3.1% and 2.9% according to the Central Bank and the European Commission, respectively. ^[1] - ^[2]

CPI inflation is projected to decelerate further in 2024 and 2025, mainly driven by the recent easing of price pressures and the tight financing conditions.

CPI inflation is forecast to decrease from 3.5% in 2023 to 2.1% in 2024 and 2.0% in 2025. Compared to the October issue, the inflation forecast for 2024 has been revised down by 0.5 percentage points, as international commodity prices eased in the final quarter of 2023 and domestic inflation decelerated substantially in November and December.

Risks to the growth outlook are tilted to the downside, while risks to the inflation outlook are skewed to the upside, mainly owing to geopolitical turmoil.

REFERENCES

1. Central Bank of Cyprus. 2023. Macroeconomic Projections for the Economy of Cyprus. December (in Greek). Available at: <https://www.centralbank.cy/el/announcements/projections-22-12-2023>
2. European Commission. 2023. European Economic Forecast, Autumn 2023. Institutional paper 258. November.

Economics Research Centre

University of Cyprus

Website: <https://www.ucy.ac.cy/erc/en/>

The bulletin reflects only the authors' views.*

* Research team:

Vasiliki Bozani (email: bozani.vasiliki@ucy.ac.cy)

Marianna Charalambous (email: charalambous.a.marianna@ucy.ac.cy)

Niki Demosthenous (email: demosthenous.niki@ucy.ac.cy)

Nicoletta Pashourtidou (email: pashourtidou.nicoletta@ucy.ac.cy)

The material in this document can be copied, distributed, transmitted and otherwise disseminated, but the source must be acknowledged.