

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

July 2023

Summary

Real GDP growth in Cyprus is forecast to decelerate from 5.6% in 2022 to 3.0% in 2023; the forecast has remained unchanged in relation to the May issue. Growth in 2024 is projected at 2.9%, down by 0.2 percentage points compared to the May issue. The effects of monetary tightening, the high inflation rates registered in previous quarters, and the recent growth slowdown in the euro area are expected to weigh on the growth outlook for Cyprus. On the other hand, recent positive developments in Cyprus (e.g. resilient activity and labour market, strong fiscal performance, declining uncertainty) and in international markets (e.g. further declines in commodity prices, improvements in stock market indices) are expected to support growth, particularly in 2023. Nevertheless, the risks to the growth outlook have remained tilted to the downside, as in the May issue.

Inflation (based on the Consumer Price Index) is forecast to decrease from 8.4% in 2022 to 3.0% in 2023 and to 2.0% in 2024, mainly as a result of the recent declines in international commodity prices, the deceleration of domestic inflation, and the tightening of financial conditions. The inflation forecast for 2023 has remained unchanged compared to that in the May issue. The inflation forecast for 2024 has been revised downwards by 0.4 percentage points relative to that in the May issue, mostly because of the significant moderation in domestic inflation and the declines in international commodity prices during the second quarter of the year. However, risks to the inflation outlook are skewed to the upside.

Ιούλιος 2023

Περίληψη

Ο ρυθμός μεγέθυνσης του πραγματικού ΑΕΠ προβλέπεται να επιβραδυνθεί από 5,6% το 2022 σε 3,0% το 2023. Η πρόβλεψη έχει παραμείνει αμετάβλητη σε σχέση με αυτή στο τεύχος Μαΐου. Ο ρυθμός μεγέθυνσης το 2024 προβλέπεται σε 2,9%, μειωμένος κατά 0,2 ποσοστιαίες μονάδες σε σύγκριση με το τεύχος Μαΐου. Οι επιπτώσεις της νομισματικής σύσφιξης, ο υψηλός πληθωρισμός που είχε σημειωθεί σε προηγούμενα τρίμηνα και η πρόσφατη επιβράδυνση του ρυθμού μεγέθυνσης στην ευρωζώνη αναμένεται να επιβαρύνουν τις εγχώριες προοπτικές. Αντίθετα, πρόσφατες θετικές εξελίξεις στην Κύπρο (π.χ. ανθεκτική δραστηριότητα και αγορά εργασίας, ισχυρές δημοσιονομικές επιδόσεις, υποχώρηση αβεβαιότητας) και στις διεθνείς αγορές (π.χ. περαιτέρω μειώσεις στις τιμές εμπορευμάτων, ιδίως στις τιμές του πετρελαίου, βελτιώσεις σε χρηματιστηριακούς δείκτες) αναμένεται να λειτουργήσουν υποστηρικτικά για την οικονομική μεγέθυνση, ειδικότερα το 2023. Εντούτοις, οι κίνδυνοι για δυσμενέστερες προοπτικές από τις προβλεπόμενες συνεχίζουν να κυριαρχούν, όπως και στο τεύχος Μαΐου.

Ο πληθωρισμός (με βάση τον Δείκτη Τιμών Καταναλωτή) προβλέπεται να μειωθεί από 8,4% το 2022 σε 3,0% το 2023 και σε 2,0% το 2024, κυρίως ως αποτέλεσμα των πρόσφατων μειώσεων στις διεθνείς τιμές εμπορευμάτων (π.χ. πετρελαίου), της πρόσφατης αποκλιμάκωσης του εγχώριου πληθωρισμού και της νομισματικής σύσφιξης. Η πρόβλεψη για τον πληθωρισμό του 2023 έχει παραμείνει αμετάβλητη σε σύγκριση με το τεύχος Μαΐου. Η πρόβλεψη για τον πληθωρισμό του 2024 έχει αναθεωρηθεί προς τα κάτω κατά 0,4 ποσοστιαίες μονάδες σε σχέση με το τεύχος Μαΐου, κυρίως λόγω της σημαντικής αποκλιμάκωσης του πληθωρισμού στην Κύπρο και των περαιτέρω μειώσεων στις διεθνείς τιμές εμπορευμάτων κατά το δεύτερο τρίμηνο του έτους. Ωστόσο, οι κίνδυνοι για υψηλότερο πληθωρισμό από τον προβλεπόμενο υπερσχύουν.

1. Recent developments

In the first quarter of 2023, economic growth in Cyprus continued to slow, although economic activity and the labour market remained resilient. In the first quarter of the year, real GDP increased by 3.4%, year-on-year (y-o-y), compared with 4.4% in the last quarter of 2022.

In the first quarter of 2023, real gross value added expanded (y-o-y) in all sectors of economic activity. Growth picked up in construction, financial and insurance activities, and recreation services, while it decelerated in the remaining sectors, notably in the sector of information and communication.

In the first quarter of the year, private consumption growth (y-o-y) slowed but remained robust, and government consumption increased following a contraction in the final quarter of 2022. Gross fixed capital formation rose strongly (y-o-y) in the first quarter of 2023, driven by increases in the categories of transport equipment, dwellings and machinery. Net exports contributed negatively to growth in the first quarter, as export growth (y-o-y) continued to decelerate, while growth in imports strengthened considerably.

Positive developments in leading indicators (e.g. volume of retail trade, use of credit cards, tourist arrivals, number of property sale contracts, registrations of motor vehicles) suggest that domestic activity continued to expand in the second quarter of 2023. Moreover, declines (y-o-y) in the number of registered unemployed and falling unemployment rate (Eurostat) indicate improved labour market conditions in Cyprus in the second quarter of the year vis-à-vis the first quarter. However, negative developments in some indicators during the second quarter (e.g. registrations of new companies, industrial production, number of building permits) are expected to weigh on economic activity in Cyprus.

The Economic Sentiment Indicator (ESI) declined marginally in the second quarter of 2023, as a result of weaker business confidence in services (particularly in the financial sector, and, to a smaller degree, in hospitality services), and lower consumer confidence. Also, firms' employment expectations deteriorated slightly in the second quarter compared with the first quarter, mainly owing to downward revisions in employment plans in June. However, the

ESI for Cyprus remained well above its long-term average and the EU-wide ESI throughout the second quarter. Survey-based measures of economic uncertainty in Cyprus declined further in the second quarter, but recent developments in price expectations reflect substantial price uncertainty. Selling price expectations continued to ease in industry and retail trade, but fluctuated at high levels in services and construction, while consumer price expectations were revised upwards in June.

The fiscal performance remained strong during the first five months of 2023. Over the period January – May, government revenue rose (y-o-y) faster than expenditure, and the budget surplus increased compared with the same period in 2022. Public debt increased from EUR 23.1 billion in March to EUR 24.1 billion in May, while, the long-term interest rate for Cyprus decreased slightly in April and May, hovering around 4%.

Domestic lending interest rates have remained on an upward trend, as the key European Central Bank interest rates have been on the rise since July 2022. New lending expanded (y-o-y) over the period January – May, driven by an increase in new business loans, despite a contraction in new housing loans. The contraction in the stock of loans accelerated in April and May, while the annual growth rates of deposits strengthened from March onwards. The ratio of non-performing loans (NPLs) to total loans declined further, to 9.0% in March from 9.5% in January.

In the second quarter of 2023, inflation, measured by the Consumer Price Index (CPI), eased to 2.9% from 6.5% in the first quarter. This decline was mainly driven by the lower inflation rates registered in the categories of housing, water, energy, transport, household goods, restaurants and hotels. Nevertheless, food inflation has remained elevated.

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 first quarter of 2023 were employed. Monthly indicators that contain information about some or all the months in the second quarter of 2023 were also used. The cut-off

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date for the data used in the analysis was 12 July 2023.

Table 1 presents the forecasts for the growth rate of real GDP for 2023 and 2024. Real GDP growth is forecast to slow from 5.6% in 2022 to 3.0% in 2023, unchanged compared to the forecast in the May issue. Growth in 2024 is projected at 2.9%, somewhat below the forecast in the May issue (3.1%). The growth outlook for both years is adversely affected by the tightening of financing conditions, the high inflation rates registered in Cyprus in previous quarters (especially in 2022), the persistently high inflation in Cyprus's trading partner economies, and the slowdown of growth in the euro area in the final quarter of 2022 and in the first quarter of 2023. Nevertheless, positive developments on the domestic front (e.g. resilient activity and labour market, strong fiscal performance, growth in new business loans, declining uncertainty), as well as further declines in

global commodity prices and recent improvements in international stock markets are expected to benefit the outlook for Cyprus, particularly in 2023, and to partially offset the effects of factors that limit growth.

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	
FORECAST	3.0		2.9	
	WEIGHT	FORECAST BY COMPONENT	WEIGHT	FORECAST BY COMPONENT
COMPONENTS				
I. Real economy	0.44	3.0	0.45	3.0
II. Aspects other than real economy	0.50	2.8	0.65	3.0
III. Real economy and other aspects	99.06	3.0	98.90	2.9
Fiscal	5.80	3.2	5.85	3.1
Prices	12.13	2.4	13.02	1.9
Exchange rates	3.33	3.0	3.53	3.2
Interest rates, spreads	18.15	2.8	19.71	2.4
Stock markets	14.57	3.4	13.55	3.4
Economic sentiment, uncertainty	34.86	3.0	35.10	3.2
Loans, deposits	10.21	3.4	8.12	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.

The main factors that shape the outlook for 2023 and 2024 are discussed below. Some factors point to challenges ahead, while others suggest a rather robust outlook.

- *Real economy.* In the first quarter of 2023, growth (y-o-y) in real activity and employment in Cyprus weakened but remained above the euro area averages, while unemployment declined. A number of domestic leading indicators for the second quarter of the year suggest that economic activity continued to grow and the labour market remained solid. Moreover, unemployment in trading partner economies (e.g. EU, euro area, UK) has declined to historically low levels. These positive developments are expected to support growth in the coming quarters. However, challenges to short-term prospects stem from the low growth rates registered in trading partner economies in the previous quarters (especially the first quarter of 2023) and from negative developments in some leading indicators in the second quarter of the year (e.g. continuing declines in the EU retail trade turnover, sluggish domestic industrial production, declines in new company registrations in Cyprus).
- *Economic confidence.* The improvements registered in survey indicators in the first quarter of 2023 are expected to continue to support growth in the following quarters. Positive developments in survey indicators in the second quarter of the year are also expected to back the outlook. More specifically, in the second quarter, domestic business confidence improved further in construction, manufacturing and retail trade, survey-based economic uncertainty in Cyprus declined significantly, and consumer confidence in the EU and the UK continued to pick up. However, the deterioration of business confidence in the EU and in the domestic financial sector during the second quarter is found to weigh on the growth prospects.
- *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 May and June. Higher sovereign and private sector borrowing costs in the euro area are found to weigh on the outlook. The recent increases in domestic lending interest rates for businesses and households are found to have pronounced dampening effects on growth in both

2023 and 2024. However, the dampening impact of rising borrowing costs on growth is mitigated by stronger deposit growth, declining NPLs, and the recent pickup in new business loans. In addition, the outlook is found to be strongly supported by improvements in domestic and international stock market indices (especially improvements observed in the second quarter of 2023), and lower volatility in financial markets.

- *Price developments.* In the first half of 2023 international commodity prices, especially oil prices, continued to follow a downward trend, and domestic inflation eased further. However, the past strong increases in international commodity prices and in the general price level continue to put downward pressure on growth, as they have impacted real incomes negatively. The growth prospects are also hampered by the persistently high inflation rates in trading partner economies (e.g. EU, UK), previous upward revisions in price expectations, and increased inflation uncertainty reflected in movements in survey-based price expectations. The recent increases in nominal wages and pensions, as well as past and existing fiscal measures to mitigate the effects of high inflation, are expected to support economic activity.
- *Fiscal performance.* In the first five months of 2023, government revenue increased faster than expenditure, the fiscal balance remained in surplus, and the debt-to-GDP ratio stayed broadly on a declining path. The recent strong fiscal performance in Cyprus is expected to back growth, by creating buffers in conditions of slowing growth and rising borrowing costs, and by preserving economic confidence.

The risks to the growth outlook have remained tilted to the downside, as in the May issue. Downside risks to the outlook for Cyprus could arise from the following: a sharper-than-expected slowdown in trading partner economies, new upward pressures on international commodity prices which negatively impact real incomes, uncertainties related to Russia's ongoing war in Ukraine and the impact of sanctions, and geopolitical tensions.

Downside risks to the outlook for Cyprus could also stem from monetary policy tightening, if inflation in the euro area remains elevated for longer than expected. Rising interest rates could lead to

increasing credit risk in conditions of weakening growth, especially as uncertainties around the implementation of the foreclosure law have persisted. Therefore, the current downward trend in NPLs could be reversed, denting the capital and liquidity position of the domestic banking sector, and weighing on economic confidence and activity.

Furthermore, risks to public finances with adverse effects on confidence and growth may arise in conditions of slowdown from policies that reduce fiscal space (e.g. the new agreement on the cost-of-living allowance that has increased the public sector wage bill).

Upside risks to the outlook could result from the positive effects of public and private investment projects in Cyprus which have not been reflected in published data. Also, stronger-than-expected external demand may lead to higher-than-projected growth rates.

CPI inflation is forecast to decrease from 8.4% in 2022 to 3.0% in 2023 and to 2.0% in 2024, mainly driven by the recent declines in international commodity prices (especially oil prices), the deceleration of domestic inflation, and the tightening of financial conditions, reflected in rising interest rates and slowing growth.³ The inflation forecast for 2023 has remained unchanged compared to that in the May issue. The inflation forecast for 2024 has been revised downwards by 0.4 percentage points relative to that in the May issue, largely as a result of the substantial deceleration of domestic inflation, and the declines in international commodity prices in the second quarter. Other developments in the second quarter of the year that contribute to the projected moderation of inflation include the recent strengthening of the euro against the US dollar, and downward revisions in price expectations in Cyprus, particularly in the sectors of manufacturing and retail trade.

The risks to the inflation outlook are skewed to the upside. New upward pressures on international commodity prices, as a result of, for example, the ongoing war in Ukraine or other geopolitical shocks, may lead to higher-than-projected inflation. Other upside risks to the inflation outlook may stem from stronger-than-expected domestic and/or external

demand, and second-round effects on inflation due to wage rises, including the increased cost-of-living allowance.

Downside risks to the inflation outlook may arise from weaker-than-anticipated demand because of tightening financial conditions, faster declines in international commodity prices, and the appreciation of the euro.

3. Concluding remarks

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

In the first quarter of 2023, GDP growth in Cyprus remained robust, but lower than the growth rates registered in 2022. Many leading indicators suggest that domestic activity and the labour market remained resilient in the second quarter of 2023. However, some leading indicators, particularly for the EU and for branches of domestic services, point to underlying challenges for growth in Cyprus.

Real GDP growth is forecast to decelerate from 5.6% in 2022 to 3.0% in 2023; the forecast has remained unchanged in relation to the May issue. Growth in 2024 is projected at 2.9%, down by 0.2 percentage points compared to the May issue. The effects of monetary tightening, the high inflation rates registered in previous quarters, and the recent growth slowdown in the euro area are expected to weigh on growth in the following quarters. On the other hand, recent positive developments in Cyprus (e.g. resilient activity and labour market, strong fiscal performance, declining uncertainty), and in international markets (e.g. further declines in commodity prices, improvements in stock market indices) are expected to support growth, particularly in 2023. Nevertheless, the risks to the growth outlook have remained tilted to the downside, as in the May issue.

Forecasts by other organisations also point to a growth slowdown in 2023. Real GDP growth in Cyprus for 2023 is forecast at 2.6%, 2.3% and 2.8% by the Central Bank, the European Commission and the Ministry of Finance, respectively. For 2024, the growth projections by the above organisations range

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

from 2.7% (European Commission) to 3.0% (Ministry of Finance).^{[1]·[3]}

CPI inflation is forecast to decrease from 8.4% in 2022 to 3.0% in 2023 and to 2.0% in 2024, mainly as a result of the recent declines in international commodity prices, the deceleration of domestic inflation, and the tightening of financial conditions. The inflation forecast for 2023 has remained unchanged relative to that in the May issue. The inflation forecast for 2024 has been revised downwards compared to that in the May issue (2.4%), largely because of the significant moderation in domestic inflation and the declines in international commodity prices during the second quarter of the year. However, risks to the inflation outlook are skewed to the upside.

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The bulletin reflects only the authors' views.*

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