

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

May 2022

Summary

Real GDP growth is projected to decelerate from 5.5% in 2021 to 2.6% in 2022. For 2023, real GDP growth is forecast at 3.1%. The current growth forecast for 2022 is lower than the forecast in the January issue by 1.5 percentage points. Russia's invasion of Ukraine and sanctions on Russia have weakened the outlook for Cyprus, mainly as a result of the expected collapse of tourist arrivals from Russia and Ukraine, rising international commodity prices, as well as weaker economic sentiment and less favourable financial conditions compared to the previous issue.

The risks to the growth outlook are to the downside. The war in Ukraine and sanctions against Russia could impact activity in Cyprus more adversely than indicated by the current forecasts. Moreover, the continuation of the war and tighter EU sanctions against Russia may weigh on growth prospects primarily through higher fuel, food and raw material prices.

New COVID-19 waves continue to pose significant downside risks to the outlook through new containment measures, and supply bottlenecks that exert upward pressures on prices.

Additional policy support may be needed because of the war in Ukraine, the rising energy prices and the continuation of the pandemic. However, fiscal challenges in view of elevated public debt and monetary tightening may cloud the outlook. Furthermore, the impact of the war in Ukraine on businesses in Cyprus together with the tightening financial conditions (in response to high inflation), could negatively affect bank asset quality, creating risks to the outlook.

CPI inflation is projected to reach 4.8% in 2022 and to decline to 2.2% in 2023. The inflation forecast for 2022 has been revised upwards (by 2.2 percentage points) compared to the forecast in the previous issue. Russia's invasion of Ukraine and sanctions on Russia have intensified inflationary pressures through increases in international commodity prices, especially fuel and food prices. The risks to the inflation outlook are to the upside.

Μάιος 2022

Περίληψη

Ο ρυθμός μεγέθυνσης του πραγματικού ΑΕΠ προβλέπεται να επιβραδυνθεί από 5,5% το 2021 σε 2,6% το 2022. Για το 2023, ο ρυθμός μεγέθυνσης του ΑΕΠ προβλέπεται στο 3,1%. Η πρόβλεψη για το 2022 έχει αναθεωρηθεί σημαντικά προς τα κάτω (1,5 ποσοστιαίες μονάδες) σε σχέση με αυτή στο τεύχος Ιανουαρίου. Η εισβολή της Ρωσίας στην Ουκρανία και οι κυρώσεις κατά της Ρωσίας έχουν αποδυναμώσει τις προοπτικές για την Κύπρο, κυρίως ως αποτέλεσμα της απώλειας των αφίξεων τουριστών από Ρωσία και Ουκρανία, της αύξησης των διεθνών τιμών εμπορευμάτων (π.χ. πετρελαίου, τροφίμων), της αποδυνάμωσης του οικονομικού κλίματος, καθώς και των λιγότερο ευνοϊκών διεθνών χρηματοοικονομικών συνθηκών σε σύγκριση με το τελευταίο τρίμηνο του 2021.

Οι κίνδυνοι για χειρότερες προοπτικές από τις προβλεπόμενες κυριαρχούν. Ο πόλεμος στην Ουκρανία και οι κυρώσεις κατά της Ρωσίας θα μπορούσαν να επηρεάσουν δυσμενέστερα τη δραστηριότητα στην Κύπρο απ' ό,τι εκτιμάται με βάση τις τρέχουσες προβλέψεις. Επιπλέον, η συνέχιση του πολέμου και οι αυστηρότερες κυρώσεις της ΕΕ κατά της Ρωσίας ενδέχεται να επηρεάσουν τις προοπτικές ανάπτυξης κυρίως μέσω υψηλότερων τιμών ενέργειας, τροφίμων και πρώτων υλών.

Νέα κύματα λοιμώξεων COVID-19 συνεχίζουν να αποτελούν σημαντικό κίνδυνο για τις προοπτικές μέσω πιθανών νέων περιοριστικών μέτρων αναχαίτισης της πανδημίας, καθώς και προβλημάτων στις εφοδιαστικές αλυσίδες που ασκούν ανοδικές πιέσεις στις τιμές.

Εξαιτίας του πολέμου στην Ουκρανία, της αύξησης των τιμών της ενέργειας και της συνέχισης της πανδημίας πιθανό να χρειαστεί πρόσθετη δημοσιονομική στήριξη. Ωστόσο, οι δημοσιονομικές προκλήσεις ενόψει του αυξημένου δημόσιου χρέους και της νομισματικής σύσφιξης μπορεί να αποδυναμώσουν τις προοπτικές. Επιπλέον, ο αρνητικός αντίκτυπος του πολέμου στις κυπριακές επιχειρήσεις σε συνδυασμό με λιγότερο χαλαρές χρηματοπιστωτικές συνθήκες (λόγω υψηλού πληθωρισμού), θα μπορούσαν να επηρεάσουν αρνητικά την ποιότητα του ενεργητικού των τραπεζών, δημιουργώντας κινδύνους για τις προοπτικές.

Ο πληθωρισμός (με βάση τον Δείκτη Τιμών Καταναλωτή) προβλέπεται να φτάσει στο 4,8% το 2022 και να υποχωρήσει στο 2,2% το 2023. Η πρόβλεψη για τον πληθωρισμό του 2022 έχει αναθεωρηθεί προς τα πάνω (κατά 2,2 ποσοστιαίες μονάδες) σε σχέση με το τεύχος Ιανουαρίου. Η εισβολή της Ρωσίας στην Ουκρανία και οι κυρώσεις στη Ρωσία έχουν εντείνει τις πληθωριστικές πιέσεις μέσω των αυξήσεων στις διεθνείς τιμές εμπορευμάτων, ιδίως των καυσίμων και των τροφίμων. Οι κίνδυνοι για υψηλότερο πληθωρισμό από τον προβλεπόμενο υπερισχύουν.

## 1. Recent developments

In 2021, real GDP in Cyprus rebounded strongly after the contraction in 2020 caused by the COVID-19 pandemic. Real GDP rose by 5.5% in 2021 and economic activity returned to pre-pandemic levels.

During 2021, growth in terms of real gross value added returned to positive territory in all sectors although growth in the construction sector stalled in the second half of 2021. The rebound in activity in 2021 was particularly strong in the sector of trade, transportation and hospitality and the industrial sector. However, real activity in the sector of trade, transportation and hospitality has remained below its pre-pandemic level.

In 2021, private and public consumption expenditure (in real terms) expanded; the latter increased vigorously, but at a slower pace compared to 2020. Exports rose faster than imports in 2021, significantly narrowing the trade deficit (in real terms) vis-à-vis 2020. Gross fixed capital formation contracted in 2021 as a result of a decline in construction investment in the category of dwellings and a negative contribution from transport equipment.

Monthly hard data, available for January - February 2022 and in some cases for March 2022, suggest that domestic activity remained robust, despite the surge in COVID-19 infections, and intensifying inflationary pressures as a result of Russia's invasion of Ukraine and sanctions against Russia. Monthly data that signalled improvements in real activity in January - March 2022 (subject to data availability) relate to the use of local and foreign credit cards in Cyprus, tourist arrivals and the number of property sale contracts (including contracts for foreign buyers). A small number of leading indicators (e.g. motor vehicle registrations, building permits, registrations of new companies) paints a less bright picture for the first quarter of 2022.

The war in Ukraine and sanctions imposed on Russia are expected to negatively impact the Cypriot economy not only through higher inflation but also through lower service exports. The negative impact was first reflected in a sharp drop in economic sentiment in March. The steep decline in the Economic Sentiment Indicator (ESI) in March, was driven by confidence losses in services, retail trade and industry as well as among consumers; the

largest fall in confidence was recorded among firms in services. Nevertheless, the average value of the Indicator for the first quarter of 2022 remained above its historical mean. Firms' employment expectations recorded during the first quarter of 2022 were less optimistic compared to the last quarter of 2021. Selling price expectations and consumer price expectations continued to trend upwards during the first quarter of 2022.

The number of registered unemployed continued to decline at fast pace in the first quarter of the year. In February 2022, the unemployment rate (Eurostat) edged down to 6.4% and registered its lowest value since the onset of the COVID-19 pandemic.

Over the period January - February 2022, government revenue registered a double-digit increase (y-o-y), while expenditure decreased (y-o-y), resulting in a budget surplus compared to a deficit over the same period in 2021. Debt stood at about EUR 24.3 billion (104% of GDP) in December, down from its peak of EUR 26.0 billion in March, but reached EUR 25.2 billion in February. The long-term interest rate for Cyprus increased, reaching its highest level since the second quarter of 2020.

The stock of business and housing loans continued to grow robustly during the first two months of 2022. The ratio of non-performing loans (NPLs) to total loans decreased to 11.1% in December from 15.4% in September 2021. In January and February, growth of new lending (y-o-y) accelerated, mainly driven by strong increases in new loans for house purchase. Domestic lending interest rates have remained very low by historical standards. The annual growth rate of deposits strengthened further in February.

Inflation (measured by the Consumer Price Index - CPI) increased to 6.4% in the first quarter of 2022 vis-à-vis 4.5% in the fourth quarter of 2021. In the first quarter of the year, consumer prices rose at their fastest pace since Cyprus has adopted the euro. The acceleration of inflation during the first quarter of 2022 mainly resulted from large price increases in the categories of petroleum products, electricity and agricultural products. In March, the upward pressures in international commodity prices, especially for oil and food were intensified as a result of Russia's invasion of Ukraine and sanctions imposed on Russia, since both countries are major exporters of commodities (e.g. wheat, corn, natural gas, oil).

## 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 fourth quarter of 2021 are employed. Monthly indicators that contain information about some or all the months in the first quarter of 2022 are also used. The cut-off date for the data used in the analysis is 18 April 2022.

The forecasts presented in this bulletin are based solely on published data up to the cut-off date; no assumptions about the future path of predictors included in the models are adopted. The only exception is the growth forecast for 2022; in addition to the observed effects of recent developments in various indicators, the projection also reflects the impact of reduced external demand for tourist services on economic activity, as a result of the ongoing war in Ukraine and sanctions on Russia.<sup>1</sup> The effects of Russia's invasion of Ukraine and sanctions on domestic activity arising from economic links other than tourism (e.g. external demand for professional services in Cyprus) are less clear-cut and therefore not directly incorporated in the projection; these effects are partly reflected in developments in short-term indicators. Also, indirect effects triggered by the war and sanctions, such as higher energy and food prices, slower global growth and elevated uncertainty are captured by movements in leading indicators.

Table 1 presents the forecasts for the growth rate of real GDP for 2022 and 2023. Following the strong recovery in 2021 from the pandemic-induced downturn, real economic activity in Cyprus is expected to continue to expand in 2022 but at a slower pace vis-à-vis 2021. Real GDP growth is projected to decelerate from 5.5% in 2021 to 2.6% in 2022. In 2023, real GDP growth is forecast at 3.1%.

**Table 1: GDP growth forecasts and components**

Year	2022		
FORECAST	2.6		
	CONTRIBUTION	WEIGHT	FORECAST BY COMPONENT
COMPONENTS			
I. Real economy	0.01	0.33	3.1
II. Aspects other than real economy	0.00	0.18	2.1
III. Real economy & other aspects	2.57	99.49	2.6
Fiscal	0.14	5.52	2.5
Prices	0.35	11.59	3.0
Exchange rates	0.08	3.42	2.3
Interest rates, spreads	0.48	16.86	2.8
Stock markets	0.38	15.46	2.5
Economic sentiment, uncertainty	0.93	38.34	2.4
Loans, deposits	0.21	8.31	2.5
Year	2023		
FORECAST	3.1		
	CONTRIBUTION	WEIGHT	FORECAST BY COMPONENT
COMPONENTS			
I. Real economy	0.01	0.45	3.2
II. Aspects other than real economy	0.02	0.60	3.0
III. Real economy & other aspects	3.10	98.95	3.1
Fiscal	0.19	5.87	3.2
Prices	0.30	11.22	2.7
Exchange rates	0.11	3.46	3.1
Interest rates, spreads	0.59	18.79	3.2
Stock markets	0.43	14.32	3.0
Economic sentiment, uncertainty	1.20	36.92	3.2
Loans, deposits	0.28	8.36	3.4

The current growth forecast for 2022 is lower than the forecast in the previous issue by 1.5 percentage points. Russia's invasion of Ukraine and sanctions on Russia have weakened the outlook for Cyprus,

Ukraine in 2022 vis-à-vis the pre-invasion path, although the loss in arrivals from the two countries could be partly offset by increased numbers of visitors from other countries.

<sup>1</sup> The influx of visitors from Russia and Ukraine accounted for 23% of tourist arrivals in Cyprus over 2015 – 2019 and exceeded 30% in 2021. The growth projection for 2022 incorporates the impact from the collapse in tourist arrivals from Russia and

mainly as result of the expected collapse of tourist arrivals from Russia and Ukraine, rising international commodity prices, as well as weaker economic sentiment and less favourable financial conditions compared to the January issue.

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 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.<sup>2</sup> The component that combines information on both the real economy and other economic aspects plays a key role in forming the final forecasts.<sup>3, 4</sup>

The drivers of the outlook are discussed below.

• *Slowing recovery.* In Cyprus and its trading partner economies (e.g. EU, euro area, UK), economic activity continued to recover at a fast pace in the final quarter of 2021, while unemployment continued its downward trend in the first months of 2022. The strong recovery from the pandemic-induced recession has been accompanied by rising inflation, creating risks for the growth momentum. Importantly, the war in Ukraine and sanctions on Russia have increased uncertainties surrounding the outlook for Cyprus, particularly through higher commodity prices and disruptions in trade, especially tourist services. The available hard indicators on domestic activity have not yet reflected the recent negative developments. Nevertheless, the loss in tourist arrivals from Russia and Ukraine that jointly account for a large share of total arrivals in Cyprus is expected to directly limit the country's growth prospects. Specifically, the expected collapse of tourist arrivals from Russia and Ukraine in 2022 is estimated to lead to significantly slower growth in the sector of

trade, transportation, accommodation and food services vis-à-vis the pre-invasion path; moreover, the shock to tourist arrivals impacts negatively the growth rates in the sectors of entertainment and recreation, industry and construction.

- *Weakening economic sentiment.* Economic sentiment in Cyprus, the EU and the euro area declined in the first quarter of the year, mainly owing to the large confidence losses registered in March as a result of Russia's invasion of Ukraine. The recent weakening in economic confidence is found to weigh on growth in 2022.
- *Shifting financial conditions.* In the first quarter of 2022, the performance of international stock markets weakened and volatility rose, reflecting tightening external financial conditions, as a result of high inflation, and uncertainties about global growth. The less favourable performance of financial markets in the first quarter of 2022 compared to the last quarter of 2021 is found to limit domestic growth prospects. Despite increases in long-term interest rates for euro area countries in January and February, financial conditions in the euro area have remained supportive. The low levels of lending interest rates in the euro area and the strong pickup in new loans in Cyprus are continuing to back the outlook. However, the expected change in the monetary stance in the euro area as the pandemic and the war in Ukraine continue may weigh on domestic growth prospects through limited fiscal space and deteriorating asset quality in the banking system.
- *Rising inflation and depreciating euro.* The war in Ukraine intensified inflationary pressures through higher international commodity prices, particularly energy and food prices. The war may exacerbate supply disruptions caused by the pandemic, adding to inflation. Higher inflation erodes real incomes,

<sup>2</sup> 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, as well as fiscal and banking sector series.

<sup>3</sup> Monthly leads of leading indicators (e.g. interest rates, economic sentiment) and of series used in extracting the factors (e.g. unemployment rate, registered unemployed, arrivals of

tourists, registrations of motor vehicles) are also included in the models.

<sup>4</sup> 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.

dampening growth in both 2022 and 2023. Moreover, the recent depreciation of the euro, particularly against the US dollar has also added to domestic inflation, clouding the outlook.

The risks to the growth outlook are to the downside. The war in Ukraine and sanctions against Russia could impact activity in Cyprus more adversely than indicated by the current forecasts. Moreover, the continuation of the war and tighter EU sanctions against Russia may weigh on growth prospects through higher fuel, food and raw material prices.

New COVID-19 waves continue to pose significant downside risks to the outlook. New infection waves could lead to new containment measures that may limit economic activity; also, a resurgence of the pandemic may intensify supply bottlenecks and amplify upward pressures on prices, dampening growth.

Additional policy support may be needed because of the war in Ukraine, the rising energy prices and the continuation of the pandemic. However, fiscal challenges in view of elevated public debt and monetary tightening may cloud the outlook. Furthermore, the impact of the war in Ukraine on businesses in Cyprus together with the tightening financial conditions (in response to high inflation), could negatively affect bank asset quality, creating risks to the outlook.

As economic and social activities adapt further to the pandemic, upside risks to the outlook may stem from stronger-than-anticipated domestic and external demand. Also, investments and reforms, particularly through the Recovery and Resilience Plan for Cyprus are expected to support economic activity.

CPI inflation is projected to reach 4.8% in 2022; the current forecast is 2.2 percentage points higher than that in the January issue. For 2023, CPI inflation is projected to ease to 2.2%.<sup>5</sup> Domestic and foreign inflation accelerated in the first quarter of 2022, as a result of the strong recovery from the pandemic downturn and pandemic-related supply bottlenecks. Furthermore, Russia's invasion of Ukraine and sanctions on Russia have intensified inflationary pressures through increases in international commodity prices, especially energy and food prices,

adding to inflation in the following quarters. Survey data show that firms' selling price expectations and consumers' expectations about price trends increased to historically high levels in the first quarter of the year, contributing to the elevated inflation projected for 2022.

The risks to the inflation outlook are on the upside. Additional increases in international commodity prices, particularly in oil and food prices, as a result of the war in Ukraine and new sanctions on Russia could exacerbate inflationary pressures. Other upside risks to the inflation outlook include pandemic-induced supply bottlenecks, wage increases, and a further depreciation of the euro. Downside risks to the inflation outlook may stem from weaker-than-expected domestic and/or global demand, and faster-than-expected tightening of financial conditions.

### 3. Concluding remarks

Quarterly and monthly series released up until 18 April 2022 are employed in dynamic econometric models to construct forecasts for GDP growth and CPI inflation. The strong recovery of economic activity continued in the final quarter of 2021. In the first quarter of 2022, many leading indicators continued to improve, while inflation accelerated. Confidence indicators deteriorated markedly in March as a result of Russia's invasion of Ukraine and sanctions on Russia. The data used in the construction of the forecasts do not fully reflect the effects of the war in Ukraine on economic activity in Cyprus. Thus, in addition to the observed effects of recent developments in various indicators, the growth projection for 2022 also reflects the impact of reduced external demand for tourist services on economic activity, as a result of the war and sanctions.

Real GDP growth in 2022 is projected at 2.6%, down by 1.5 percentage points compared to the forecast in the January issue. Russia's invasion of Ukraine and sanctions on Russia have weakened the outlook for Cyprus, mainly as a result of the expected collapse of tourist arrivals from Russia and Ukraine, rising international commodity prices, as well as weaker economic sentiment and less favourable financial

<sup>5</sup> CPI inflation forecasts are constructed using a methodology similar to that described for GDP growth forecasts.

conditions compared to the previous issue. Growth in 2023 is projected at 3.1%. The risks to the growth outlook are to the downside.

In 2022, CPI inflation is projected at 4.8%, a significant upward revision relative to the projection in the January issue (2.6%). The upward revision resulted from the acceleration of inflation in the first quarter of 2022, as a result of the strong recovery from the pandemic downturn and pandemic-related supply bottlenecks. Furthermore, Russia's invasion of Ukraine and sanctions on Russia have intensified inflationary pressures through increases in international commodity prices, especially fuel and food prices. For 2023, inflation is projected at 2.2%. The risks to the inflation outlook are to the upside.

The growth forecast for 2022 presented in this bulletin is slightly more optimistic than the forecast released by the International Monetary Fund (2.1%). For 2023, the growth forecast in this issue is somewhat lower than that published by the International Monetary Fund (3.5%) [1].

## REFERENCES

1. International Monetary Fund. 2022. World Economic Outlook: War Sets Back the Global Recovery. Washington, DC, April.

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The bulletin reflects only the authors' views.\* The views expressed in this bulletin do not necessarily reflect those of the CypERC Academic Advisors, the CypERC Council or the CypERC Sponsors.

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