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ECONOMIC OUTLOOK

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Summary

The Cypriot economy is forecasted to continue to post robust growth in 2018 and 2019. In 2018, real GDP is projected to increase by 3.9%. In 2019, growth is forecasted to moderate as real GDP is forecasted to expand by 3.3%. The main drivers of the outlook in 2018 and 2019 include the recent strong economic performance in Cyprus, the supportive external environment, the low levels of interest rates and inflation, and the high levels of domestic and European economic sentiment.

The recent sale of the Cyprus Cooperative Bank and the newly introduced amendments to the legislations regarding insolvency and foreclosures, and the sale and securitisation of loans, are expected to enhance the soundness of the banking sector, reduce uncertainty and restore depositors' and investors' confidence, with positive effects on economic activity. Nevertheless, significant downside risks to the outlook continue to stem from the high levels of indebtedness and NPLs as well as from the reinforcement of the feedback loop between bank and sovereign risk. The effectiveness in the management of problematic assets via the recently amended legal tools as well as the provisions of the proposed government subsidy scheme for vulnerable borrowers, will influence repayment culture, banking sector soundness and economic confidence, and could tilt risks to the outlook in either direction. Moral hazard in the economy (e.g. borrowers, banks) could involve significant downside risks to both public finances and growth. Thus, given the high level of public debt, (i) delays in the implementation of structural reforms (e.g. justice system, public administration), and (ii) the introduction of permanent government expenditures based on temporary revenues, may weaken confidence, the sustainability of public finances and growth prospects.

Other downside risks to the outlook are associated with a potential slowdown in the euro area, weaker-than-expected growth in the UK due to Brexit negotiations, and losses in the competitiveness of the Cypriot tourist product vis-à-vis other destinations. Upside risks to the outlook are associated with stronger-than-expected demand, mainly due to public and private investment projects, and domestic consumption.

Ιούλιος 2018

Περίληψη

Η Κυπριακή οικονομία εκτιμάται ότι θα συνεχίσει να καταγράφει ισχυρούς ρυθμούς ανάπτυξης κατά το 2018 και 2019. Το 2018, το πραγματικό ΑΕΠ προβλέπεται να αυξηθεί κατά 3,9%. Το 2019, ο ρυθμός ανάπτυξης αναμένεται να μετριαστεί, καθώς το πραγματικό ΑΕΠ προβλέπεται να αυξηθεί κατά 3,3%. Ανάμεσα στους κυριότερους παράγοντες που συμβάλλουν στη διαμόρφωση των προοπτικών για το 2018 και 2019 περιλαμβάνονται οι ισχυροί ρυθμοί ανάπτυξης που σημείωσε η Κύπρος πρόσφατα, το υποβοηθητικό εξωτερικό περιβάλλον, τα πολύ χαμηλά επίπεδα επιτοκίων και πληθωρισμού, καθώς και τα ψηλά επίπεδα οικονομικής εμπιστοσύνης στην Κύπρο και στην Ευρώπη.

Η πρόσφατη πώληση της Κυπριακής Συνεργατικής Τράπεζας και οι τελευταίες τροποποιήσεις στις νομοθεσίες για την αφερεγγυότητα και τις εκποιήσεις και την πώληση και τιτλοποίηση δανείων, αναμένεται να ενισχύσουν την ευρωστία του τραπεζικού τομέα, να μειώσουν την αβεβαιότητα και να αποκαταστήσουν την εμπιστοσύνη των καταθετών και επενδυτών, με θετικές επιπτώσεις στην οικονομική δραστηριότητα. Ωστόσο, σημαντικοί κίνδυνοι για χειρότερες από τις προβλεπόμενες προοπτικές εξακολουθούν να πηγάζουν από τα ψηλά επίπεδα ιδιωτικού χρέους και μη εξυπηρετούμενων δανείων, καθώς και από την ισχυρότερη πλέον αλληλεξάρτηση μεταξύ τραπεζικού τομέα και κράτους. Η αποτελεσματικότητα που θα επιδειχθεί στη διαχείριση των προβληματικών δανείων, μέσω των νομοθεσιών που τροποποιήθηκαν πρόσφατα, αλλά και οι τελικές πρόνοιες του προτεινόμενου σχεδίου Εστία για στήριξη ευάλωτων δανειοληπτών, θα επηρεάσουν την κουλτούρα αποπληρωμής, την ευρωστία του τραπεζικού συστήματος και την οικονομική εμπιστοσύνη, και ως εκ τούτου οι προοπτικές θα μπορούσαν να αλλάξουν προς οποιαδήποτε κατεύθυνση. Ο ηθικός κίνδυνος στην οικονομία (π.χ. δανειολήπτες, τράπεζες) συνεπάγεται επιπτώσεις στα δημόσια οικονομικά και στην ανάπτυξη. Συνεπώς, λόγω του ψηλού επιπέδου δημόσιου χρέους, (i) καθυστερήσεις στην εφαρμογή των διαρθρωτικών μεταρρυθμίσεων (π.χ. δικαστικό σύστημα, δημόσια διοίκηση) και (ii) εισαγωγή κρατικών δαπανών με μόνιμο χαρακτήρα βάσει προσωρινών εσόδων, ενδεχομένως να υποσκάψουν την εμπιστοσύνη, τη βιωσιμότητα των δημόσιων οικονομικών και των προοπτικών ανάπτυξης.

Άλλοι κίνδυνοι για τις προοπτικές συνδέονται με πιθανή επιβράδυνση της ανάπτυξης στην Ευρωζώνη, χαμηλότερους ρυθμούς ανάπτυξης από τους αναμενόμενους στο Ηνωμένο Βασίλειο λόγω των διαπραγματεύσεων για το Brexit και απώλεια ανταγωνιστικότητας του κυπριακού τουριστικού προϊόντος σε σχέση με άλλους προορισμούς. Θετικότερες από τις προβλεπόμενες προοπτικές μπορούν να διαμορφωθούν λόγω αυξημένης ζήτησης ως αποτέλεσμα, κυρίως, δημόσιων και ιδιωτικών επενδύσεων και εγχώριας κατανάλωσης.

UNIVERSITY OF CYPRUS



1. Recent developments

In the first quarter of 2018, the Cypriot economy continued to perform strongly as real GDP increased by 4.0% year-on-year (y-o-y). All sectors of economic activity continued to expand in terms of their real gross value added except financial and insurance activities. As in 2017, construction remained the fastest-growing sector; output growth in manufacturing, trade and professional services outpaced the performance of the rest of the economy. In the first quarter of 2018, household consumption growth (y-o-y) remained robust but somewhat below the rates registered in the second half of 2017, and below government consumption growth. Investment in construction continued to post double-digit growth rates (y-o-y), while total gross fixed capital formation shrank (y-o-y) due to a sharp drop in transport equipment investment. Net exports contributed positively to growth in the first quarter of 2018.

Many leading indicators of domestic activity (e.g. credit card use, index of industrial production, registrations of motor vehicles, registrations of new companies, property sale contracts, building permits) continued to perform favourably in the second quarter of 2018, although some indicators relating to tourism (e.g. arrivals, revenue) registered a slowdown. In the second quarter of the year, the Economic Sentiment Indicator (ESI) decreased from its peak reached in the first quarter of 2018. The deterioration in domestic economic sentiment was driven by confidence losses in all sectors, particularly in services (most notably in accommodation and food services). Nevertheless, the ESI for Cyprus is currently above its long-run average and at about the same level as the EU and euro area Indicators.

The decline in the number of registered unemployed accelerated further in the second quarter of 2018. The unemployment rate (Eurostat) was decreasing during the first five months of the year; in April – May 2018, unemployment declined to about the euro area average, slightly below 9%.

The fiscal position continued to improve during January – May 2018, mainly due to rapid growth in government revenue, leading to higher surpluses compared with the corresponding period in 2017. The issuance of government bonds in April 2018 as a result of negative developments in the banking sector, led to a sizeable increase in public debt, reversing its downward trajectory recorded in previous months. Also, the interest rates for long-term government bonds rose in April –

May 2018 from the all-time low levels recorded in the final quarter of 2017 and in the first quarter of 2018.

Domestic deposits increased at a faster pace in April – May 2018 vis-à-vis the first quarter of the year, while the contraction of foreign deposits held in Cyprus accelerated over the same period. The total stock of loans continued to shrink at about a steady rate of 2% during the first five months of the year. Nevertheless, the increase in loans to non-financial corporations picked up in April – May 2018. Interest rates declined marginally to historically low levels in April – May 2018. The stock of non-performing exposures was up in January – February 2018, reversing the progress registered in the last months of 2017.

Inflation (measured by the Consumer Price Index – CPI) turned positive in the second quarter of 2018 after three quarters in negative territory. CPI increased by 1.1% in the second quarter of 2018, mainly driven by price increases in the categories of food, transport and housing-water-electricity-gas.

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 first quarter of 2018 are employed. Monthly indicators released by 6 July 2018 that contain information covering all the months in the second quarter of 2018 at the most, are also used. All forecasts presented in this bulletin are based solely on published data; thus, they only incorporate effects captured by the quarterly series and the monthly leading indicators used in the estimations.

The forecasts for the y-o-y growth rate of real GDP for the three remaining quarters in 2018 and the four quarters in 2019 are shown in Table 1; the projections for the whole of 2018 and 2019 are also provided.

Based on the historical relationships between growth and numerous macroeconomic and financial indicators, real economic activity in Cyprus is estimated to continue to expand at a solid pace in 2018 and 2019. Real GDP growth is forecasted to increase by 3.9% in 2018 and 3.3% in 2019.

- Real GDP is estimated to have increased by 4.0% (y-o-y) in the second quarter of 2018; real activity is forecasted to expand by 4.1% in the third quarter and subsequently to

to edge down to 3.7% in the final quarter of the year. The corresponding quarter-on-quarter (q-o-q) projections are 1.0% for both the second and third quarters, and 0.7% for the fourth quarter of 2018.

- Growth is projected to moderate in 2019 but, nonetheless, to remain robust. In the first half of 2019, real GDP growth is forecasted at about 3.5% (y-o-y), and in the second half of the year growth is projected to decelerate to 3.1%. On a q-o-q basis, real activity is forecasted to expand by 0.8% in the first half and 0.7% in the second half of 2019.

Table 1: GDP growth forecasts, forecast errors and contribution of components to forecasts ¹

YEAR	2018			
FORECAST ²	3.9			
Quarter	2	3	4	
FORECAST (y-o-y)	4.0	4.1	3.7	
Forecast error ³	0.7	1.2	1.9	
COMPONENTS ⁴				
I. Real economy	0.02	0.02	0.02	
II. Aspects other than real economy	0.04	0.04	0.03	
III. Real economy & other aspects	3.96	4.00	3.63	
Fiscal	0.24	0.23	0.20	
Prices	0.53	0.53	0.44	
Exchange rates	0.13	0.12	0.10	
Interest rates, spreads	0.99	1.09	1.01	
Stock markets	0.63	0.64	0.60	
Economic sentiment	1.14	1.10	1.03	
Loans, deposits	0.30	0.28	0.25	
YEAR	2019			
FORECAST	3.3			
Quarter	1	2	3	4
FORECAST (y-o-y)	3.5	3.4	3.2	3.0
Forecast error ³	2.7	3.1	3.5	4.4
COMPONENTS ⁴				
I. Real economy	0.02	0.01	0.01	0.01
II. Aspects other than real economy	0.03	0.03	0.03	0.03
III. Real economy & other aspects	3.49	3.38	3.12	3.00
Fiscal	0.19	0.17	0.16	0.15
Prices	0.43	0.43	0.38	0.38
Exchange rates	0.10	0.10	0.09	0.10
Interest rates, spreads	0.95	0.94	0.96	0.90
Stock markets	0.59	0.58	0.48	0.45
Economic sentiment	0.96	0.83	0.74	0.69
Loans, deposits	0.28	0.33	0.31	0.33

¹ Table 1 is presented in the Appendix (Table A1) in greater detail by reporting the forecast resulting from each component together with the weight assigned to the component forecast for the computation of the final forecast.

² For the first quarter of 2018 the y-o-y growth rate of GDP obtained from published data is used (Quarterly National Accounts, Seasonally Adjusted Data, Statistical Service, 08/06/2018).

³ Pseudo out-of-sample root mean squared forecast error of the forecast method.

⁴ Differences between the forecasts and the sum of the components are due to rounding.

Table 1 also presents the forecast errors associated with the estimated y-o-y growth rates in each quarter. As expected, the errors are larger for quarters closer to the end of the forecast horizon. Furthermore, Table 1 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 (of about 1.4%) to the overall forecasts in all quarters.¹ The component that combines information on both the real economy and other economic aspects plays a key role in forming the final forecasts. More specifically, the forecasts are mainly formed by dynamic models that include real economy factors (one at a time) together with leading indicators (one at a time), such as interest rates, spreads, economic sentiment indicators, domestic or foreign/international price indices and stock market returns.^{2, 3}

The main drivers of the outlook in 2018 and 2019 are discussed below.

- *Strong economic performance in Cyprus.* In the first quarter of the year, real GDP growth remained vigorous and employment growth picked up. Leading indicators point to further improvements in activity and labour market conditions during the second quarter of the year. Some leading indicators have shown signs of moderation reflected in the outlook for 2019.

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, deposits).

² Monthly leads of leading indicators (e.g. interest rates, economic sentiment) and monthly leading values 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.

³ Economic sentiment indicators refer to data obtained through the Harmonised Business and Consumer Surveys Programme conducted by the Directorate General for Economic and Financial Affairs. The Economics Research Centre acknowledges funding from the European Commission and the Ministry of Finance for conducting the Business and Consumer Survey Project in Cyprus.

- *Supportive external environment.* In the first quarter of 2018, growth in the EU and the euro area remained solid, and economic activity in the UK and Russia expanded at modest rates. However, the growth rates in the first quarter were lower compared to those registered in the second half of 2017, affecting the outlook to some extent.
- *High levels of economic sentiment.* Despite the decline of domestic and European sentiment indicators in the second quarter, economic confidence remains well-above its long-run level and continues to contribute considerably towards the projected rates.
- *Low levels of interest rates and favourable financial conditions.* Very low lending interest rates together with improvements in real activity and labour market conditions play a key role in shaping the forecasts. Despite weaker returns in the first half of 2018, the performance of financial markets continues to support growth.
- *Low past inflation.* The low or negative inflation rates in the previous quarters will continue to benefit activity growth in the short run.

Some factors that suggest a more conservative outlook for 2019 compared to that in the previous issue include:

- the recent decrease of domestic economic sentiment, reflecting both revisions in expectations in the services sector and uncertainties in the domestic banking system;
- recent movements in the long term government bond yields of some euro area countries and the UK, reflecting economic and political uncertainties;
- the upswing in international oil prices.

Some risks to the outlook that are mostly associated with the domestic financial sector are not fully captured by published predictors and are discussed below.

The recent developments in the domestic banking sector revealed the fragility of depositors' confidence in a system, marked by high levels of non-performing loans (NPLs) despite robust growth, and limited use of the insolvency and foreclosure frameworks. The newly introduced amendments to the legislations regarding insolvency and foreclosures, and the sale and securitisation of loans, are expected to accelerate the reduction of NPLs. Moreover, the sale of the healthy part of the Cyprus Cooperative Bank (CCB) to Hellenic Bank, accompanied by state support, and the shift

of CCB's problematic assets to a state-financed 'Residual entity' will considerably reduce the stock of NPLs in the banking system.⁴ Consequently, this transaction and the above legislation amendments are expected to enhance the soundness of the banking sector, reduce uncertainty and restore depositors' and investors' confidence, with positive effects on economic activity. Nevertheless, significant downside risks to the outlook continue to stem from the high levels of indebtedness and NPLs as well as from the reinforcement of the feedback loop between bank and sovereign risk. The effectiveness in the management of problematic assets via the recently amended legal tools as well as the provisions of the proposed government subsidy scheme for vulnerable borrowers, will influence repayment culture, banking sector soundness and economic confidence, and could tilt risks to the outlook in either direction. Moral hazard in the economy (e.g. borrowers, banks) could involve significant downside risks to both public finances and growth. Thus, given the high level of public debt, (i) delays in the implementation of structural reforms (e.g. justice system, public administration), and (ii) the introduction of permanent government expenditures based on temporary revenues, may weaken confidence, the sustainability of public finances and growth prospects.

Other downside risks to the outlook are associated with a potential slowdown in the euro area, weaker-than-expected growth in the UK due to Brexit negotiations and losses in the competitiveness of the Cypriot tourist product vis-à-vis other destinations (e.g. depreciation of Turkish lira). Upside risks to the outlook are associated with stronger-than-expected demand, mainly due to public and private investment projects, and domestic consumption.

In 2018 and 2019, CPI inflation is forecasted at 1.3% and 1.4%, respectively, as international oil prices continue to increase and demand strengthens.⁵ Upside risks to the forecasts relate to faster wage growth and stronger demand, and more rapid increases in international commodity prices. Downside risks to the projections are associated with weaker demand.

⁴ The finalised transaction is estimated to remove about EUR 6 billion of NPLs from the domestic banking system (see, [2]).

⁵ CPI inflation forecasts are constructed using a methodology similar to that for GDP growth forecasts.

3. Concluding remarks

Quarterly and monthly series released until 6 July 2018, are employed in dynamic econometric models to construct forecasts for growth and inflation.

The forecast for real GDP growth in 2018 has remained broadly unchanged compared to that in the May issue. The growth forecast for 2019 has been revised from 3.5% in the May issue to 3.3%, mainly as a result of weaker economic sentiment in Cyprus and uncertainty regarding growth momentum in Europe, reflected in weaker first quarter GDP growth data and second quarter leading indicators (e.g. confidence indicators, government bond yields).

The CPI inflation projection for 2018 has been revised from 0.6% in the previous issue to 1.3% as inflation returned to positive territory in the second quarter of the year. The 2019

forecast has remained broadly unchanged compared to the May issue.

The forecasts presented in this issue suggest that real activity will continue to expand at strong rates in 2018, while growth is projected to decelerate in 2019. The growth forecasts for 2018 and 2019 presented here are more conservative than the projected rates of 4.1% and 3.9% for 2018 and 2019, respectively, published by the Central Bank of Cyprus. For 2018, the growth forecast in this bulletin is more optimistic than the European Commission's projection of 3.6%; the 2019 growth forecast here is in line with the forecast by the European Commission, i.e. 3.3% [2].

REFERENCES

1. Central Bank of Cyprus, "Economic Bulletin - June 2018", Nicosia - Cyprus (in Greek), June 2018.
2. European Commission, "Post-Programme Surveillance Report: Cyprus, Spring 2018", European Economy, Institutional Paper 083, July 2018.

APPENDIX

Table A1: GDP growth (y-o-y) forecasts, components of forecasts, weights and forecasts by component

YEAR	CONTRIBUTION BY COMPONENT			WEIGHT			FORECAST BY COMPONENT					
	2018			2018			2018					
QUARTER	2	3	4	2	3	4	2	3	4			
COMPONENTS												
I. Real economy	0.02	0.02	0.02	0.57	0.55	0.48	4.0	4.0	3.6			
II. Aspects other than real economy	0.04	0.04	0.03	0.99	0.89	0.85	4.0	3.9	3.7			
III. Real economy & other aspects	3.96	4.00	3.63	98.44	98.56	98.67	4.0	4.1	3.7			
Fiscal	0.24	0.23	0.20	5.83	5.72	5.53	4.0	4.0	3.6			
Prices	0.53	0.53	0.44	13.12	12.93	11.78	4.0	4.1	3.7			
Exchange rates	0.13	0.12	0.10	3.25	2.90	2.68	4.0	4.1	3.6			
Interest rates, spreads	0.99	1.09	1.01	24.47	26.71	27.47	4.1	4.1	3.7			
Stock markets	0.63	0.64	0.60	15.78	15.93	16.32	4.0	4.0	3.7			
Economic sentiment	1.14	1.10	1.03	28.49	27.79	28.64	4.0	4.0	3.6			
Loans, deposits	0.30	0.28	0.25	7.50	6.58	6.25	4.1	4.3	4.1			
FORECAST	4.0	4.1	3.7									
YEAR	CONTRIBUTION BY COMPONENT				WEIGHT				FORECAST BY COMPONENT			
YEAR	2019				2019				2019			
QUARTER	1	2	3	4	1	2	3	4	1	2	3	4
COMPONENTS												
I. Real economy	0.02	0.01	0.01	0.01	0.48	0.43	0.40	0.42	3.5	3.3	3.1	3.0
II. Aspects other than real economy	0.03	0.03	0.03	0.03	0.86	0.84	0.84	0.86	3.5	3.5	3.3	3.3
III. Real economy & other aspects	3.49	3.38	3.12	3.00	98.65	98.74	98.77	98.72	3.5	3.4	3.2	3.0
Fiscal	0.19	0.17	0.16	0.15	5.26	5.01	5.22	5.23	3.5	3.3	3.0	2.9
Prices	0.43	0.43	0.38	0.38	12.35	12.36	11.94	12.54	3.5	3.5	3.2	3.1
Exchange rates	0.10	0.10	0.09	0.10	2.80	2.89	2.89	3.13	3.4	3.4	3.3	3.2
Interest rates, spreads	0.95	0.94	0.96	0.90	27.33	29.61	33.49	32.66	3.5	3.2	2.9	2.8
Stock markets	0.59	0.58	0.48	0.45	16.49	16.43	14.51	14.39	3.6	3.5	3.3	3.1
Economic sentiment	0.96	0.83	0.74	0.69	27.91	25.09	23.43	22.94	3.4	3.3	3.1	3.0
Loans, deposits	0.28	0.33	0.31	0.33	6.51	7.35	7.29	7.83	4.3	4.5	4.2	4.3
FORECAST	3.5	3.4	3.2	3.0								



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