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ECONOMIC OUTLOOK

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Summary

The Cypriot economy is forecasted to continue to grow at robust rates in 2019, albeit at a somewhat slower pace compared to 2018. In 2018, real GDP is estimated to have increased by 3.8%. In 2019, growth is forecasted to decelerate as real GDP is projected to grow by 3.1%. The main drivers of the outlook include robust activity and employment growth in the previous quarters, supportive domestic financial conditions (e.g. low lending interest rates, deleveraging, declining NPLs), and high levels of domestic economic confidence. The slowdown in the growth momentum projected for 2019 is mainly driven by a weaker performance of some domestic economic indicators as well as by higher uncertainty in the external environment about (among other things) global growth, international trade policies and Brexit, reflected in a number of foreign macroeconomic and financial series.

Downside risks to the outlook due to domestic factors include: the high levels of private debt and NPLs relative to the size of the economy; the high level of public debt together with the stronger connection between bank and sovereign risk, after the sale of the Cyprus Cooperative Bank; potential additional fiscal costs from the publicly financed scheme for vulnerable borrowers (Estia) and/or the newly-established state-owned asset management entity; fiscal risks that may arise from (i) the introduction of the National Health System, (ii) faster-than-planned increases in the public sector wage bill, and (iii) delays in the implementation of structural reforms (e.g. judicial system, public administration).

Downside risks stemming from the external environment include: higher uncertainty, faster depreciation of the British pound and weaker-than-expected growth in the UK in the event of no-deal Brexit; slower-than-expected growth in the euro area as a result of weaker global trade, among other things; a slowdown in Russia due to lower oil prices; intensified competition from other tourist destinations.

Upside risks to the outlook are associated with a faster reduction in the stock of NPLs, and a higher degree of materialisation of investment plans (e.g. investments relating to tourism, property developments, energy) than that reflected in the data.

Ιανουάριος 2019

Περίληψη

Η Κυπριακή οικονομία εκτιμάται ότι θα συνεχίσει να αναπτύσσεται με αρκετά θετικούς ρυθμούς κατά το 2019, αν και κάπως χαμηλότερους συγκριτικά με το 2018. Το 2018, το πραγματικό ΑΕΠ εκτιμάται ότι έχει αυξηθεί κατά 3,8%. Το 2019, ο ρυθμός μεγέθυνσης αναμένεται να μετριαστεί, καθώς το πραγματικό ΑΕΠ προβλέπεται να αυξηθεί κατά 3,1%. Ανάμεσα στους κυριότερους παράγοντες που συμβάλλουν στη διαμόρφωση των προοπτικών περιλαμβάνονται: οι ισχυροί ρυθμοί αύξησης της εγχώριας οικονομικής δραστηριότητας και απασχόλησης τα προηγούμενα τρίμηνα, οι υποβοηθητικές χρηματοοικονομικές συνθήκες στην Κύπρο (π.χ. χαμηλά επιτόκια δανεισμού, απομόχλευση, μείωση των μη εξυπηρετούμενων δανείων) και τα ψηλά επίπεδα εγχώριας οικονομικής εμπιστοσύνης. Η πρόβλεψη για επιβράδυνση του ρυθμού μεγέθυνσης το 2019 συγκριτικά με το 2018 συνδέεται κυρίως με λιγότερο θετικές επιδόσεις εγχώριων οικονομικών δεικτών καθώς και με αυξημένη αβεβαιότητα στο εξωτερικό οικονομικό περιβάλλον, σχετικά με π.χ. τον μελλοντικό ρυθμό μεγέθυνσης της παγκόσμιας οικονομίας, πολιτικές αναφορικά με το διεθνές εμπόριο και Brexit, που αντικατοπτρίζεται στην πορεία αρκετών ξένων μακροοικονομικών και χρηματοοικονομικών δεικτών.

Κίνδυνοι για χαμηλότερους από τους προβλεπόμενους ρυθμούς μεγέθυνσης που σχετίζονται με εγχώριους παράγοντες περιλαμβάνουν: τα ψηλά επίπεδα ιδιωτικού χρέους και μη εξυπηρετούμενων δανείων· το ψηλό δημόσιο χρέος, μαζί με την ισχυρότερη διασύνδεση μεταξύ τραπεζικού τομέα και κράτους, μετά την πώληση της Κυπριακής Συνεργατικής Τράπεζας· πιθανό επιπρόσθετο δημοσιονομικό κόστος από την εφαρμογή του σχεδίου Εστία ή/και από τη νεοσύστατη κρατική εταιρεία διαχείρισης περιουσιακών στοιχείων· δημοσιονομικοί κίνδυνοι που ενδεχομένως να προκύψουν από (i) την εφαρμογή του ΓΕΣΥ, (ii) μεγαλύτερες από τις προγραμματιζόμενες αυξήσεις στο κρατικό μισθολόγιο και (iii) καθυστερήσεις στην εφαρμογή διαρθρωτικών μεταρρυθμίσεων (π.χ. δικαστικό σύστημα, δημόσια διοίκηση).

Κίνδυνοι για τις προοπτικές ανάπτυξης που πηγάζουν από το εξωτερικό περιβάλλον περιλαμβάνουν: ψηλότερη αβεβαιότητα, περαιτέρω υποτίμηση της στερλίνας και ασθενέστερη από την αναμενόμενη μεγέθυνση στο Ηνωμένο Βασίλειο σε περίπτωση Brexit χωρίς συμφωνία με την ΕΕ· χαμηλότερους από τους προβλεπόμενους ρυθμούς μεγέθυνσης στην ευρωζώνη· επιβράδυνση της ρωσικής οικονομίας λόγω χαμηλότερων τιμών του πετρελαίου· αυξημένος ανταγωνισμός από άλλους τουριστικούς προορισμούς.

Θετικότερες από τις προβλεπόμενες προοπτικές μπορούν να διαμορφωθούν λόγω ταχύτερης μείωσης των μη εξυπηρετούμενων δανείων καθώς και από μεγαλύτερο βαθμό υλοποίησης επενδύσεων από ό,τι αντανάκλαται στους οικονομικούς δείκτες.

UNIVERSITY OF CYPRUS



1. Recent developments

Growth in Cyprus remained strong in the third quarter of 2018, as real GDP increased by 3.7% year-on-year (y-o-y). The growth rate in the third quarter decelerated slightly vis-à-vis the first half of 2018. All sectors of economic activity, except financial and insurance activities, continued to expand in terms of their real gross value added (y-o-y). In the third quarter of 2018, construction, arts and entertainment as well as professional services were the fastest-growing sectors. Growth in the largest sector of the economy, namely trade, transportation, accommodation and food services, remained above GDP growth in the third quarter, but softened compared to the first half of 2018. In the third quarter of 2018, private consumption growth decelerated, while growth in government consumption expenditure turned positive following a contraction in the first half of the year. Gross fixed capital formation rose strongly (y-o-y) in the third quarter of 2018 as a result of ongoing vigorous growth in construction investment, and higher investment in transport equipment compared to the same period in 2017. Net exports weighed on growth in the third quarter of 2018 as the exports – imports gap widened further.

In the final quarter of 2018, many leading indicators of domestic activity continued to improve (y-o-y) either by registering faster growth rates vis-à-vis the third quarter (e.g. tourist arrivals, credit card use by tourists, index of industrial production), or by posting robust growth, albeit at slower rates compared to previous quarters (e.g. volume index of retail trade, overall credit card use, registration of motor vehicles). The Economic Sentiment Indicator (ESI) rose in the fourth quarter of 2018 as a result of confidence improvements in services, industry and, to a lesser degree, among consumers. In the final quarter of 2018, ESI regained the losses of the previous two quarters, but stood below its historically high level reached in the first quarter of the year. Firms' employment expectations strengthened further, reaching a new high in the fourth quarter of 2018. Nevertheless, another group of leading indicators worsened in the final quarter of 2018 compared to the same period in 2017 (e.g. registration of new companies, total number of property sale contracts, total value of property transfers).

The number of registered unemployed continued to drop in the fourth quarter, but at a slightly slower rate vis-à-vis the previous two quarters. The unemployment rate (Eurostat)

increased from its six-year low registered in the third quarter of 2018 to just above 8% in the fourth quarter.

Government revenue continued to rise in third quarter but at a slower pace compared to the first half of 2018. Over the same period, government expenditure surged as a result of the sale of the Cyprus Cooperative Bank, creating a sizeable deficit. In September 2018, public debt registered another large increase, the third one during the period January – November 2018.

In October – November 2018, deposits registered positive annual growth rates, just below those recorded in the second and third quarters, driven by robust growth in domestic deposits. The decline in the total stock of loans accelerated in October – November 2018, reflecting ongoing deleveraging and subdued new credit. The volumes of new loans to business and households over January – November 2018 were lower compared to the same period in 2017, despite the historically low levels of interest rates. The most recent data on non-performing loans (NPLs) show a significant decline in September 2018, mainly due to the removal of loans from the banking sector to the newly established state-owned asset management entity, following the sale of the Cyprus Cooperative Bank.

Inflation (measured by the Consumer Price Index – CPI) decelerated from 2.7% in the third quarter to 2.4% in the final quarter of 2018, largely as a result of lower inflation in the categories of transport, communication and food. Overall, inflation reached 1.4% in 2018 vis-à-vis 0.5% in 2017.

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 2018 are employed. Monthly indicators released by 23 January 2019 that contain information about some or all the months in the fourth quarter of 2018 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 fourth quarter of 2018 and all the quarters of 2019 are

shown in Table 1; the projections for the whole of 2018 and 2019 are also provided.

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

Year	2018	2019			
FORECAST ²	3.8	3.1			
Quarter	4	1	2	3	4
FORECAST (y-o-y)	3.5	3.1	3.2	3.2	3.1
Forecast error ³	0.8	1.3	2.1	3.1	3.3
COMPONENTS ⁴					
I. Real economy	0.02	0.02	0.02	0.02	0.02
II. Aspects other than real economy	0.03	0.03	0.02	0.02	0.03
III. Real economy & other aspects	3.40	3.02	3.14	3.13	3.07
Fiscal	0.20	0.19	0.18	0.17	0.17
Prices	0.46	0.43	0.42	0.40	0.41
Exchange rates	0.11	0.10	0.10	0.10	0.10
Interest rates, spreads	0.89	0.85	0.88	0.85	0.77
Stock markets	0.51	0.42	0.44	0.44	0.43
Economic sentiment	0.94	0.78	0.86	0.89	0.83
Loans, deposits	0.28	0.27	0.26	0.28	0.36

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 three quarters of 2018 the y-o-y growth rates of GDP obtained from published data are used (Gross Domestic Product, Quarterly, Chain-linked Volume Measures (Seasonally Adjusted), Statistical Service, 07/12/2018).

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.

Based on the historical relationships between growth and numerous macroeconomic and financial indicators, real economic activity in Cyprus is expected to continue to rise in 2019, albeit at somewhat slower rates vis-à-vis 2018. Real GDP is estimated to have increased by 3.8% in 2018. Real GDP is forecasted to grow by 3.1% in 2019.

- Real GDP is estimated to have increased by 3.5% (y-o-y) in the final quarter of 2018. The corresponding quarter-on-quarter (q-o-q) projection is 0.8%.
- Growth is projected to moderate in 2019 but, nonetheless, to remain robust. In the first quarter of 2019, real GDP growth is forecasted to decelerate to 3.1% (y-o-y), and to stabilise at just above 3% in the remaining quarters of the year. On a q-o-q basis, real activity is forecasted to grow in the range of 0.7% to 0.9% in 2019.

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 are discussed below.

- *Robust economic performance in Cyprus.* In the third quarter of 2018, real GDP and employment increased strongly, albeit at slightly slower rates compared to the first half of 2018. Many leading indicators have pointed to further improvements in domestic economic conditions in the final quarter of 2018. However, some leading indicators have shown signs of moderation in the growth momentum.
- *Supportive domestic financial conditions.* The historically low levels of domestic lending interest rates, the ongoing

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, the Ministry of Finance and the University of Cyprus for conducting the Business and Consumer Survey Project in Cyprus.



deleveraging, and the recent large decreases in the stock of NPLs contribute towards a robust outlook.

- *High levels of domestic economic confidence.* The robust outlook is backed by the pickup of the economic sentiment in Cyprus in the final quarter of 2018, following two consecutive quarters of declines. Nevertheless, in 2018 business sentiment (apart from confidence in the construction sector) and consumer confidence did not significantly change from their 2017 levels, suggesting a softening of growth in the following quarters.

Compared to the previous issue, the outlook is also weakened by higher uncertainty in the external environment reflected in a number of foreign series. In the third quarter of 2018, growth (y-o-y) in the EU and the euro area decelerated to below 2%, while economic sentiment declined further in the fourth quarter of 2018. The deterioration in the performance of international stock markets in the last quarter of 2018 reflects uncertainties, inter alia, about global growth, international trade policies and Brexit, weighing on domestic outlook. In the UK, growth remained modest in the third quarter, but economic sentiment weakened and the pound depreciated against the euro in the final quarter of 2018, amid Brexit uncertainty.

The low levels of interest rates and spreads in the euro area continue to provide a favourable environment, backing activity growth in Cyprus. The recent increases in sovereign yields, particularly in the case of Italy, are found to weigh on domestic growth prospects as they reflect risks to the bloc's growth, among other things.

Past increases in international oil prices, especially in the second and third quarters of 2018, and the pickup in inflation, as well as the sharp increase in government expenditure and deficit in the third quarter of 2018, are found to limit the growth momentum in the next quarters.

There are downside and upside risks to the outlook associated with both domestic factors and the external environment; these risks are not fully reflected in the published predictors employed in the computation of the forecasts.

- The high levels of private debt and NPLs relative to the size of the economy continue to pose risks to the soundness of the banking system, economic confidence and growth prospects. Despite recent progress, NPL ratios

of households and SMEs remain high, weighing on new credit and investment.

- The high level of public debt together with the stronger connection between bank and sovereign risk, after the sale of the Cyprus Cooperative Bank, renders Cyprus vulnerable to shocks. Potential additional fiscal costs from the publicly financed scheme for vulnerable borrowers (Estia) and/or the newly-established state-owned asset management entity could add to the economy's vulnerabilities.
- Fiscal risks that may arise from (i) the introduction of the National Health System, (ii) faster-than-planned increases in the public sector wage bill, and (iii) delays in the implementation of structural reforms (e.g. judicial system, public administration), may undermine economic confidence, the sustainability of public finances and the medium-term growth prospects.
- Other downside risks to the outlook include:
 - higher uncertainty, faster depreciation of the British pound and weaker-than-expected growth in the UK in the event of no-deal Brexit;
 - slower-than-expected growth in the euro area as a result of weaker global trade, among other things;
 - a slowdown in Russia due to lower oil prices;
 - intensified competition from other tourist destinations.

Upside risks to the outlook are associated with a faster reduction in the stock of NPLs, and a higher degree of materialisation of investment plans (e.g. investments relating to tourism, property developments, energy) than that reflected in the predictors.

In 2019, CPI inflation is forecasted at 1.8%, as international oil prices declined and inflation decelerated in the final quarter of 2018, and some activity indicators showed signs of deceleration in the second half of 2018.⁴ Upside risks to the forecasts relate to faster wage growth and stronger demand, and a further weakening of the euro vis-à-vis the US dollar. Downside risks to the forecast are associated with weaker demand and downward pressures in international commodity prices.

⁴ CPI inflation forecasts are constructed using a methodology similar to that for GDP growth forecasts.

3. Concluding remarks

Quarterly and monthly series released until 23 January 2019, are employed in dynamic econometric models to construct forecasts for growth and inflation.

The forecast for real GDP growth for 2018 has been marginally revised from 3.9% in the October issue to 3.8%. The growth forecast for 2019 has been revised from 3.5% in the October issue to 3.1%. The downward revisions are mainly driven by a weakening of the growth momentum in Cyprus, the EU and the euro area in the third quarter, and a weaker performance of leading indicators in the final quarter of 2018, particularly series relating to the external environment (e.g. economic sentiment in the EU; international stock market indicators).

The CPI inflation forecast for 2019 has been revised from 2.6% to 1.8%. The large downward revision is driven by declines in international oil prices and slower inflation in the final quarter of 2018, as well as by weaker activity growth.

The forecasts presented in this issue suggest that real activity in Cyprus will continue to increase at robust rates in 2019, albeit at a somewhat slower pace compared to 2018. The growth forecast for 2019 presented here is more conservative than the forecasts published by the Central Bank of Cyprus (3.7%), the European Commission (3.5%) and the IMF (4.1%), [1] – [3].

REFERENCES

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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	2019				2018	2019				2018	2019			
Quarter	4	1	2	3	4	4	1	2	3	4	4	1	2	3	4
FORECAST	3.5	3.1	3.2	3.2	3.1										
COMPONENTS															
I. Real economy	0.02	0.02	0.02	0.02	0.02	0.58	0.64	0.52	0.53	0.49	3.5	3.1	3.2	3.2	3.2
II. Aspects other than real economy	0.03	0.03	0.02	0.02	0.03	0.94	0.97	0.74	0.75	0.80	3.5	3.1	3.2	3.1	3.2
III. Real economy & other aspects	3.40	3.02	3.14	3.13	3.07	98.48	98.38	98.74	98.72	98.71	3.5	3.1	3.2	3.2	3.1
Fiscal	0.20	0.19	0.18	0.17	0.17	5.97	6.11	5.73	5.34	5.22	3.4	3.0	3.2	3.2	3.2
Prices	0.46	0.43	0.42	0.40	0.41	13.70	14.33	13.53	13.69	13.95	3.4	3.0	3.1	2.9	3.0
Exchange rates	0.11	0.10	0.10	0.10	0.10	3.04	3.07	2.99	2.96	3.07	3.5	3.1	3.2	3.2	3.3
Interest rates, spreads	0.89	0.85	0.88	0.85	0.77	25.60	27.32	27.68	27.27	26.90	3.5	3.1	3.2	3.1	2.9
Stock markets	0.51	0.42	0.44	0.44	0.43	14.91	14.13	14.76	14.89	14.97	3.4	3.0	3.0	3.0	2.8
Economic sentiment	0.94	0.78	0.86	0.89	0.83	27.37	25.54	27.29	27.92	26.45	3.4	3.1	3.2	3.2	3.1
Loans, deposits	0.28	0.27	0.26	0.28	0.36	7.88	7.88	6.76	6.63	8.15	3.6	3.4	3.8	4.3	4.4



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