



ECONOMIC OUTLOOK

ECONOMICS RESEARCH CENTRE

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Summary

Real GDP growth in Cyprus is projected at 3.7% in 2021 and 3.8% in 2022. The growth forecasts have been revised upwards relative to the forecasts in the previous issue. The upward revisions were mainly driven by the pickup in real activity in the first quarter of 2021 vis-à-vis the final quarter of 2020, as well as by substantial improvements in the second quarter of 2021, signalled by business and consumer confidence indicators for Cyprus and the EU.

Downside risks to the outlook stem from setbacks to the gradual normalisation of activities due to new waves of COVID-19 infections, new virus variants and delays in the vaccination coverage, particularly among younger age groups. Downside risks are also associated with the path of external demand for tourist services that depends on the epidemiological conditions and vaccination coverage in Cyprus and abroad.

As the pandemic persists, downside risks may emerge as a result of the high levels of public and private indebtedness in conjunction with delays in key structural reforms and uncertainty around the foreclosure framework. Upward pressures on public finances and NPLs, as the pandemic evolves, may undermine the country's credit rating position and weigh on banks' balance sheets, limiting the growth prospects.

On the upside, a pickup in the pace of vaccinations in Cyprus and abroad, leading to improvements in the epidemiological conditions could boost demand, especially for tourist services. The implementation of Cyprus's Recovery and Resilience Plan is expected to directly affect domestic activity and employment through higher investment, and enhance the country's growth potential via reforms.

In 2021 and 2022, CPI inflation is projected at 1.6% and 1.8%, respectively, as demand is expected to recover.

Ιούλιος 2021

Περίληψη

Η κυπριακή οικονομία προβλέπεται να καταγράψει υψηλούς ρυθμούς ανάκαμψης το 2021 και 2022, μετά τη συρρίκνωση του 2020 λόγω της πανδημίας COVID-19, καθώς αναμένεται σταδιακή επιστροφή στην κανονικότητα και αύξηση της εμβολιαστικής κάλυψης. Ο ρυθμός μεγέθυνσης του πραγματικού ΑΕΠ εκτιμάται σε 3,7% για το 2021 και σε 3,8% για το 2022. Οι προβλέψεις έχουν αναθεωρηθεί προς τα πάνω κυρίως ως αποτέλεσμα της αύξησης της πραγματικής δραστηριότητας το πρώτο τρίμηνο του 2021 σε σχέση με το τελευταίο τρίμηνο του 2020, καθώς και σημαντικών βελτιώσεων κατά το δεύτερο τρίμηνο του 2021 που αποτυπώνονται στους δείκτες οικονομικής εμπιστοσύνης της Κύπρου και της ΕΕ.

Πιθανοί κίνδυνοι για δυσμενέστερες από τις προβλεπόμενες προοπτικές πηγάζουν από ανατροπές στη σταδιακή επιστροφή στην κανονικότητα λόγω νέων κυμάτων της πανδημίας, νέων παραλλαγών του ιού και καθυστερήσεων στην εμβολιαστική κάλυψη, ιδίως των νεαρότερων ηλικιακών ομάδων. Η πορεία της εξωτερικής ζήτησης για το κυπριακό τουριστικό προϊόν, επίσης, εμπεριέχει κινδύνους, αφού εξαρτάται από τις επιδημιολογικές συνθήκες, συμπεριλαμβανομένων των εμβολιασμών, στην Κύπρο και στο εξωτερικό.

Ενώ η πανδημία συνεχίζεται, ενδέχεται να προκύψουν κίνδυνοι για τις προοπτικές ως αποτέλεσμα του υψηλού δημόσιου και ιδιωτικού χρέους σε συνδυασμό με καθυστερήσεις στην εφαρμογή σημαντικών διαρθρωτικών μεταρρυθμίσεων και αβεβαιότητα γύρω από το πλαίσιο εκπομπών. Ανοδικές πιέσεις στα δημόσια οικονομικά και στα μη εξυπηρετούμενα δάνεια, ενώ η πανδημία βρίσκεται ακόμα σε εξέλιξη, ενδέχεται να υπονομεύσουν την πιστοληπτική αξιολόγηση της χώρας και να επιβαρύνουν τους ισολογισμούς των τραπεζών, περιορίζοντας τις προοπτικές ανάπτυξης.

Καλύτερες προοπτικές από τις προβλεπόμενες μπορούν να διαμορφωθούν από ενδυνάμωση της ζήτησης, ιδίως για τουριστικές υπηρεσίες, λόγω αύξησης του ρυθμού εμβολιασμών στην Κύπρο και στο εξωτερικό, και βελτίωσης των επιδημιολογικών συνθηκών. Η εφαρμογή του Σχεδίου Ανάκαμψης και Ανθεκτικότητας της Κύπρου αναμένεται να επηρεάσει θετικά την εγχώρια δραστηριότητα και απασχόληση μέσω αυξημένων επενδύσεων και να ενισχύσει τις δυνατότητες ανάπτυξης μέσω μεταρρυθμίσεων.

Ο πληθωρισμός για το 2021 και 2022 προβλέπεται να αυξηθεί στο 1,6% και 1,8% αντίστοιχα, καθώς η ζήτηση αναμένεται να ανακάμψει.

UNIVERSITY OF CYPRUS



1. Recent developments

Economic activity in Cyprus continued to recover in the first quarter of 2021, despite the renewed pandemic containment measures in January that were gradually relaxed in February and March 2021. The contraction in real GDP decelerated to 1.6% in the first quarter of the year vis-à-vis 4.4% in the final quarter of 2020.

In the first quarter of 2021, the year-on-year (y-o-y) decline in gross value added moderated in the sectors of trade, transportation and hospitality, arts and entertainment, professional and administrative activities, as well as in the industrial sector. Real gross value added in the sector of financial and insurance activities declined (y-o-y), while activity in the remaining service sectors and construction expanded (y-o-y) in the first quarter of the year.

On the demand side, real private consumption increased vigorously in the first quarter of 2021, exceeding its pre-pandemic levels; real consumption expenditure of the general government continued to register strong growth, cushioning the economic downturn. The rise (y-o-y) in the gross fixed capital formation was driven by higher construction investment and investment in transport equipment. The trade gap narrowed in the first quarter; the decline (y-o-y) in exports moderated, because of higher services exports, while imports decreased (y-o-y).

A new rise of COVID-19 infections led to a short lockdown in late April followed by the reopening of most economic activities by mid-May, against the backdrop of increasing vaccination coverage in Cyprus. Consequently, domestic activity indicators registered strong increases (y-o-y) during the second quarter of 2021, reflecting the recovery of demand, which has been supported to a large extent by policy measures. Leading indicators relating to the property market (e.g. number of property sale contracts, value of property transactions) and professional services (e.g. registrations of new companies) recorded notable improvements over the period April – June 2021.

The Economic Sentiment Indicator (ESI) increased significantly in the second quarter of 2021 as a result of stronger confidence among firms in all sectors and among consumers; in June, ESI surpassed its historical average. During the second quarter, the largest confidence gains were registered in services; however, in June, confidence in the hospitality sector was lower than in other sectors. Firms' employment expectations picked up in the second quarter of the year, following a plunge in the first quarter.

The rise in the number of registered unemployed decelerated considerably in the second quarter of 2021. Nevertheless, the unemployment rate (Eurostat) increased to over 9% in April and May 2021, exceeding the euro area average.

Over the period January – May 2021, both government revenue and expenditure increased (y-o-y) strongly, while the general government deficit widened considerably vis-à-vis the same period in 2020. In May 2021, public debt declined from the peak reached in March, but debt-to-GDP ratio remained significantly elevated. The long-term interest rates for Cyprus remained at very low levels in May 2021, despite an uptick observed for euro area countries after January 2021.

The annual growth rate of domestic deposits accelerated in April and May 2021. New lending over the period January – May 2021 continued to recover, supported by low lending interest rates and policy measures to counteract the economic effects of the pandemic. In March 2021, non-performing loans (NPLs) recorded a slight increase from their December 2020 level, driven by higher NPLs among non-financial corporations, particularly small and medium-sized enterprises.

After four quarters in negative territory, inflation (measured by the Consumer Price Index – CPI) turned positive in the second quarter of 2021, reaching 2.4% vis-à-vis -1.4% in the first quarter. The higher inflation rate in the second quarter reflected the low levels of the Index in 2020 due to the pandemic shock, as well as the rising international energy prices and recovering demand as the economies reopen. The recent increase in inflation is mainly associated with the categories of transport, housing, water and energy, as well as clothing and footwear.

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 2021 are employed. Monthly indicators that contain information about some or all the months in the second quarter of 2021 are also used. The cut-off date for the data used in the analysis is 5 July 2021. All forecasts presented in this bulletin are based solely on published data; thus, they only incorporate effects captured by the indicators used in the estimations.

Table 1: GDP growth forecasts and components

Year	2021		
FORECAST	3.7		
	CONTRIBUTION	WEIGHT	FORECAST BY COMPONENT
COMPONENTS			
I. Real economy	0.02	0.57	3.2
II. Aspects other than real economy	0.02	0.55	3.6
III. Real economy & other aspects	3.68	98.88	3.7
Fiscal	0.17	5.77	3.0
Prices	0.41	10.65	3.9
Exchange rates	0.10	3.24	3.1
Interest rates, spreads	0.59	18.02	3.3
Stock markets	0.56	15.21	3.7
Economic sentiment, uncertainty	1.63	38.50	4.2
Loans, deposits	0.22	7.49	2.9
Year	2022		
FORECAST	3.8		
	CONTRIBUTION	WEIGHT	FORECAST BY COMPONENT
COMPONENTS			
I. Real economy	0.02	0.47	3.3
II. Aspects other than real economy	0.02	0.57	3.7
III. Real economy & other aspects	3.81	98.96	3.8
Fiscal	0.19	5.65	3.4
Prices	0.38	10.42	3.7
Exchange rates	0.10	2.96	3.5
Interest rates, spreads	0.72	21.47	3.4
Stock markets	0.55	13.80	4.0
Economic sentiment, uncertainty	1.66	39.20	4.2
Loans, deposits	0.20	5.46	3.6

Table 1 presents the forecasts for the growth rate of real GDP for 2021 and 2022. Based on the historical relationships between growth and numerous macroeconomic and financial indicators, real economic activity in Cyprus is projected to recover strongly in 2021, following the downturn in 2020 as a result of the COVID-19 pandemic. Growth in 2022 is projected to remain vigorous, as conditions are expected to gradually normalise, partly because of higher vaccination coverage. Real GDP growth is projected at 3.7% in 2021 and 3.8% in 2022. The current growth forecasts for 2021 and 2022 have been revised upwards relative to the forecasts in the previous issue. The upward revisions were mainly driven by the pickup in real activity in the first quarter of 2021 vis-à-vis the final quarter of 2020, as well as by substantial improvements in leading indicators, most notably economic confidence indicators, registered in the second quarter of the year.

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 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 to the overall forecasts.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, 3}

The drivers of the outlook are discussed below.

- *Strong recovery momentum.* Despite new waves of COVID-19 infections and renewed containment measures, the contraction of economic activity in Cyprus and the EU eased significantly in the first quarter of 2021. Monthly hard data suggest that the recovery of activity in Cyprus and the EU gained further momentum during the second quarter of the year. The downturn in other trading partner economies (e.g. the UK, Russia) also moderated in the first quarter; leading indicators point to further improvements in economic conditions in these countries during the second

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.

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 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.

quarter. Monthly data on registered unemployed in Cyprus signal an improving situation in the domestic labour market; nevertheless, the recent rises in the unemployment rate, as well as the decrease in employee earnings in the first quarter of 2021 weigh on the outlook.

- *Substantial improvement in economic sentiment.* Domestic and European economic confidence indicators improved markedly during the second quarter, fuelling the recovery. The recent upswing in economic sentiment in Cyprus and the EU has positively affected the outlook, pointing to improved growth prospects compared to the April issue.
- *Favourable external financial conditions.* In the second quarter of 2021, the performance of international stock markets continued to improve, while volatility declined further. In the euro area, borrowing costs for the private sector as well as for sovereigns have remained very low, reflecting the continuation of accommodative monetary policy. These positive developments in the financial markets are expected to back the recovery of the global economy, favourably affecting the economic outlook for Cyprus.
- *Supportive financing conditions and policy response.* The conditions in the domestic banking system have facilitated new lending to businesses and households, which is expected to fuel the recovery. The domestic financing conditions are currently characterised by very low lending interest rates, as a result of the continued monetary policy accommodation in the euro area, improved bank balance sheets vis-à-vis the previous crisis, and policy measures to support credit growth. Moreover, the policy response to the pandemic has been successful at mitigating the economic effects by supporting business liquidity, employment and household incomes. However, as the pandemic persists, the legacies of high private and public debt could dampen the growth prospects because of renewed upward pressures on NPLs, following the end of loan moratoria, and limited fiscal space.
- *Past declines in prices.* Despite the rise in inflation in the second quarter of the year, the declines in prices registered in previous quarters, as a result of the pandemic, continue to benefit the recovery by preserving purchasing power, especially in combination with policy support measures.

Uncertainty about the outlook remains high, mainly because of pandemic-related factors, particularly the prevalence of rapidly spreading variants.

Downside risks to the outlook stem from setbacks to the gradual normalisation of activities due to new waves of COVID-19 infections, new virus variants and delays in the vaccination coverage, particularly among younger age groups. Downside risks are also associated with the path of external demand for tourist services that depends on the epidemiological conditions and vaccination coverage in Cyprus and abroad.

As the pandemic persists, downside risks may emerge as a result of the high levels of public and private indebtedness in conjunction with delays in structural reforms (e.g. judicial system, public administration, local authorities) and uncertainty around the foreclosure framework. Upward pressures on public finances and NPLs, as the pandemic evolves, may undermine the country's credit rating position and weigh on banks' balance sheets, limiting the growth prospects.

On the upside, a pickup in the pace of vaccinations in Cyprus and abroad, leading to improvements in the epidemiological conditions could boost demand, especially for tourist services. The positive effects of domestic and EU pandemic-related support programmes on activity may turn out stronger than those reflected in published data. In particular, the implementation of Cyprus's Recovery and Resilience Plan is expected to directly affect domestic activity and employment through higher investment and enhance the country's growth potential via reforms.

In 2021, CPI inflation is projected at 1.6%, as the economic recovery is expected to continue.⁴ The projection for 2021 is driven by the gradual strengthening of demand and the increase in inflation during the second quarter. The rise in inflation in the second quarter mostly reflected the recovery in international oil prices, reinforced by base effects from the low levels recorded in 2020. CPI inflation is projected to rise to 1.8% in 2022, as growth is expected to remain robust. Upside risks to the forecasts include faster increases in international commodity prices, particularly oil prices, pandemic-induced supply constraints and stronger-than-expected growth in Cyprus and abroad. Downside risks to the inflation outlook are associated with a weaker-than-anticipated recovery in domestic and global activity and an easing of upward pressures on international commodity prices. Survey data for the second quarter of 2021 incorporated in the forecasts reveal moderate upward price pressures; firms' selling price expectations have broadly

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

returned to their pre-pandemic levels, while consumers' expectations about price trends have remained subdued, below their pre-pandemic levels.

3. Concluding remarks

Quarterly and monthly series released up until 5 July 2021, are employed in dynamic econometric models to construct forecasts for GDP growth and CPI inflation. Despite the short lockdown in late April, leading indicators for the second quarter of 2021 reflect a strong recovery in demand as the economy reopened in mid-May against the backdrop of increasing vaccination coverage in Cyprus. Nevertheless, the projections do not incorporate either the adverse effects of the current steep rise in COVID-19 infections in Cyprus and abroad, or the positive impact of investments and reforms under the recently endorsed Recovery and Resilience Plan for Cyprus.

Real GDP growth is projected at 3.7% in 2021 and 3.8% in 2022. The growth forecasts have been revised upwards compared to those in the April issue (3.3% and 3.6% for 2021 and 2022, respectively). The upward revisions were largely driven by the pickup in real activity in the first quarter of 2021 vis-à-vis the final quarter of 2020, as well as by significant improvements during the second quarter, signalled by business and consumer survey data for Cyprus and the EU.

CPI inflation is projected at 1.6% in 2021 and 1.8% in 2022. The forecasts for inflation have been revised upwards relative

to the projections in the April issue (0.9% and 1.5% for 2021 and 2022, respectively). The upward revisions reflect the gradual strengthening of demand and the rise in inflation in the second quarter of the year, including base effects.

The growth forecast for 2021 presented in this bulletin is very close to the forecast published by the Central Bank of Cyprus (3.8%) and the Ministry of Finance (3.6%), but slightly lower than the projection given by the European Commission (4.3%). For 2022, the growth forecast shown here as well as the projections released by the European Commission and the Ministry of Finance (3.8%) are somewhat more optimistic than that by the Central Bank (3.1%) [1] – [3].

The forecasts in this issue are accompanied by downside risks, mainly induced by the course of the pandemic and the pace of vaccinations, as well as by upside risks mostly associated with the implementation of Cyprus's Recovery and Resilience Plan.

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