

## 12. CYPRUS

### Prolonged recession and deleveraging ahead

#### Strong contraction of the economy in 2012 ...

Economic activity in Cyprus significantly weakened with real GDP expected to have decreased by 2.3% in 2012, in line with the autumn forecast. The deterioration was driven by a marked contraction of domestic demand against the background of falling domestic consumption and private investment. The largest fall in economic activity took place in construction and in the broad industrial sector, while financial services also showed sign of weakening activity. The fiscal consolidation implemented at the end of 2011, the significant deterioration in the labour market, and the prolonged high economic uncertainty concerning Cyprus's request for financial assistance in June 2012 have all weighed on private consumption. The ongoing process of deleveraging also implied tightening credit conditions, which together with the high-level of corporate indebtedness and the weak business and consumer confidence (the lowest in the EU), hit investment activity strongly. At the same time, the contribution of net exports to GDP growth is expected to have been stronger than previously anticipated due to the stronger export performance of goods and services (tourism being the main driver). A significant decline in the volume of imports, mainly goods, resulted from the subdued domestic demand and lower import propensity. While the trade balance is expected to have improved, the current-account balance is projected to have worsened due to a deterioration of the income balance stemming from developments in the financial sector, particularly through its financial activities in Greece.

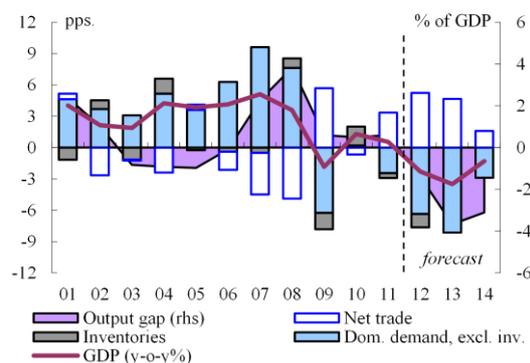
#### ... sets to deteriorate further in 2013 and 2014

Projections of the economic outlook for 2013 and 2014 point to a prolonged recession, due to further declines in domestic demand and investment activity. The effects of much-needed fiscal consolidation measures (including measures affecting public sector wages, social outlays, increases in employee contributions, and indirect taxes), coupled with increasing unemployment, are likely to weigh strongly on household disposable income. On the back of banks deleveraging and the deceleration of credit growth, gross fixed capital formation is expected to decline further, with the

growth rates of the construction activity remaining negative over the forecast horizon.

The external sector is set to provide a positive contribution to growth this year and next year. Prospects for the exports of goods and services remain favourable, particularly for tourism services (underlying the good prospects for high tourist arrivals particularly from Russia) and some business services (accounting, legal, and information society services). At the same time, import of goods and services should continue to fall against backdrop of weak domestic demand. Overall, the current-account balance is expected to improve gradually over the forecast horizon, driven by imports but yet conditional on the outlook of the income balance.

Graph II.12.1: Cyprus - GDP growth and contributions



#### Unemployment rates jump to historically high levels...

Labour market conditions are expected to have worsened in 2012 with the unemployment rate reaching a record 12.1% and to worsen further in subsequent years, reflecting the contraction of the economic activity. The subdued business activity, the hiring freeze in the public sector, and the developments in domestic demand have all weighed on employment in 2012 with job losses particularly pronounced in the construction and agricultural sectors. Average wage growth in 2012 is expected to decline compared to the previous year and the unfavourable economic environment is set to affect wages in the economy as a whole, influenced also by the cuts in public sector wages and benefits.

**.. while inflation declines.**

HICP inflation declined in 2012 reflecting the decline in electricity and oil product prices. Subdued domestic demand and lower disposable income are projected to lower inflation further in 2013 and 2014 in spite of the higher indirect taxes (VAT and excise duties) adopted.

**Excessive government deficit persists...**

The government deficit improved slightly despite the sizeable consolidation implemented in 2012. Revenues stagnated due to less tax-rich growth, lower corporate profitability and deteriorating labour market conditions. Expenditure reduction was lower than expected, in particular due to the increased number of early retirements and growing unemployment albeit investments were being reduced. In both 2013 and 2014, the deficit and structural deficit is set to decrease gradually thanks to the adopted consolidation measures. The debt-to-GDP ratio reached 86.5% in 2012, due to the deficit, nominal GDP developments, and the participation in a bank recapitalisation..

**... while downside risks exist.**

Risks remain important and tilted to the downside. The conclusion of a macro-economic adjustment programme would be of paramount importance in stabilising the economy, but risks would remain on both the external environment and the domestic front. In spite of recent developments, the worsening of economic conditions in Greece remain a downside risk for Cyprus. On the domestic front, downside risks are associated with domestic credit conditions due to financial sector deleveraging, the worsening of labour market conditions, a stronger than expected fall in house prices, and a further loss of business and consumer confidence from prolonged economic uncertainty. Also, the restructuring of the Cypriot banking sector could have stronger effects on related professional business services. Upside risks for the economy may emerge in 2014 with higher investment activity in the energy sector.

Table II.12.1:

**Main features of country forecast - CYPRUS**

	2011			92-08	Annual percentage change					
	mio EUR	Curr. prices	% GDP		2009	2010	2011	2012	2013	2014
GDP	17979.3		100.0	4.3	-1.9	1.3	0.5	-2.3	-3.5	-1.3
Private consumption	11959.2	66.5		-	-7.5	1.5	0.2	-3.0	-4.1	-1.0
Public consumption	3605.0	20.1		-	6.8	1.0	-0.2	-3.2	-9.3	-3.3
Gross fixed capital formation	2938.4	16.3		-	-9.7	-4.9	-13.1	-22.3	-23.7	-11.6
of which: equipment	828.2	4.6		-	-0.3	-5.9	-23.1	-26.3	-22.0	-14.0
Exports (goods and services)	7699.0	42.8		-	-10.7	3.8	3.3	3.1	1.6	1.9
Imports (goods and services)	8251.6	45.9		-	-18.6	4.8	-4.1	-8.8	-8.0	-0.5
GNI (GDP deflator)	17917.4	99.7		4.4	-4.9	2.4	3.6	-9.3	-4.0	-0.9
Contribution to GDP growth:										
Domestic demand				-	-6.3	0.2	-2.4	-6.3	-7.7	-2.5
Inventories				-	-1.6	1.8	-0.5	-1.3	0.0	0.0
Net exports				-	5.7	-0.7	3.4	5.3	4.2	1.1
Employment				-	-0.5	0.0	0.5	-3.6	-1.3	-0.5
Unemployment rate (a)				-	5.5	6.5	7.9	12.1	13.7	14.2
Compensation of employees/head				-	2.5	2.7	3.3	1.1	-4.4	-1.2
Unit labour costs whole economy				-	3.9	1.4	3.3	-0.3	-2.3	-0.4
Real unit labour costs				-	3.8	-0.5	0.5	-1.9	-3.7	-1.9
Saving rate of households (b)				-	11.1	13.6	8.8	9.5	8.5	8.5
GDP deflator				3.4	0.1	1.9	2.7	1.7	1.5	1.5
Harmonised index of consumer prices				-	0.2	2.6	3.5	3.1	1.5	1.4
Terms of trade of goods				-	2.7	-0.9	-0.6	-2.4	-0.1	0.1
Merchandise trade balance (c)				-	-25.5	-26.8	-24.2	-21.2	-18.9	-18.7
Current-account balance (c)				-	-10.7	-9.2	-4.2	-6.0	-1.7	0.1
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				-	-10.6	-9.0	-4.0	-5.5	-1.2	0.5
General government balance (c)				-	-6.1	-5.3	-6.3	-5.5	-4.5	-3.8
Cyclically-adjusted budget balance (c)				-	-6.3	-5.5	-6.5	-5.0	-2.9	-2.5
Structural budget balance (c)				-	-6.3	-5.5	-6.2	-5.7	-3.9	-2.5
General government gross debt (c)				-	58.5	61.3	71.1	86.5	93.1	97.0

(a) Eurostat definition. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.