

## 12. CYPRUS

### Recession deepens sharply as painful adjustments get underway

#### Economic activity contracted in 2012 ...

2012 was marked by declining economic activity, with real GDP falling by 2.4%. The contraction was driven by a marked decline in domestic consumption and investment activity, affected by the tightening credit conditions, fiscal consolidation, deteriorating labour market conditions, and very low consumer confidence. The external sector contributed positively due to good export performance and a strong contraction of import volumes. On 12 April 2013, the Eurogroup welcomed the staff-level agreement on macroeconomic adjustment programme for Cyprus, expecting formal approval by end of April 2013.

#### .. and will deteriorate sharply over 2013-14

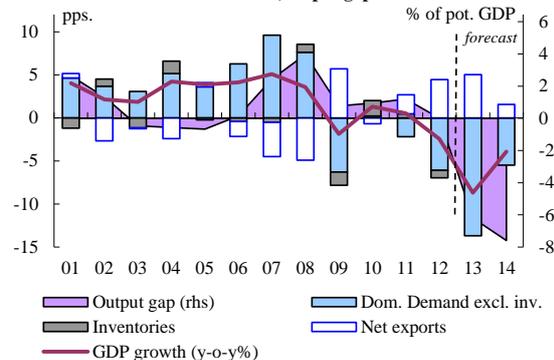
In 2013, real GDP is expected to decline sharply by 8.7%, affected in particular by the immediate restructuring of the banking sector, which affects net credit growth, fiscal consolidation, and the high degree of economic uncertainty which weighs on domestic demand and investment. In addition, the temporary imposition of capital controls and withdrawal restrictions are expected to hamper international capital flows and to reduce business volumes in both domestic and internationally-oriented companies. The bail-in of uninsured depositors implies a loss of wealth, which will also affect private consumption and investment.

The forecast points to the prolongation of recession into 2014. On the back of deleveraging by banks and the tight credit growth conditions, gross fixed capital formation is expected to decline further. Fiscal consolidation measures and rising unemployment are projected to weigh strongly on private consumption. The contraction in domestic demand is expected to be mirrored by shrinking imports over the forecast horizon. Little reprieve could be expected from exports (tourism being most promising) amid uncertain external conditions and a shrinking financial services sector. The current-account balance is set to improve considerably given also the divestments in the banking sector. Overall, the Cypriot economy is expected to contract by around 15% cumulatively in 2012-14.

#### Unemployment rates jump to unprecedented levels, while inflation declines

The profound contraction in economic activity is expected to weigh on employment. Reduced business activity, possible spillovers from the restructuring of the banking sector to professional business services and the hiring freeze in the public sector are expected to push the unemployment rate higher in 2013 and more so in 2014. Subdued domestic demand is projected to lead to lower inflation in 2013 and 2014, offsetting the imposed higher indirect taxes.

Graph II.12.1: Cyprus - GDP growth and contributions, output gap



#### Significant downside risks exist

Risks remain tilted to the downside. Implementation of the agreed macroeconomic adjustment programme could have a stronger impact on the economy through domestic demand, exports, business and consumer confidence. Also, risks of household and corporate defaults propagating through the economy may lead to further losses in the banking sector and increased unemployment. Upside risks relate to potential investment activity in the energy sector.

#### Sizeable government deficit persists

The government deficit did not improve in 2012, despite the sizeable consolidation measures undertaken. While tax revenues decreased mainly due to lower corporate profits in 2011, non-tax revenues improved due to higher sales revenues. Social contributions decreased in line with the deterioration in labour market conditions. Overall, expenditure slightly increased. Interest payments increased due to borrowing difficulties leading to

higher interest rates and to higher debt, while primary expenditure was reduced significantly. While wages and salaries were reduced, social benefits increased due to the wave of early retirements prior to the MoU agreement. The one-off payment to insurance companies related to the 2011 Vasilico explosion adversely affected other current expenditures. In contrast, investment expenditure decreased significantly keeping the overall level of expenditure unchanged from 2011.

In 2013 and 2014, revenue expectations are subject to uncertainty arising from developments in the financial sector. Revenues are expected to be held back by the slump in the economic activity. Despite the increase in direct taxation (measures on corporate, interest income, and property tax), the decline in economic activity is expected to lead to worse revenues in 2013 than in 2012 and to a faster worsening in 2014, as these taxes are collected in the following year. Indirect tax receipts are also expected to fall in both 2013 and 2014 in line with the reduction of domestic consumption and despite the increases on the VAT rates and on excise duties. Sales revenues are foreseen to decrease despite the increase of

government fees, while the one-off signing fees from licencing of plots for the exploitation of natural gas will increase current revenues in 2013. On the expenditure side, compensation of public sector employees is expected to fall further due to wages cuts and the hiring moratorium. Intermediate consumption and social transfers are also projected to fall while the interest bill will be affected by the jump of the debt level. Public investments are expected to remain at low levels, while capital transfers and other current expenditure are set to decline, reversing the one-off expenditures in 2012. The structural balance is expected to improve by 1¼% of GDP in 2013 and to marginally improve in 2014.

Debt in 2012 reached 85.8% of GDP, rising noticeably from 2011, mainly due to the government participation in the recapitalisation of a commercial bank. During the forecast period, debt-to-GDP is expected to rise to unprecedented levels for Cyprus. Public debt developments are projected to be largely influenced by the general government deficit, the recapitalisation of some financial institutions, notably the cooperative credit institutions and the contraction of GDP.

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	-2.4	-8.7	-3.9
Private consumption	12013.7	66.8		-	-7.5	1.5	0.5	-3.0	-12.3	-5.5
Public consumption	3605.0	20.1		-	6.8	1.0	-0.2	-1.7	-8.9	-3.6
Gross fixed capital formation	2938.3	16.3		-	-9.7	-4.9	-13.1	-23.0	-29.5	-12.0
of which : equipment	829.3	4.6		-	-0.3	-5.9	-23.1	-30.0	-26.0	-14.2
Exports (goods and services)	7783.9	43.3		-	-10.7	3.8	4.4	2.3	-5.0	-2.5
Imports (goods and services)	8562.3	47.6		-	-18.6	4.8	-0.7	-7.2	-16.0	-6.5
GNI (GDP deflator)	18054.5	100.4		4.4	-4.9	2.4	4.3	-6.6	-5.5	-4.4
Contribution to GDP growth :										
Domestic demand				-	-6.3	0.2	-2.2	-6.1	-13.7	-5.5
Inventories				-	-1.6	1.8	0.5	-0.9	0.0	0.0
Net exports				-	5.7	-0.7	2.2	4.4	5.0	1.6
Employment				-	-0.4	-0.2	0.5	-4.1	-6.6	-3.1
Unemployment rate (a)				-	5.4	6.3	7.9	11.9	15.5	16.9
Compensation of employees/head				-	2.5	2.6	3.3	1.6	-7.5	-5.0
Unit labour costs whole economy				-	4.1	1.1	3.2	-0.1	-5.4	-4.2
Real unit labour costs				-	4.0	-0.9	0.5	-2.0	-5.9	-5.2
Saving rate of households (b)				-	11.1	13.6	8.8	4.4	9.9	11.4
GDP deflator				3.4	0.1	1.9	2.7	2.0	0.6	1.1
Harmonised index of consumer prices				-	0.2	2.6	3.5	3.1	1.0	1.2
Terms of trade of goods				-	2.7	-0.9	-2.1	-1.2	-1.6	-1.0
Merchandise trade balance (c)				-	-25.5	-26.8	-24.2	-21.6	-18.1	-16.8
Current-account balance (c)				-	-10.7	-9.2	-4.8	-4.8	-1.9	-0.6
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				-	-10.6	-9.0	-4.6	-4.8	-2.1	-0.7
General government balance (c)				-	-6.1	-5.3	-6.3	-6.3	-6.5	-8.4
Cyclically-adjusted budget balance (c)				-	-6.5	-5.7	-6.8	-6.3	-3.8	-5.1
Structural budget balance (c)				-	-6.5	-5.7	-6.6	-6.7	-5.4	-5.1
General government gross debt (c)				-	58.5	61.3	71.1	85.8	109.5	124.0

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