

13. CYPRUS

Recession deepens while adjustments are underway

Note: This forecast was finalised at end-July, after the first quarterly review of the Economic Adjustment programme, and will be revisited during the second quarterly review. The text reflects recent developments.

Resilient households curbed the contraction...

Economic activity continued its decline in the first half of 2013, although to a lesser extent than foreseen in the Spring 2013 European Economic Forecast, as private consumption proved less weak than anticipated. The unwinding of macroeconomic imbalances, disruptions to credit intermediation, and private sector deleveraging continued to weigh on domestic demand. Uncertainty about future business prospects led firms to accelerate their destocking, weighing further on growth. On the other hand, on the back on a sharp contraction in import, net trade contributed positively to growth.

Consumer confidence and business sentiment indicators hit historically low levels following the agreement of an economic adjustment programme for Cyprus in April. Although some improvement in the indicators has been observed since, they continue to point to further contraction in activity for the coming quarters.

... yet economic activity is expected to contract in 2013 and 2014 ...

Amid high uncertainty, real GDP in 2013 and 2014 is expected to profoundly contract, to broadly the same extent cumulatively as expected in the Spring Forecast. The Cypriot economy will continue to face several headwinds. Domestic demand will continue to fall, amid declining credit and wage growth alongside further fiscal consolidation. On the back of further shrinking of import in 2013-14, a positive contribution to growth is expected from net trade, and the current-account balance is forecast to improve significantly.

.... but growth is set to resume in 2015

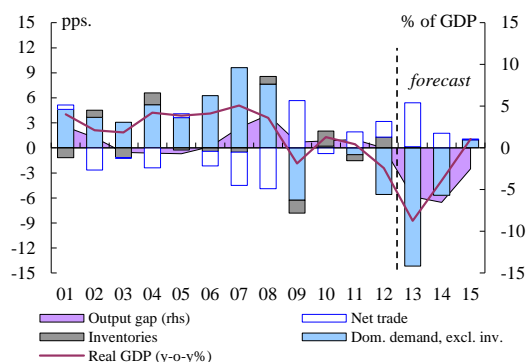
In 2015, the recession is expected to come to an end and growth is foreseen to resume gradually, as private domestic demand regains strength. The ongoing deleveraging of both households and corporates will remove impediments to a more

balanced growth over time. At the same time, the restoration of a sound and well-capitalised banking sector is expected to gradually loosen the tight credit conditions, supporting domestic demand. The rebound in domestic demand is expected to support imports, therefore limiting the positive contribution of net export to GDP and negatively impacting the current-account balance.

Unemployment rates reach historical high levels while inflation remains weak

The profound contraction in economic activity in 2013 and 2014 is expected to weigh on employment and push unemployment to unprecedented levels. Subdued domestic cost pressure and sizeable spare capacity are projected to contain inflation in 2013 and 2014 despite higher indirect taxes. As domestic demand picks up in 2015, inflation is projected to accelerate, albeit remaining below 2%.

Graph II.13.1: Cyprus - Real GDP growth and contributions



Fiscal adjustments are underway

Despite the significant consolidation effort undertaken in line with the programme requirements, the general government deficit is expected to increase in 2013. This is largely due to a one-off compensation of provident and retirement funds in Cyprus Popular Bank, which amounts to 1.8% of GDP. The deficit is projected to stay flat in 2014 and to decline in 2015, in line with the annual targets set out in the context of the programme.

Developments in 2014 are expected to be largely driven by the continuation of the deep recession

and the sizeable consolidation measures undertaken. This combination is likely to result in a decrease of broadly the same magnitude of both total revenue and total expenditure. On the revenue side, falling wages and employment in the private and public sectors as well as declining profits are forecast to lower revenues from direct taxes, while the measures undertaken to raise revenues from indirect taxes are unlikely to be sufficient to cushion the negative effect stemming from the drop in private consumption and imports. On the expenditure side, further restraint is expected from measures to reduce the public sector wage bill, continued compression in public investment, intermediate consumption and other current expenditure. Overall, expenditure-reducing measures are projected to outweigh the increase in social transfers connected to the adverse labour market developments.

In 2015, total revenue is expected to recover in line with the improving macroeconomic situation, while total expenditure is projected to decrease

further on the back of better labour market conditions.

Debt is expected to sharply increase in 2013, mainly as a result of the participation of the government in the recapitalisation of the banking sector. The debt-to-GDP ratio is projected to further increase in 2014 and 2015, reflecting the weak GDP growth.

Downside risks prevail

Risks are tilted to the downside. On the domestic front, a more protracted period of disruptions to efficient credit intermediation alongside tighter credit supply conditions and a further deterioration in the confidence in the banking sector could pose considerable risks to the real economy. Moreover, a further worsening of labour market conditions may lead to a more prolonged weakness of business and consumer confidence. On the fiscal front, weaker-than-expected growth could lead to revenue shortfalls.

Table II.13.1:

Main features of country forecast - CYPRUS

	2012			Annual percentage change						
	mio EUR	Curr. prices	% GDP	94-09	2010	2011	2012	2013	2014	2015
GDP	17720.3	100.0		3.8	1.3	0.4	-2.4	-8.7	-3.9	1.1
Private Consumption	12087.3	68.2		-	1.5	1.3	-2.5	-12.4	-5.7	1.6
Public Consumption	3438.2	19.4		-	1.0	-0.2	-3.1	-8.9	-3.7	-1.7
Gross fixed capital formation	2430.0	4.3		-	-4.9	-8.7	-19.6	-29.5	-11.9	2.2
of which: equipment	757.3	4.3		-	-6.5	-15.8	-16.0	-26.0	-14.3	1.4
Exports (goods and services)	7710.2	43.5		-	3.8	4.4	-2.7	-5.4	-2.5	1.7
Imports (goods and services)	8180.1	46.2		-	4.8	-0.2	-6.4	-16.5	-6.7	1.7
GNI (GDP deflator)	17184.8	97.0		3.7	2.4	4.8	-6.3	-8.6	-5.9	-0.8
Contribution to GDP growth:										
Domestic demand				4.0	0.2	-0.8	-5.6	-14.2	-5.7	1.0
Inventories				-0.2	1.8	-0.7	1.3	0.2	0.0	0.0
Net exports				-0.6	-0.7	1.9	1.9	5.3	1.8	0.1
Employment				2.0	-0.2	0.5	-4.2	-7.8	-3.7	1.0
Unemployment rate (a)				4.4	6.3	7.9	11.9	16.7	19.2	18.4
Compensation of employees / head				-	2.6	2.5	-0.9	-9.5	-4.6	-1.4
Unit labour costs whole economy				-	1.1	2.5	-2.7	-8.5	-4.4	-1.5
Real unit labour cost				-	-0.9	0.2	-4.2	-9.0	-5.4	-3.0
Saving rate of households (b)				11.0	13.6	8.8	12.4	3.3	7.4	5.0
GDP deflator				2.9	1.9	2.3	1.6	0.6	1.1	1.5
Harmonised index of consumer prices				2.6	2.6	3.5	3.1	1.0	1.2	1.6
Terms of trade goods				-	-0.9	-1.8	-1.1	-1.6	-1.0	-0.4
Trade balance (c)				-26.1	-26.8	-24.3	-21.7	-17.9	-16.5	-16.7
Current-account balance (c)				-4.9	-9.2	-4.3	-6.6	-2.0	-0.6	-0.9
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-4.7	-9.0	-4.6	-4.8	-1.1	-0.8	-1.0
General government balance (c)				-2.8	-5.3	-6.3	-6.4	-8.3	-8.4	-6.3
Cyclically-adjusted budget balance (c)				-3.2	-5.7	-6.8	-6.4	-5.7	-5.5	-5.2
Structural budget balance (c)				-3.2	-5.7	-6.5	-6.8	-5.5	-5.5	-5.2
General government gross debt (c)				61.7	61.3	71.5	86.6	116.0	124.4	127.4

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