



# ECONOMIC OUTLOOK

## ECONOMICS RESEARCH CENTRE

Issue 22/1

January 2022

### Summary

*Real GDP is estimated to have increased by 5.6% in 2021. In 2022, growth is expected to remain robust as real GDP is projected to expand by 4.1%. The drivers of the outlook include: the robust recovery from the pandemic crisis, the strong economic sentiment, the supportive financing conditions and the accommodative fiscal policy.*

*The latest COVID-19 wave, though more aggressive in terms of the surge in infections, has not led to significant restrictions in economic activity, possibly weakening the link between growth and epidemiological conditions. Nevertheless, new virus variants leading to new infection waves remain a key source of economic uncertainty and pose a major downside risk to the domestic and global outlook. New COVID-19 waves may intensify supply disruptions and amplify upward pressures on prices, especially international commodity prices, limiting growth prospects. Moreover, downside risks could emerge as a result of the high levels of public and private debt that may render the Cypriot economy vulnerable to tightening financial conditions and changes in investor sentiment. Finally, overdue structural reforms dent economic confidence and dampen investment prospects.*

*As economic and social activities adapt further to the pandemic, upside risks to the outlook may stem from stronger-than-anticipated domestic demand and external demand, especially for tourist services. Rising vaccination coverage, and widespread and frequent COVID-19 testing allow further normalisation, benefitting economic activity. Also, investments and reforms, particularly through the Recovery and Resilience Plan for Cyprus are expected to positively affect output and employment.*

*In 2022, CPI inflation is projected at 2.6%.*

Ιανουάριος 2022

### Περίληψη

*Το πραγματικό ΑΕΠ εκτιμάται ότι έχει αυξηθεί κατά 5,6% το 2021. Το 2022, το πραγματικό ΑΕΠ προβλέπεται να αυξηθεί κατά 4,1%. Οι παράγοντες που συμβάλλουν στη διαμόρφωση των προοπτικών περιλαμβάνουν: την ισχυρή ανάκαμψη από την πανδημική κρίση του 2020, την ενδυναμωμένη οικονομική εμπιστοσύνη, τις ευνοϊκές συνθήκες χρηματοδότησης και την υποστηρικτική δημοσιονομική πολιτική.*

*Το τελευταίο κύμα της πανδημίας COVID-19, αν και πιο επιθετικό όσον αφορά την αύξηση των λοιμώξεων, δεν οδήγησε σε σημαντικούς περιορισμούς στην οικονομική δραστηριότητα, αποδυναμώνοντας πιθανώς τη σχέση μεταξύ οικονομικής μεγέθυνσης και επιδημιολογικών συνθηκών. Ωστόσο, οι νέες παραλλαγές του ιού που οδηγούν σε νέα κύματα λοιμώξεων παραμένουν βασική πηγή οικονομικής αβεβαιότητας και συνιστούν σημαντικό καθοδικό κίνδυνο για τις εγχώριες και παγκόσμιες προοπτικές. Νέα κύματα της πανδημίας ενδέχεται να οξύνουν προβλήματα στις αλυσίδες εφοδιασμού και να εντείνουν τις ανοδικές πιέσεις στις τιμές, ιδίως στις διεθνείς τιμές αγαθών, περιορίζοντας τις προοπτικές ανάπτυξης. Επιπλέον, κίνδυνοι για χειρότερες από τις προβλεπόμενες προοπτικές πηγάζουν από το υψηλό επίπεδο χρέους στην Κύπρο και από καθυστερήσεις στην εφαρμογή διαρθρωτικών μεταρρυθμίσεων. Τα υψηλά επίπεδα δημόσιου και ιδιωτικού χρέους μπορεί να καταστήσουν την κυπριακή οικονομία ευάλωτη στο ενδεχόμενο λιγότερο χαλαρών χρηματοοικονομικών συνθηκών και σε αλλαγές στην εμπιστοσύνη των επενδυτών. Καθυστερήσεις στην προώθηση διαρθρωτικών μεταρρυθμίσεων πλήττουν την οικονομική εμπιστοσύνη και περιορίζουν τις επενδυτικές προοπτικές.*

*Καθώς οι οικονομικές και κοινωνικές δραστηριότητες προσαρμόζονται περαιτέρω στην πανδημία, καλύτερες προοπτικές από τις προβλεπόμενες σχετίζονται με ισχυρότερη από την αναμενόμενη εγχώρια ζήτηση, αλλά και εξωτερική ζήτηση, κυρίως για τουριστικές υπηρεσίες. Η αυξανόμενη εμβολιαστική κάλυψη, και η εκτεταμένη και τακτική διενέργεια τεστ ανίχνευσης της νόσου στον πληθυσμό, επιτρέπουν περαιτέρω ομαλοποίηση των δραστηριοτήτων, ενισχύοντας τις οικονομικές προοπτικές. Επίσης, επενδύσεις και μεταρρυθμίσεις, ιδίως μέσω του Σχεδίου Ανάκαμψης και Ανθεκτικότητας για την Κύπρο αναμένεται να επηρεάσουν θετικά την παραγωγή και την απασχόληση.*

*Ο πληθωρισμός για το 2022 προβλέπεται στο 2,6%.*



### 1. Recent developments

In the third quarter of 2021, economic activity in Cyprus continued to pick up; real GDP increased by 5.6% compared to the third quarter of 2020, reaching the level registered in the last quarter of 2019.

Real gross value added increased across all sectors in the third quarter of 2021. The sector of trade, transportation and hospitality, and the industrial sector posted the strongest year-on-year (y-o-y) growth rates. Despite two consecutive quarters of double-digit growth, the sector of trade, transportation and hospitality is still below its pre-pandemic output level and is showing the largest gap between the current and pre-pandemic real activity. In the third quarter of 2021, robust growth rates (y-o-y) were registered in information and communication, as well as in financial and insurance services; growth (y-o-y) in these sectors had remained strong during the pandemic slump in 2020.

Apart from gross fixed capital formation, all expenditure components of GDP increased in the third quarter of 2021 vis-à-vis the corresponding quarter in 2020. Gross fixed capital formation contracted (y-o-y) as investment in transport equipment declined and construction investment stalled; however, the categories of dwellings, and machinery and equipment (excluding transport equipment) exhibited positive growth rates (y-o-y). In the third quarter of 2021, net exports had a large positive contribution to growth as a result of a strong increase in exports.

Most leading indicators for domestic activity continued to grow in the final quarter of 2021, reflecting the economy's adjustment to pandemic conditions. Indicators that picked up in October – December 2021 (subject to data availability) relate to the volume of retail trade, the use of local and foreign credit cards in Cyprus, tourist arrivals, the number of property sale contracts (including contracts for foreign buyers), and the value of property transactions. A small number of leading indicators (e.g. motor vehicle registrations, building permits in terms of square metres) have deteriorated.

The Economic Sentiment Indicator (ESI) increased further in the final quarter of 2021, as a result of stronger business confidence in services, retail trade and industry. The confidence gains in the services sector during the fourth quarter were driven by improvements in hospitality, as well as in financial and insurance services. Confidence indicators for the construction sector and consumers faltered in the fourth quarter of 2021. In December 2021, economic

sentiment remained above its historical average, but firms' employment expectations fell below their long-run mean after two consecutive months of downward revisions.

The decline in the number of registered unemployed accelerated in the fourth quarter of 2021. In November 2021, the unemployment rate (Eurostat) stood just above 6% and below the euro area average.

Over the period January – November 2021, government revenue registered stronger growth (y-o-y) than expenditure, and the general government deficit narrowed significantly vis-à-vis the same period in 2020. Debt-to-GDP ratio has remained high, despite the declines in debt after March 2021. The long-term interest rates for Cyprus stayed at very low levels during the last quarter of 2021, although small increases were registered in October and November 2021.

The stock of loans grew steadily during the period January – November 2021. The ratio of non-performing loans (NPLs) to total loans declined significantly in September 2021, going down to 15.4%. Over the period January – November 2021, new lending, especially loans for house purchase, rose strongly compared to the same period in 2020. After robust growth in the second and third quarters of 2021, the annual growth rate of deposits strengthened further in October – November 2021.

Inflation (measured by the Consumer Price Index – CPI) reached 4.5% in the fourth quarter of 2021 vis-à-vis 4.4% in the third quarter; for 2021 as a whole, CPI inflation rose to 2.4% from –0.6% in 2020. The acceleration of inflation during the second half of 2021 mainly resulted from large price increases in the categories of housing, water and energy, transport, and food. The recent price increases were largely associated with the strong pickup in international commodity prices, especially for oil and food, as well as with the recovery of demand.

### 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 2021 are employed. Monthly indicators that contain information about some or all the months in the fourth quarter of 2021 are also used. The cut-off date for the data used in the analysis is 17 January 2022. 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 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 estimated to have registered a strong recovery in 2021, after the 2020 downturn caused by the COVID-19 pandemic. Real GDP is estimated to have increased by 5.6% in 2021. In 2022, real economic activity is expected to continue to expand at a vigorous pace, mainly because of accumulated experience in living with COVID-19 and broader vaccination coverage compared to 2021. Real GDP is projected to expand by 4.1% in 2022.

The current growth forecast for 2021 is higher than the forecast in the previous issue by 0.2 percentage points; the small upward revision resulted from stronger-than-projected growth in the third quarter of 2021. The forecast for 2022 has remained unchanged compared to that in the previous issue.

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.<sup>1</sup> The component that combines information on both the real economy and other economic aspects plays a key role in forming the final forecasts.<sup>2, 3</sup>

<sup>1</sup> 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 concerning aspects other than the real economy is based on indicators such as interest rates, stock market returns, economic sentiment indicators, exchange rates, domestic and foreign price indices, international commodity prices, as well as fiscal and banking sector series.

<sup>2</sup> Monthly leads of leading indicators (e.g. interest rates, economic sentiment) and of series used in extracting the factors (e.g.

**Table 1: GDP growth forecasts and components**

Year	2021		
FORECAST	5.6		
	CONTRIBUTION	WEIGHT	FORECAST BY COMPONENT
<b>COMPONENTS</b>			
<b>I. Real economy</b>	0.02	0.44	5.6
<b>II. Aspects other than real economy</b>	0.03	0.50	5.6
<b>III. Real economy &amp; other aspects</b>	5.56	99.06	5.6
Fiscal	0.31	5.56	5.6
Prices	0.61	10.90	5.6
Exchange rates	0.19	3.48	5.6
Interest rates, spreads	1.03	18.51	5.6
Stock markets	0.83	14.79	5.6
Economic sentiment, uncertainty	2.05	36.28	5.6
Loans, deposits	0.54	9.54	5.6
Year	2022		
FORECAST	4.1		
	CONTRIBUTION	WEIGHT	FORECAST BY COMPONENT
<b>COMPONENTS</b>			
<b>I. Real economy</b>	0.02	0.47	3.8
<b>II. Aspects other than real economy</b>	0.02	0.51	3.5
<b>III. Real economy &amp; other aspects</b>	4.05	99.03	4.1
Fiscal	0.21	5.64	3.8
Prices	0.40	10.88	3.7
Exchange rates	0.13	3.48	3.8
Interest rates, spreads	0.70	18.76	3.7
Stock markets	0.62	14.77	4.2
Economic sentiment, uncertainty	1.59	36.22	4.4
Loans, deposits	0.39	9.29	4.2

unemployment rate, registered unemployed, arrivals of tourists, registrations of motor vehicles) are also included in the models.

<sup>3</sup> 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.

The drivers of the outlook are discussed below.

- *Robust recovery.* In the third quarter of 2021 economic activity in Cyprus continued to recover at a fast pace and employment growth strengthened. Moreover, GDP growth in the EU and in other trading partner economies (e.g. the UK, Russia) remained vigorous in the third quarter of 2021. Domestic leading indicators suggest that activity and labour market conditions continued to improve in the final quarter of 2021, fuelling growth in the following quarters. Nevertheless, developments in some domestic and foreign leading indicators during the last quarter of 2021 have revealed uncertainties about the growth momentum over the next quarters.
- *Strong economic sentiment.* Economic confidence in Cyprus, predominantly among businesses, improved further in the fourth quarter of 2021, contributing significantly to the strong outlook. Despite declines in November and December 2021, economic sentiment in the EU and euro area has remained well above its historical average, supporting the recovery in Cyprus. However, the recent weakening in economic confidence in the EU and the euro area, as well as the faltering consumer confidence and employment expectations in Cyprus may weigh on growth prospects.
- *Favourable developments in international stock markets.* The positive performance of stock market indices continued in the final quarter of 2021, despite some upward pressures in volatility in November. The stock market developments during the last months of 2021 indicate that external economic conditions have not significantly worsened in the face of the recent resurgence of COVID-19 infections due to the Omicron variant. Nevertheless, the outlook currently projected by stock market indicators is less optimistic than previously forecast by the same group of indicators.
- *Supportive financing conditions.* As a result of the accommodative monetary policy in the euro area, sovereign and private sector borrowing costs have remained at or near historically low levels, assisting the recovery and generating positive effects on the outlook. However, these effects are currently lower than previously estimated and are expected to weaken towards the end of the horizon. The increase of new lending in Cyprus during 2021 is expected to back growth in the following quarters. Factors that facilitated the recovery of domestic credit in 2021 include: the low interest rates, policy measures to counteract the economic effects of the pandemic, rising

deposits and declining NPLs; these factors also contribute to the robust outlook.

Other factors that influence the outlook include fiscal developments, prices and exchange rates.

Fiscal stimulus in 2020 and 2021 has been instrumental in limiting the depth of the pandemic recession and backing the recovery, but has put pressure on public finances. The recent accommodative fiscal policy will continue to assist growth; however, the positive policy effects are currently less pronounced compared to previous quarters, especially as the impact of support measures gradually wanes.

The acceleration of inflation during the second half of 2021, mainly as a result of rising international commodity prices, has put a downward pressure on real incomes, weighing on growth prospects. Moreover, supply-chain bottlenecks caused by the pandemic, and the recent depreciation of the euro, particularly against the US dollar, have also pushed domestic inflation up, softening somewhat the growth prospects.

There are both downside and upside risks to the outlook, most of which have remained broadly unchanged compared to the October issue.

The latest COVID-19 wave, though more aggressive in terms of the surge in infections, has not led to significant restrictions in economic activity, possibly weakening the link between growth and epidemiological conditions. Nevertheless, new virus variants leading to new infection waves remain a key source of economic uncertainty and pose a major downside risk to the domestic and global outlook. New COVID-19 waves may intensify supply disruptions and amplify upward pressures on prices, especially international commodity prices, limiting growth prospects.

Moreover, downside risks could emerge as a result of the high levels of public and private debt that may render the Cypriot economy vulnerable to tightening financial conditions and changes in investor sentiment. Finally, overdue structural reforms dent economic confidence and dampen investment prospects.

As economic and social activities adapt further to the pandemic, upside risks to the outlook may stem from stronger-than-anticipated domestic demand and external demand, especially for tourist services. Rising vaccination coverage, and widespread and frequent COVID-19 testing allow further normalisation, benefitting economic activity. Also, investments and reforms, particularly through the Recovery and Resilience Plan for Cyprus are expected to positively affect output and employment.

CPI inflation is projected at 2.6% in 2022.<sup>4</sup> The inflation forecast is driven by the pickup in inflation in the second half of 2021, largely because of rising international prices for energy and food, and the recovery of demand. Survey data show that firms' selling price expectations and consumers' expectations about price trends have fluctuated well above their historical averages in the second half of 2021, adding to inflation in the following quarters.

Upside risks to the inflation outlook include: further increases in international commodity prices, particularly in oil and food prices, pandemic-induced supply bottlenecks, wage increases, the depreciation of the euro, geopolitical tensions, and stronger-than-expected demand. Downside risks to the inflation outlook stem primarily from weaker-than-expected growth in domestic and global activity.

### 3. Concluding remarks

Quarterly and monthly series released up until 17 January 2022, are employed in dynamic econometric models to construct forecasts for GDP growth and CPI inflation. The recovery of economic activity continued in the third quarter of 2021; most leading indicators continued to grow in the final quarter of 2021, reflecting the economy's adjustment to pandemic conditions. The data used in the construction of the forecasts do not fully reflect the effects of the recent surge in COVID-19 infections on activity; however, new pandemic containment measures implemented in December 2021 and January 2022 have not severely hindered economic and social activities.

Real GDP growth in 2021 is projected at 5.6%, up by 0.2 percentage points compared to the forecast in the October issue. The small revision is mainly a result of stronger-than-projected growth in the third quarter of 2021. Growth in 2022 is projected at 4.1%, unchanged from the forecast in the October issue.

During the second half of 2021 inflation accelerated, mainly as a result of rising international commodity prices and the strong recovery from the pandemic crisis; moreover, business and consumer expectations about prices remained elevated in the final quarter of 2021. CPI inflation is projected at 2.6% in 2022, an upward revision relative to the projection in the October issue (1.8%).

The growth forecast for 2021 presented in this bulletin is very close to the forecast released by the Central Bank (5.6%) and the European Commission (5.4%). For 2022, the growth forecast in this issue is similar to that published by the European Commission (4.2%) and slightly higher than the projection published by the Central Bank (3.6%), [1], [2].

### REFERENCES

1. Central Bank of Cyprus, "Economic Bulletin – December 2021", Nicosia – Cyprus (in Greek), December 2021.
2. European Commission, "European Economic Forecast – Autumn 2021", European Economy, Institutional Paper 160, November 2021.

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



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