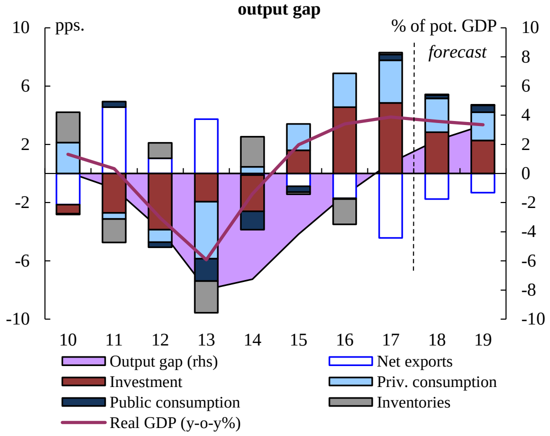
13. CYPRUS
Strong growth momentum continues

Economic growth is expected to be strong, fuelled by foreign-funded investment and solid private consumption. Unemployment has fallen below 10% and is expected to continue decreasing. Inflation remains very low and is set to stay moderate. The budget surplus is projected to further improve, although risks to the fiscal outlook remain. Public debt is expected to increase in 2018 but to decline again in 2019.

Strong domestic demand-driven growth

After strong growth of 3.9% in 2017, early hard data and survey indicators point to robust growth in the first quarter of 2018. The growth momentum is expected to continue with GDP forecast to expand by 3.6% in 2018 and 3.3% in 2019, underpinned by strong domestic demand. Net exports, by contrast, are projected to have a negative impact on growth.

Graph II.13.1: **Cyprus - Real GDP growth and contributions, output gap**



Solid consumption is set to last

Private consumption accelerated in 2017, as rapid employment growth and low inflation provided a boost to households' real disposable incomes. Most sectors of the economy have markedly increased the number of employees and the unemployment rate fell below 10% in early 2018. Employment expectations and consumer confidence are on the rise, supporting the outlook.

Investment becomes the engine for growth

In 2017, investment surged further. It was strongly supported by construction, as the tourism boom has created additional demand for accommodation and other infrastructure, while new residential construction also increased. Investment in equipment has been even stronger, mainly as a result of the growth in ship registrations. The near-term outlook for investment is very positive, supported by foreign-funded large-scale projects. A gradual revival of new bank lending is expected to lift investment further.

Amid strong domestic demand, imports increased sharply in 2017, outweighing the healthy growth of exports and leading to a marked widening of the current account deficit. Activities of special purpose entities, particularly linked to ship registration, heavily influence the current account in Cyprus, determining a very large share of its deficit. A further deterioration of the current account is projected in both 2018 and 2019 due to the high import content in investment and consumption, which should outweigh the forecast increase in service exports.

Inflation remains subdued

After a very modest 2017, HICP inflation was surprisingly weak in the first quarter of 2018 (-0.9%), with all components, except services, in negative territory. While some of the deflationary pressures came from one-off factors, notably in unprocessed food category, stronger competition among suppliers keeps prices in Cyprus low. Inflation is expected to rebound somewhat, driven by energy and service prices, but to remain low at 0.7% for the year as a whole before increasing moderately to 1.2% in 2019.

Downside and upside risks widen

Recent developments in the financial sector have widened the risks to the outlook. Tourism faces both upside and downside risks. While the recently expanded air transport and accommodation capacity brightens the sector's prospects, the reopening of neighbouring markets for this season increases competition. At the same time, even stronger investment than currently foreseen and advancement of gas exploration projects could further support the outlook in the short to medium term.

General government surpluses increasing further, but risks to the outlook remain

The government's fiscal performance in 2017 was remarkably strong. The general government headline balance registered a surplus of 1.8% of GDP, whilst the primary balance reached a surplus of 5.0% of GDP, one of the highest in the EU. This was mostly due to high tax collection, in particular of VAT, social security contributions and corporate income taxes. In structural terms, this corresponds to a surplus of about 1½% of GDP.

In 2018, the headline and primary surpluses are forecast to remain high at 2.0% of GDP and 5.0% of GDP, respectively. This is mainly explained by the expected good performance in revenues underpinned by the positive economic outlook and the improving labour market. Both total revenue and total expenditure are forecast to increase (by around 4% each), but they are set to marginally decline as a percentage of GDP (to 39.6% and 37.6%, respectively). In 2019, under a no-policy change assumption, the headline surplus is expected to increase to 2.2% of GDP, mainly on account of positive cyclical developments and a rise in social security contributions (by 0.4 pps. of GDP). The structural balance is forecast to deteriorate somewhat over the forecast horizon.

Downside risks to public finances stem from the absence of a mechanism regulating public sector payroll growth from 2019 onwards, the potential additional costs of the national health system reform and the contingent risks from the high proportion of NPLs in the banking sector. The forecast is also subject to uncertainties on the budgetary impact of the government's transaction on 3rd April 2018 related to the Cyprus Cooperative Bank (CCB).

Public debt expected to increase in 2018

Public debt fell significantly in 2017. However, it is expected to rise by around 8 pps. of GDP in 2018 to 105.7%, due to the government's operations with the CCB, which included the issuance of bonds of EUR 2.35 bn, the proceeds of which were deposited with the CCB. However, public debt is projected to steadily decline thereafter, mostly owing to the projected primary surplus and strong real GDP growth.

Table II.13.1:

Main features of country forecast - CYPRUS

	2016			Annual percentage change						
	mio EUR	Curr. prices	% GDP	98-13	2014	2015	2016	2017	2018	2019
GDP		18219.1	100.0	2.3	-1.4	2.0	3.4	**3.9**	**3.6**	**3.3**
Private Consumption		12573.4	69.0	2.9	0.7	2.6	3.3	**4.2**	**3.4**	**2.9**
Public Consumption		2729.5	15.0	3.1	-7.2	-2.6	-0.4	**2.7**	**1.5**	**3.3**
Gross fixed capital formation		3172.9	17.4	-0.7	-17.5	13.6	35.0	**27.8**	**13.4**	**9.8**
of which: equipment		1601.1	8.8	-2.6	-34.8	70.4	113.8	**28.1**	**1.5**	**3.0**
Exports (goods and services)		11789.6	64.7	1.8	4.2	5.8	4.0	**3.4**	**2.3**	**1.9**
Imports (goods and services)		11931.1	65.5	1.6	4.6	7.4	6.8	**10.1**	**4.8**	**3.7**
GNI (GDP deflator)		17934.2	98.4	2.3	-0.4	6.6	1.1	**3.5**	**3.6**	**3.4**
Contribution to GDP growth:	Domestic demand			2.3	-3.3	3.0	6.8	**8.2**	**5.4**	**4.7**
	Inventories			-0.1	2.1	-0.1	-1.7	**0.1**	**0.0**	**0.0**
	Net exports			0.1	-0.1	-0.9	-1.7	**-4.4**	**-1.8**	**-1.3**
Employment				1.3	-1.8	1.5	3.3	**3.4**	**2.8**	**2.8**
Unemployment rate (a)				6.0	16.1	15.0	13.0	**11.1**	**9.0**	**7.1**
Compensation of employees / head				3.3	-3.6	-1.2	-0.7	**0.7**	**1.4**	**2.0**
Unit labour costs whole economy				2.3	-4.0	-1.7	-0.8	**0.2**	**0.6**	**1.4**
Real unit labour cost				-0.3	-2.4	-0.5	-0.1	**-1.3**	**-0.9**	**-0.3**
Saving rate of households (b)				6.4	-6.3	-5.0	-2.3	**-4.2**	**-4.2**	**-4.1**
GDP deflator				2.6	-1.6	-1.2	-0.7	**1.5**	**1.5**	**1.7**
Harmonised index of consumer prices				2.5	-0.3	-1.5	-1.2	**0.7**	**0.7**	**1.2**
Terms of trade of goods				0.0	7.1	3.2	-0.4	**0.4**	**0.6**	**0.4**
Trade balance (goods) (c)				-23.5	-16.0	-16.7	-21.2	**-23.5**	**-25.0**	**-25.7**
Current-account balance (c)				-8.5	-4.4	-1.4	-4.9	**-8.1**	**-9.0**	**-9.7**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-8.1	-4.4	-1.1	-4.7	**-7.6**	**-8.6**	**-9.3**
General government balance (c)				-3.2	-9.0	-1.3	0.3	**1.8**	**2.0**	**2.2**
Cyclically-adjusted budget balance (d)				-3.6	-5.2	0.8	1.1	**1.4**	**0.8**	**0.5**
Structural budget balance (d)				-	3.3	1.7	1.2	**1.4**	**0.8**	**0.5**
General government gross debt (c)				61.6	107.5	107.5	106.6	**97.5**	**105.7**	**99.5**

(a) as % of total labour force. (b) gross saving divided by adjusted gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.