13. CYPRUS

Strong growth momentum continues

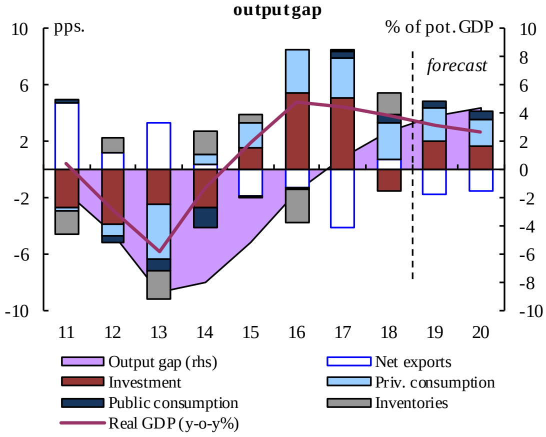
Cyprus' economic expansion is set to remain robust, driven by domestic demand, but risks are tilted to the downside. Inflation is forecast to remain subdued. The budget is expected to return to surplus and public debt to steadily decline from 2019 onwards. Risks to the fiscal outlook are also mainly on the downside.

Solid growth but increased downside risks

Cyprus continues to enjoy a remarkable post-crisis rebound with real GDP growth of 3.9% in 2018. Growth is forecast to ease to 3.1% this year and 2.7% in 2020 as the external environment turns less favourable and the private sector continues to deleverage.

Private consumption remains a key growth driver due to rapid employment growth. Employment in 2018 rose by 4% and more recent labour market indicators remain favourable. The unemployment rate fell to 7.1% in February 2019, with a significant reduction in long-term unemployment. Wages increased moderately over the previous year and are set to continue rising, with employers in several sectors scheduled to renegotiate wages with unions amid tightening labour market conditions. Public consumption is also set to provide support to growth, driven by the automatic indexation of public wages, wage increments and the unfreezing of promotions.

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



Investment is forecast to be robust, growing more strongly than the overall economic activity. An important part of investment comes from ongoing tourism-related projects. Other investment projects relate to residential construction, with half of all transactions in the sector driven by foreign demand, which in turn is supported by the Citizenship by Investment programme. Finally, a large share of investment in Cyprus is associated with ship registrations. These are inherently volatile but more likely to increase following efforts to strengthen the shipping sector in the country.

Net exports are projected to be a drag on economic growth. Imports are set to increase reflecting the large import content of domestic demand. Meanwhile, exports in Cyprus are dominated by services and the largest share of services is linked to tourism. The outlook of tourism-linked services is clouded by the recent bankruptcies of several airlines servicing Cyprus, slowing global demand, fierce competition, and high Brexit-related uncertainty (UK citizens account for more than a third of all tourists).

Risks to the outlook are tilted to the downside. As a small open economy, Cyprus would be exposed to strong headwinds from slowing global growth. The economy's heavy reliance on foreign funding also leaves it vulnerable to external developments.

Despite high growth, inflation remains low

Headline HICP inflation in 2018 was 0.8%, almost the same as it was in 2017 (0.7%). Inflationary pressures came mainly from energy and unprocessed food categories, while core inflation fluctuated around zero. Two factors seem to provide some explanation for this. First, the increasing competition among wholesalers, retailers and internet platforms, as well as the absence of legislation on when shops can offer sales, is weighing on prices. Second, although the unemployment rate has fallen sharply in recent years, the fastest job creation occurred in low-paid sectors and there is still significant slack in the labour market to be absorbed. Inflationary pressures are thus expected to remain subdued.

Public finances are set to return to budgetary surpluses

The general government headline balance is expected to return to surpluses of around 3% of GDP in 2019 and 2020, after posting a temporary deficit of 4.8% of GDP in 2018. This was entirely due to the one-off support measures related to the Cyprus Cooperative Bank sale. The underlying fiscal performance is projected to remain strong, on the back of the supportive macroeconomic environment and the improving labour market.

The general government surplus is forecast to reach 3.0% of GDP in 2019. Revenue is forecast to continue increasing, mainly as a result of a sizable rise in social security contributions, partly offset by a reduction in the excise duties on fuel and the revision of vehicle taxation. Compared to public expenditure net of one-offs in 2018, expenditure is forecast to rise at a higher rate than revenue. This is mostly due to deficit-increasing measures, such as the gradual increase in public wages to reverse wage cuts implemented after the crisis, the Estia scheme to support non-performing loan repayment and the government's support for low-income pensioners. The forecast takes into account the start of contributions to the national health insurance system as of March 2019 and the inclusion of the two entities resulting from the sale of the Cyprus Cooperative Bank within the general government sector. Under a no-policy-change assumption, the general government surplus is forecast to narrow slightly to 2.8% of GDP in 2020. The structural budget surplus is set to decline over the forecast period from 2% of GDP in 2018 to around ¾% in 2020, mainly due to the positive output gap.

The main downside risks to the fiscal outlook relate to uncertainties surrounding the macroeconomic outlook, the outcome of court rulings on past measures concerning the public sector wage bill and the potential deficit of public healthcare providers during the first years of the national health insurance system. Positive cash balances from the resulting CCB entities constitute an upside risk.

After increasing considerably to 102.5% of GDP in 2018, due to the government's one-off support for the Cyprus Cooperative Bank sale, public gross debt is forecast to steadily decline to below 90% of GDP by 2020. The decrease is mainly due to projected primary budget surpluses and strong nominal GDP growth.

Table II.13.1:

Main features of country forecast - CYPRUS

	2017		Annual percentage change						
mio EUR	Curr. prices	% GDP	99-14	2015	2016	2017	2018	2019	2020
GDP	19648.7	100.0	2.1	2.0	4.8	4.5	**3.9**	**3.1**	**2.7**
Private Consumption	13331.3	67.8	2.9	2.4	4.5	4.1	**3.7**	**3.5**	**2.8**
Public Consumption	2968.4	15.1	1.8	-0.5	-0.8	3.1	**4.3**	**3.6**	**4.0**
Gross fixed capital formation	4220.1	21.5	-1.3	13.8	41.8	29.0	**-7.1**	**10.2**	**8.1**
of which: equipment	1865.3	9.5	-2.3	52.1	107.9	26.5	**-35.1**	**3.3**	**3.1**
Exports (goods and services)	12726.3	64.8	1.8	5.2	4.6	6.0	**3.3**	**0.8**	**0.8**
Imports (goods and services)	13415.6	68.3	1.8	8.4	6.6	12.2	**2.0**	**3.5**	**3.0**
GNI (GDP deflator)	19115.0	97.3	1.7	6.9	1.4	3.7	**3.9**	**3.1**	**2.7**
Contribution to GDP growth: Domestic demand			2.1	3.2	8.4	8.4	**1.7**	**4.9**	**4.2**
Inventories			0.1	0.6	-2.3	0.2	**1.5**	**0.0**	**0.0**
Net exports			-0.1	-1.9	-1.3	-4.1	**0.8**	**-1.8**	**-1.5**
Employment			1.1	1.5	4.6	4.3	**4.0**	**2.6**	**2.0**
Unemployment rate (a)			6.7	15.0	13.0	11.1	**8.4**	**6.7**	**5.9**
Compensation of employees / head			2.8	-1.3	-1.1	0.7	**0.1**	**2.5**	**2.8**
Unit labour costs whole economy			1.9	-1.7	-1.4	0.6	**0.3**	**2.0**	**2.0**
Real unit labour cost			-0.2	-0.5	-0.8	-1.1	**-1.3**	**0.9**	**0.8**
Saving rate of households (b)			5.8	-4.5	-3.1	-3.1	**-6.4**	**-8.0**	**-8.0**
GDP deflator			2.1	-1.2	-0.6	1.7	**1.6**	**1.1**	**1.3**
Harmonised index of consumer prices			2.3	-1.5	-1.2	0.7	**0.8**	**0.9**	**1.1**
Terms of trade of goods			0.3	3.2	-0.4	0.4	**0.1**	**-0.1**	**-0.1**
Trade balance (goods) (c)			-23.1	-16.7	-21.0	-24.2	**-21.5**	**-22.4**	**-23.1**
Current-account balance (c)			-6.2	-1.4	-5.1	-8.4	**-6.5**	**-8.0**	**-9.4**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-5.8	-1.1	-4.9	-7.8	**-6.9**	**-7.1**	**-8.6**
General government balance (c)			-3.5	-1.3	0.3	1.8	**-4.8**	**3.0**	**2.8**
Cyclically-adjusted budget balance (d)			-3.8	1.3	1.1	1.3	**-6.2**	**1.1**	**0.7**
Structural budget balance (d)			-	2.1	1.1	1.3	**2.0**	**1.1**	**0.7**
General government gross debt (c)			65.5	108.0	105.5	95.8	**102.5**	**96.4**	**89.9**

(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.