

13. CYPRUS

Recession bottoms out while adjustments are underway

The unwinding of macroeconomic imbalances weighed significantly on economic activity and sentiment in 2013. The recession is expected to ease in 2014 and growth is set to return in 2015 as domestic demand recovers. Following a better-than-expected performance last year, the fiscal situation is set to improve further this year and next.

Note: This forecast was finalised early February, after the third quarterly review of the Economic Adjustment Programme, and will be revisited during the fourth quarterly review.

The recession in 2013...

Economic activity is expected to have contracted by 6.0% in 2013, which is significantly lower than projected in the autumn 2013 forecast. This reflects on one hand, resilient performance of the tourism and professional service sectors, and, on the other hand, a smaller-than-anticipated decline in private consumption. A substantial adjustment in prices and wages also helped curb the decline in real GDP. Nevertheless, several factors continued to weigh on economic growth, including tight credit conditions, private and public sector deleveraging and worsening labour market conditions. Reflecting the significant contraction in domestic demand, imports fell further, leading to a positive contribution of external demand to GDP growth. The fourth-quarter flash estimate released after the finalisation of this forecast suggests a milder recession than envisaged in the third review mission.

... will extend into 2014...

Business sentiment and consumer confidence indicators suggest a continuation of the recession. The real GDP is projected to decline by -4.8% in 2014, with domestic demand weighed down by the need for an adjustment of private and public sector debt from currently high levels. Tight credit conditions will continue to act as a drag on growth. Downward wage adjustments are expected to continue, weighing on disposable income. On the back of further shrinking of imports and a lesser fall in exports, a positive contribution to growth is expected from net trade.

...before coming to an end in 2015.

In 2015, the recession is expected to come to an end, with growth seen to resuming gradually, as private domestic demand regains strength. The

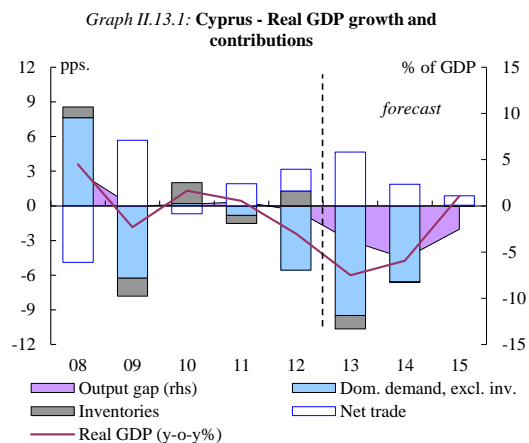
restoration of a sound and well-capitalised banking sector and the gradual deleveraging of both households and corporates are expected to progressively remove the impediments to more balanced growth. Export of goods and services are forecast to grow, accompanied by a marginal increase in imports.

Labour market conditions to improve from 2015

Unemployment is projected to peak in 2014 before falling slightly in 2015. Unit labour costs are expected to edge further down, driven by a further decline in compensation of employees. The associated weak domestic cost pressure and sizeable spare capacity will contain HICP inflation over the forecast horizon, despite indirect tax rate hikes in 2013 and 2014.

Downside risks remain

Risks are tilted to the downside. On the domestic front, a more protracted period of tight credit supply conditions could pose considerable risks to the real economy. In addition, a slower reduction of households' debt could prolong the needed deleveraging process. Moreover, a further worsening of labour market conditions may lead to a more prolonged weakness of business and consumer confidence.



Fiscal adjustment underway

Against the background of the milder recession and thanks to the significant consolidation efforts undertaken in line with the programme requirements, the general government deficit for 2013 is estimated to be significantly better than projected earlier, reaching 5.5% of GDP. However, the deficit is projected to widen slightly to -5.8% of GDP in 2014. This is mainly due to falling profits as well as declining wages and employment in the private and public sectors that are expected to translate into lower revenues from direct taxes. Further drop in private consumption is set to weigh on the revenues from indirect taxes. On the expenditure side, further effort to reduce the public sector wage bill, intermediate consumption and

other current expenditure is projected to outweigh the increase in social transfers driven by the further worsening labour market conditions.

In 2015, the improving macroeconomic situation and better labour market conditions are expected to support revenue from taxes and social contributions, while total expenditure is projected to remain largely unchanged, with higher pension payments in the private pension scheme, largely offset by a deceleration of the retirement wave in the public sector.

After a sharp increase in 2013, the debt-to-GDP ratio is expected to further increase in 2014 and 2015, broadly reflecting the macroeconomic conditions.

Table II.13.1:

Main features of country forecast - CYPRUS

	2012			94-09	Annual percentage change					
	mio EUR	Curr. prices	% GDP		2010	2011	2012	2013	2014	2015
GDP	17886.8	100.0	3.8	-	1.3	0.4	-2.4	-6.0	-4.8	0.9
Private Consumption	12087.3	67.6	-	-	1.5	1.3	-2.5	-7.5	-6.3	0.7
Public Consumption	3438.2	19.2	-	-	1.0	-0.2	-3.1	-6.0	-1.5	-2.7
Gross fixed capital formation	2430.0	13.6	-	-	-4.9	-8.7	-19.6	-24.0	-18.1	1.3
of which: equipment	757.3	4.2	-	-	-6.9	-15.4	-15.5	-22.5	-14.0	3.0
Exports (goods and services)	7710.2	43.1	-	-	3.8	4.4	-2.7	-4.8	-2.7	1.9
Imports (goods and services)	8180.1	45.7	-	-	4.8	-0.2	-6.4	-14.7	-7.2	0.2
GNI (GDP deflator)	17296.2	96.7	3.7	-	2.4	5.6	-7.3	-5.8	-6.2	2.2
Contribution to GDP growth:				-						
Domestic demand				-	0.2	-0.8	-5.6	-9.8	-6.7	0.1
Inventories				-	1.8	-0.7	1.2	-0.6	0.1	0.0
Net exports				-	-0.7	1.9	1.9	4.7	1.9	0.8
Employment				-	-0.2	0.5	-4.2	-5.7	-4.4	0.8
Unemployment rate (a)				-	6.3	7.9	11.9	16.0	19.2	18.4
Compensation of employees / head				-	2.6	2.5	-0.9	-5.0	-3.0	0.9
Unit labour costs whole economy				-	1.1	2.5	-2.7	-4.7	-2.6	0.8
Real unit labour cost				-	-0.9	-0.3	-4.6	-2.5	-3.2	-0.7
Saving rate of households (b)				-	19.2	15.2	12.8	9.9	12.2	14.7
GDP deflator				2.9	1.9	2.8	1.9	-2.3	0.6	1.5
Harmonised index of consumer prices				-	2.6	3.5	3.1	0.4	0.4	1.4
Terms of trade goods				-	-0.9	-1.8	-1.1	-1.3	-0.4	-0.5
Trade balance (c)				-	-26.8	-24.2	-21.5	-18.3	-16.9	-16.7
Current-account balance (c)				-	-9.2	-3.5	-6.8	-1.7	0.0	0.4
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-	-9.0	-3.3	-6.7	0.2	1.0	1.3
General government balance (c)				-	-5.3	-6.3	-6.3	-5.5	-5.8	-6.1
Cyclically-adjusted budget balance (c)				-	-5.3	-6.4	-6.0	-4.0	-3.5	-5.2
Structural budget balance (c)				-	-5.3	-6.2	-6.4	-3.8	-4.5	-5.2
General government gross debt (c)				-	61.3	71.1	85.8	112.0	121.5	125.8

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