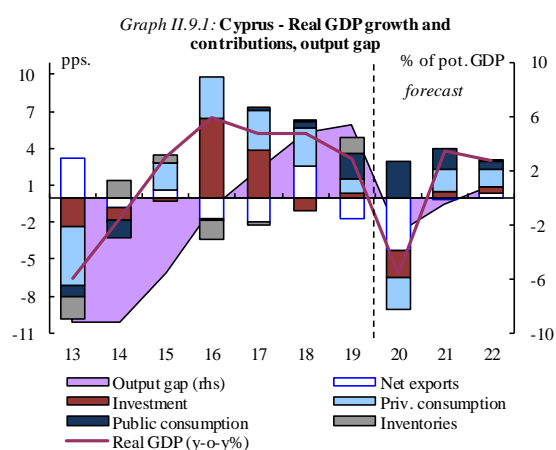


9. CYPRUS

Economic activity in Cyprus contracted sharply in the first half of the year, due to the COVID-19 crisis. The important tourism sector has borne the brunt, while domestic demand has shown resilience. The impact on the labour market has been mitigated by temporary income support measures. Public finances are set to deteriorate significantly in 2020 before improving with more contained budget deficits in 2021 and 2022.

A deep economic recession in 2020

In the first half of the year, economic activity declined sizeably by 5.5% y-o-y, dragged by the impact of the COVID-19 crisis and accompanying lockdown measures. Domestic demand fared better than anticipated early this summer, notably private consumption. Investment, particularly construction fell significantly. Exports of goods and services also declined considerably, the latter reflecting the impact of travel restrictions on tourism. The relatively contained epidemiological situation on the island allowed for a gradual relaxation of lockdown measures within the country as of May. This gave way to a gradual recovery of domestic demand over the summer, as suggested by high-frequency indicators, such as credit card use and production indices. However, growth in the fourth quarter is set to slow down, as economic sentiment and consumer confidence remain low and the epidemiological situation in Cyprus and its main trading partners is worsening. For the year 2020 as a whole, GDP growth is forecast to fall by 6.2%.



Tourism has been hit badly by the crisis

Tourist arrivals between January and September were down by some 85%, while revenues between January and July were nearly 90% lower. Tourist arrivals from the UK and Russia – Cyprus's main tourist markets – plummeted, as some travel

restrictions remained throughout the summer for travellers from the two countries. The recovery of the sector to its pre-crisis level is expected to take longer than the forecast horizon.

The economy is set to rebound in 2021 and 2022

GDP growth is projected to increase by 3¾% in 2021 and 3% in 2022, when output is expected to slightly exceed its pre-pandemic level. The recovery is expected to be driven by domestic demand. Private consumption is set to rebound due to pent up demand. Public consumption is expected to continue growing, due to the stimulus measures extended into 2021 and the planned increases in compensation of employees. Investment is set to partially recover thanks to on-going tourism-related infrastructure projects. By contrast, demand for high-end residences is set to slow down, due to the abolition of the investor citizenship scheme. The broad utilisation of the temporary income support schemes – up to 65% of eligible employees – has helped to keep unemployment at low levels so far. Since June, the schemes have been targeted to tourism sector, planned to continue until March 2021.

The large pre-crisis private and public sector debt increases the risks of a prolonged economic downturn. The planned expiration of loan payment moratoria at the end of the year, with a sizeable take-up by the tourism industry point to challenges ahead. The potential impact of the Cypriot Resilience and Recovery Plan (RRP) on growth remains an upside risk.

Inflation turns negative

Headline inflation is forecast to be negative in 2020, at -0.9% down from 0.5% in 2019, mainly driven by lower energy prices and non-energy industrial goods. Inflation is set to rebound gradually in 2021 and 2022 at 0.9% and 1.3%, respectively, on the back of increasing food and services prices.

Public finances to deteriorate sharply this year, before a partial recovery in 2021

The general government balance is forecast to record a deficit of 6.1% of GDP in 2020 after a surplus of 1.5% of GDP in 2019. Fiscal performance in 2020 is projected to be severely affected by falling revenues and the deficit-increasing fiscal measures adopted to fight the crisis. The deficit should narrow to 2.3% of GDP in 2021 and 2022, assuming that revenue collection picks up on account of the projected recovery and that the majority of the fiscal measures adopted to fight the pandemic, estimated at 4% of GDP, will only have a temporary effect in 2020. The projections do not include Resilience and Recovery Facility measures and are made on the basis of a no-policy change assumption. The public debt-to-GDP ratio is forecast to rise to 112.6% in 2020, before decreasing progressively to 108.2% in 2021 and 102.8% in 2022.

Expenditure is projected to surge in 2020, growing by 11.8%, before stabilising in 2021 and increasing by 2% in 2022. Almost the entirety of the COVID-19 related expenditures is expected to be reversed in 2021. However, the rollout of the second phase of the National Health Insurance

System (NHIS) and higher compensation for public employees are set to boost public expenditure progressively in 2020, 2021 and 2022.

The projected fall in revenue in 2020 (by 6.1%) reflects the large expected decrease in tax revenues (by 7.9%), in particular from indirect and corporate taxes. Social security contribution revenues are expected to stagnate, despite the two increases in health contribution rates in April 2019 and 2020 to finance the implementation of the NHIS. Revenue is expected to pick up by 8.8% in 2021 and by 2.2% in 2022 on account of the projected economic recovery.

The potential realisation of contingent liabilities is a risk to public finances in particular the large exposure of the state to the implementation of the NHIS. Other risks stem from the explicit contingent liabilities of the state through the asset protection schemes provided to Hellenic Bank in the context of the sale and dissolution of the Cooperative Central Bank in 2018, and the implicit contingency risks to the broader financial sector. On the other hand, the potential impact of the Cypriot RRP on public revenues is an upside risk.

Table II.9.1:

Main features of country forecast - CYPRUS

	2019			Annual percentage change						
	mio EUR	Curr. prices	% GDP	01-16	2017	2018	2019	2020	2021	2022
GDP	22286.9		100.0	1.9	5.2	5.2	3.1	-6.2	3.7	3.0
Private Consumption	14398.9		64.6	2.5	4.9	4.7	1.8	-4.1	2.8	2.2
Public Consumption	3691.0		16.6	1.9	2.1	3.5	14.2	17.8	7.9	2.8
Gross fixed capital formation	4326.0		19.4	1.4	21.3	-5.2	2.0	-11.1	2.6	3.0
of which: equipment	1077.5		4.8	2.9	20.6	-34.6	-14.9	-17.0	8.0	8.0
Exports (goods and services)	16018.6		71.9	2.5	9.9	8.0	-0.4	-17.7	7.2	8.1
Imports (goods and services)	16256.4		72.9	2.7	12.9	4.5	2.0	-11.5	7.0	7.0
GNI (GDP deflator)	21391.4		96.0	2.3	5.9	4.6	2.9	-6.6	3.8	3.0
Contribution to GDP growth:		Domestic demand		2.3	7.4	2.5	3.6	-1.9	3.9	2.6
		Inventories		-0.1	-0.3	0.2	1.2	0.0	0.0	0.0
		Net exports		-0.2	-1.9	2.6	-1.7	-4.3	-0.2	0.3
Employment				1.3	5.4	5.3	3.1	-2.6	1.1	1.5
Unemployment rate (a)				7.8	11.1	8.4	7.1	8.2	7.8	7.2
Compensation of employees / head				2.0	1.7	1.3	1.8	-2.5	1.7	1.8
Unit labour costs whole economy				1.4	1.9	1.4	1.9	1.3	-0.9	0.3
Real unit labour cost				-0.3	0.8	0.1	1.0	0.5	-2.1	-0.8
Saving rate of households (b)				3.4	3.0	3.1	3.1	5.7	3.8	4.5
GDP deflator				1.7	1.1	1.2	0.9	0.8	1.3	1.2
Harmonised index of consumer prices				1.7	0.7	0.8	0.5	-0.9	0.9	1.3
Terms of trade of goods				0.8	-1.6	-2.4	-0.9	2.2	-0.1	-0.1
Trade balance (goods) (c)				-22.9	-24.6	-21.2	-20.8	-18.8	-19.6	-20.8
Current-account balance (c)				-8.3	-5.3	-3.9	-6.3	-10.4	-10.1	-9.9
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-8.0	-4.9	-3.3	-6.2	-10.3	-10.0	-9.8
General government balance (c)				-3.2	1.9	-3.5	1.5	-6.1	-2.3	-2.3
Cyclically-adjusted budget balance (d)				-3.1	1.0	-5.9	-1.3	-4.8	-1.9	-2.5
Structural budget balance (d)				-	1.0	2.1	0.0	-4.8	-1.9	-2.5
General government gross debt (c)				71.8	93.5	99.2	94.0	112.6	108.2	102.8

(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.