

12. CYPRUS

Persistent external imbalances

Buoyant but activity slowing down in 2008

Economic activity in Cyprus remained strong in the first half of 2008, recording a growth rate of 4%. However, GDP is expected to have decelerated somehow over the second half of the year, which should lead to an annual rate of 3¼%. Economic activity has been exclusively driven by robust domestic demand. Private consumption benefited from continued employment and wage growth, low interest rates and sustained credit expansion as well as euro adoption confidence effects. Gross fixed capital formation has decelerated from the unusually high levels of last year although still dynamic. A deteriorated external environment and a slowing of economic activity in Cyprus' main trading partners had an adverse effect on exports. Specifically, revenue from tourism decreased in nominal terms. Due to the more moderate growth of private consumption and investment, imports are also expected to slow down, compared with 2007. All in all, the growth contribution of external sector will be negative.

Subdued real estate activity weighs on 2009 growth prospects

In 2009, economic activity is foreseen to decelerate further and grow by almost 3%. GDP would continue being driven exclusively by domestic demand. Private consumption would still be robust supported by rising disposable income, which reflects sustained employment and wage growth, as well as the impact of the recent income tax reform. Compared with the most recent past though, private consumption is projected to show signs of moderation in the face of rising household

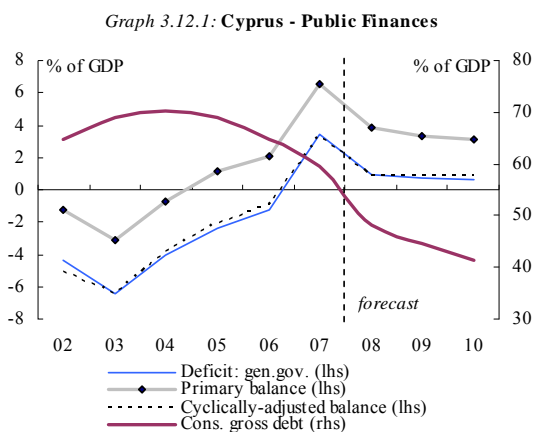
debt burden, of a severely uncertain environment and of the ongoing international financial crisis. Housing investment will decelerate strongly and weigh on growth, largely due to a subdued demand for dwellings by non-residents. As a result, housing prices, mainly in the coastal areas, are foreseen to somehow moderate. The projected slowdown in private consumption and deceleration in investment should put a brake on import growth. Exports of goods would grow only moderately while exports of services are expected to grow below their long-term trend, due to the adverse external conditions. The contribution of net exports to GDP growth will remain negative.

GDP growth is projected to recover mildly in 2010, on the back of a soft rebound in private consumption and investment. Imports are foreseen to follow. In line with an improving external environment and demand, exports, particularly of services, are projected also to rebound. However, the contribution of net exports to growth will improve only marginally while the current account deficit is projected to remain at about 10% of GDP.

Labour market remains tight, while costs and prices rise

In line with moderating economic activity, employment growth is projected to decelerate and grow at around 1½% per year until 2010. Less dynamic immigration inflows, coupled with solid employment growth, should keep the unemployment rate decreasing despite the softening growth outlook. On top of higher than anticipated contractual salary increases in a context of tight labour market conditions, the application of the cost-of-living-allowance system would lead to strong high wage growth. Also, the increase in pension contributions in 2009, as part of the pension reform, will add additional pressure on the compensation of employees. As productivity will grow only moderately, unit labour costs will continue growing at high levels in the coming years, above the euro area average. As a result, the competitive position of the Cypriot economy will keep deteriorating, which would contribute to the persistent current account deficit.

Following the developments in oil and commodity markets, HICP inflation accelerated in the first



eight months of 2008 to 4¼%. Base effects from the past sharp increase in oil prices would help rein in inflation. HICP inflation is projected to decrease just below 3% in 2009 and inch up in 2010, in line with the projected energy prices.

Public finances remain in surplus

For 2008, the government surplus is projected at 1% of GDP. This is much lower than the 2007 outturn of 3½% of GDP. Revenue decelerated, largely due to a more moderate property tax receipts, but still remain at historically high levels. However, expenditure increased on the back of higher contractual salary increases and transfers to disadvantaged social groups as well as spending related to the drought, such as importation of potable water and compensation to farmers whose crops were destroyed by the drought.

For 2009, a government surplus of ¾% is forecasted. This is slightly lower than the budget target of a 1% of GDP surplus, mainly on account of a somewhat less optimistic macroeconomic scenario and a more prudent assessment of measures on the revenue side. A small increase in revenue is totally offset by an equivalent rise in expenditure. A reduction in direct taxes and other

revenues, associated with subdued real estate activity and lower corporate profitability would be only partially offset by an increase in indirect taxes. The latter reflects the introduction of the minimum rate on specific goods and services. However, social contributions are projected to rise by about ½ p.p. of GDP, within the framework of the recently adopted pension reform. In terms of GDP, expenditure is targeted to increase slightly. Increases in public wages, social transfers and other expenditure amounting to about 1 p.p. of GDP are expected to be only partially offset by a reduction in interest payments and subsidies. Measured by the cyclically-adjusted balance net of one-offs, the structural balance would remain at similar levels as in 2008. Based on the customary no-policy-change assumption, the 2010 surplus is projected to inch down at about ½% of GDP.

Debt would continue on a decreasing path attaining about 41% of GDP by 2010, largely reflecting high primary surpluses and the planned reduction of deposits with the central bank, amounting to almost 6% of GDP in 2008.

Table 3.12.1:

Main features of country forecast - CYPRUS

| | 2007 | | | Annual percentage change | | | | | | |
|--|----------|--------------|-------|--------------------------|-------|-------|-------|-------|-------|-------|
| | mio Euro | Curr. prices | % GDP | 92-04 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
| GDP at constant prices | 15578.5 | 100.0 | | 4.4 | 3.9 | 4.1 | 4.4 | 3.7 | 2.9 | 3.2 |
| Private consumption | 10221.4 | 65.6 | | - | 4.0 | 4.5 | 6.9 | 5.7 | 3.9 | 4.2 |
| Public consumption | 2764.5 | 17.7 | | - | 3.4 | 7.4 | -0.1 | 5.2 | 5.9 | 3.6 |
| Gross fixed capital formation | 3340.3 | 21.4 | | - | 3.3 | 10.5 | 7.6 | 4.2 | 1.3 | 1.9 |
| of which : equipment | 923.0 | 5.9 | | - | -5.6 | 15.5 | 4.9 | 5.0 | 1.3 | 1.0 |
| Exports (goods and services) | 7605.4 | 48.8 | | - | 4.7 | 3.8 | 7.5 | 5.5 | 2.4 | 3.2 |
| Imports (goods and services) | 8484.0 | 54.5 | | - | 3.1 | 6.6 | 11.1 | 7.1 | 3.8 | 4.0 |
| GNI at constant prices (GDP deflator) | 15036.9 | 96.5 | | 4.2 | 4.3 | 4.4 | 4.4 | 3.9 | 3.5 | 3.7 |
| Contribution to GDP growth : | | | | | | | | | | |
| Domestic demand | | | | - | 3.8 | 6.2 | 6.1 | 5.6 | 3.9 | 4.0 |
| Stockbuilding | | | | - | -0.6 | -0.4 | 0.7 | -0.7 | 0.0 | 0.0 |
| Foreign balance | | | | - | 0.7 | -1.6 | -2.3 | -1.2 | -1.0 | -0.7 |
| Employment | | | | - | 3.6 | 1.8 | 3.2 | 2.0 | 1.5 | 1.6 |
| Unemployment rate (a) | | | | - | 5.3 | 4.6 | 4.0 | 3.9 | 3.8 | 3.7 |
| Compensation of employees/head | | | | - | 1.8 | 3.0 | 3.3 | 5.5 | 5.7 | 4.5 |
| Unit labour costs whole economy | | | | - | 1.4 | 0.6 | 2.1 | 3.8 | 4.2 | 2.8 |
| Real unit labour costs | | | | - | -0.9 | -2.3 | -1.1 | -0.6 | 0.9 | -0.7 |
| Savings rate of households (b) | | | | - | - | - | - | - | - | - |
| GDP deflator | | | | 3.3 | 2.4 | 3.0 | 3.3 | 4.4 | 3.3 | 3.5 |
| Harmonised index of consumer prices | | | | - | 2.0 | 2.2 | 2.2 | 4.5 | 2.9 | 3.2 |
| Terms of trade of goods | | | | - | -3.7 | 4.3 | -0.4 | -1.5 | 0.0 | -0.1 |
| Trade balance (c) | | | | - | -25.0 | -27.2 | -29.6 | -31.7 | -32.1 | -32.3 |
| Current account balance (c) | | | | - | -5.9 | -5.9 | -9.7 | -10.5 | -10.3 | -9.8 |
| Net lending(+) or borrowing(-) vis-à-vis ROW (c) | | | | - | -5.3 | -5.7 | -9.7 | -10.2 | -10.0 | -9.6 |
| General government balance (c) | | | | - | -2.4 | -1.2 | 3.5 | 1.0 | 0.7 | 0.6 |
| Cyclically-adjusted budget balance (c) | | | | - | -2.0 | -0.9 | 3.5 | 0.9 | 0.8 | 0.8 |
| Structural budget balance (c) | | | | - | -2.9 | -0.9 | 3.5 | 0.9 | 0.8 | 0.8 |
| General government gross debt (c) | | | | - | 69.1 | 64.6 | 59.5 | 48.2 | 44.7 | 41.3 |

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