

12. CYPRUS

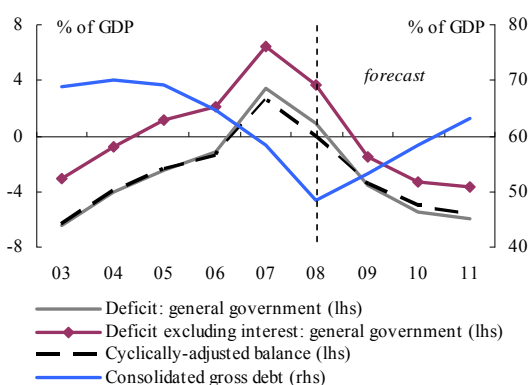
Ongoing economic adjustment, slow recovery ahead

Declining activity and policy response

After more than a decade of sustained and strong expansion, the Cypriot economy has decelerated sharply. Notwithstanding the robust growth of 3¾% recorded in 2008 as a whole, the slowdown of economic activity started in the third quarter of last year and gained momentum in the first half of the current year. An adverse external economic environment, high household indebtedness together with tight lending conditions, restructuring corporate balance sheets and deteriorating confidence weighed on growth. The crisis has also highlighted the accumulation of a high external imbalance, a particularly oversized housing sector and competitiveness losses. These factors set the stage for the structural adjustment of the economy.

GDP contracted in the second quarter of 2009. This trend is expected to continue until the year's end and, for the first time in 30 years, Cyprus is set to record a negative growth rate (-¾%). The downturn is expected to take a heavy toll on public finances: deficits exceeding 3% of GDP are projected over the forecast period, reflecting both lower tax elasticities and higher expenditure. As a result, the long-term sustainability prospects for public finances are deteriorating. The labour market is also expected to suffer, especially the labour-intensive sectors.

Graph II.12.1: Cyprus - Public Finances



As a response to the crisis, the Cypriot government acted in a timely manner, adopting some fiscal stimulus and structural measures amounting to 1½% of GDP. The stimulus package was essentially

addressed to construction (1¼% of GDP) and tourism (¼% of GDP). Some support measures without a direct impact on the deficit were also targeted to households.

Regarding the financial sector, Cypriot banks have not been exposed to toxic assets, mainly thanks to strict supervision by the Central Bank. However, in order to underpin confidence in the banking system, the government raised the deposits guarantee and issued treasury bills to provide liquidity to the banking system.

Subdued growth weighs on labour market

The outlook envisages a slow economic recovery in 2010 and 2011, with Cyprus lagging behind the EU average in both years. GDP is projected to stall in 2010, reflecting mainly sluggish world demand and depressed private consumption and investment. Specifically, private consumption growth is likely to be subdued over the forecast period despite nominal wage growth above inflation and a falling debt-servicing burden consistent with declining interest rates. This is due to a high household debt burden, tight financial conditions and downbeat consumer sentiment in an uncertain environment. Prospects for gross fixed capital formation are also likely to remain muted over the forecast years. Given the economic outlook in Cyprus' main trading partners, foreign demand for dwellings by non-residents should remain weak. Domestic demand for housing and activity in real estate is also expected to stay subdued, on the back of high indebtedness and high growth of prices in recent years. Although infrastructure projects, including private and Public Private Partnerships (PPP), should support investment somewhat, it is unlikely that they would be sufficient to fully offset the impact of the contraction in housing on total investment. Investment in equipment, largely associated with construction, is also set to follow a similar trend.

As regards the external sector, imports should shrink in 2010 and recover only in 2011 due to the slowdown in final demand. Exports of both goods and services, particularly tourism, are set to recover somewhat in view of an improving economic outlook in Cyprus' main trading partners. All in all, the contribution of net exports

to GDP growth should be positive in both 2010 and 2011.

The subdued economic outlook should weigh particularly on labour-intensive sectors in 2010, especially construction and tourism. Accordingly, employment is projected to decline while unemployment should rise to historically high levels, reaching 6½% in 2010.

Overall, the balance of risks appears to be neutral. Higher total demand would hinge on a faster recovery of the economies of Cyprus' major trading partners. Also, a reduction in interest rate spreads and in banking lending rates could underpin private consumption and soften the adjustment of the housing sector. On the negative side, a sharper-than-expected fall of external demand would certainly weigh on economic activity more than projected in the baseline scenario. At the same time, a tightening of credit conditions coupled with high indebtedness of private agents could lead to a sharper fall in investment and consumption. Furthermore, in a context of weak growth in both real and nominal terms, the external constraint becomes more severe. Eventually, it could lead to either higher cost of debt-financing or higher savings, in each case affecting adversely economic activity.

Restoring the external balance should underpin a sustained recovery

Within this economic outlook, the challenge for the Cypriot economy is to return to a sustained convergence path. This could be tackled more successfully if the recovery were to lead to the correction of the imbalances, in a context of higher potential growth.

Due to the strong deceleration of activity in 2009 there was a significant, yet partial, correction of the external deficit. However, as a percentage of GDP, it is set to remain at two-digit levels. In the medium term, the deficit should continue to improve but at a much more moderate rate, reflecting lower GDP growth. In particular, the current account deficit should still reach 7¾% of GDP by 2011. As a result, the external imbalance is likely to weigh on economic growth over the medium-term. Growing public sector dissavings would need to be financed by either foreign debt or domestic private savings. Thus, the adjustment of the current account imbalance would require either higher cost of debt-financing or higher savings

from the private sector. The latter would imply lower output growth through lower private consumption or investment (crowding-out effect).

The external imbalance to a certain extent reflects a deterioration of competitiveness, partly due to a weak response of wages in both the public and private sectors to the current recession. In particular, nominal compensation per employee is estimated to increase by about 1¾% in 2009, which exceeds productivity growth. Furthermore, even with the prospect of no or minimal wage growth in the forthcoming sectoral collective agreements, the wage drift and indexation (COLA), which adjusts wages based on inflation in the previous 6 months, should contribute to a sustained wage growth, especially in the second half of the forecast period. In line with slowing activity, productivity growth is expected to slump. This, coupled with a minor acceleration in wages, is set to keep unit labour costs rising modestly, yet higher than the euro area. All in all, the disassociation between wages and developments in productivity is undermining the competitiveness of the Cypriot economy.

Although the inflation rate is estimated to be very low in 2009, a rapid return to the trend rate of 2½% is envisaged over the forecast horizon. This should be driven by developments in oil prices, on which Cyprus is highly dependent, and a powerful base effect. Core inflation should remain above the euro area average, mainly reflecting pressures in product markets, especially services.

Deterioration in public finances

Public finances in Cyprus are likely to face a relatively prolonged period of low tax elasticities, reflecting not only lower growth but also a less tax-friendly growth composition linked to the fading out of the asset boom. The projected increase of expenditures for this year and next largely reflects the functioning of automatic stabilisers and interest payments associated with increasing debt levels and the continuation of largely untargeted social transfers.

While the Cypriot budget balance was in surplus during the last two years, it is expected to have turned into a deficit of about 3½% in 2009 compared to a 0.9% surplus in 2008, due to both lower than anticipated revenue and to higher-than-planned expenditure. Revenue appears to be declining across the board, reflecting the downturn

of economic activity, particularly in the construction and real estate sector coupled with the fading out of the asset boom. Social contributions are the only revenue item to post positive growth, benefiting from the rise of contribution rates as part of the pension reform adopted this year. One-off revenues associated with the penalty imposed by the Competition Authority on oil companies, corporate tax obligations and the shortening of payment period for VAT account for almost ¾% of GDP. One-off expenditure cuts associated with budgeted appropriations for ministries account for an additional ½% of GDP.

For 2010, the Draft Budget Law targets a deficit of 4½% of GDP, on the basis of an estimated deficit outcome for 2009 of 2.9% of GDP. The 2010 Draft Budget does not incorporate any additional measures to the previous year thus foreseeing a continuation of the 2009 policies. Although the Draft Budget mentions a series of supplementary measures that could be taken during the course of the year as a means to restrain the budgetary deficit in 2010 below 3%, they are not accounted in the budget target. These measures are namely aimed at fighting tax evasion, at a real property amnesty (one-off), freezing public sector employment for the next 18 months and improving the state's cash management.

The Commission services project a deficit of 5¾% of GDP for 2010, reflecting the base effect of a higher estimated deficit for 2009 (3½%), a somewhat gloomier macroeconomic scenario and a more prudent assessment of measures on the revenue side. In the absence of information on the modalities of implementation of the potential extra-budget measures, this deficit forecast does not take them into account.

Based on the customary no-policy-change scenario assumption, the deficit should increase further to almost 6% of GDP in 2011. This projected fiscal deterioration is driven by rising expenditure, which is only partly offset by moderately increasing revenues. With weak GDP growth and an increasing deficit, the debt-to-GDP ratio will raise and exceed 60% of GDP by 2011, thus weakening the long-term sustainability of the public finances.

Table II.12.1:

Main features of country forecast - CYPRUS

	2008		92-05	Annual percentage change						
	mio Euro	Curr. prices		% GDP	2006	2007	2008	2009	2010	2011
GDP	16948.5		100.0	4.4	4.1	4.4	3.7	-0.7	0.1	1.3
Private consumption	11668.3		68.8	-	4.5	8.2	7.0	-1.4	0.3	0.6
Public consumption	3091.8		18.2	-	7.4	0.1	8.7	8.5	3.1	2.4
Gross fixed capital formation	3952.2		23.3	-	10.4	10.4	9.8	-11.9	-9.0	0.9
of which : equipment	1088.9		6.4	-	15.3	4.5	21.7	-19.0	-14.0	1.5
Exports (goods and services)	7978.3		47.1	-	3.9	7.2	1.1	-15.0	0.7	3.4
Imports (goods and services)	9904.9		58.4	-	6.6	12.5	9.9	-15.9	-1.5	2.4
GNI (GDP deflator)	15728.6		92.8	4.2	3.5	3.4	2.0	1.0	1.8	2.6
Contribution to GDP growth :										
Domestic demand				-	6.2	7.5	8.3	-2.2	-1.0	1.1
Stockbuilding				-	-0.5	0.2	0.7	-0.8	0.0	0.0
Foreign balance				-	-1.6	-3.2	-5.3	2.3	1.1	0.2
Employment				-	1.8	3.2	2.6	-0.4	-0.1	0.6
Unemployment rate (a)				-	4.6	4.0	3.6	5.6	6.6	6.7
Compensation of employees/head				-	3.0	2.1	4.0	2.0	1.8	2.2
Unit labour costs whole economy				-	0.6	0.9	3.0	2.3	1.6	1.5
Real unit labour costs				-	-2.3	-2.4	-1.8	-0.2	-1.6	-1.5
Savings rate of households (b)				-	-	-	-	-	-	-
GDP deflator				3.2	3.0	3.4	4.8	2.5	3.2	3.0
Harmonised index of consumer prices				-	2.2	2.2	4.4	0.8	3.1	2.5
Terms of trade of goods				-	4.3	0.1	-2.6	5.4	-0.3	-0.3
Trade balance (c)				-	-27.2	-30.2	-32.7	-24.2	-23.6	-24.1
Current account balance (c)				-	-7.0	-12.0	-18.0	-11.6	-9.0	-7.7
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				-	-6.8	-11.9	-17.9	-11.5	-8.8	-7.5
General government balance (c)				-	-1.2	3.4	0.9	-3.5	-5.7	-5.9
Cyclically-adjusted budget balance (c)				-	-1.4	2.6	-0.2	-3.4	-5.2	-5.6
Structural budget balance (c)				-	-1.4	2.6	-0.2	-4.7	-5.2	-5.6
General government gross debt (c)				-	64.6	58.3	48.4	53.2	58.6	63.4

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