9. CYPRUS

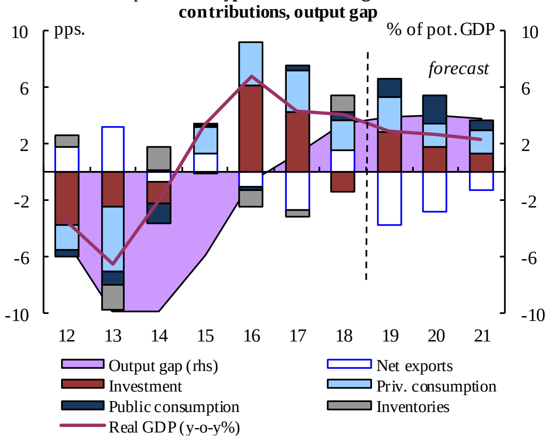
Growth momentum moderates

Cyprus' economic expansion remains strong but is set to gradually moderate, mainly due to external headwinds. Domestic demand is projected to stay the main driver of growth, supported by private consumption and an improving labour market. Meanwhile inflation should remain subdued. The general government budget is expected to remain in surplus and public debt to steadily decline from 2019 onwards. Risks to the fiscal outlook are also mainly on the downside.

Growth slows amid external headwinds

After reaching 4.1% in 2018, real GDP growth slowed down in the first half of this year. The weakness came mainly from the external environment, while domestic demand held up well. External headwinds are expected to continue, leading to more moderate growth over the forecast horizon, which is projected at 2.9% this year, 2.6% in 2020 and 2.3% in 2021.

Graph II.9.1: **Cyprus - Real GDP growth and contributions, output gap**



Private consumption should continue to provide strong support for growth as real disposable income continues to rise. The unemployment rate fell in 2019, standing at 6.8% in August. Meanwhile, wages in the private sector have risen only moderately. This was attributable to continued presence of slack in the labour market despite high employment rates in certain sectors, such as construction and tourism. Public sector wages, however, have increased much more prominently, notably reflecting increases in the wage bill for health care providers (with the launch of the national health system) and the gradual phasing out of wage cuts implemented during the crisis. These developments are likely to provide solid support for both private and public consumption.

Investment in 2019 has been strong, particularly in construction. This sector has benefitted largely from the Citizenship by Investment scheme, which has brought in substantial foreign direct investment (FDI), concentrated in the real estate sector. The tighter requirements of the Scheme caused a frontloading of applications, thus also FDI in the first half of the year before their entry into force; hence, a deceleration in the second half of the year is expected.

Net exports were negative in the first half of 2019 and are expected to continue to weigh on growth. Tourism, a flagship industry and major exporter of services, saw a fall in revenues, driven by several factors. First, tourists from the UK - the most important tourism market for Cyprus – suffered from the depreciation of the pound sterling versus the euro. Second, competition from cheaper neighbouring destinations led to a decline in Russian tourist arrivals (the second largest market). Finally, the persisting air access problems led to a contraction of German arrivals by nearly one fifth. Imports, meanwhile, are set to increase alongside strong domestic demand.

Looking forward, some of the above factors are set to continue, while slowing global demand coupled with the bankruptcy of the travel company Thomas Cook may further compound the situation in the tourism sector. Furthermore, the economy's reliance on foreign funding leaves it heavily exposed to adverse external developments.

Inflation remains subdued and is expected to average 0.6% in 2019 and 0.7% in 2020 and rise to 1.3% in 2021. Inflationary pressures stem mainly from services and unprocessed food categories. Energy inflation is on a declining path following a period of significant increases. Core inflation remains subdued, albeit increasing reflecting overall moderate wage growth. Over the forecast horizon, inflation is expected to remain low due to the continued presence of slack in the labour market and the currently low oil price, which should lead to lower energy prices.

Public finances are back to budgetary surpluses

The general government headline balance is expected to record a hefty surplus of around 3.7% of GDP in 2019, after a temporary deficit of 4.4% of GDP in 2018 that was due to the one-off support measures related to the Cyprus Cooperative Bank sale. Cyprus' fiscal performance is projected to remain strong, on the back of a still relatively strong GDP growth and improving labour market. After an expected surplus of 3.7% of GDP in 2019, the general government surplus is expected to decrease to 2.6% in 2020 and 2.4% in 2021.

Government revenue is forecast to increase strongly in 2019 and in the next two years driven by strong tax collection and by a sizable rise in social security contributions due to higher contribution rates and to the introduction of the National Health Insurance System (NHIS). However, rising revenues will be more than offset by higher expenditure growth in 2020 and 2021. This is mostly due to the gradual reversal of wage cuts implemented during the crisis, the introduction of the Estia scheme to support non-performing loan repayments, and changes in the statistical treatment of a signature bonus for the exploration of hydrocarbons. The structural budget surplus is set to decline over the forecast period from 1½% of GDP in 2019 to ½% in 2020, mainly reflecting the large positive output gap.

Risks to the fiscal outlook however are on the downside. Key risks include the court cases that could lead to the reversal of civil service pay cuts implemented during the crisis as well as the potential deficit of public healthcare providers during the first years of the NHIS. The potential realisation of contingent liabilities remains a major risk to public finances. Positive cash balances from the resulting Cyprus Cooperative Bank (CCB) entities constitute an upside risk.

Following a significant increase in government debt in 2018, due to the one-off government support to the banking sector, the debt-to-GDP ratio is projected to fall to 93.8% in 2019, to 87.8% in 2020 and to 81.8% in 2021. The decrease is mainly due to projected primary budget surpluses, strong GDP growth and active debt management. Cyprus repaid in advance the Russian loan in September 2019 and plans to repay early the IMF loan in 2020.

Table II.9.1:

Main features of country forecast - CYPRUS

	2018		Annual percentage change						
mio EUR	Curr. prices	% GDP	00-15	2016	2017	2018	2019	2020	2021
GDP	21137.8	100.0	1.9	6.7	4.4	4.1	**2.9**	**2.6**	**2.3**
Private Consumption	13777.4	65.2	2.7	4.4	4.5	3.3	**3.8**	**2.7**	**2.5**
Public Consumption	3149.8	14.9	1.7	-0.9	2.1	3.5	**8.7**	**11.7**	**3.7**
Gross fixed capital formation	4042.2	19.1	-1.3	48.9	24.1	-6.6	**14.7**	**8.3**	**6.0**
of which: equipment	1300.1	6.2	-2.1	121.6	20.7	-31.9	**7.0**	**4.0**	**2.0**
Exports (goods and services)	15444.5	73.1	2.6	7.2	8.7	4.6	**-2.5**	**-1.3**	**0.7**
Imports (goods and services)	15278.3	72.3	2.6	9.0	12.8	2.4	**2.6**	**2.5**	**2.5**
GNI (GDP deflator)	20387.5	96.5	2.3	3.2	5.4	3.5	**2.9**	**2.7**	**2.3**
Contribution to GDP growth:	Domestic demand		1.9	9.0	7.6	1.3	**6.6**	**5.4**	**3.6**
	Inventories		0.1	-1.2	-0.5	1.2	**0.0**	**0.0**	**0.0**
	Net exports		0.0	-1.1	-2.7	1.6	**-3.7**	**-2.8**	**-1.3**
Employment			1.1	4.7	5.3	4.1	**2.5**	**2.2**	**1.8**
Unemployment rate (a)			7.3	13.0	11.1	8.4	**7.2**	**6.3**	**5.7**
Compensation of employees / head			2.5	-0.9	1.0	0.5	**3.4**	**3.1**	**3.0**
Unit labour costs whole economy			1.7	-2.9	1.9	0.6	**3.0**	**2.7**	**2.5**
Real unit labour cost			-0.2	-2.1	0.2	-0.8	**1.5**	**1.2**	**0.8**
Saving rate of households (b)			3.4	1.3	3.7	2.4	**3.8**	**4.5**	**6.4**
GDP deflator			1.9	-0.8	1.7	1.4	**1.5**	**1.5**	**1.7**
Harmonised index of consumer prices			2.1	-1.2	0.7	0.8	**0.6**	**0.7**	**1.3**
Terms of trade of goods			0.7	-0.4	-0.3	-1.9	**-0.4**	**-0.3**	**0.0**
Trade balance (goods) (c)			-23.2	-22.1	-25.0	-22.1	**-24.7**	**-25.6**	**-26.3**
Current-account balance (c)			-8.4	-4.2	-5.1	-4.4	**-8.1**	**-10.6**	**-11.1**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-8.0	-4.1	-4.7	-3.8	**-7.1**	**-9.9**	**-10.3**
General government balance (c)			-3.4	0.1	1.7	-4.4	**3.7**	**2.6**	**2.4**
Cyclically-adjusted budget balance (d)			-3.3	0.5	1.0	-6.1	**1.7**	**0.6**	**0.5**
Structural budget balance (d)			-	0.5	1.0	1.9	**1.7**	**0.6**	**0.5**
General government gross debt (c)			68.9	103.4	93.9	100.6	**93.8**	**87.8**	**81.8**

(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.