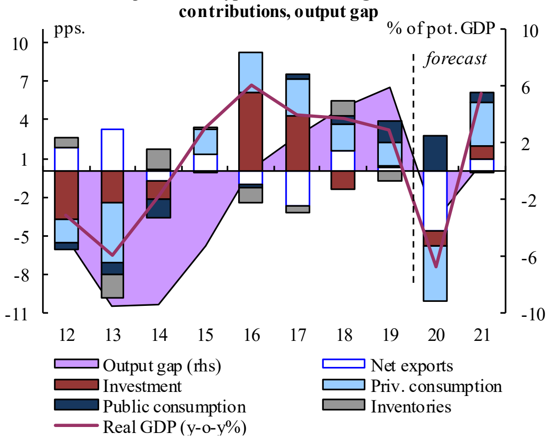
9. CYPRUS

Cyprus' economic activity is heading into a severe contraction in 2020 due to the global outbreak of COVID-19 and the confinement measures that followed. External demand for services is set to dip significantly, with tourism expected to be particularly hard hit by the crisis. Domestic demand is also forecast to contract significantly due to the restrictions to consumption and construction activity as well as a drop in confidence. The general government budget is expected to record a large deficit and public debt is set to increase as a result before declining again in 2021.

Economic growth headed for a large drop in 2020

Cyprus' recovery from the deep financial and economic crisis of 2013 has been remarkable. By 2017, real GDP had risen above its pre-crisis level. In 2019, economic activity grew by 3.2%. However, the COVID-19 crisis is set to push the economy into a severe recession in 2020, with real GDP forecast to contract by 7½ in 2020 before bouncing back with growth of around 6% in 2021.

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



The impact of the outbreak and subsequent health-policy responses on economic activity is expected to be significant in the second quarter as the outbreak in the country and the lockdown started in mid-March. The economy is expected to start a slow recovery towards the end of the second quarter. However, the impact of the crisis on the tourism sector is likely to last longer.

Exports of services to plummet in 2020

The COVID-19 pandemic is expected to significantly dampen demand for tourism. Cyprus is heavily dependent on tourism, as every year the country hosts around 4 million tourists (4.5 times more than its population) and the sector accounts for more than 20% of GDP [119]. Imports are expected to evolve in line with final demand, resulting in a contraction in 2020 and a rebound in 2021. The contribution of net exports to GDP growth is set to be significantly negative in 2020, but to turn positive in 2021.

Domestic demand to fall moderately

Private consumption is set to fall sharply during the lockdown period and to gradually recover in the second half of the year. Private consumption is expected to fall more than real disposable income, leading to a surge of savings in 2020, which should normalise in 2021. The unemployment rate is projected to increase, albeit modestly. The fiscal measures adopted are expected to support employment and households' incomes. Investment in construction could rebound quickly after the lockdown owing to the pipeline of large and already commenced multi-year projects. Public consumption is the only component of domestic demand that is expected to continue growing in 2020, reflecting the fiscal stimulus measures adopted, increases in the public payroll, and expenditures linked to the national health system.

Downside risks are significant. In addition to the uncertainty surrounding the pandemic and the economic recovery after the lifting of the lockdown measures, the large private and public sector debt overhang increases further downside risks related to a prolonged economic downturn. Moreover, as a small open economy, Cyprus is exposed to external risks related to the economic impact of the pandemic on its main trading partners i.e. the EU, the UK and Russia.

Inflation to remain subdued

Headline inflation is forecast to fall from 0.5% in 2019 to -0.2% in 2020, driven by lower energy prices and non-energy industrial goods. Headline

(119) Including indirect impact.

inflation is expected to turn positive again in 2021, at 1%, reflecting increasing food and services prices. This is set to lead to a moderate increase in core inflation.

Public finances are set to deteriorate

The general government balance is forecast to dive into a deficit of 7% of GDP in 2020 after a sizeable surplus of 1¾% of GDP in 2019. Cyprus' fiscal performance in 2020 is projected to be severely affected by falling revenues due to the economic downturn and measures to dampen the social and economic effects of the COVID-19 crisis. In 2021, public finances should improve, with the general government deficit narrowing to 1¾% of GDP, based on the assumption that the measures adopted to fight the pandemic will only have a temporary effect in 2020. The public debt-to-GDP ratio is set to rise to over 115½% in 2020 from 95½% in 2019, before decreasing to 105% in 2021.

Expenditure growth is projected to surge by 17½% in 2020 and to decrease by 1½% in 2021. Spending measures adopted to fight the pandemic (4.3% of GDP), which include wage subsidies, income support for the self-employed, and additional spending to strengthen the healthcare system, are expected to have a temporary effect on public finances in 2020. However, higher compensation of public employees and the cost of the roll-out of the second phase of National Health Insurance System (NHIS) are projected to increase public expenditure in 2020 and 2021. The projected decrease in revenue in 2020 (-3%) primarily reflects the large expected decrease in tax revenues (-10%). Revenue is expected to pick up in 2021 on account of the projected economic recovery.

Looking forward, the potential realisation of contingent liabilities is a risk to Cyprus' public finances. They concern in particular the asset protection schemes to Hellenic Bank, as well as the potential deficit of public healthcare providers during the first years of the NHIS.

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	**3.2**	**-7.4**	**6.1**
Private Consumption		13777.5	65.2	2.7	4.4	4.5	3.3	**3.0**	**-6.7**	**5.1**
Public Consumption		3149.8	14.9	1.7	-0.9	2.1	3.5	**11.3**	**16.6**	**3.7**
Gross fixed capital formation		4042.2	19.1	-1.3	48.9	24.1	-6.6	**0.1**	**-6.1**	**5.3**
of which: equipment		1300.1	6.2	-2.1	121.6	20.7	-31.9	**-15.0**	**-9.0**	**12.5**
Exports (goods and services)		15444.6	73.1	2.6	7.2	8.7	4.6	**2.0**	**-21.8**	**16.8**
Imports (goods and services)		15278.4	72.3	2.6	9.0	12.8	2.4	**1.5**	**-15.2**	**13.7**
GNI (GDP deflator)		20387.5	96.5	2.3	3.2	5.4	3.5	**3.2**	**-7.6**	**6.2**
Contribution to GDP growth:	Domestic demand			1.9	9.0	7.6	1.3	**3.6**	**-2.8**	**5.1**
	Inventories			0.1	-1.2	-0.5	1.2	**-0.7**	**0.0**	**0.0**
	Net exports			0.0	-1.1	-2.7	1.6	**0.3**	**-4.6**	**1.0**
Employment				1.1	4.7	5.3	4.1	**3.1**	**-2.5**	**2.3**
Unemployment rate (a)				7.3	13.0	11.1	8.4	**7.1**	**8.6**	**7.5**
Compensation of employees / head				2.5	-0.9	1.0	0.5	**2.9**	**-5.4**	**6.6**
Unit labour costs whole economy				1.7	-2.9	1.9	0.6	**2.8**	**-0.4**	**2.7**
Real unit labour cost				-0.2	-2.1	0.2	-0.8	**2.2**	**-0.9**	**1.8**
Saving rate of households (b)				3.4	1.3	3.7	2.4	**2.5**	**8.7**	**3.4**
GDP deflator				1.9	-0.8	1.7	1.4	**0.6**	**0.5**	**0.9**
Harmonised index of consumer prices				2.1	-1.2	0.7	0.8	**0.5**	**-0.2**	**1.0**
Terms of trade of goods				0.7	-0.4	-0.3	-1.9	**-0.1**	**-0.4**	**-0.6**
Trade balance (goods) (c)				-23.2	-22.1	-25.0	-22.1	**-21.5**	**-18.8**	**-21.1**
Current-account balance (c)				-8.4	-4.2	-5.1	-4.4	**-5.7**	**-10.9**	**-10.1**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-8.0	-4.1	-4.7	-3.8	**-5.0**	**-10.3**	**-9.5**
General government balance (c)				-3.4	0.3	2.0	-3.7	**1.7**	**-7.0**	**-1.8**
Cyclically-adjusted budget balance (d)				-3.2	0.2	0.7	-6.0	**-1.2**	**-5.2**	**-2.1**
Structural budget balance (d)				-	0.3	0.7	2.0	**0.1**	**-5.2**	**-2.1**
General government gross debt (c)				68.9	103.4	93.9	100.6	**95.5**	**115.7**	**105.0**

(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.