

## 13. CYPRUS

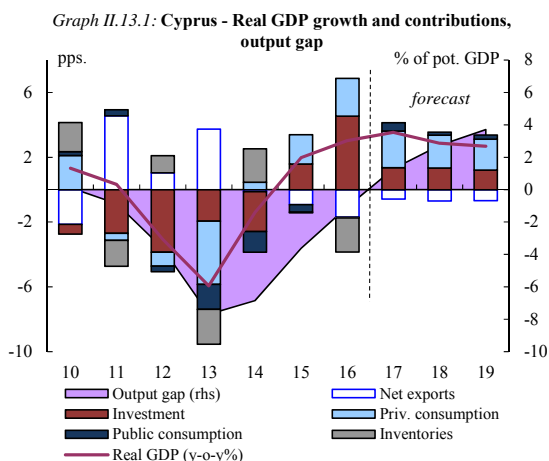
### Growth surprises on the upside

*Economic growth has exceeded expectations in recent quarters. It is forecast to reach 3.5% in 2017 and to ease but remain robust over 2018 and 2019. Domestic demand is expected to be the main growth driver. Unemployment is set to continue falling and inflation is expected to remain moderate. On the fiscal side, headline surpluses are expected between 2017 and 2019, underpinned by a favourable macroeconomic environment.*

#### Growth accelerates

Cyprus' economy accelerated in the first half of 2017 and GDP growth is expected to reach around 3.5% for the year as a whole. In the first half of the year, the economy grew by 3.6%, well above expectations, following a strong revision of the first quarter's data. Driven by domestic demand, growth is expected to remain strong, but to ease in 2018 and 2019 to 2.9% and 2.7% respectively.

Growth was driven by private consumption and strong investment, with public consumption also contributing positively. Private consumption continues to benefit from pent-up demand and is expected to remain the main growth driver, supported by steadily rising household disposable income amid robust employment and expectations for wage increases. Moreover, consumer confidence is buoyant, well above pre-crisis levels.



After years of subdued and volatile investment levels, gross fixed capital formation in the first half of 2017 was solid, reaching a share of 19% of GDP, just below the EU average. Construction investment was particularly strong, linked to tourist accommodation and residential properties. Strong momentum in investment is set to continue, with leading indicators in the construction sector pointing to a strong second half of the year.

Further support is expected from the recovery in the real estate market and very sizable tourism-related projects planned in the coming years.

Net exports were weak in the first half of 2017 due to a fall in exports, particularly of goods, that rising exports of services were unable to fully offset, despite record numbers of tourists and a 20% increase in tourism revenues. At the same time, imports remained stable. However, when excluding one-offs related to ship purchases in 2016, imports have increased in line with consumption and investment growth.

#### Strong labour market and modest inflation

Employment growth has gathered steam in 2017, increasing by more than 3% (y-o-y) in the first half of 2017. All sectors (except agriculture) contributed positively, with employment in the construction sector rising fast. The unemployment rate fell below 11% in mid-2017. The strong performance of the labour market is expected to continue over the coming years, with the unemployment rate set to fall to 9.3% in 2019.

Inflation accelerated somewhat in the first half of 2017, driven by energy prices and unprocessed food. With the effect of past increases in oil prices expected to fade away, headline inflation is set to moderate in the second half of the year, leading to an average rate of around 1.0% for the year as a whole. In 2018-19 inflation is expected to rise moderately, driven by wage pressures.

Risks to the growth outlook are broadly balanced. Downside risks mainly pertain to the still very high share of non-performing loans, the macroeconomic prospects of the UK, one of the key trading partners of Cyprus, and possible delays in construction of tourism-related projects. Among upside risks, buoyant confidence leading to stronger domestic demand and a more pronounced economic recovery in the rest of the EU could spur growth more than expected.

### Continued general government surplus

The fiscal performance of Cyprus continues to be strong and has again outperformed the government's budgetary targets. In 2017, the general government balance is expected to improve further, reaching a surplus of 1.1% of GDP. The general government primary surplus is also forecast to increase to 3.5% of GDP, while remaining one of the highest in the euro area in 2017. In structural terms, this corresponds to a surplus of about ½% of GDP.

The strong fiscal performance in 2017 is expected to be driven by high revenue collection, underpinned by the favourable macroeconomic situation and positive developments in the labour market. More specifically, total revenue is forecast to increase by 0.8 pps. of GDP as a result of significant revenue increases in both direct and indirect taxes and social security contributions. These gains are expected to be partially offset by the abolition of the immovable property tax and the termination of the temporary wage levy. Furthermore, the government's signature of gas exploration contracts for 2017-2019 will contribute to a rise in revenue (of 0.2 pps. of GDP in each of these years). Public expenditure is expected to

increase but at a slower pace (by 0.2 pps. of GDP), mainly due to higher spending on intermediate consumption, compensation of employees following the hiring of additional personnel for security forces, as well as the projected rise in public investment.

In 2018, under a no-policy change assumption, the fiscal surplus is expected to increase to 1.4% of GDP. The revenue-to-GDP ratio is projected to remain broadly stable, while the expenditure-to-GDP ratio is set to decline only slightly. In 2019, the general government surplus is forecast to further increase to 1.9% of GDP, on the back of the cyclical recovery and a rise in social security contributions (by 0.4 pps. of GDP). The structural balance is forecast to be close to a balanced position in both 2018 and 2019. Over the medium-term, downside risks to the forecast stem from the reform of the healthcare system and the absence of a mechanism regulating public sector payroll growth beyond 2018.

Public debt-to-GDP ratio is expected to decline and fall below 100% of GDP by 2018. As a result of the expected continuous primary surpluses and positive nominal growth, general government debt is forecast to reach 93.9% of GDP in 2019.

Table II.13.1:

#### Main features of country forecast - CYPRUS

	2016			Annual percentage change						
	mio EUR	Curr. prices	% GDP	98-13	2014	2015	2016	2017	2018	2019
GDP	18122.5	100.0	2.3	-1.4	2.0	3.0	3.5	2.9	2.7	
Private Consumption	12573.5	69.4	2.9	0.7	2.6	3.3	3.3	2.9	2.7	
Public Consumption	2729.2	15.1	3.2	-7.2	-2.8	-0.4	3.3	1.3	1.7	
Gross fixed capital formation	3172.8	17.5	-0.7	-17.5	13.6	35.0	7.8	7.3	6.4	
of which: equipment	1601.1	8.8	-2.6	-34.8	70.6	113.0	0.7	2.5	3.3	
Exports (goods and services)	11834.8	65.3	1.8	4.2	6.3	3.9	2.8	2.2	2.0	
Imports (goods and services)	11976.3	66.1	1.6	4.6	8.1	6.6	3.7	3.2	2.9	
GNI (GDP deflator)	17838.5	98.4	2.3	-0.4	5.5	1.8	3.5	2.9	2.7	
Contribution to GDP growth:										
Domestic demand			2.3	-3.3	2.9	6.8	4.1	3.6	3.4	
Inventories			-0.1	2.1	-0.1	-2.1	0.0	0.0	0.0	
Net exports			0.1	-0.1	-0.9	-1.7	-0.6	-0.7	-0.7	
Employment			1.3	-1.8	1.5	3.1	2.9	1.9	1.4	
Unemployment rate (a)			6.0	16.1	15.0	13.0	11.0	10.0	9.3	
Compensation of employees / head			3.3	-3.6	-1.2	-0.8	1.7	1.5	1.8	
Unit labour costs whole economy			2.3	-4.0	-1.7	-0.7	1.0	0.5	0.5	
Real unit labour cost			-0.3	-2.4	-0.5	0.2	-0.2	-0.5	-1.1	
Saving rate of households (b)			6.1	-7.9	-5.7	-4.7	-4.7	-4.8	-4.9	
GDP deflator			2.6	-1.6	-1.2	-0.9	1.2	1.1	1.6	
Harmonised index of consumer prices			2.5	-0.3	-1.5	-1.2	1.0	1.1	1.4	
Terms of trade of goods			0.0	7.1	3.2	-0.4	-0.1	-0.3	0.5	
Trade balance (goods) (c)			-23.5	-16.0	-16.7	-21.3	-23.7	-24.6	-25.2	
Current-account balance (c)			-8.5	-4.4	-2.5	-4.9	-5.4	-6.2	-6.8	
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-8.1	-4.4	-2.2	-4.8	-5.1	-6.2	-6.8	
General government balance (c)			-3.2	-8.8	-1.2	0.5	1.1	1.4	1.9	
Cyclically-adjusted budget balance (d)			-3.6	-5.2	0.7	1.0	0.4	0.0	-0.1	
Structural budget balance (d)			-	3.3	1.6	1.1	0.4	0.0	-0.1	
General government gross debt (c)			61.6	107.5	107.5	107.1	103.0	98.3	93.9	

(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.