13. CYPRUS

Resilient domestic demand leads the recovery

Economic growth in Cyprus is set to ease but should remain robust over the forecast horizon. The recovery has benefitted the labour market and unemployment has started to decrease, although it remains high. Inflation is forecast to return to moderate positive levels. The general government position is expected to remain close to balance, helping to reduce the public debt ratio.

Real GDP growth strengthened, supporting the labour market

Real GDP growth reached 2.9% y-o-y in the second quarter of 2016, the sixth consecutive quarter of positive growth. The recovery has so far been primarily driven by domestic demand, amid declining consumer prices and an improving labour market. The tourism sector, benefitting from measures to extend the season, improved air connectivity, and geopolitical tensions in the competing markets, has provided significant support to exports. Net exports nevertheless contributed negatively to growth due to increasing imports.

The unemployment rate declined to 12.4% of the labour force in mid-2016, due to both increasing employment and a declining labour force. The economic recovery and the renewal of collective agreements have put upward pressure on labour costs. Combined with low productivity growth, unit labour costs have started to increase.

The decline in consumer prices has moderated, bringing HICP inflation to -1.4% y-o-y in the first nine months of 2016. Following a marked increase in profits margins since 2013, the latest indicators point to a reversal of this trend.

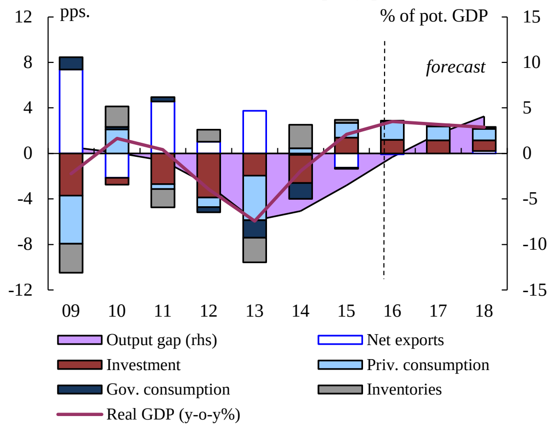
Robust growth forecast until 2018...

Real GDP growth is expected to reach 2.8% in 2016 and then to moderate gradually to 2.3% in 2018. The 2017-2018 growth forecast is driven by private consumption and investment, the latter benefitting from a stabilising housing market. Growth in the tourism sector is forecast to continue, albeit less buoyantly. Job creation is expected to continue reducing unemployment and thus putting upward pressure on wages and unit labour costs.

HICP inflation is expected to return to positive territory in 2017, providing less support to real GDP growth. However, the increase in HICP inflation is forecast to remain moderate, as profit margins are forecast to narrow further, limiting the pass-through of higher unit labour costs to consumer prices.

Meanwhile, ongoing deleveraging and continued loan restructuring efforts by banks combined with weak lending activities is projected to put a lid on more pronounced domestic private demand growth as investments continue having to be financed mainly from retained profits and savings.

Graph II.13.1: **Cyprus - Real GDP growth and contributions, output gap**



...with risks remaining balanced.

On the upside, lagged effects from declining energy prices and stronger labour incomes could support consumption more than currently envisaged, and FDI could perform better than currently forecast. Moreover, the performance in the tourism sector could turn out stronger than forecast. On the downside, risks stemming from main trading partners and negative spillovers from the UK's referendum to leave the EU could weigh more on activity than forecast. In the financial sector, the slow reduction in non-performing loans could lead to a more prolonged period of tight credit conditions, which would dampen the recovery.

Stable headline balance

In 2016, the general government primary balance is expected to improve further, reaching a surplus of 2.3% of GDP. However, taking into account the one-offs recorded in 2015 related to the banking sector recapitalisation, there is an underlying deterioration of 0.4 pps. of GDP in 2016, that is also explained by a significant reduction in property tax and the partial switch to professional soldiers, which will take place in November 2016. There are also additional factors beyond the control of the government weighing on the revenue, notably new location rules regarding VAT on e-commerce services and a decrease in dividend income from the Central Bank of Cyprus (CBC) due to a decrease in the emergency liquidity assistance. In parallel with the primary balance, the headline balance also improved recording a deficit of 0.3% of GDP (from -1.1% of GDP in 2015).

In 2017, the general government primary surplus is forecast to decrease marginally to 2.0% of GDP. The authorities are expected to abolish the immovable property tax paid to the central government without compensatory measures. In addition, a special payroll contribution levied in response to the crisis is expected to expire at the end of 2016. The implementation of the new location rules regarding VAT for e-commerce services is also expected to have a negative impact on revenue in 2017. The partial switch to professional soldiers should contribute to the rise in expenditure, as it is expected to take place in November 2016, but with a full-year effect in 2017. This will increase the compensation of employees in 2017 by about 0.1% of GDP. In addition, compensation of employees is also forecast to increase further due to the expiration at end-2016 of the freeze on public sector hiring and wage increments.

In 2018, the small improvement in the general government primary surplus is largely based on the improving economic outlook.

Despite the stable headline balance, the structural balance is expected to worsen over the forecast horizon.

Public debt is expected to decline to 100.6% of GDP in 2018. The debt path is slightly better than envisaged in the spring, mainly due to higher nominal GDP.

Table II.13.1:

Main features of country forecast - CYPRUS

	2015		Annual percentage change						
mio EUR	Curr. prices	% GDP	97-12	2013	2014	2015	2016	2017	2018
GDP	17637.2	100.0	2.8	-6.0	-1.5	1.7	**2.8**	**2.5**	**2.3**
Private Consumption	12254.5	69.5	3.4	-5.9	0.7	1.9	**2.4**	**1.8**	**1.5**
Public Consumption	2772.2	15.7	4.5	-8.2	-7.9	-0.6	**-0.2**	**0.9**	**0.9**
Gross fixed capital formation	2347.3	13.3	0.4	-12.9	-17.5	12.0	**9.1**	**8.3**	**6.4**
of which: equipment	813.3	4.6	-0.5	-16.3	-34.8	94.1	**10.0**	**7.0**	**6.2**
Exports (goods and services)	10797.1	61.2	1.7	2.1	4.2	0.0	**5.5**	**4.6**	**3.9**
Imports (goods and services)	10738.1	60.9	1.9	-4.8	4.6	2.1	**5.7**	**4.7**	**3.6**
GNI (GDP deflator)	17574.7	99.6	2.7	-7.5	-0.6	5.2	**2.7**	**2.5**	**2.3**
Contribution to GDP growth: Domestic demand			3.0	-7.4	-3.4	2.6	**2.9**	**2.5**	**2.1**
Inventories			0.0	-2.2	2.1	0.3	**0.0**	**0.0**	**0.0**
Net exports			-0.2	3.7	-0.1	-1.3	**-0.1**	**0.0**	**0.2**
Employment			1.8	-5.9	-1.9	0.8	**1.8**	**1.6**	**1.5**
Unemployment rate (a)			5.4	15.9	16.1	15.0	**12.5**	**11.1**	**10.0**
Compensation of employees / head			3.9	-5.4	-3.6	-0.5	**1.2**	**1.5**	**1.9**
Unit labour costs whole economy			2.8	-5.4	-4.0	-1.5	**0.3**	**0.6**	**1.1**
Real unit labour cost			0.0	-4.4	-2.5	-0.2	**1.3**	**0.2**	**-0.1**
Saving rate of households (b)			6.8	-3.3	-7.9	-5.7	**-2.5**	**-1.3**	**-0.7**
GDP deflator			2.8	-1.0	-1.5	-1.3	**-1.1**	**0.3**	**1.2**
Harmonised index of consumer prices			2.6	0.4	-0.3	-1.5	**-1.1**	**0.7**	**1.3**
Terms of trade of goods			0.1	0.2	7.1	3.2	**2.0**	**-0.3**	**0.6**
Trade balance (goods) (c)			-24.1	-16.2	-16.0	-18.0	**-19.7**	**-21.2**	**-21.6**
Current-account balance (c)			-8.5	-4.9	-4.4	-3.0	**-2.8**	**-3.3**	**-3.4**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-8.2	-3.5	-3.5	-2.7	**-2.5**	**-2.9**	**-3.1**
General government balance (c)			-3.2	-4.9	-8.8	-1.1	**-0.3**	**-0.4**	**0.0**
Cyclically-adjusted budget balance (d)			-	-1.1	-5.4	0.8	**0.1**	**-1.3**	**-1.8**
Structural budget balance (d)			-	-0.4	3.0	1.7	**0.2**	**-1.3**	**-1.8**
General government gross debt (c)			58.4	102.2	107.1	107.5	**107.1**	**103.7**	**100.6**

(a) as % of total labour force. (b) gross saving divided by gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.