

13. CYPRUS

Solid growth accompanied by fiscal loosening ahead

Supported by robust employment, consumption and investment, Cyprus' economy has enjoyed a broad-based recovery and is forecast to post solid growth over the forecast horizon. Employment growth is expected to remain strong and unemployment to fall further. The general government budget position in 2016 turned out better than anticipated and some loosening of fiscal policy is expected.

Robust growth becoming more broad-based

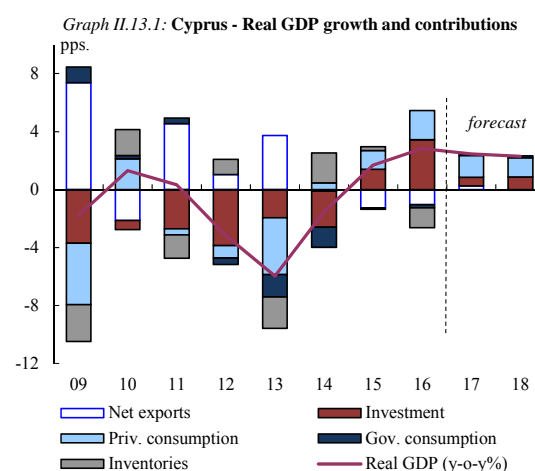
The economy of Cyprus expanded by 2.8% in real terms in 2016, driven by private consumption and investment. Private consumption was supported by falling prices, increasing employment and rising disposable income. Investment surprised on the upside, surging by 26%, with a few very sizable acquisitions of transport equipment adding to the gradual revival of investment in the real economy. These transport equipment acquisitions also had a major impact on goods imports, which increased by nearly 11%. As a result, the overall contribution to growth from net exports was negative despite strong exports. Exports particularly benefitted from the record-high tourism season (revenues from tourism exceeded 13% of GDP in 2016).

In 2017, real GDP growth is forecast at 2.5%, mainly driven by domestic demand. Private consumption is expected to be the engine of growth, fuelled by demand pent up during the crisis years and significant increase in employment in 2016. Purchasing power, however, is expected to see some erosion as inflation returns to positive territory. Some support for growth is set to come from government consumption, which is expected to start growing after five years of contraction, and net exports.

Investment in Cyprus suffered a sharp fall during the crisis and is forecast to gradually recover towards its long-term average. The clear upward trend in investment in housing and other construction, observed in 2016, is expected to continue as a real estate market picks up. While there is large uncertainty surrounding the investment outlook, the gradual easing of bank lending conditions, increasing foreign direct investment and improving confidence in the economy are expected to sustain the positive investment momentum.

In 2018, real growth is forecast to further ease to 2.3%. The main drivers are expected to be private and public consumption as well as investment. As unit labour costs are forecast to rise, the

contribution of net exports is expected to become neutral.



Unemployment expected to fall further while inflation turns positive

Employment increased by 2.7% in 2016, with gains across all sectors. With the ongoing recovery, job creation is expected to continue in the coming years. The unemployment rate fell to 13.1% in 2016, as discouraged workers started returning to the active labour force, and is expected to gradually decline to 10.6% in 2018.

Annual HICP inflation is projected to amount to 1.2% in 2017 and 1.1% in 2018. The inflationary pressure in 2017 is forecast to stem from higher energy prices, while core inflation is expected to be marginally positive. In 2018, domestic price pressures are set to intensify along with the economic recovery.

Risks to the outlook are on the upside in the short term, with early indications pointing to a strong tourism season in 2017 amid ongoing flows from Russia and with limited impact so far from the depreciation of the pound sterling on tourists from the UK. Over the medium-term, the risks are balanced. Rising domestic confidence and the EU economic recovery could spur growth more than expected, but competition from other tourist destinations could turn out stiffer than expected.

Expansionary fiscal policy

The government's fiscal performance in 2016 exceeded expectations again. The headline general government position registered a surplus of 0.4% of GDP, whilst the general government primary balance reached a surplus of 3.0% of GDP, one of the highest in the euro area and up by 0.3 pps. compared to the previous year (excluding one-off measures in relation to the recapitalisation of the banking sector in 2015). This was due to a sizeable increase of VAT and social security revenues as a result of a strong tourism season and positive labour market developments; and the continued reduction in intermediate consumption, compensation of employees and interest expenditure.

In 2017, the general government headline deficit is forecast to ease marginally to 0.2% of GDP and the primary surplus to 2.7% of GDP. Total expenditures are expected to diminish by 1.0 pp. of GDP, mostly led by interest expenditure. Government gross fixed capital formation is also expected to fall due to a combination of recurrent and one-off expenditure items. Total revenues are

expected to fall by 1.1 pps. of GDP due to a combination of new fiscal policy measures and the full year impact of the 2016 measures, such as the abolishment of the immovable property tax and the expiration of a special payroll contribution levied in response to the crisis. The implementation of the new place-of-supply rules regarding VAT for e-commerce services is also expected to have a negative impact on government revenue in 2017.

In 2018, the expected improvement in the general government headline balance is largely driven by the improving economic outlook and a decrease in interest expenditure.

The structural balance is expected to deteriorate over the forecast horizon due to the projected fiscal loosening. Public debt reached 107.8% of GDP in 2016 and is expected to be on a declining path afterwards, falling below 100% of GDP in 2018. The decline in the debt-to-GDP ratio over the forecast period is mainly due to the expectation that high primary surpluses will continue, as well as favourable debt dynamics due to positive nominal growth.

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	2.9	2.1	1.9
Public Consumption	2772.2		15.7	4.5	-8.2	-7.9	-0.6	-1.4	0.7	0.8
Gross fixed capital formation	2340.9		13.3	0.4	-12.9	-17.5	12.0	25.9	3.4	4.9
of which: equipment	807.0		4.6	-0.5	-16.3	-34.8	94.1	81.3	0.0	5.1
Exports (goods and services)	10797.1		61.2	1.7	2.1	4.2	0.0	3.6	3.3	3.2
Imports (goods and services)	10738.1		60.9	1.9	-4.8	4.6	2.1	5.3	2.9	3.2
GNI (GDP deflator)	17574.7		99.6	2.7	-7.5	-0.6	5.2	0.4	2.5	2.3
Contribution to GDP growth:		Domestic demand		3.0	-7.4	-3.4	2.6	5.2	2.2	2.3
		Inventories		0.0	-2.2	2.1	0.3	-1.4	0.0	0.0
		Net exports		-0.2	3.7	-0.1	-1.3	-1.0	0.3	0.0
Employment				1.8	-5.9	-1.8	1.9	2.7	2.3	1.9
Unemployment rate (a)				5.4	15.9	16.1	15.0	13.1	11.7	10.6
Compensation of employees / head				3.9	-5.4	-3.8	-1.1	-0.6	0.7	1.1
Unit labour costs whole economy				2.8	-5.4	-4.0	-0.9	-0.7	0.6	0.8
Real unit labour cost				0.0	-4.4	-2.6	0.4	0.6	-0.2	-0.1
Saving rate of households (b)				6.8	-3.3	-7.9	-5.7	-4.5	-2.6	-1.2
GDP deflator				2.8	-1.0	-1.5	-1.3	-1.3	0.8	0.9
Harmonised index of consumer prices				2.6	0.4	-0.3	-1.5	-1.2	1.2	1.1
Terms of trade of goods				0.1	0.2	7.1	3.2	-0.4	0.2	-0.5
Trade balance (goods) (c)				-24.1	-16.2	-16.0	-18.0	-21.2	-22.2	-22.9
Current-account balance (c)				-8.5	-4.9	-4.4	-3.0	-5.7	-5.9	-6.3
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-8.2	-3.5	-4.4	-2.7	-5.2	-5.3	-5.8
General government balance (c)				-3.2	-5.1	-8.8	-1.2	0.4	0.2	0.7
Cyclically-adjusted budget balance (d)				-	-1.5	-5.5	0.5	0.8	-0.2	-0.4
Structural budget balance (d)				-	-0.8	3.0	1.4	0.9	-0.2	-0.4
General government gross debt (c)				58.4	102.2	107.1	107.5	107.8	103.4	99.8

(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.