CENTRAL BANK OF CYPRUS

ECONOMIC BULLETIN

JUNE 2023

NICOSIA - CYPRUS

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EUROSYSTEM

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Note: The cut-off date for data in this *Bulletin* is 26th of November 2021.

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ABBREVIATIONS

BLS	Bank Lending Survey
BPM	Balance of Payments and International Investment Position Manual
CBC	Central Bank of Cyprus
Cystat	Statistical Service of the Republic of Cyprus
DLS	Department of Lands and Surveys
ECB	European Central Bank
EER	Effective Exchange Rate
ESA	European System of Accounts
ESI	Economic Sentiment Indicator
ESMA	European Securities and Markets Authority
EU	European Union
EURIBOR	Euro Interbank Offered Rate
Eurostat	Statistical Office of the European Union
FED	Federal Reserve
GDP	Gross Domestic Product
GHS	General Health System
HICP	Harmonised Index of Consumer Prices
IIP	International Investment Position
IMF	International Monetary Fund
LFS	Labour Force Survey
MFIs	Monetary Financial Institutions
NEER	Nominal Effective Exchange Rate
NACE	Statistical classification of economic activities in the European Union
NFCs	Non-Financial Corporations
NPFs	Non-Performing Facilities
REER	Real Effective Exchange Rate
RPPI	Residential Property Price Index
SDW	Statistical Data Warehouse
SPEs	Special Purpose Entities
UK	United Kingdom
US	United States of America

Governor's introduction

The positive trend of Cyprus's economic activity, along with improvements in the banking sector's assets, continues into 2023, despite the ongoing conflict in Ukraine and interest rate hikes in the euro area to combat persistent inflationary pressures.

According to the preliminary estimate by the Statistical Service of Cyprus, Gross Domestic Product (GDP) for the first quarter of this year recorded an annual growth rate of 3.4%, following a 5.6% increase in 2022. This growth rate was influenced by a base effect compared to the previous year, since the swift reopening of the economy after the lockdowns of 2021 led to a sharp increase in 2022 GDP. The GDP trajectory this year was affected by the fragile external environment. Yet, its positive trend in the first quarter of 2023 mainly reflects the resilience of domestic demand as recorded in the wholesale and retail trade sectors and, to a lesser extent, in net exports mainly due to the exceptional performance recorded by tourism sector during the said period.

According to the latest forecasts from the Central Bank of Cyprus (CBC) of June 2023 ("June forecasts"), GDP growth is expected to reach 2.6% in 2023, 2.8% in 2024, and 3.1% in 2025. Strong domestic demand and, to a lesser extent, net exports are expected to support growth, thanks to the anticipated expansion of the business operations of foreign companies already established in Cyprus. The continued rise in tourism revenues, which have already rebounded to pre-pandemic levels in the first three months of 2023, is also a significant contributor to economic growth. Additionally, ongoing large private investments, projects supporting digital and green transition, such as grants for promoting Renewable Energy Sources and energy efficiency measures, and other structural reform projects under the Recovery and Resilience Plan are expected to substantially support economic activity. It is noteworthy that investments for the implementation of the Recovery and Resilience Plan are estimated to reach approximately €600 million for the period 2023-2025, contributing 0.8% to the annual GDP growth rate, with around €100 million allocated for project implementation in 2023. A smaller contribution is expected from residential investments due to the subsidized interest rate scheme for new housing loans, which were concluded by the end of 2021 and have a disbursement period of up to three years. Finally, the continued positive performance of the labour market supports private consumption and strengthens the country's GDP growth rate. According to the June forecasts, unemployment rate is expected to marginally decrease to 6.7% in 2023 compared to 6.8% in 2022, and further decline to 6.1% in 2024 and 5.6% in 2025, approaching full employment conditions.

Regarding prices, inflation (based on the Harmonized Index of Consumer Prices, HICP) reached 2.4% (Eurostat preliminary estimate) in July, which is the lowest inflation rate since July 2021. The significant decline in inflation is primarily a result of the normalisation path in energy prices and the disinflationary impact of the ECB monetary policy, with further impact expected due to the time lag in its transmission. Core inflation, primarily due to the monetary policy impact, has significantly decreased from its peak of 7.2% in August 2022. Specifically, it decreased to 3.5% (Eurostat preliminary estimate) in July compared to an average of 4.6% during the period of January-June 2023. Despite this reduction, core inflation remains at high levels primarily due to the maintenance of domestic demand at high levels, partly as a result of wage increases. Additionally, these high underlying inflationary pressures reinforce the need, among other things, for targeted fiscal policy to operate as supportively as possible toward the timely return of inflation to the ECB's medium-term target of 2%.

According to the CBC June forecasts, a significant reduction in inflation to 3.3% is expected in 2023, compared to 8.1% in 2022, with further moderation of inflation expected for 2024 and 2025, to 2.3% and 2%, respectively. This is mainly due to the anticipated further impact of the monetary policy in the euro area, as well as the expected continued normalisation of energy prices and other major categories of the HICP.

In relation to the country's banking system, it should be noted that the prolonged challenges stemming from the health crisis, geopolitical developments and strong inflationary pressures have not adversely affected its resilience. In particular, at the end of the first quarter of 2023, credit institutions not only had sufficient regulatory capital but the common equity capital ratio (CET1) stood at 17,3%, compared to the European ratio which was 15,8%, an indication of their ability to absorb future and unexpected losses. Additionally, the banking system continues to record very strong liquidity reserves as the liquidity coverage ratio stood at 318% in March 2023, almost double the corresponding Eurozone average. Nevertheless, the international geopolitical and economic developments that drive the reduction in the domestic growth rate from the high levels of 2022, in conjunction with the recent banking turmoil in the US and Switzerland, leave no room for complacency. The challenges in the banking system remain and require the performance of ongoing and thorough prudential supervision, including, among others, the supervision of the governance arrangements and the performance of on-site and off-site investigations from the supervisor.

Despite the significant reduction in NPLs, from 44% in 2017 to 9% in March 2023, this percentage is still higher than the EU average of 1,8%. The progress that is slowly but steadily being achieved is concentrated mainly in the largest banks as the smaller banks are not dealing with the problem as effectively. Given the rise in interest rates, as well as the uncertainty in the economic environment, banks may be faced with increases in NPLs.

Therefore, given the limited progress that smaller banks have achieved in reducing NPLs, and with the aim of further strengthening the resilience of the banking sector, and by extension the boarder economy, the CBC has entered into an agreement with a consortium comprised of international and well reputable companies, for the design of a systemic solution, which along with the existing tools, will contribute to a drastic reduction of NPLs across the banks. In addition to this initiative, the CBC repeatedly urged banks to proceed with viable restructurings, without undue delays, with minimal charges and with a special focus on the most vulnerable customers.

An equally important initiative of the CBC is the "digital onboarding" project, which is expected to strengthen the competitiveness of the Cypriot banking sector and improve the experience of customers of banks, reducing the time they are involved in banking operations and significantly upgrading the speed and quality of their service. It is expected that it will also have a positive effect in dealing with the inherent risks in the digital transition and, as a result, also strengthen cyber security. Additionally, and given the increasing risks in the cyberspace, the CBC gives significant importance to strict supervision of banks' security and operational risks arising from the increased penetration of technology into banking practices and operations.

Constantinos Herodotou
Governor
Central Bank of Cyprus

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(A) Domestic Environment

- *The Cypriot economy exhibits significant resilience and flexibility to the negative exogenous factors related to the Russian-Ukrainian war, thus recording a positive, yet decelerating GDP growth rate of 3.4% in the first quarter of 2023.*
- *As from August 2022 onwards, domestic HICP has been registering a sizeable ongoing disinflation trend mainly driven by the developments in energy prices, remaining, however, still at levels above the 2% medium –term target.*
- *Domestic core inflation remains high and more persistent than the HICP inflation.*
- *In April 2023, HICP inflation fell to 3,9%, while core inflation to 4,2%.*
- *Acceleration in the increase of the residential property prices by 6,6% was recorded in 2022Q4, mainly due to the increased construction cost and increased demand.*
- *The labour market demonstrates resilience despite the ongoing war and its economic repercussions, primarily due to inflationary pressures.*
- *The Current Account Deficit was significantly affected by inflationary pressures and the sanctions against Russia. Significant potential for quick improvement is observed in the sectors of tourism and information technology services.*
- *Acceleration in the domestic private sector deposits annual growth was recorded in the first quarter of 2023. This was supported by the robust economic growth of the Cyprus economy, the continuous improvement in employment and also by a base effect.*
- *New lending to domestic non-financial corporations is broadly stable, while new*

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lending to domestic households continues to moderate amid tighter credit standards applied to the approval of loans and reduced loan demand in the context of rising interest rates and high inflation.

- *Cyprus' lending interest rates recorded a steady ascent since the 2nd half of 2022. The increases became more pronounced in 2023 in line with ECB's interest rate hikes and tighter financing conditions. Deposit rates remained low, with a marginal increase observed in the first months of 2023.*
- *The government budget balance recorded a surplus of 1,1% of GDP in the first quarter of 2023, compared with a surplus of 0,9% of GDP in the respective quarter of the previous year.*
- *Government debt-to-GDP ratio decreased in March 2023 compared to its level in March 2022, due to a strong economic recovery and robust primary surplus.*

1. Economic Activity

According to the latest preliminary data published by Cystat that was available at the relevant cut-off date of this Economic Bulletin, in 2003Q1, GDP registered a positive, albeit decelerating annual growth rate of 3,4%, the second highest growth rate compared with the rest of the euro area countries. Positive growth was recorded in hotels and restaurants, transportation and storage, information and communication, trade, as well as financial activities sectors.

Based on detailed annual data, available at the cut-off date of this Economic Bulletin, a significant recovery of GDP by 5,6% was recorded for 2022 (**Table 1**), following a 6,6% increase in 2021, mainly due to the increase in private consumption. The increase in inventories also had a significant contribution, a phenomenon common across Europe, related to supply chain disruptions and the increase in commodity and oil prices. More specifically, private consumption increased by 7,7%, as a result of the gradual recovery in disposable income levels and consumption behaviour, after a long period of restraint and restrictions during the pandemic. The increase in investments by 6,6%,which does not change substantially when the data is adjusted for the impact of Special Purpose Entities (SPEs), is due to the ongoing implementation of major infrastructure projects by the private sector, as well as the noteworthy increase recorded in housing construction. Public consumption increased marginally by 0,1%, primarily due to base effects related to the rise in expenditure for the purchase of health services by General Health Services (GHS) in 2021 (see Fiscal Developments). The growth in total exports by 13,7% (smaller growth if data is adjusted for the impact of SPEs) is driven by the large rise in exports of information, communication and telecommunication services (ICT), as well as the significant recovery in tourism in 2022, with tourist receipts reaching 91% of 2019 levels (see Balance of Payments). At the same time, the increase in total imports by 18,8% (smaller increase if data is adjusted for the impact of SPEs) reflects the rise in imports of services and to a lesser extent, the increase in imports of goods for private consumption and investment.

From a sectoral perspective (**Table 2**), GDP

TABLE 1 **GDP by expenditure category**
(real terms, annul change, %)

	2018	2019	2020	2021	2022
GDP	5,6	5,5	-4,4	6,6	5,6
Private consumption	5,1	3,9	-6,8	4,5	7,7
Public consumption	3,6	12,0	11,5	9,0	0,1
Gross fixed capital formation	-4,9	6,9	4,5	-4,2	6,6
Exports of goods and services	7,2	8,7	2,2	13,5	13,7
Imports of goods and services	4,3	9,5	3,2	9,0	18,8

Source: Cystat.

TABLE 2 **GDP by economic activity**
(weighted contribution to the overall annual change, percentage points)

	2018	2019	2020	2021	2022
GDP (%)	5,6	5,5	-4,4	6,6	5,6
Construction	0,9	0,8	-0,4	0,5	-0,1
Trade, transportation, hotels and restaurants	2,3	0,9	-6,8	2,5	2,7
Information and communication	0,5	1,2	1,2	0,7	1,3
Financial and insurance activities	-1,4	-0,2	2,4	1,1	0,6
Professional, scientific and administrative activities	1,2	0,8	-0,3	0,5	0,4
Other sectors[1]	2,2	2,0	-0,5	1,3	0,8

Source: Cystat.
(1) Main sectors included are those of agriculture, manufacturing, public administration, education and health, as well as, arts, entertainment and recreation.

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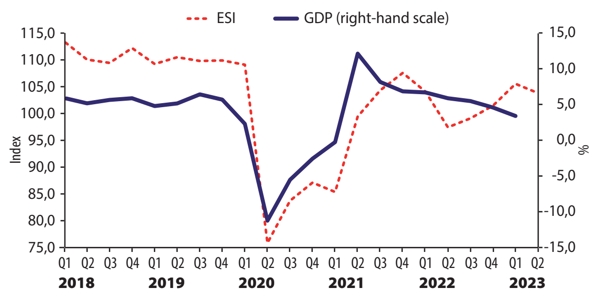
recovery in 2022 emanated from the increased activity observed across all sectors, except construction (-0,1 percentage points), as the latter was affected by the significant increase in construction costs, among other factors. The sectors with the largest contribution to GDP were trade, transportation, hotels and restaurants with 2,7 percentage points, arising from the fast recovery recorded by the sectors after the pandemic and lockdown period. Smaller contributions were recorded by the information and communication (1,3 percentage points) and the category of financial and insurance activities (0,6 percentage points), supported by the influx of foreign companies (headquartering) operating in the technology and investment services sectors, respectively. The category of professional services, as well as the arts, entertainment and recreation sector, contributed 0,4 and 0,2 percentage points, respectively.

Available qualitative indicators (soft data) for 2023Q2, point to a decelerating GDP growth rate. In particular, the GDP path closely follows developments in the Economic Sentiment Index (ESI) (**Chart 1**) and its sub-indicators (**Table 3**). So far, it appears that the Cypriot economy exhibits resilience, and the effects of the invasion and the imposed sanctions are expected to become more pronounced in the remaining quarters of 2023. Specifically, the ESI average score in the period April - May 2023 was 103,8, slightly lower than 105,5 reached in 2023Q1, but higher compared with 97,4 in 2022Q2 (**Table 3**). Based on the underlying ESI sub-indicators (**Table 3**), the period April - May 2023 shows an improvement in all sectors and especially

CHART 1 **Annual GDP growth and Economic Sentiment Indicator index**



Sources: Cystat, European Commission
Note: Data for 2023Q2 refer to the months of April and May.

TABLE 3 **Business and consumer surveys: confidence indicators**
(for sub-indices: difference between percentage of positive answers and percentage of negative answers, period average)

	2022 Q1	2022 Q2	2022 Q3	2022 Q4	2023 Q1	2023 Apr.-May
ESI	104,1	97,4	99,1	101,5	105,5	103,8
Industry	-2,6	-11,3	-6,2	-7,6	-3,0	-0,4
Services	23,7	10,7	9,7	16,8	24,9	17,1
Consumer	-23,7	-34,5	-32,9	-30,3	-19,3	-25,6
Retail trade	-5,3	-10,8	-11,4	-6,3	-1,1	0,0
Construction	-17,5	-19,5	-17,6	-16,0	-15,6	-12,0

Source: European Commission.
Note: Seasonally adjusted data.

retail trade, compared with 2022Q2. Nevertheless, the sentiment indicator was lower compared with 2023Q1. As a result, CBC adopted a conservative forecast for 2023 in its June 2023 projections (see Macroeconomic forecasts), taking into consideration the recent sanctions that are expected to have a negative, albeit manageable effect on the turnover of professional services.

2. Prices

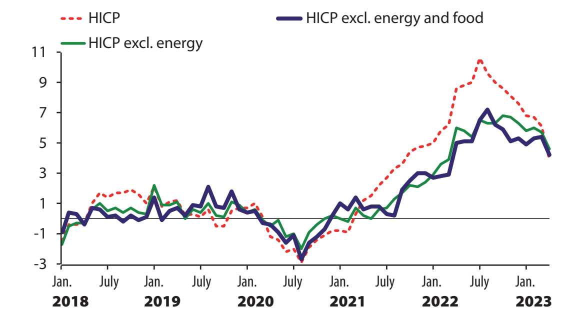
Inflation

The domestic Harmonised Index of Consumer Prices (HICP) registered, on average, a yearly increase of 5,9% during the period January-April 2023 compared with 6,4% in the corresponding period of 2022 (**Chart 2a** and **Table 4**). During the first four months of 2023, the domestic HICP inflation continued to fluctuate at elevated levels, similar to the euro area inflation dynamics, mainly driven by factors that are still related to a great extent, to the economic consequences of the ongoing Russian invasion of Ukraine which adversely affect the main components of HICP (**Table 4**). At the same time, the resilient growth in domestic economic activity, the robust demand for goods and services, the wage growth and the profit margins for firms (see **Box 1**, p. 24) contributed positively to maintaining domestic inflation at high levels during the period under review.

More analytically, during the period January-April 2023, the domestic HICP continued to be significantly affected by the developments in the non-energy industrial goods "NEIG" prices. In particular, the increased production cost in the aftermath of the war, the solid demand for goods as well as the profit margins for firms continued to pose sizeable upward price pressures in the key sub-categories of NEIG inflation such as motor cars, furniture and fittings and major household electrical appliances.

Food prices (processed and unprocessed food prices) had also a significant contribution

CHART 2a **Inflation in Cyprus (HICP)**
(annual change, %)



Source: Eurostat.

TABLE 4 **Inflation in Cyprus**
(annual change, %)

	2023(1)	Jan.-Apr. 2022	Jan.-Apr. 2023	Apr. 2022	Mar. 2023	Apr. 2023
HICP	1000,00	6,4	5,9	8,6	6,1	3,9
Total Food prices,						
of which:	209,75	6,9	6,9	9,5	6,1	5,8
(i) Unprocessed food prices	51,59	19,4	-1,4	21,5	-5,8	-2,2
(ii) Processed food prices	180,94	3,4	9,6	6,0	10,2	8,4
Energy prices	112,38	28,4	9,2	33,6	10,3	-1,7
Services prices	421,77	3,1	4,4	5,6	5,0	3,4
Non-energy industrial goods prices	233,32	3,6	6,0	3,9	6,1	5,7
HICP excluding energy	887,62	4,1	5,5	6,0	5,7	4,6
HICP excluding energy and food	655,09	3,4	5,0	5,0	5,4	4,2

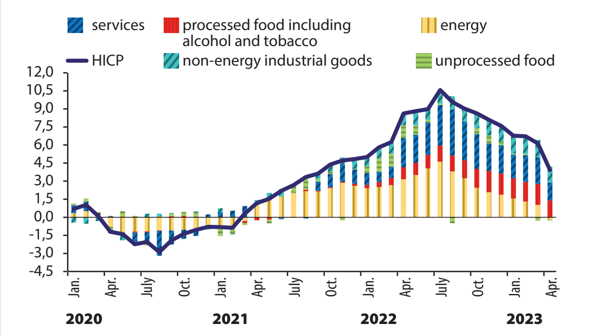
Source: Eurostat.
(1) Based on the weight for 2023.

to the domestic HICP during the first four months of 2023. This development is mainly related to the sizeable increases in their production cost due to the rise in the prices of energy, fertilisers, wheat, and oil products.

During the period January-April 2023, services prices had an increased contribution in the domestic inflation. This development is primarily attributed to the positive impact from the continuing growth of domestic economy and also due to the significant demand for various services which are related to domestic consumption and tourism (restaurants and cafes, accommodation services and travelling) after the end of the covid-19 restrictive measures around the world and the reopening of the economy. It is also noted that on average, the increases in energy and food prices posed substantial indirect upward pressures in the said key sub-categories of services inflation during the period under review. Moreover, the increases in wages and the profit margins for firms seem to be additional factors that have an upward impact on services prices.

Concerning energy prices, these continued, on average, to have a positive contribution in the overall HICP during the first four months of 2023, albeit to a significantly lesser extent compared with the corresponding period of 2022 (**Chart 2b**). This is mainly due to the notable drop in the price of Brent oil compared with the corresponding period of last year along with the impact of the ongoing targeted CY government mitigating measures on main fuels and electricity prices for the domestic consumers. It is noted that the downward impact of the said mitigating measures related

CHART 2b **Contributions of HICP components to overall domestic HICP inflation**
(annual percentage changes; percentage point contributions)



Sources: Eurostat and CBC calculations.

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to energy prices are partly offset by the continued high cost of purchasing greenhouse gas emissions allowances (in accordance with the policy that concerns all EU member states) which affects negatively the price of domestic electricity until today.

Beyond the described key developments in the main components of the domestic HICP, it is worth-mentioning the fact that, after its peak in July 2022 (10,6%) as from August 2022 onwards, the CY HICP albeit it continues to still remain at high levels, it shows a sizeable ongoing disinflation trend (**Table 4**, p.17 and **Chart 2b**). This development is largely due to the aforementioned developments in energy prices. It is also worth-mentioning the fact that from September 2022 onwards the domestic HICP inflation has been fluctuating at much lower levels than its counterpart in the euro area. Indicatively, HICP inflation in Cyprus marked a significant decline to 3,9% in April 2023 from 6,1% in March 2023 and 8,6% in April 2022, while HICP in the euro area reached 7,0% in April 2023 compared with 6,9% in March 2023 and 7,4% in April 2022.

Regarding domestic inflation excluding energy and food prices (core inflation), this continued to fluctuate at high levels remaining, in general, more persistent than the overall domestic HICP (as also holds in the euro area). Particularly, core inflation registered, on average, a yearly increase of 5,0% during the period January-April 2023 compared with, on average, 3,4% in the corresponding period of 2022 (**Chart 2a** and **Table 4**, p.17) in light of the developments in both NEIG and services prices (core inflation components). Having said that, it should be noted that in April 2023, domestic core inflation slowed-down to 4,2% compared with 5,4% in March 2023 and 5,0% in April 2022.

Construction sector and real estate prices

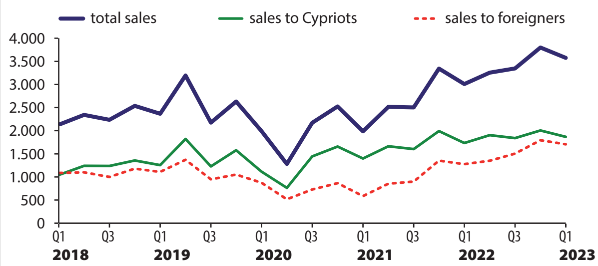
Despite the limited construction activity during 2022, in which an annual decrease of 6,5% was recorded in the index of production in construction, demand for real estate as recorded in the number of sales contracts, is still in high levels.

The domestic market remains the main source of demand for housing property, while the foreigners' transactions are also recording significant increases (**Chart 3**).

According to data of sales contracts from the Department of Land and Surveys (DLS), real estate sales in Cyprus reported an annual increase of 20,8% during the first four months of 2023. This increase corresponds to an annual increase of 8,9% and 37,3% in sales to domestic and foreign buyers, respectively (**Table 5**). Having said that, the building confidence indicator in Cyprus remains in negative levels in the first four months of 2023 (**Table 5**). Despite the decrease in new housing loans and the increase in interest rates, the demand, as recorded in the sales contracts (**Chart 3**), has not so far significantly been affected.

Specifically, according to the Monetary and Financial Statistics of CBC, in the first four months of 2023 the new housing loans decreased by 39,9% compared with to the corresponding months of 2022, while the interest rate for housing loans during the first

CHART 3 **Number of sales contracts**



Source: Department of Lands and Surveys.
Note: The definition of foreigner has changed since 2018Q1, thus the figures are not comparable with previous periods.

TABLE 5 **Real estate sector**
(annual change, %, unless otherwise stated)

	Jan.-Apr. 2022	Jan.-Apr. 2023	Apr. 2022	Mar. 2023	Apr. 2023
Sales contracts (total)	40,1	20,8	12,7	22,7	27,1
Sales contracts (locals)(1)	15,9	8,9	-2,9	12,1	12,0
Sales contracts (foreigners)	97,7	37,3	49,8	37,3	50,3
Building sentiment indicator (average of index) - Cyprus	-18,7	-14,9	-22,5	-17,5	-12,8
Property price expectations for the next 3 months (average of index)	82,0	79,2	87,2	77,2	74,2
Price index of construction materials	19,4	8,2	24,5	8,1	2,2

Sources: Cystat, DLS, European Commission.
(1) The number of sales contracts to Cypriots results from CBC calculations.

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four months of 2023 increased to 3,91% from 2,16% in the first four months of 2022.

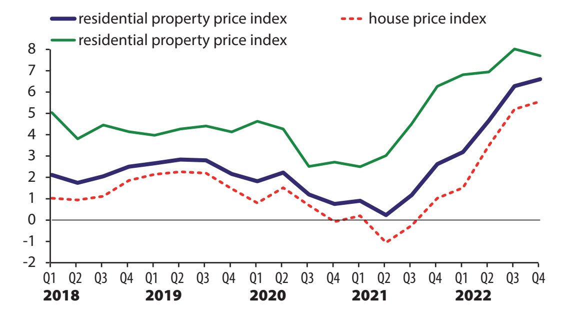
Residential property prices during 2022 continued the upward trend (**Chart 4**). Specifically, according to CBC RPPI available data, in 2022 the residential property prices recorded an annual increase of 5,2% (compared with 1,2% in 2021), representing an annual increase of 7,4% in the apartment prices and 3,9% in the house prices for the same period.

These increases are mainly driven by the increased construction cost for the aforementioned period, which is however recording a deceleration in the first months of 2023. Specifically, during February, March and April of 2023, the index of construction materials, published by CYSTAT, recorded a deceleration in the annual growth rate (**Chart 5**). Further reductions are expected in the index of construction materials due to the fact that a relative delay has been observed in the pass-through reductions in Cyprus prices of basic construction materials. The index of property price expectations for the next three months, which is published in the Business and Consumer Surveys of the European Commission, continued to range in high levels during the first quarter of 2023 (**Chart 5**, p.21 and **Table 5**, p. 20), proofing the majority of the market continues to expect increases in the residential property prices in the near future.

Labour Costs

The labour cost (nominal expenditure per employee) continued to rebound in 2022, recording an annual increase of 3,8%, as it did in 2021. The rise in nominal expenditure per

CHART 4 **House and Apartment price indices**
(annual change, %)



Source: CBC.

CHART 5 **Residential property price index (RPPI), Price Index of Construction Materials and House Price (HP) Expectations for the next three months**

Sources: CBC, European Commission

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employee was primarily attributed to an increase in labour cost per working hour (2,4%) and, to a lesser extent, to an increase in working hours per employee (1.2%).

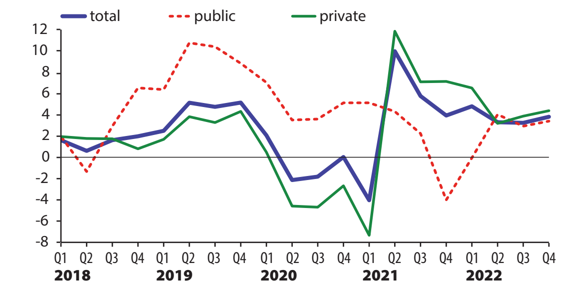
Specifically, nominal expenditure per employee in 2022 (**Chart 6**) was mainly influenced by the normalization of wage increases following the end of the pandemic, as well as tightness observed in the labour market. Another significant factor is the gradual restoration of public sector salaries. Public sector expenditure recorded an annual increase of 2,6%, while a larger increase of 4,4% observed in the private sector. The public sector expenditure is mainly a result of the continued phasing out of the reductions in salaries and pensions that adopted during the 2013 crisis years. In the private sector, the aforementioned increase is primarily due to wage increases in the fields of trade, transportation, hotels and restaurants, and to a lesser extent, in the financial services, professional, and information and communication sectors.

Real expenditure per employee[1] in 2022 registered a decrease of 3,9%, following a 2,9% increase in 2021, affected by significant inflationary pressures (**Chart 7**).

Regarding productivity, calculated as the change in real GDP per employee, the relative index recorded a 2,7% increase in 2022 compared to a 5,3% increase in 2021. The slowing trend of this index is due to the increase in employment relative to GDP growth (**Chart 7**).

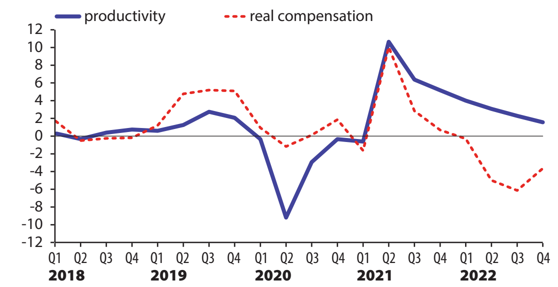
The unit labour cost increased by 1% in 2022 compared with 1,4% in 2021. This increase is a result of higher expenditure per employee compared to productivity growth

CHART 6 **Nominal compensation per employee by sector**
(annual change, %)



Sources: SDW (ECB), Cystat, CBC.
Note: The sectoral breakdown is based on CBC calculations.

CHART 7 **Productivity and real compensation per employee**
(annual change, %)



Sources: SDW (ECB), CBC.

1. It is noted that the private consumption deflator is used, rather than the CPI deflator.

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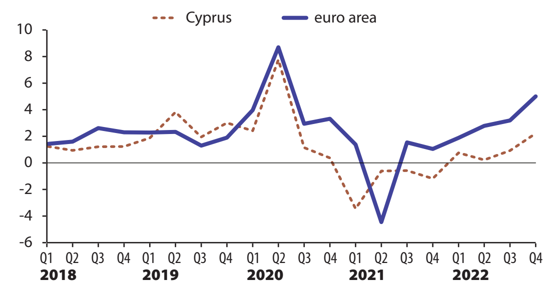
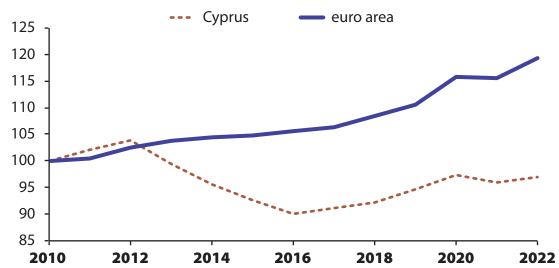
(**Chart 8a**). Unit labour cost is a significant indicator of competitiveness against other economies. Despite recent increases, the substantial cumulative reductions in wages since 2012, as well as after the crisis, continue to contribute to the long-term maintenance of Cyprus's economic competitiveness. Specifically, the index recorded a cumulative decrease of 13,2% during the period 2013-2016 and, despite the annual increases observed since then, it remains at lower levels compared to the euro area since 2013 (approximately 22 percentage points lower in 2022) (**Chart 8b**).

CHART 8a **Unit labour costs: Cyprus and the euro area**
(annual change, %)



Source: SDW (ECB).

CHART 8b **Unit labour costs: Cyprus and the euro area**
(index 2010=100)



Source: SDW (ECB).

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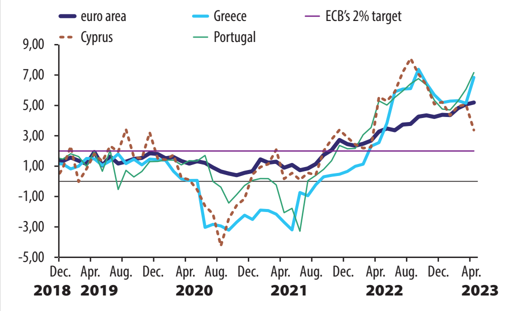
Box: The impact of Profit Margins on Services Inflation

This Box aims to examine how changes in profit margins affect the domestic services inflation. Over the past two years there has been a significant increase in overall inflation in Cyprus (see Section A2. Prices, p. 17), with services inflation playing a substantial role in the increase since April 2022. Services inflation peaked at 8,1% in August 2022 and subsequently decreased, standing at 3,4% in April 2023 (**Chart 1**), following a similar trajectory to the overall HICP inflation.

Services inflation in Cyprus, especially after the pandemic, follows a similar trajectory to other countries, such as Greece and Portugal. As shown in **Chart 1a**, services inflation exhibits relatively large percentage changes and greater volatility compared to other countries such as Germany, Italy and Spain (**Chart 1b**).

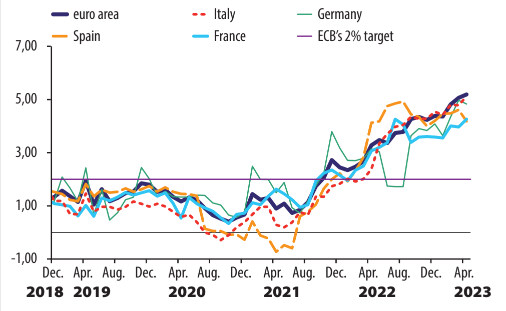
Increased inflation seems to have widened firm profit margins, both in Cyprus and in the euro area[1]. Profit margins, from a macroeconomic perspective, are indicative of a firm's profitability within an economy while they also measure their efficiency, i.e., how easily sales are converted into profits. Profit margins can significantly vary across different sectors of the economy. Some sectors such as information technology, typically have higher profit margins due to lower production costs or higher pricing power. Others, like retail, may have lower profit margins due to a focus on sales volume, intense competition, and/or higher operational expenses.

CHART 1a **Services Inflation in Cyprus and selected Euro Area countries**
(annual change, %)



Source: Eurostat.

CHART 1b **Services Inflation in selected Euro Area countries**
(annual change, %)



Source: Eurostat.

Under certain conditions, during periods of high inflation, companies can pass on their higher cost to the consumers without significantly expanding profit margins. However, companies with strong pricing power, usually in sectors with inelastic demand, may take advantage of rising costs to expand their profit margins without significantly affecting demand. In such cases, customers accept price increases, often due to a lack of alternatives. This can

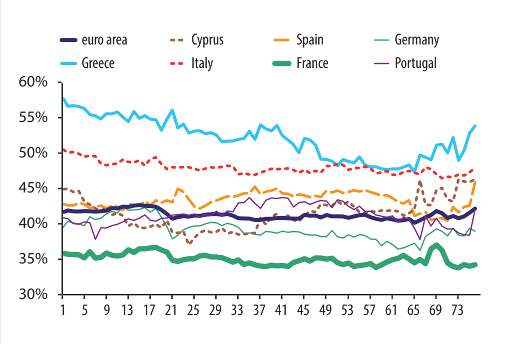
1. In this analysis, we define profit margins of the economy as Gross Operating surplus and mixed income over Gross Domestic Product. For robustness, alternative definitions have been utilized, even though not presented here.

lead to further inflationary pressures in the economy. For example, since both food and energy tend to have inelastic demand, it is easier for businesses in related sectors to pass on any cost increases and accompany them with an increase in profit margins, given that the price increase will not have a strong impact on overall demand.

Below we present a comparative analysis of profit margins in Cyprus and other euro area countries from 2004 to 2022 (**Chart 2**). Specifically, firm profit margins in Cyprus (orange line) exhibit higher levels of volatility compared with the euro Area (black line). This can be attributed to the fact that the Cyprus economy relies more on services, which are significantly influenced by food and energy prices, both of which have high volatility. It's worth noting that the typical standard deviation (using monthly data) of the services inflation in Cyprus is at 1,9% compared with 0,8% in the Euro Area. As the weighted contribution of services inflation to the overall HICP inflation in Cyprus is also higher compared with the Eurozone (29,1% for year 2022 and 33,5% from January to April 2023 for Cyprus compared with 17,7% and 26,4% for the euro area in the respective periods), this leads to greater fluctuations in profit margins. It is also recognised that the broader macroeconomic environment played a significant role in adjusting the profit margins of the economy.

Specifically, following Cyprus's accession to the European Union in the second quarter of 2004, firm profit margins in the country displayed a declining trajectory,

CHART 2 **Euro Area countries (Gross) Profit Margins**
(annual change, %)



Source: Eurostat.

falling from 45,0% in the second quarter of 2004 to 37,0% in the fourth quarter of 2009. However, unlike the broader euro area, Cyprus exhibited a subsequent upward trend in profit margins, especially after 2013. By the first quarter of 2020, before the Covid-19 pandemic, profit margins in Cyprus reached a historically high level of 42,1%. The fluctuations during the pandemic were attributed to both the uncertainty of the macroeconomic environment and the subsidies provided to businesses and employees, resulting in an increase in profit margins. After the fourth quarter of 2021, when significant increases in energy prices were recorded, profit margins began to rise again. In 2022, profit margins were on average approximately 4,5 percentage points higher than their 2019 levels.

In contrast to Cyprus, as previously mentioned, profit margins in the euro Area experienced much smaller fluctuations, ranging from 40,1% to 42,7% during the 2004-2020 period. However, after the

Covid-19 pandemic and the supply chain disruptions, profit margins increased, reaching levels seen prior to 2009. In the fourth quarter of 2022, profit margins in the Eurozone stood at 42,2%.

As mentioned previously, the aim of this box is to examine the impact of changes in firm profit margins on the services inflation. For this purpose, we employ a Vector Error Correction ("VEC")[2] econometric model that includes key economic variables[3]. Specifically, to assess the factors influencing service inflation, we employ energy and food prices, which are the main drivers of inflationary pressures in the Cypriot economy. Additionally, we use compensation per employee to account for labour-related pressures on inflation. To account for other sources of imported inflation, we also include Non-Energy Industrial Goods ("NEIG")[4]. The data range from the fourth quarter of 2002 to the fourth quarter of 2022. The model used provides satisfactory results in terms of statistical fit, and it utilises two lagged time periods for estimation. Chart 3 below illustrates the estimated effects based on impulse response functions resulting from the model's application[5].

As **Chart 3** (p. 27) suggests, profit margins tend to decline following an increase in energy prices (*graph (1)*). However, profit margins tend to increase significantly when food prices increase (*graph (2)*). As profit margins increase, services inflation also increases, by approximately 0,60% in the long term, following a 1% increase in profit margins (*graph (6)*). Evidence suggesting the potential creation of a vicious cycle between margins and services since margins tend to increase when the overall services inflation index rises (*graph (4)*). The only variable that has a clear (and expected) negative impact on profit margins is compensation per employee (*graph (5)*), as increasing wages tend to reduce profit margins. Furthermore, all effects appear to be of a permanent nature, as they do not die out over time.

From the above it appears that cost pass on from businesses to consumers and the increase in profit margins were significant. As already mentioned, factors such as the lack of cheap alternatives from other markets (e.g. China) due to rising shipping costs and the increase in energy prices played a role in driving up prices. Despite the price increases however, the overall demand in the economy does not seem to have been significantly affected, which facilitated the pass-through of price hikes to consumers. This is primarily attributed to the accumulated savings of consumers from the pandemic period. As a result, many households were able to continue their consumption at the same level as before, reducing excess savings.

On the basis of the above results, as well as other model estimates using alternative model specifications and definitions of profit margins, we estimate that around

2. Johansen, S., & Juselius, K. (1990). Maximum likelihood estimation and inference on cointegration--with applications to the demand for money. Oxford Bulletin of Economics and Statistics, 52(2), 169-210.
3. Additional variables of the real economy (e.g., unemployment) have been used in model robustness checks.
4. Koester, G., Rubene, I., Gonçalves, E., Nordeman, J., 2021. Recent developments in pipeline pressures for non-energy industrial goods inflation in the euro area, Economic Bulletin Boxes. European Central Bank.
5. The shaded area represents a 68% confidence interval using the bootstrap method for readability. Confidence intervals with 90% and 95% confidence are also available.

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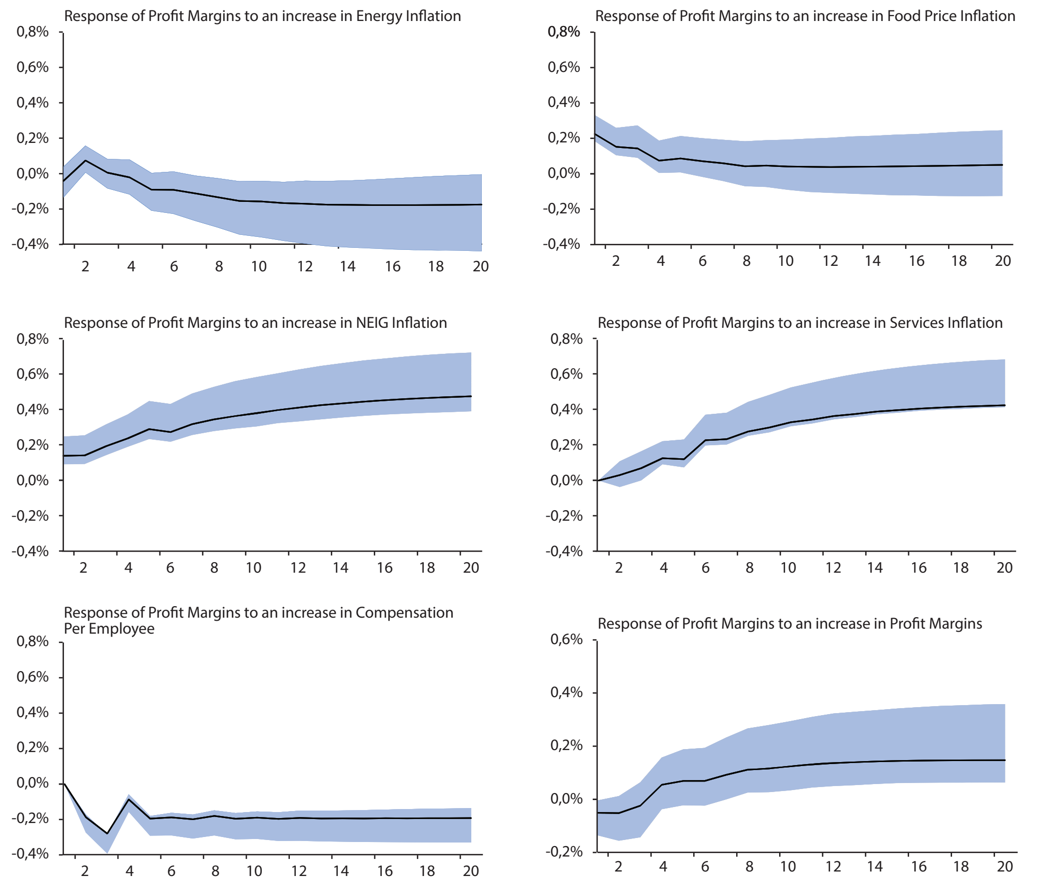
CHART 3 **Impulse Response Functions**



Source: CBC calculations.

25% of the services inflation in the 2021-2022 period can be attributed to profit margins. This translates to raising services inflation by 0,35% in 2021 and 1,3% in 2022, with the impact on headline inflation estimated at 0,15% in 2021 and 0,50% in 2022. The reduction in inflation forecasted from 2023 onwards, as well as the increase in worker's compensation due to COLA, are expected to result in a slight decrease in profit margins.

The aforementioned conclusions are consistent with the findings of recent studies by the ECB[6] and the European Commission[7]. Furthermore, it is emphasized that the expected decrease in profit margins pertains to the broader macroeconomic level, as results by sector are not currently available. Another study at the sectoral level might help further understand the relationship between profit margins and inflation.

6. European Central Bank Economic Bulletin Issue 4, 2023: Box 3 "How have unit profits contributed to the recent strengthening of euro area domestic price pressures?"
7. European Commission Spring 2023 European Economic Forecast: Box I.2.3: "Profit margins and their role in euro area inflation"

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3. Labour market

Recent developments following the onset of the war in Ukraine have not significantly affected the labour market in Cyprus. According to the latest available labour market statistics, employment showed gradual recovery in 2022, with an annual growth rate of 2,9%, compared to 1,3% in 2021 (**Chart 9**). The increase in employment observed across all sectors, but notably in trade, transportation, hotels and restaurants, and to a lesser extent, in professional services, manufacturing, and information and communication.

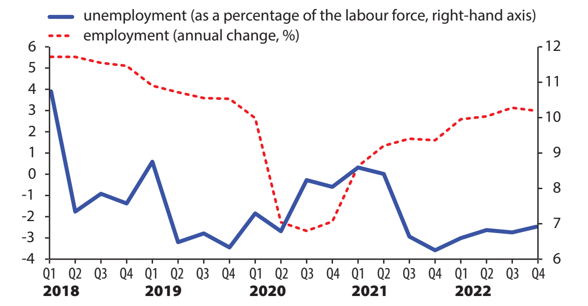
The annual working hours per employed individual recorded a 1,2% increase in 2022 compared with 3,5% in 2021, attributed to a higher increase in employment relative to working hours.

The adverse effects of the Russian-Ukrainian war on unemployment for 2022 are limited. According to data from the Labour Force Survey (LFS), the unemployment rate decreased to 6,8% in 2022 compared with 7,5% in 2021 (**Chart 9**).

Regarding age-specific unemployment, developments (**Chart 10a**), the 25-34 age group contributed the most with a 2,5 percentage point increase to the overall unemployment rate of 6,8% in 2022. A smaller contribution to the overall unemployment rate came from the 15-24 age group, which increased to 18,6% in 2022 compared with 17,1% in 2021, accounting for only 1,5 percentage points of the overall unemployment rate for 2022.

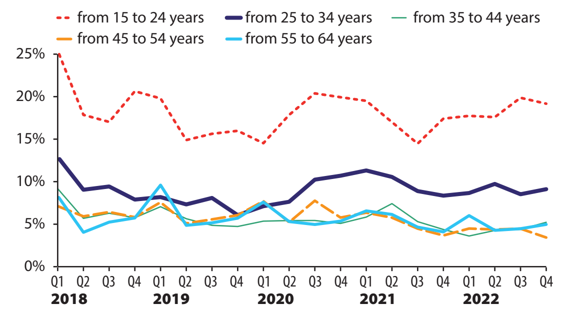
Recent data from the Statistical Service of

CHART 9 **Unemployment and employment**



Source: Cystat (LFS).

CHART 10a **Unemployment rate by age group**
(as a percentage of the labour force)



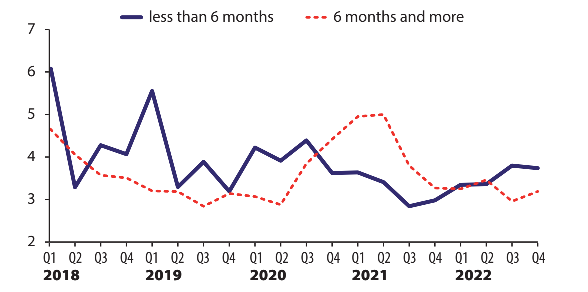
Source: Cystat (LFS).

Cyprus (Cystat) on registered unemployment indicated a continuous declining trend since June 2021 (**Chart 11**), with the most recent figures for April 2023 showing a year-on-year decrease of 3,3% (from 11,664 to 11,284 individuals). Apart from the significant impact of GDP recovery, it should be noted that the substantial reductions in registered unemployment data from the second half of 2021 were expected due to the termination of automatic renewals of registered unemployed individuals and new registrations without physical presence, a system introduced in March 2020 during the pandemic.

A critical factor in analyzing labour market developments is the stabilization of long-term unemployment at low levels. According to the LFS, the percentage of unemployment rate of over six months was 3,2% in the fourth quarter of 2022, remaining at the same levels as the corresponding quarter of the previous year (**Chart 10b**). These figures are encouraging, indicating labour market stability.

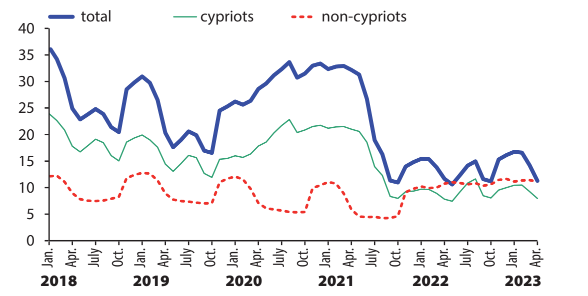
Regarding the potential issue of generalized labour market shortage, this does not seem to be a concern. According to the LFS data, the influx of foreign labour continues, which can meet the staffing needs of companies. Additionally, the research highlighted a significant increase in job vacancies in 2022, primarily in the tourism industry. This partly reflects the strong economic recovery and the continued resilience of the labour market, where long-term unemployed individuals can gradually be absorbed into the labour force, given the enhanced capacity of Public Employment Services to place unemployed people in job vacancies.

CHART 10b **Unemployment by duration**
(as a percentage of the labour force)



Source: Cystat (LFS).

CHART 11 **Registered unemployment**
(number of unemployed, thousands)



Source: Cystat.

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4. Balance of payments[2]

The current account deficit widened to €2.463,3 million (-9,1% of GDP) in 2022, compared with a deficit of €1.638,2 million (-6,8% of GDP) in 2021 (**Table A.6**). Adjusted for the impact of SPEs, which concern mostly ships and aircrafts, the deficit stood at 10,4% of GDP in 2022, compared with 8,1% of GDP) in 2021 (**Chart 12**). The deterioration of the deficit was mainly attributed to the goods balance, given the inflationary pressures observed following Russia's invasion in Ukraine and the sanctions imposed against Russia.

In particular, the trade deficit of goods worsened to €5.883,5 million in 2022, compared with a deficit of €4.317,8 million in 2021. All categories of goods imported for home consumption have been affected by the inflationary pressures caused by supply chain disruptions, as well as the quick recovery of domestic demand following the pandemic. Significant increases were recorded in the category of fuel and lubricants, consumer, intermediate and capital goods, as well as transport equipment. Exports of domestic goods and goods in transit also recorded an increase.

The surplus of the services balance increased by €762,6 million, partly offsetting the deficit in the trade account (**Table A.7**, p. 31). More specifically, in 2022 exports of services increased by €2.931,6 million whereas imports of services increased by €2.169,0 million. The travel sector recovered signifi-

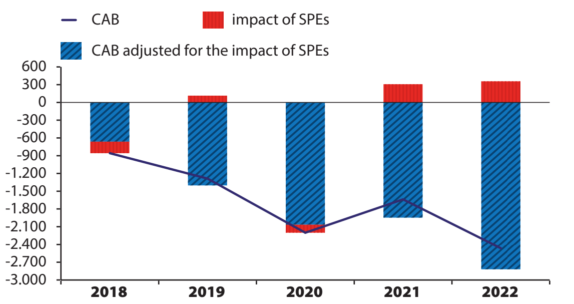
2. The external statistics data are significantly affected by the classification of SPEs as residents of Cyprus and, in particular, by those which are considered as economic owners of mobile transport equipment (mainly ships). The transactions of SPEs do not affect nor are affected substantially by the domestic economic cycle.

TABLE 6 **Balance of payments (main categories)**

	2021 (€ million)	2022 (€ million)	Change (€ million)
Current account balance	**-1.638,2**	**-2.463,3**	**-825,1**
Current account balance adjusted for the impact of SPEs	**-1.946,5**	**-2.819,9**	**-873,4**
Goods and services balance	**701,8**	**-101,3**	**-803,1**
Trade balace	**-4.317,8**	**-5.883,5**	**-1.565,7**
Exports of goods	3.589,7	4.570,2	980,5
of which:			
Exports of goods - SPEs	1.116,2	1.376,7	260,5
Imports of goods	7.907,5	10.453,7	2.546,2
of which:			0,0
Imports of goods - SPEs	1.193,1	1.401,8	208,7
Services balance	**5.019,5**	**5.782,2**	**762,6**
Exports of services	17.214,7	20.146,4	2.931,6
Imports of services	12.195,2	14.364,2	2.169,0
Primary income (net)	**-2.029,2**	**-2.145,8**	**-116,6**
Secondary income (net)	**-310,7**	**-216,2**	**94,6**
Current account balance (% of GDP)	**-6,8**	**-9,1**	
Current account balance adjusted for the impact of SPEs (% of GDP)	**-8,1**	**-10,4**	

Sources: Cystat, CBC.

CHART 12 **Current account balance (CAB)**
(€ million)



Sources: Cystat, CBC.

cantly, recording an annual increase in tourist receipts of €960,8 million (53,9%) and despite the loss of the Russian market, due to increased tourist flows from mostly European countries. The Information, Communications and Technology (ICT) sector recorded an annual increase in revenue of €1.637,0 million (41,6%), due to the continues attraction of foreign businesses to set up and/or expand their operations in Cyprus (headquartering). Other business services recorded a decline in receipts of €97 million (-6,5%), while financial services receipts remained stable compared with 2021. The duration of the war and the sanctions will determine the size of the impact on the sectors of foreign trade.

The deficit in the primary income account, which mainly includes income from employment and investment, widened by €116,6 million, in 2022. This development is mainly associated with the income from portfolio investments. More specifically, the decline in Cypriots' income from abroad was larger than the decline in foreigners' income in Cyprus. On the contrary, the deficit in the secondary income account, which mainly includes current transfers, shrank by €94,6 million and stood at €216,2 million, as a result of the increase in government inflows from European funds (**Table A.6**, p. 30).

Significant inflows were recorded in the financial account in 2022, primarily due to the decrease in net assets owned by the private sector.

The net International Investment Position (IIP) stood at -€28,4 billion (-105,3% of GDP) at the end of 2022, and was mainly affected by the inclusion of the economic transfer of

TABLE 7 **Services balance (main categories)**
(€ million)

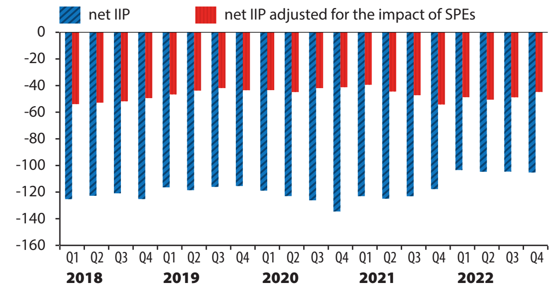
	2021 (€ million)	2022 (€ million)	Change (€ million)
Services balance	**5.019,5**	**5.782,2**	**762,6**
Exports of services	**17.214,7**	**20.146,4**	**2.931,6**
of which:			
Transport	3.359,8	3.584,8	225,0
Travel	1.782,0	2.742,7	960,8
Finanacial services	5.507,2	5.506,2	-1,0
Telecommunications, computer and information services	3.936,0	5.573,0	1.637,0
Other business services	1.492,6	1.395,6	-97,0
Imports of services	**12.195,2**	**14.364,2**	**2.169,0**
of which:			
Transport	2.037,4	2.520,9	483,5
Travel	748,4	1.288,3	539,9
Finanacial services	3.204,2	3.308,5	104,3
Telecommunications, computer and information services	3.047,7	4.021,9	974,1
Other business services	2.246,2	2.368,7	122,5

Source: CBC.

mobile transport equipment by SPEs registered in Cyprus (**Chart 13**). These companies have significant financial liabilities, in particular loans, which are mainly associated with the purchase of ships. While these loans have a direct impact on the net IIP, the respective real assets (ships) do not, thus creating an imbalance in the figures reported. As these companies are financed almost entirely by non-domestic banks, they do not constitute a risk to the Cypriot financial system.

Adjusted for the impact of SPEs, net IIP improved by 64,4 percentage points, standing at -€11,0 billion or -40,9% of GDP at the end of 2022, compared with -€10,8 billion (-44,8% of GDP) at the end of 2021 (**Chart 13**). It is noted that the improvement in net IIP was due to the GDP recovery. It is further noted that net IIP as a percent of GDP at the end of 2022 moved closer to the -35% threshold of the Macroeconomic Imbalance Procedure set by the European Commission.

CHART 13 **Net International Investment Position (IIP)**
(as a percentage of GDP)



Sources: Cystat, CBC.

Tourism

Tourism constitutes a major pillar of Cyprus' economic growth, which is recovering at a faster than expected speed. More specifically, the sector is recovering from the huge blow that the sector experienced during the pandemic, but also, the loss of the Russian tourist market, the second largest market for Cyprus after the UK, due to the sanctions imposed on Russia as a result of the war in Ukraine. It is noted that during 2022, tourist receipts and arrivals reached 91% and 80% respectively of the levels of 2019, the record year prior to the pandemic.

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More specifically, in 2022 tourist arrivals reached 3,2 million, recording a 65,3% growth on an annual basis (**Table 8** and **Chart 14a**). Most tourists came from the UK (1,2 million) and Israel (277 thousand). Significant improvements in tourist flows were also recorded from EU countries, such as Germany, Poland, France and the Scandinavian countries. As a result, the percentage of tourist arrivals from EU countries stood at 40,8% in 2022, compared with 35,8% in 2021. Based on more recent data, a significant improvement in tourist arrivals is recorded in the first four months of 2023, compared with the corresponding period of 2022 (37,9%). Although data for the first four months of the year correspond to winter months, which contribute less to whole year arrivals compared with the summer months, they offer a positive signal for this year's tourist season.

Tourist revenue increased in 2022 and stood at €2.439 million, compared with €1.513 million in 2021 (**Table 8**, p. 33 and **Chart 14b**). This development was driven by the increase in tourist arrivals, despite the fact that per capita expenditure was reduced by 2,5% as a result of the shorter duration of stay compared with 2021. Tourist revenue continue to be elevated in the first two months of 2023 compared with 2022, despite the ongoing decline in the average duration of stay, from 12,7 days in 2022 to 7,9 days in 2023.

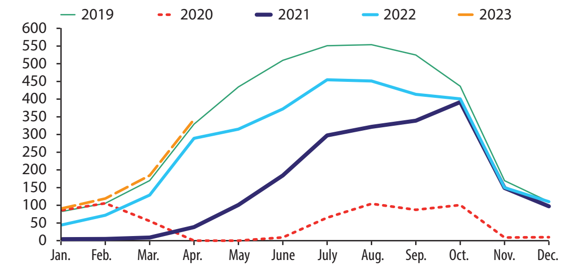
Factors that contributed to the revival of the tourist industry include, among others, aviation incentive schemes that target the improvement of air connectivity and the development of new routes, government measures to support domestic tourism, and

TABLE 8 **Tourism**

	Tourist arrivals (thous.)	Tourist receipts (€ million)	Expenditure per person (€)
2021	1.936,9	1.513,6	781,5
2022	3.201,1	2.439,2	762,0
annual % change	65,3	61,2	-2,5
2022 Jan. - Feb.	115,9	67,8	585,0
2023 Jan. - Feb.	209,6	102,2	487,6
annual % change	80,8	50,7	-16,6
2022 Jan. - Mar.	534,0	n/a	n/a
2023 Jan. - Mar.	736,6	n/a	n/a
annual % change	37,9	n/a	n/a

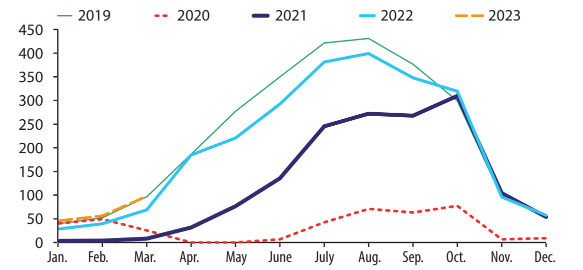
Source: Cystat.

CHART 14a **Tourist arrivals**
(number of persons, thousands)



Source: Cystat.
Note: Due to pandemic COVID-19 entrance to the Republic was prohibited for the period 15/3-8/6/2020 and since then threre was a gradual lifting of the restrictive measures

CHART 14b **Receipts from tourism**
(€ million)



Source: Cystat.
Note: Due to pandemic COVID-19 entrance to the Republic was prohibited for the period 15/3-8/6/2020 and since then threre was a gradual lifting of the restrictive measures

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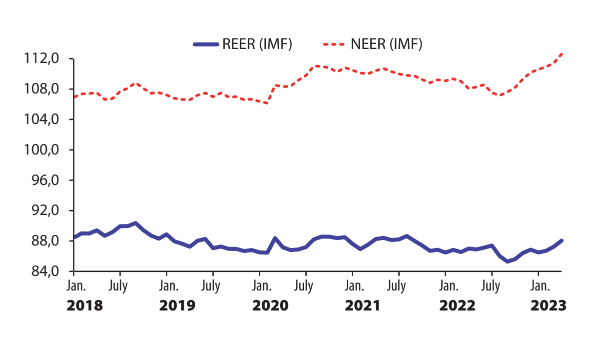
the extension of the tourist season. Other important developments include hotel renovations and new infrastructure building, such as the construction of luxury hotels, marinas and the commencement of operations of the casino-resort. Furthermore, the National Tourism Strategy 2030 goals include the promotion of rural, mountainous and remote areas as tourist destinations (e.g. Christmas villages).

Despite the uncertainties around the length and outcome of the war in Ukraine and the related sanctions imposed against Russia, the strong dynamism of the Cypriot tourism product is expected to continue for the remainder months of 2023, such that it outperforms the results of record year 2019 (see Macroeconomic Forecasts).

Effective exchange rate

Chart A.15 shows the effective exchange rate (EER) index of the euro in Cyprus, in nominal (NEER) and real (REER) terms, as calculated by the IMF. Between January and August 2022 both indices appear to have moved downwards recording exchange rate depreciation, while later moved upwards recording exchange rate appreciation. The upward movement of the indices continued in the period Jan. – Apr. 2023. Overall, the trend of the REER index and the gap between the NEER and REER indices were influenced by the developments in the nominal value of the euro against other currencies, but also by the lower inflation recorded in Cyprus compared with its trading partners.

CHART 15 **Real and nominal effective exchange rates (IMF weights)**
(base year 2010=100)



Source: IMF.

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The REER index, the inflation rate, as well as the unit labour costs that have been analysed in the previous section, are important measures of the competitiveness of an economy. Lower unit labour costs (see Labour Costs, p.21) and a lower REER in Cyprus compared with competing countries suggest that domestic exports tend to be more price competitive. In general, inflation is related to, among other factors, the variables mentioned above and therefore reflects the degree of competitiveness of the Cyprus economy.

5. Financing conditions and credit developments[3,4]

The Cypriot banking system remains resilient against exogenous shocks such as the continuation of the war in Ukraine, with the domestic private sector deposits recording positive annual growth rates in the first quarter of 2023. Specifically, domestic private sector deposits recorded an annual increase of 5.5% in March 2023 compared with 3.2% in December 2022 and 3.8% in March 2022. The acceleration recorded in deposits growth was supported by the robust economic growth and also by a base effect, despite the fact that high inflation weighs on households' real disposable income. Moreover, the current macroeconomic uncertainty related to the ongoing geopolitical instability has also led to an increase in deposits, reflecting precautionary motives as a safety net for the future.

Domestic household deposits remained robust and exhibit an upward trend since June 2022, reflecting strong economic activity and the continuous improvement in employment, which reinforced household saving capacity. Specifically, domestic household deposits recorded an annual growth of 5,2% in March 2023 compared with 4,8% in December 2022 and 2,8% in March 2022. At the same time, the annual growth of domestic non-financial corporations deposits stood at 7,6% in March 2023 compared with 5,4% in December 2022 and 8,5% in March 2022, maintaining liquidity buffers amid heightened

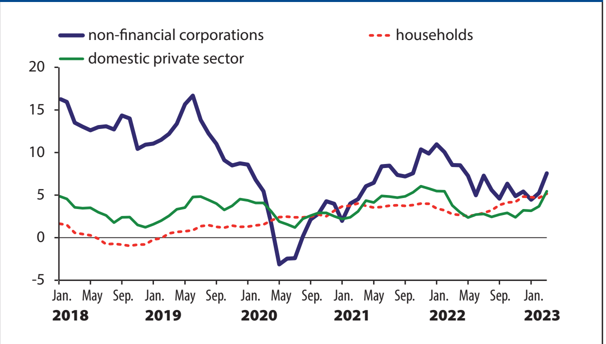
3. For a detailed explanation of the methodology and technical analysis of monetary aggregates (deposits and credit growth), see Technical Notes on p.57.
4. The analysis on deposits and credit growth in this section of the Economic Bulletin focuses on domestic residents excluding SPEs. SPEs are included in the non-residents category unless otherwise stated.

uncertainty over future economic prospects but also due to a base effect. Moreover, non-financial corporation deposits were bolstered by the good performance of important sectors of the economy underpinned by the recovery in turnover and in tourism receipts (**Chart 16**).

At the same time, non-resident deposits[5] continue to register negative annual growth rates since May 2022, mostly reflecting the impact of the sanctions imposed to Russia and the gradual phasing out of RCB's banking operations. Specifically, their annual growth, stood at -6,0% in March 2023 compared with -8,7% in December 2022 and 2,7% in March 2022, continuing their downward trend broadly recorded since the 2013 financial crisis (**Chart 17**).

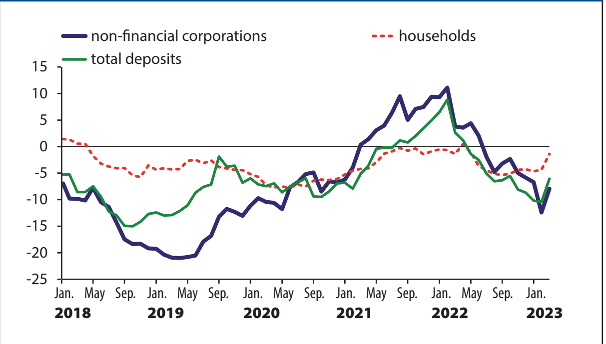
Turning to credit developments, the moderation in new lending to the non-financial private sector[6] after 2022Q1 which mainly related to housing loans, persisted in 2023Q1. The moderation reflects the impact of rising interest rates coupled with high inflation, despite its gradual deceleration since August 2022. These factors have been eroding households' disposable income and firms' profit margins while increasing economic uncertainty. Consequently, both interested borrowers and banks are more cautious regarding new lending. New lending to the non-financial private sector decreased to €756 million in 2023Q1 compared with €911 million in the same period of 2022 (**Chart 18**). The decrease in new lending primarily pertains to new housing loans to households. Specifically, new housing loans in 2023Q1 decreased to €244 million compared with €437 million in

CHART 16 **Deposits of the domestic private sector**
(annual change, %)



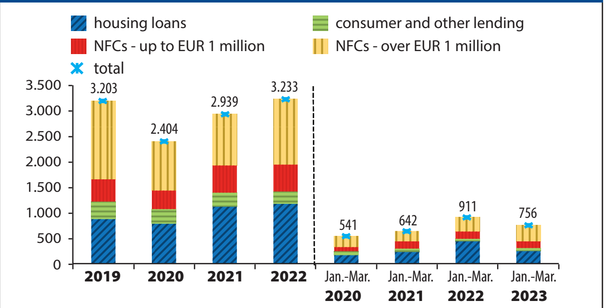
Source: CBC.

CHART 17 **Deposits of non-residents: Cyprus**
(annual change, %)



Source: CBC.

CHART 18 **Volumes of pure new loans (euro-denominated) to euro area non-fianancial corporations and households**(1)
(€ million)



Source: CBC.
1. Pure new loans include all new loan contracts within the reference period.

5. Including SPEs.
6. New loan contracts (euro-denominated) to euro area non-financial corporations and households.

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2022Q1. In contrast, new lending to non-financial corporations, despite tightening financial conditions, has so far remained broadly stable at €448 million in 2023Q1 compared with €420 million in 2022Q1. This sustained high level of new lending to enterprises appears to reflect their increased financing needs to cover current operational expenses stemming from high production costs and the need to build up inventory. On the other hand, in the face of macroeconomic uncertainty, demand for financing investments continued to decline (see Bank Lending Survey results below).

In line with the trends observed in new lending and the rise in repayments, likely influenced by higher interest rates, the annual growth rate of net loans[7] to the domestic private sector[8] has significantly slowed down since mid-2022, registering no annual change in February and March 2023. Specifically, the annual growth rate of net loans in this sector decelerated to 0,0% in March 2023, from 3,2% in June 2022 and 3,3% in December 2021. This development is mainly driven by net loans to domestic non-financial corporations, with annual growth rates turning negative as of end-2022. Specifically, the annual growth rate of net loans to non-financial corporations stood at -1,6% in March 2023 from 4,9% in April 2022. With new lending to non-financial corporations remaining broadly stable (see above), negative growth rates in net loans seem to reflect increased loan repayments by corporations with sufficient liquidity, a response to the escalating lending rates. At the same time, the annual growth rate of net loans to domestic households has deceler-

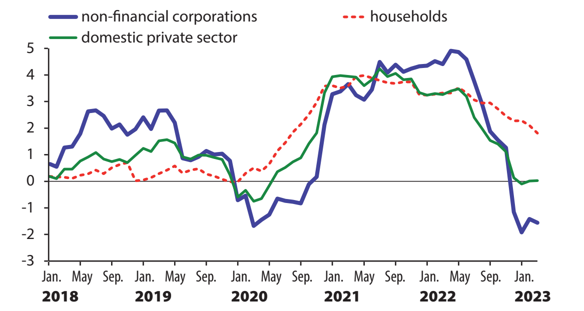
7. New lending plus capitalisation of interest minus repayments.
8. Domestic private sector refers to non-MFIs domestic residents, excluding SPEs and general government.

ated since mid-2022, declining to 1,8% in March 2023 (**Chart 19**). Specifically, as regards the categories of loans to domestic households, housing loans recorded an annual increase of 4,0% in March 2023, albeit registering a gradual deceleration. By contrast, the annual growth rates of both consumer credit and other lending to domestic households at end-March 2023 remained negative, standing at -0,3% and -8,1%, respectively (**Table 9**), indicating that annual repayments in these loan categories surpassed new lending.

On the lending supply side, given the macroeconomic developments, banks maintain a cautious approach to their lending policies, aiming to mitigate the creation of new non-performing loans. According to the latest Bank Lending Survey[9] (April 2023) results, credit standards for loans to enterprises tightened further in 2023Q1. At the same time, credit standards for all lending to households, remained unchanged in 2023Q1, thus remaining at the tightened levels reached at the end of 2022 (**Table 10**). The tightening of credit standards across all loan categories since 2020 was primarily a result of heightened credit risk perceptions among the banks participating in the Survey, amid the successive crises, and their reduced risk tolerance.

At the same time, according to the participating banks, net loan demand in Cyprus, both by enterprises and by households, for all loan categories, continued to decline in 2023Q1 (**Table 10**). The net decline in demand for business loans, which began in 2022Q2, continues to be attributed by banks to reduced demand for financing fixed investment and higher lending rates. Conversely,

CHART 19 **Loans to the domestic private sector**
(annual change, %)



Source: CBC.

TABLE 9 **Loans to domestic households**[(1),(2)]

	Outstanding balance as % of total[(3)]	Annual percentage change 2021 Dec.	2022 Mar.	2022 June	2022 Sep.	2022 Dec.	2023 Mar.
Domestic households	100,0	3,3	3,3	3,3	3,0	2,3	1,8
1. Consumer credit	11,0	1,0	0,5	0,5	-0,4	-2,0	-0,3
2. Lending for house purchase	77,5	5,0	5,5	5,7	5,6	5,0	4,0
3. Other lending	11,4	-2,3	-4,1	-5,3	-7,1	-7,9	-8,1

Source: CBC.
(1) Sectoral classification is based on ESA 2010.
(2) Including non-profit institutions serving households.
(3) As at the end of the last month available. Figures may not add up due to rounding.

TABLE 10 **Banking Lending Survey (BLS)**

Summary of BLS results - April 2023	Cyprus 2023Q1	2023Q2 (expectations)
Credit standards for loans		
Enterprises	Tightening	Tightening
Households		
- *Housing loans*	Unchanged	Unchanged
- *Consumer credit and other lending*	Unchanged	Unchanged
Demand for loans		
Enterprises	Decrease	Decrease
Households		
- *Housing loans*	Decrease	Decrease
- *Consumer credit and other lending*	Decrease	Decrease

Source: CBC.

9. Detailed analysis of the survey results for Cyprus is available on the CBC website (Central Bank of Cyprus - Bank Lending Survey).

demand for inventory and working capital financing has continued to rise as businesses continue to face increased production and operating costs. As for housing loans, the downward trend in loan demand is mainly attributed to the conclusion of the government's interest subsidy scheme for new housing loans in early 2022, followed by deteriorating consumer confidence, higher lending rates and less favourable housing market prospects. Similarly, the drop in demand for consumer credit and other lending by households since the beginning of 2022 is attributed to the decline in consumer confidence, higher interest rates as well as the decrease in spending on consumer durables.

A further tightening of credit standards is expected in 2023Q2, coupled with a further decline in loan demand, both for loans to enterprises and for all categories of loans to households (**Table 10**, p. 39), indicating a continued moderation in new lending in the coming months.

Regarding the quality of banks' loan portfolios, domestic banks, particularly the larger ones, have made significant progress in reducing NPFs[10] in recent years. The downward trajectory should be continued, encompassing the remaining banks, to better align with the EU average. It is important to note that, despite persistent pressures from high inflation and rising lending rates, no significant new inflows of NPFs have been observed to date. On the contrary, the outstanding amount of NPFs in the banking system continues to decline. Under the present macroeconomic conditions, the need to maintain and enhance the quality of banks'

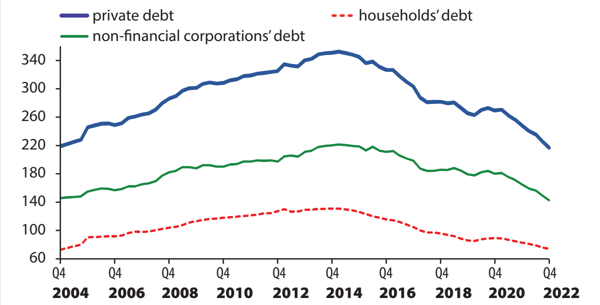
10. All credit institutions operating in Cyprus (domestic operations only).

loan portfolios, with a specific focus on new lending and timely management of any potential deterioration, is amplified. Based on the latest available data, the outstanding amount of NPFs in the banking sector stood at €2,3 billion. (9,3% of total loans) in February 2023 compared with €22,1 billion. (45,7% of total loans) in January 2018. This significant reduction was primarily achieved through sales/transfers of loan portfolios to credit acquiring companies (CACs) as well as organic reductions such as loan write-offs, loan repayments and debt-to-asset swaps (real estate). It should be noted, as highlighted in previous bulletins, that, while selling NPFs to CACs improves the quality of the banking sector's loan portfolio quality, these loans remain part of private debt as they continue to burden borrowers.

Since 2015, the domestic private non-financial sector[11] debt to GDP has been on a downward trajectory, with a temporary increase recorded in 2020 (**Chart 20**), due to the pandemic-related slowdown in economic activity. Specifically, the private debt-to-GDP ratio decreased by 136 percentage points (-38%) from its peak in 2015Q1 until the end of 2022 (latest available data), standing at 217% compared with 248% at the end of 2021 and 353% at the end of 2015Q1. The overall decline was mainly driven by the increase in nominal GDP (denominator effect) and loan write-offs.

Despite the reduction, private debt in Cyprus remains high compared to other euro area countries. A significant contributing factor is the inclusion of the debt of non-financial special purpose entities (SPEs) in private debt in Cyprus. These entities, al-

CHART 20 **Private non-financial sector(1) debt as a % of GDP(1)**
(%)



Sources: CBC, Cystat.
(1) The private non-financial sector consists of the non-financial corporations and the households.

11. The domestic non-financial private sector consists of domestic non-financial corporations (including Special Purpose Entities (SPEs)) and domestic households.

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though registered/established in Cyprus, have minimal or no connection with the domestic real economy. Excluding the debt of these SPEs, the private debt ratio decreases to 163% of GDP at the end of 2022. Equally significant is the ongoing inclusion of a large part of legacy loans in private debt, contracted prior to the 2013 financial crisis and subsequently transferred/sold to CACs.

In the current environment of heightened interest rates, inflationary pressures and geopolitical uncertainty, the prevalence of a high proportion of floating rate loans in Cyprus could have adverse implications for the sustainability of new debt. Nevertheless, banks' prudent lending policies, by granting new loans after the 2013 financial crisis under stricter supervisory guidelines and criteria, as well as the CBC's macroprudential measures in effect, such as the debt service to income ratio, which limits newly issued loans as a function of household disposable income, seem to be safeguarding the country's financial stability, with the default rate of new loans remaining at low levels.

Considering the above and the CBC's latest macroeconomic forecasts, private debt in Cyprus is expected to continue declining in the forthcoming years, mainly supported by nominal GDP growth. It is noted that the reduction of the private debt-to-GDP ratio below the European Commission's 133% threshold is anticipated to occur over time, particularly with the consolidation of the debt held by the CACs.

Domestic lending rates recorded a significant ascent since the second half of 2022, with the increases becoming more pronounced in

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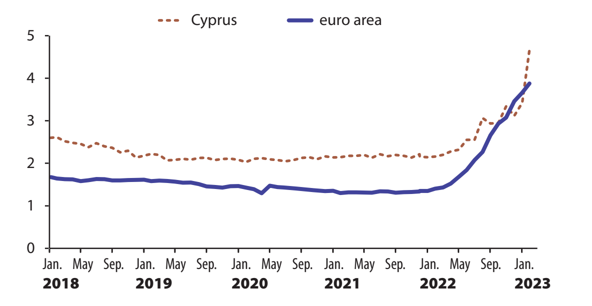
the first months of 2023, reflecting the successive increases in the ECB's key interest rates and the tightening of financial conditions.

Specifically in March 2023, the average interest rate on new euro-denominated loans from Cyprus MFIs to households with an initial rate fixation of up to one year, stood at 5,05% for consumer credit, 4,67% for house purchase and 4,28% for other lending. Indicatively in December 2022, the above mentioned interest rates stood at 4,21%, 3,34% and 3,79 respectively (**Chart 21**). It is worth noting that since July 2022, the increase in housing lending rates has been more contained compared with the Euribor increase. This is due to the fact that a significant proportion of housing loans is not linked to Euribor but to the bank's base rate which has not recorded substantial increases so far. Moreover, a positive development is the intention of certain banks to activate schemes to reward existing performing borrowers for primary residence mortgages, to ensure their debt servicing capacity.

A stronger upward trend seems to be reflected in Non-financial corporations'[12] lending rates which recorded a higher interest rate pass-through. It should be noted that the average interest rate on new loans to NFCs for amounts up to €1 million stood at the highest level of the last eight years and more specifically at 5,60% in March 2023, compared with 4,71% in December 2022 and 3,14% in March 2022. It should be noted that increases have been recorded since the second half of 2022, becoming more pronounced in the first quarter of 2023. The average interest rate for new loans to NFCs for amounts over €1 million followed a similar

CHART 21 **MFI interest rates on euro-denominated housing loans (new business) to euro area households[(1)]**
(% per annum, period averages)



Sources: SDW (ECB), CBC.
(1) With floating rate and up to 1 year initial rate fixation.

12. New business with initial interest rate fixation up to one year.

trend reaching 5,29% in March 2023, from 3,52% and 3,28% in December and March 2022 respectively (**Chart 22**).

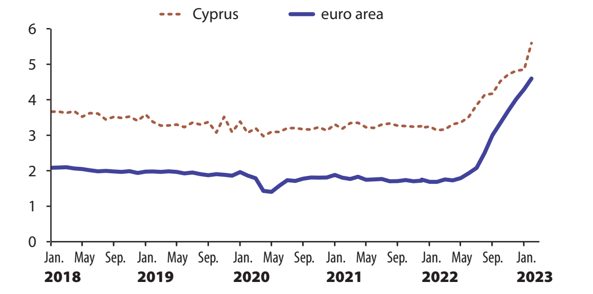
Lending rates in Cyprus overall fluctuate at higher levels compared with the respective EA average. During the period December 2022 - March 2023, the spread between domestic and euro area lending rates for housing loans increased by 53 basis points, while for non-financial corporations for loans up to €1 million decreased marginally by 2 basis points, reaching 79 and 100 basis points, respectively.

Deposit interest rates remained relatively low during 2022, with some increases observed in the first months of 2023, more pronounced in non-financial corporation deposit rates. The limited adjustment in deposit rates seems to be related to the abundant liquidity currently maintained by domestic banks, accumulated as a result of the continued expansionary monetary policy of the ECB in the previous years. Furthermore, it should be noted that a significant part of deposits are held in current and saving deposits accounts which are priced very low throughout Europe due to their characteristics (close to 0%). The shift of depositors to longer term deposits with higher yields is still at early stage in Cyprus.

Indicatively, the average interest rate[13] on new household deposits increased to 0,47% in March 2023 compared with 0,35% and 0,05% in December and March 2022 respectively (**Chart 23**). The corresponding interest rate for non-financial corporations increased significantly, reaching 1,12% in March 2023 compared with 0,61% in December 2022 and -0,01% in March 2022 (**Chart 24**).

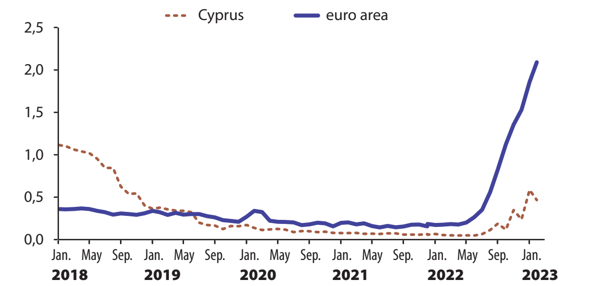
13. Average interest rate with an agreed maturity of up to one year.

CHART 22 **MFI interest rates on euro-denominated loans (new business) up to €1 million to euro area non-financial corporations(1)**
(% per annum, period averages)



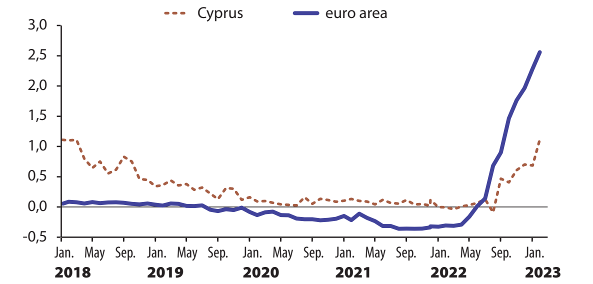
Sources: SDW (ECB), CBC.
(1) With floating rate and up to 1 year initial rate fixation.

CHART 23 **MFI interest rates on euro-denominated deposits (new business) by euro area households(1)**
(% per annum, period averages)



Sources: SDW (ECB), CBC.
(1) With agreed maturity up to 1 year.

CHART 24 **MFI interest rates on euro-denominated deposits (new business) by euro area non-financial corporations(1)**
(% per annum, period averages)



Sources: SDW (ECB), CBC.
(1) With agreed maturity up to 1 year.

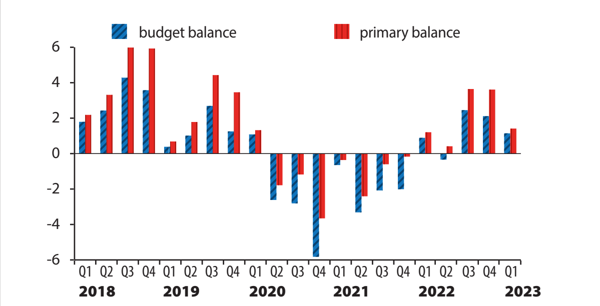
6. Fiscal developments

The government budget balance remained in surplus in the first quarter of 2023, reflecting the base effect of the strong economic recovery during the previous year. According to CyStat data, the budget surplus reached 1,1% of GDP in the first quarter of 2023, compared with a surplus of 0,9% of GDP in the respective quarter of 2022 (**Chart 25** and **Table 11**). For the same period, the primary surplus reached 1,4% of GDP, compared with a surplus of 1,2% of GDP in the respective period of 2022.

In the current year, inflationary pressures, which boosted government's total revenue and had a positive impact on the budget balance in 2022, appear to have an impact on government's expenditure side as well, through the automatic indexation of public sector wages and pensions and the increased cost of purchasing goods and services. Consequently, the increase in government's total spending in the first quarter of 2023 reached at 11,2% compared with the corresponding quarter of 2022, while for the last quarter of 2022 total spending increased at a lower rate – 6,3% compared to the corresponding quarter of 2021.

Public revenue recorded an increase of 13,7% compared with the corresponding period of the previous year (**Table 11**), mainly reflecting the increase in receipts from current taxes (26,7%), social contributions (15,1%) and taxes on production and imports (8%). The increase in revenues from current taxes mainly reflects the rise in firms' operating profits and to a lesser extent the increase in

CHART 25 **Budget and primary balances of the general government**
(cumulative for the year as from Q1 as a percentage of GDP)



Sources : Cystat, CBC.
Note: The budget and primary balance for 2018Q3 do not include the fiscal impacts of the measures associated with the Cyprus Cooperative Bank (CCB) (€1,5 billion) .

nominal wages. The increase in nominal wages also had a positive impact on revenues from social contributions. The growth in revenues from taxes on production mainly reflects the increases in prices of goods and services, as aggregate demand in the first quarter of 2023 continued to exhibit relative resilience, despite the negative impact that price increases started to have on it.

Public expenditure recorded an increase of 11,2%, compared with the corresponding period of the previous year (**Table 11**), mainly reflecting the significant increases in social payments (9,6%), compensation of employees (9,4%) and government investment (80,6%). The increase in social payments was affected, among other factors, by the government subsidy on electricity bills, which continued since September 2022. The increase in compensation of employees was affected by the payment of COLA and the final stage of the restitution of public sector wages, which fully reversed the wage cuts implemented in December 2012.

As regards government debt (**Chart 26**), it stood at 80,3% of GDP in March 2023, recording a decrease of more than 9 percentage points compared to March 2022. This was mainly due to the strong economic recovery and to a lesser extent the robust primary surplus.

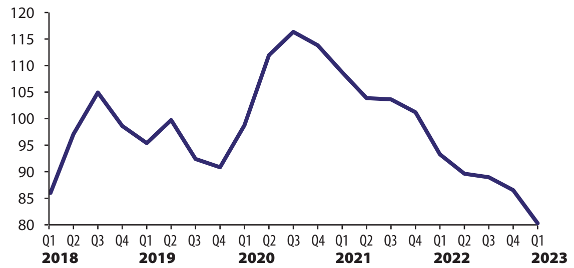
Public debt-to-GDP ratio is expected to decline significantly in the coming years, reflecting the estimates for continued recovery in economic activity (albeit at a slower rate) and primary surpluses. It is noted that rating agencies expect a significant reduction in government debt; thus, any

TABLE 11 **Accounts of general government**

	Jan.-Mar. 2022 (€ million)	Jan.-Mar. 2023 (€ million)	Change %
EXPENDITURE			
Intermediate consumption	211,9	247,1	16,6
Compensation of employees	719,5	787,0	9,4
Social transfers	925,3	1.013,9	9,6
Interest	85,5	77,6	-9,2
Subsidies	20,7	21,2	2,4
Other current expenditure	164,2	168,8	2,8
Gross fixed capital formation	73,3	132,4	80,6
Other capital expenditure	25,9	26,6	2,7
Total expenditure	**2.226,3**	**2.474,6**	**11,2**
Total expenditure as a % of GDP	**8,2**	**8,6**	
REVENUE			
Taxes on production and imports	903,1	975,6	8,0
Current taxes on income, wealth, etc	609,8	772,5	26,7
Social contributions	733,2	844,2	15,1
Other current revenue	47,5	41,4	-12,8
Sales	146,2	142,5	-2,5
Capital transfers received	4,1	4,4	7,3
Property income	22,3	23,1	3,6
Total revenue	**2.466,2**	**2.803,7**	**13,7**
Total revenue as a % of GDP	**9,1**	**9,7**	
Primary balance	**325,4**	**406,7**	
Primary Balance as a % of GDP	**1,2**	**1,4**	
Budget Surplus (+) / Deficit (-)	**239,9**	**329,1**	
Surplus (+) / Deficit (-) % of GDP	**0,9**	**1,1**	

Sources: Cystat, CBC.

CHART 26 **General government consolidated gross debt**
(as a percentage of GDP)



Sources: Cystat, CBC.

derailment will have a serious impact on the credibility of fiscal policy.

In the current environment of high uncertainty, risks to public finances remain elevated. According to the recommendations of the European Commission in the context of the European Semester, Member States need to phase out the energy support measures by the end of 2023. In Cyprus, according to the existing government's decisions, the measures introduced to mitigate the impact of increased energy prices will expire at the end of the first half of 2023, and it is estimated to amount to around 0,5% of GDP. The Commission states that the continuation of energy support measures can be justified in case of renewed energy prices increases. However, in this case, measures should be targeted at protecting vulnerable households and firms, preserving fiscal sustainability and preserving incentives for reducing the use of fossil fuels and for energy savings.

(B) Macroeconomic Forecasts for the Cyprus Economy[14]

14. Forecasts and assumptions have been prepared taking into account economic developments and available data until the 30th of November 2022.

- *The GDP path over 2023-25 is mainly driven by the expected continuation in domestic demand growth, albeit to a lesser extent compared with 2022.*
- *A relatively small impact of the war and the new sanctions on the labour market is expected, with unemployment continuing to decline in the coming years to 5,6% in 2025.*
- *A significant deceleration in inflation is also expected, due to the gradual decline in oil prices, the slowdown in food prices, as well as the impact of rising interest rates on domestic demand. In 2024 and 2025, inflation is expected to fluctuate closer to the 2% target.*
- *Compared with the baseline scenario, risks to GDP growth are slightly to the downside and for inflation risks are balanced over 2023-25.*

The macroeconomic forecasts presented in this Economic Bulletin were prepared in the context of the Eurosystem's forecast exercises using common technical assumptions.

Compared with the March 2023 projections, there is no substantial revision in GDP growth in 2023 and 2025. The small downward revision by 0,2 percentage points in 2024 is due, in part, to the expected negative impact of the new sanctions relating to the Russian-Ukrainian war on the turnover of professional services. It should be noted that this impact offsets the more favourable than expected developments in the first few months of 2023 as regards private consumption and investment. For 2025, no further impact on GDP growth due to the sanctions relating to the Russian-Ukrainian war on the

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professional services sector is envisaged. Significant support to the economic growth path is expected in 2023-25 from the absorption of financing from the EU's Recovery and Resilience Fund (RRF) for investments, by around 0,8 percentage points per annum.

Regarding inflation, the CBC's updated HICP forecasts do not point to substantial revisions compared with the March 2023 projections. There are also relatively small revisions to the core inflation outlook, (i.e. inflation excluding energy and food), by 0.1 percentage points in both 2023 and 2024 due, in part, to relatively larger than foreseen upward pressures on the prices of non-energy industrial goods as well as on services prices, respectively. The latter is mainly the result of the incorporation of larger second round effects from rises in wages due to the new transition Cost of Living Allowance (COLA) agreement.

Economic Activity

GDP growth is expected to reach 2,6% in 2023 (**Table 12**), compared with a significant GDP expansion of 5,6% in 2022. The slowdown is due to the faster than expected economic opening after the 2021 lockdowns, the still fragile external environment, the impact of restrictive monetary policy on domestic demand, the impact of new sanctions relating to the Russian-Ukrainian war on the turnover of professional services as well as the slower than expected correction of domestic inflationary pressures, which negatively affect disposable income.

In 2024 and 2025, GDP is expected to grow

TABLE 12 **National accounts projections in real terms**
(annual change, %)

	2022	2023f	2024f	2025f
GDP	5,6	2,6	2,8	3,1
Private consumption	7,7	2,0	1,6	2,0
Public consumption	0,1	2,1	2,1	2,5
Gross fixed capital formation	6,6	3,1	7,3	6,8
Exports of goods and services	13,7	2,5	2,5	2,2
Imports of goods and services	18,8	2,1	2,5	2,3

Sources: Cystat, CBC.

by 2,8% and 3,1%, respectively (**Table 12**, p. 50). The expected GDP path is mainly driven by the recovery in domestic demand and, to a lesser extent, on net exports for 2023, in the context of the expansion of the turnover of foreign companies that have already established operations in Cyprus, especially in previous years and that are active in the technology sector, as well as the continued rise in tourism revenues with a recovery back to pre-pandemic levels. The significant increase in tourist arrivals from European countries should be noted, with the relevant share in 2022 amounting to 41% of the total.

In more detail, a significant contribution is expected from large private sector investments that are in progress and which relate to various sectors such as energy, tourism, health and education, from projects supporting the digital and green transition as well as from other reform projects implemented in the context of the Recovery and Resilience Facility (RRF). The contribution from residential investments should also be noted, owing to the government's interest rate subsidisation scheme for new housing loans, relating to agreements finalised by end-2021 and for which the disbursement period is 3 years. Overall, investment is expected to increase by 3.1% in 2023, 7.3% in 2024 and 6.8% in 2025 (**Table 12**, p. 50). Private consumption is projected to decelerate significantly, with growth rates of 2% in 2023, 1.6% in 2024 and 2% in 2025. The expected trajectory of private consumption is a result of the aforementioned base effect relating to year 2022.

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Compensation, productivity and the labour market

The available data reflect the ongoing tightness observed in the labour market and the continued manageable impact from the war as reflected in the European Commission's monthly surveys of employment expectations over the next three months. In line with the positive GDP path, employment is projected to increase by 1% per annum in the years 2023 and 2024 and by 1.2% in 2025 (**Table 13**).

The unemployment rate is expected to record a continued downward trend, reaching 6.7% of the labour force in 2023 and down from 6.8% in 2022 (**Table 13**). In the coming years, and in line with continued GDP growth, the unemployment rate is projected to converge closer to full employment conditions, reaching 5.6% in 2025 (**Table 13**). The relatively small upward revision in the unemployment rate over 2023-25 compared with the March 2023 projections reflects the relatively more subdued pace of economic growth owing to the impact of the sanctions associated with the Russian-Ukrainian war on professional services (accounting, legal). However, the labour market is not expected to be significantly affected.

A significant increase of 8.4% is expected in nominal compensation per employee in 2023, followed by further rises of 5.3% and 4.8% in the years 2024 and 2025, respectively (**Table 13**). The wage outlook reflects the granting of higher COLA, also in line with the new transition agreement, and based on the previous year's prices, as well as the relatively larger increases foreseen in collective agree-

TABLE 13 **Labour market projections**
(annual change, %)

	2022	2023f	2024f	2025f
Compensation per employee	3,8	8,4	5,3	4,8
Unit labour costs	1,0	6,7	3,5	2,9
Productivity	2,7	1,6	1,8	1,8
Total employement	2,9	1,0	1,0	1,2
Unemployment rate(% of labour force)	6,8	6,7	6,1	5,6

Sources: Cystat, CBC.

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ments of some segments of the private sector due to price pressures. In 2024, growth in nominal compensation per employee also captures the rise in social security contribution rates towards the Social Insurance Fund (SIF) that will apply for the next five years. The ongoing correction in the labour market, which is approaching full employment conditions in 2025, is associated with the incorporation of larger second-round effects from wage increases, owing to the new transition agreement concerning COLA, however, it has not, so far, led to a damaging wage-price spiral.

Productivity, following a rise of 2.7% in 2022, is projected to continue its upward trajectory, recording a growth rate of 1.6% in 2023 and 1.8% per annum over 2024-25 (**Table 13**, p. 52). In general, the increase in productivity reflects the positive economic effects from the inflow of foreign companies active in the technology sector as well as from the implementation of investments covered by the absorption of funds from the EU's RRF.

Unit labour costs are expected to rise further in 2023-25 by around 13 percentage points cumulatively (**Table 13**, p. 52), mainly due to the envisaged rises in nominal compensation per employee. A relatively similar cumulative rise is expected to be recorded by the relevant index in the euro area. However, unit labour costs in Cyprus maintain a comparative advantage in relation to the rest of the euro area due to the past reductions in wages, and by consequence, the improvement in competitiveness (see Labour Costs).

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Inflation

Inflation (based on the Harmonised Index of Consumer Prices, HICP) is forecasted to slow significantly in 2023 to 3.3% from 8.1% in 2022, as a result of the ongoing expected correction in energy prices, the full normalisation of supply chain disturbances within 2023 and the foreseen impact of the single monetary policy in the euro area on domestic demand. The contribution of the envisaged reduced company profit margins to the slowdown in inflation in 2023, within the context of the foreseen slowdown in private consumption, should also be noted. Further easing of inflationary pressures is expected in 2024 and 2025, to 2.3% and 2%, respectively, due to the further normalisation in energy and food prices, as well as due to the expected impact of restrictive monetary policy on domestic demand. There are no material revisions compared with the March 2023 forecasts.

Core inflation is expected to decline to 3.7% in 2023, compared with 5% in 2022. In 2024 and 2025, it is projected to reach 2.6% and 2.3%, respectively, mainly due to the full normalisation of supply chain disruptions over 2023 as well as due to the impact of interest rate rises, so far, on demand. The relatively small upward revision by 0.1 percentage points in both 2023 and 2024 compared with the March 2023 projections is explained in part due to the relatively larger than forecasted upward price pressures in non-energy industrial goods and services prices, respectively. The latter is mainly the result of the incorporation of larger second round effects from rises in wages due to the new transition agreement on the Cost of Living Allowance (COLA).

Risk assessment of macroeconomic forecasts[15]

The expected GDP path (**Table A.12**, p. 50), as well as the HICP and the core inflation projections (**Table A.14**) represent the baseline scenario. The probabilities of deviating from the baseline scenario for GDP and HICP are outlined in **Charts A.27** and **A.28** respectively. Possible deviations in the forecast of core inflation are presented in **Chart A.29** (p. 56). A summary of the risk assessment relating to possible deviations from the baseline scenario is presented in **Table A.15** (p. 56).

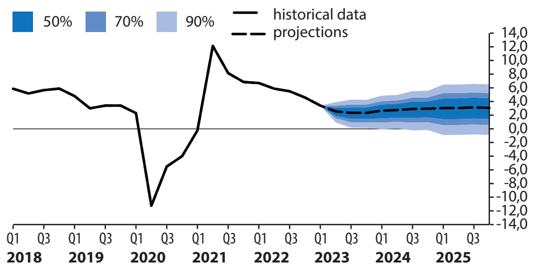
The risks of deviation of the GDP forecasts from the baseline scenario for the years 2023-25 are assessed to tilted slightly to the downside overall. Downside risks include a worse than expected outlook for the external environment, lower than expected performance in professional services exports (accounting, legal) due to new sanctions related to the Russian-Ukrainian war as well as larger and/or more persistent lagged effects from elevated energy prices. They also include tighter than anticipated financing conditions, which may affect domestic demand. They are also associated with a negative impact on domestic demand from possible materialisation of a wage-price spiral, for the years 2024-25 in particular. Downside risks are also related to a lower than expected impact from the absorption of available RRF funds for investments. Upside risks include higher than expected

TABLE 14 **HICP projections**
(annual change, %)

	2022	2023f	2024f	2025f
HICP	8,1	3,3	2,3	2,0
HICP excluding energy and food	5,0	3,7	2,6	2,3

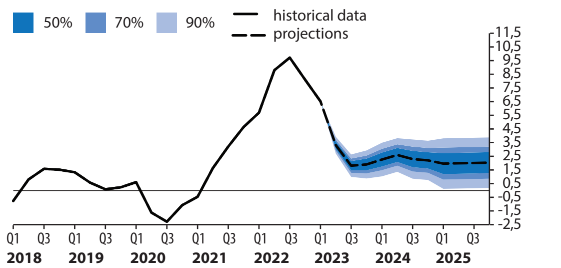
Sources: Cystat, CBC.

CHART 27 **Real GDP fan chart**
(annual change, %)



Source: CBC.

CHART 28 **HICP fan chart**
(annual change, %)



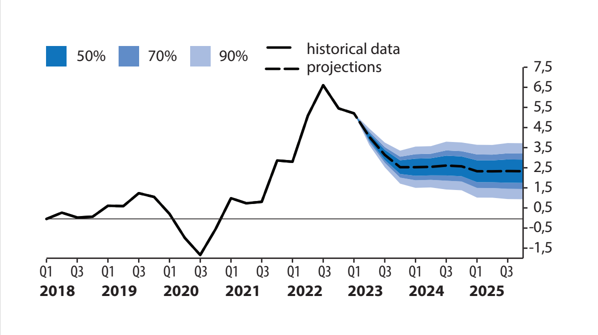
Source: CBC.

15. For further information regarding the methodology of the risk assessment of macroeconomic projections, see *Economic Bulletin*, June 2015, p. 6.

performance in tourism exports (only a small impact from the operation of the casino-resort has been included in the baseline projections) and higher than expected implementation of investment plans by the private sector, also within the context of the head-quartering policy.

The risks of deviation of the HICP inflation forecasts from the baseline scenario for the years 2023-25 are assessed as balanced overall. Upside risks mainly emanate from larger and/or more persistent lagged effects from elevated energy prices. More broadly, upside risks may arise from higher than expected demand-side pressures, for example through better than expected tourism developments and investment. For 2024-25, the possibility of a wage-price spiral coupled with potentially higher long-term inflation expectations constitute upside risks. Downside risks are associated with worse-than-expected financing conditions and lower than expected performance in professional services exports, via the negative impact of the aforementioned factors on domestic demand. Finally, the risks of deviation from the baseline projection for core inflation are also assessed to be balanced, as is the case with HICP inflation.

CHART 29 **HICP excluding energy and food fan chart (core inflation)**
(annual change, %)



Source: CBC.

TABLE 15 **Summary of risk assessment**

Risk	GDP (2023-2025)	Inflation (2023-2025)
Lower than expected impact from absorption of funds from EU support package	-	-
Higher than foreseen implementation of private sector investment projects	+	+
Larger and/or more persistent lagged effects from higher than foreseen energy prices	-	+
Worse than foreseen impact on domestic economic outlook as a result of external environment developments	-	-
Weaker than foreseen impact on non-tourism services exports owing to the sanctions	-	-
Better than foreseen developments in the tourism sector	+	+
Possible materialisation of a wage-price spiral	-	+
Tighter than foreseen financing conditions	-	-
Overall assessment	**-**	**=**

Source: CBC.
Note: the following symbols cover the spectrum of risks: ++, +, =, -, --.

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Technical Notes

(A) Domestic monetary aggregates (deposits and credit grouwth)

All monetary aggregates' data exclude the CBC.

On 1 July 2008, a new definition of residents of Cyprus entered into force (Statistical Purposes Directive, 2008). As a result, MFIs reclassified a large number of organisations or customers' businesses with limited or no physical presence in Cyprus, known as 'special purpose entities (SPEs), from non-residents to residents. The effect of this change is excluded from the monetary and financial statistics series presented in this publication, which reports domestic residents data excluding SPEs. For purposes of normalisation and comparability of monetary time series, data have been further processed by the CBC's Economic Analysis and Research Department.

The calculation of annual percentage changes is based on the methodology used by the ECB. More specifically, the growth of monetary aggregates is calculated based on the monthly differences in outstanding amounts adjusted for amounts that do not arise from transactions, such as reclassifications/other adjustments, revaluation adjustments and exchange rate adjustments, so as to reflect changes due to net transactions.

The above methodology has been adopted since the December 2009 edition of the *Economic Bulletin*. In previous editions of the *Bulletin*, the growth rate of monetary variables was calculated as the annual percentage change of outstanding balances at the end of the period. Details of the methodology can be found in the *Monetary and Financial Statistics*, published by the Statistics Department of the CBC, which is available on the CBC website.

(B) Balance of Payments

The present statistical collection system adopted as of June 2014, is based on the methodology of International Monetary Fund (BPM6), which has also been adopted by the EU, as well as on additional requirements and the level of detail required by both the Statistical Service (Eurostat) and the European Central Bank (ECB).

The adoption of BPM6 by the external statistics of the Cyprus took place in June 2014. In October 2014 was the first publication of the data. The published data for BoP, IIP and external debt cover the period from 2008 to date.

The application of new manuals provided the opportunity to adopt broader changes and revisions to improve the coverage and quality of the statistics of the external sector. Specifically, in addition to the incorporation in all external statistics produced and published of the special purpose entities that are registered / incorporated in Cyprus, the CBC has also upgraded the collection systems and compiling statistics of the external sector, giving greater emphasis to the application of new research and the use of available administrative sources.

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(C) National Accounts

In June 2014 Cystat implemented the new statistical standards for the historical data series since 1995. The ESA 2010 replaces ESA 1995 and is based on the System of National Accounts (ESA) 2008 which is in the process of being implemented worldwide. The aim is to adapt the national accounts to the current economic environment, advances in methodology and changing user needs. Regarding the sectoral classification, ESA 2010 provides a clearer separation between non-financial corporations and corporations that are not directly engaged in the non-financial activities. In particular, holding companies of non-financial corporations and other so-called captive financial institutions as well as certain Special Purpose Entities (SPEs) are now classified under a new category. In parallel, the investment funds sector is now separated from the remaining part of other financial intermediaries and insurance companies are shown separately from pension funds. The ESA 2010 has also adopted changes to the financial accounts.

More details on the methodology of compiling the balance of payments and the national accounts are available in Box 1, p. 51, of the December 2014 *Economic Bulletin* and on the website of the CBC.