

6. Macroeconomic Projections for Cyprus

The Eurosystem prepares and publishes its projections for the euro area on a biannual basis. These projections are used by the ECB's Governing Council for the evaluation of economic developments and inherent risks to price stability. The preparation of euro area projections is undertaken in cooperation with national central bank and ECB staff, based on common working assumptions. It is within this framework that the CBC prepares its projections for the Cyprus economy.

Working assumptions

The projections for the Cyprus economy are based on the Eurosystem's assumptions about the world economy, e.g. commodity prices and financial sector developments. These projections are used to analyse and evaluate the international developments and risks to price stability by the ECB's Governing Council, which is responsible for setting monetary policy in the euro area. These assumptions are the same as those used for the Eurosystem's macroeconomic projections for the euro area and mainly cover variables such as interest rates, exchange rates, the price of oil and international trade. The projections are based on the assumptions and data available as at 24 May 2011.

The working assumptions of the Eurosystem are as follows: the euro is expected to fluctuate at around \$1,42 in 2011 and \$1,43 in 2012. The price of oil is expected to be around \$111,1 per barrel in 2011, while in 2012 it is expected to fall to \$108. The projections concerning the Cyprus economy were prepared by taking into consideration only those fiscal measures which are clearly defined and most likely to be implemented. Thus, fewer measures were taken

into consideration in relation to those included in the Stability Programme and, as a result, public consumption, public investment and private consumption do not reflect the impact of any additional fiscal consolidation measures that the government may possibly adopt within the framework of fiscal consolidation.

Eurosystem projections for the euro area

Based on the above working assumptions, euro area inflation is expected to increase and fluctuate between 2,5% and 2,7% in 2011 compared with 1,6% in 2010 (Table A.10). In 2012 the average increase in HICP inflation is expected to fluctuate between 1,1% and 2,3%, while HICP inflation excluding energy and food is expected to increase gradually. GDP growth is expected to increase further in 2011, rising between 1,5% and 2,3%, while in 2012 euro area GDP is expected to increase between 0,6% and 2,8%. The anticipated recovery in GDP reflects the expected gradual increase in external demand and investment.

Projections for the Cyprus economy

The domestic economy is recovering, although growth remains subdued. The private sector is adopting a wait-and-see stance with respect to investment, while lending to non-financial corporations is at historically low levels. The confidence indicator for households remains in negative territory, while the government, by turning to domestic borrowing, is intensifying competition for bank lending. With interest rates remaining relatively high and domestic confidence at very low levels, growth in 2011 is expected to be driven mainly by external demand. The projections for inflation mainly reflect international developments, with oil

TABLE A.10 Eurosystem projections for the euro area
(annual change,%)

	2010	2011f	2012f
GDP			
June Projections 2011	1,7	1,5 - 2,3	0,6 - 2,8
December Projections 2010	1,6 - 1,8	0,7 - 2,1	0,6 - 2,8
Inflation			
June Projections 2011	1,6	2,5 - 2,7	1,1 - 2,3
December Projections 2010	1,5 - 1,7	1,3 - 2,3	0,7 - 2,3
Source: ECB.			

prices defining the high levels of 2011, as well as the gradual recovery of the domestic economy. Taking into consideration the aforementioned developments, GDP projections for 2011 and 2012 have been revised slightly downwards, compared with those of December 2010.

Prices: harmonised index of consumer prices

Cyprus HICP inflation in 2011 is expected to reach 3,3% compared with 2,6% in 2010 (Table A.11). The significant increase in HICP inflation is mainly due to the increase in oil prices, the increase in electricity prices (1,5% for three consecutive years) and the imposition of 5% VAT on food and pharmaceutical products. In addition, the gradual recovery of domestic demand has exerted an upward pressure on inflation in 2011, which is reflected in higher prices in the sub-categories of industrial goods excluding energy and services. Therefore, as a result of the expected rise in the prices of food and services, HICP inflation excluding energy is expected to increase by 1,9% in 2011 from 0,5% in 2010.

In 2012 HICP inflation is expected to increase by 2,2%, mainly due to the working assumptions for oil prices and the euro/dollar exchange rate. HICP inflation excluding energy is expected to increase by 2,1% in 2012 compared with 1,9% in 2011, reflecting the expected gradual recovery in economic activity.

Compensation, productivity and the labour market

Employment in 2010 registered a marginal increase of 0,2%. It should be noted that employment excluding the category of “private

TABLE A.11 HICP projections
(annual change,%)

	2010	2011f	2012f
HICP			
June Projections 2011	2,6	3,3	2,2
December Projections 2010	2,7	3,4	2,4
HICP excluding energy			
June Projections 2011	0,5	1,9	2,1
December Projections 2010	0,7	2,5	2,0
Sources: Cystat, CBC.			

households with employed persons” registered a decrease of 0,4%, reflecting the generally subdued climate in the labour market.

With the gradual improvement in economic conditions in 2011 and 2012, employment is expected to register a partial recovery (**Table A.12**). In particular, employment is expected to increase by 0,6% and 1,1% in 2011 and 2012, respectively. However, these rates are much lower than those registered before the crisis. Moreover, the new projections for employment are lower than the previous ones, as a result of the downward revision of GDP projections. The Labour Force Survey (LFS) unemployment rate in 2011 is expected to reach 6,2%, remaining at the same level as in 2010, while in 2012 it is projected to fall to 6%. Unemployment for 2011 was revised downwards in the latest projection round due to lower than expected unemployment in 2010. It should be noted that the scenario for unemployment in the latest forecasts is more pessimistic than in the previous forecast round.

In 2011 productivity growth is expected to reach 0,8%, thus remaining at the same level as in 2010, while in 2012 productivity is expected to increase by 1%, as a result of further improvement in economic conditions. Compensation per employee is expected to increase by 2,6% in 2011, while a further increase of 2,7% is expected in 2012. The aforementioned developments in the compensation per employee are partly related to the expected changes in the Cost of Living Allowance (COLA). As regards unit labour costs, these are expected to remain at similar levels in 2011 and 2012, reaching 1,8% and 1,7%, respectively.

National accounts

As far as the national accounts are concerned,

TABLE A.12 Labour market projections
(annual change,%, unless otherwise indicated)

	2010	2011f	2012f
Compensation per employee			
June Projections 2011	2,5	2,6	2,7
December Projections 2010	1,7	2,3	2,6
Unit labour costs			
June Projections 2011	1,6	1,8	1,7
December Projections 2010	0,8	1,3	1,5
Productivity			
June Projections 2011	0,8	0,8	1,0
December Projections 2010	0,9	1,0	1,1
Total employment			
June Projections 2011	0,2	0,6	1,1
December Projections 2010	-0,2	0,8	1,3
Unemployment rate (% of labour force)			
June Projections 2011	6,2	6,2	6,0
December Projections 2010	6,9	6,6	6,0

Sources: Cystat, CBC.

real GDP growth in Cyprus is projected to reach 1,4% in 2011, while further recovery is expected in 2012, with GDP increasing by 2,1%. The projections for 2011 and 2012 have been revised downwards, mainly due to the latest figures for the first-quarter GDP flash estimate and other published indicators for the Cyprus economy, which point towards a more moderate picture for the economy's growth path. More specifically, the flash estimate of the seasonally adjusted quarterly GDP growth in the first quarter of 2011 was 0%, which was lower than expected. The continuing recovery of the economy in 2011 reflects developments in the tourism sector and positive growth registered in the financial services sector, both of which are directly related to the dynamic recovery of our trading partners. Based on economic indicators and current data, the Cyprus economy is expected to register growth of 1,4% in 2011 (**Table A.13**).

Private consumption is expected to register a 0,3 percentage points increase compared with 2010, thus reaching a growth rate of 1,1%, with available data pointing towards very subdued growth in this category. More specifically, consumer loans to households registered smaller growth rates, increasing by 0,4% in March 2011. At the same time, car registrations have been registering negative growth for a period of more than two consecutive years, while retail sales registered a small increase. On the other hand, public consumption is expected to register a decrease of 0,8% in 2011, mainly due to one-off expenditure on defense equipment in 2010. Gross fixed capital formation is expected to register a marginal increase of 0,5%, following the significant decreases in the last two years. This is mainly due to public investments, which are expected to increase in 2011 as a result of Cyprus taking over the Presidency of the EU in 2012. As far as total exports of goods and services

TABLE A.13 National accounts projections in real terms
(annual change,%)

	2010	2011f	2012f
GDP			
June Projections 2011	1,0	1,4	2,1
December Projections 2010	0,7	1,8	2,4
Private consumption			
June Projections 2011	0,8	1,1	1,5
December Projections 2010	-0,8	0,6	0,9
Public consumption			
June Projections 2011	0,5	-0,8	0,4
December Projections 2010	1,0	0,7	3,3
Gross fixed capital formation			
June Projections 2011	-7,9	0,5	2,2
December Projections 2010	-6,4	4,3	4,4
Exports of goods and services			
June Projections 2011	0,6	3,4	3,4
December Projections 2010	3,0	3,1	3,3
Imports of goods and services			
June Projections 2011	3,1	1,3	1,8
December Projections 2010	2,7	3,5	2,4

Sources: Cystat, CBC.

are concerned, an increase of 3,4% is expected due to increased revenue from tourism and financial services, following the further improvement in the external environment. Exports of goods have also been improving since the second half of 2010. At the same time, imports of goods and services are expected to increase by 1,3% in 2011, following the slow growth in domestic demand.

In 2012 GDP is expected to recover further, increasing by 2,1%. Specifically, private consumption is anticipated to increase by 1,5%, while a marginal increase of 0,4% is expected in public consumption. In addition, gross fixed capital formation is expected to increase by 2,2%. The rate of growth of exports is expected to remain at 3,4%, while imports are expected to increase by 1,8%, following the partial recovery in domestic demand.

It should be noted that the aforementioned projections may be affected by the possible adoption of further fiscal consolidation measures which have not been taken into consideration in the current projections, since they were not clearly defined at the time when the projections were being prepared. In such a case, public consumption and public investment are expected to be negatively affected. This, in turn, will have a negative indirect impact on other components of GDP, especially private consumption. The impact of fiscal consolidation measures will depend on the type and size of measures adopted. It must, however, be emphasised that in the longer term fiscal consolidation is expected to have positive effects by reinforcing the economy's growth potential.

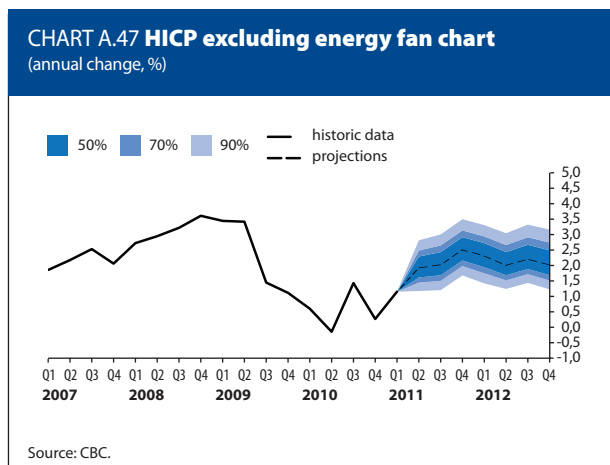
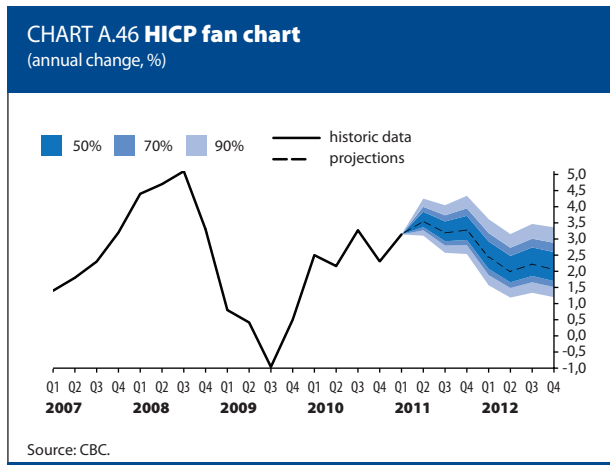
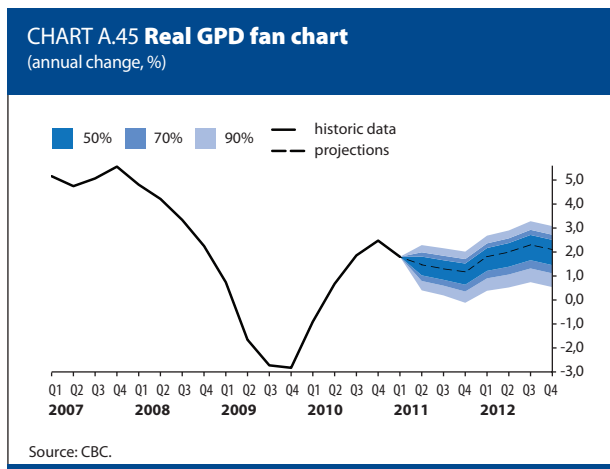
Fan charts for the macroeconomic projections

The projections for HICP inflation (Table A.11,

p. 3) as well as those for GDP growth (Table A.13, p. 5) are the modal forecasts and are considered as the most likely outcomes given the working assumptions of the Eurosystem. However, due to the tentative nature of the assumptions, the projections are subject to uncertainty.

The probability of GDP, HICP inflation and HICP inflation excluding energy forecasts lying around their respective modal projections is depicted in Charts A.45, A.46 and A.47, respectively. The three confidence intervals show the bands in which GDP, HICP inflation and HICP inflation excluding energy are expected to be with a probability of 50%, 70% and 90%. For example, the darkest band includes the modal projection and covers 50% of the probability. The probability distribution, which is based both on statistical methodology and on expert judgment, can either be normal or two piece normal with a degree of asymmetry around the modal projections. In particular, the skewed distribution is separated into two unequal parts, above and below the modal forecast¹. Moreover, the bands of the fan charts widen as the time horizon is extended, indicating the increasing uncertainty of outcomes in the longer term.

With respect to GDP, the adoption of additional fiscal consolidation measures will negatively affect GDP projections. In such a case, public investment and public consumption are expected to be negatively affected, while a further negative impact on domestic demand is expected mainly through the deterioration of private consumption. In addition, if unemployment continues to rise, this may have negative effects on GDP projections, mainly through the reduction in private consumption. On the other hand, upward risks to GDP originate from the larger



1. The estimation of the confidence intervals of the skewed distribution is based on the methodology developed by the Bank of England and the Sveriges Riksbank.

than expected recovery in the economies of our trading partners. This will positively affect GDP through the recovery of exports and the inflow of foreign investments. In addition, the developments in the Greek economy may also have an impact on the Cyprus economy. Overall, the risks for a downward revision of the modal forecast of GDP are more likely.

With regard to HICP inflation, upside risks may stem from the possible larger increases in energy prices, mainly due to the political tensions in North Africa and the Middle East, and the adoption of further indirect taxes as part of any additional fiscal consolidation measures. In contrast, a slower than expected recovery in consumer confidence and, consequently, retail sales, as well as a possible further deterioration in unemployment and a decrease in wages, are likely to have a dampening effect on inflation. The risks indicate that possible upward deviations in the modal HICP and HICP inflation excluding energy projections have a higher probability of being realised than possible downside deviations.

Comparison of projections for the Cyprus economy

Both the European Commission and IMF spring 2011 projections for 2011 and 2012 GDP and HICP inflation are not far off the CBC projections (**Table A.14**). The only exceptions are the IMF projections for HICP inflation in 2011 and 2012, which are higher than the projections of the other organisations. The differences between the projections of the various international organisations are mainly due to the different information available at the time of preparing these projections and the different working assumptions.

During 2011 GDP is expected to continue

TABLE A.14 Comparison of projections for Cyprus economy
(annual change,%)

		GDP		HICP	
		2011f	2012f	2011f	2012f
European Commission	Spring 2011	1,5	2,4	3,4	2,3
	Autumn 2010	1,5	2,2	3,3	2,5
IMF	Spring 2011	1,7	2,2	3,9	2,8
	Autumn 2010	1,8	2,5	2,3	2,5
CBC	Spring 2011	1,4	2,1	3,3	2,2
	Autumn 2010	1,8	2,4	3,4	2,4

Sources: European Commission, IMF, CBC.

growing, with the IMF projection being the most optimistic of the three, at around 1,7%. On the other hand, the CBC projection of 1,4% GDP growth in 2011 is the most pessimistic. In 2012 the Cyprus economy is expected to recover further, with the European Commission being the most optimistic, anticipating growth of around 2,4%. On the other hand, the CBC gives a projection of 2,1% for the same year.

As far as inflation for 2011 is concerned, the IMF is the most pessimistic, while the CBC and European Commission forecasts are much lower and at very similar levels. More specifically, IMF projections for inflation in 2011 and 2012 are 3,9% and 2,8%, respectively, while the CBC projections of 3,3% and 2,2%, respectively, are the most optimistic.

In conclusion, the CBC forecasts are not far off the projections of the European Commission and the IMF. It must be noted that the CBC and IMF forecasts for GDP have been revised downwards, while those of the European Commission have been revised marginally upwards. Finally, the CBC projections for HICP inflation have been revised downwards, while those of the IMF have been revised significantly upwards.