



CENTRAL BANK OF CYPRUS

# ECONOMIC BULLETIN

DECEMBER 2020

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Introduction

2

Macroeconomic  
Developments  
and Projections

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<b>Address</b>	80 Kennedy Ave 1076 Nicosia Cyprus
<b>Postal Address</b>	P.O. Box 25529 1395 Nicosia Cyprus
<b>Telephone</b>	+357 22714100
<b>Website</b>	<a href="http://www.centralbank.gov.cy">http://www.centralbank.gov.cy</a>

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CENTRAL BANK OF CYPRUS  
EUROSYSTEM

# ECONOMIC BULLETIN

DECEMBER 2020

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## ABBREVIATIONS

BLS	Bank Lending Survey	GHS	General Health System
BoE	Bank of England	HICP	Harmonised Index of Consumer Prices
BPM	Balance of Payments and International Investment Position Manual	IIP	International Investment Position
CA	Current Account	IFRS	International Financial Reporting Standard
CBC	Central Bank of Cyprus	IMF	International Monetary Fund
CCB	Cyprus Cooperative Bank	LFS	Labour Force Survey
CPPI	Commercial Property Price Index	MFIs	Monetary Financial Institutions
Cystat	Statistical Service of the Republic of Cyprus	NEER	Nominal Effective Exchange Rate
DLS	Department of Lands and Surveys	NACE	Statistical classification of economic activities in the European Union
ECB	European Central Bank	NFCs	Non-Financial Corporations
EER	Effective Exchange Rate	NGEU	Next Generation EU
EONIA	Euro Overnight Index Average	NPFs	Non-Performing Facilities
ESA	European System of Accounts	OPEC	Organisation of the Petroleum Exporting Countries
ESI	Economic Sentiment Indicator	PEPP	Pandemic Emergency Purchase Programme
ESMA	European Securities and Markets Authority	QE	Quantitative Easing
ESTR	Euro short-term rate	REER	Real Effective Exchange Rate
EU	European Union	RPPI	Residential Property Price Index
EURIBOR	Euro Interbank Offered Rate	SDW	Statistical Data Warehouse
Eurostat	Statistical Office of the European Union	SPEs	Special Purpose Entities
FED	Federal Reserve	UK	United Kingdom
FOMC	Federal Open Market Committee	US	United States of America
GDP	Gross Domestic Product		

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## Introduction

During the year 2020, the COVID-19 pandemic stroke the biggest blow to the global and European economy since the Second World War. While the latest promising developments regarding the availability of a vaccine have significantly strengthened the expectations for recovery, the recent outbreak of cases across Europe and the world, as well as the reintroduction of restrictive measures, are again increasing uncertainty and pose a significant challenge to the global and European economies. In particular, the new outbreak of cases in the EU, imposes further on the services sector, which is particularly vulnerable to the social isolation measures taken.

In the second quarter of 2020, euro area GDP fell by 11%, as a result of the first wave of the pandemic and the restrictive measures taken to contain it. In the third quarter, the recession was milder than expected, partly due to the easing of the pandemic during the summer. Nevertheless, the outbreak of the pandemic during autumn, led to a worse-than-expected GDP performance for the fourth quarter of 2020, with negative repercussions in the first quarter of 2021. In any event, the expectations for recovery in 2021 continue to be valid, partly due to the prospects for the availability and widespread distribution of an effective vaccine, as well as the positive effects of both monetary and fiscal policy measures taken in the euro area countries by the respective authorities.

In Cyprus, the pandemic caused the sharpest decline in GDP since 2013. Likewise in the euro area, the recession would have

been even deeper without the adopted measures. These measures were taken in a timely manner by the State, the European Central Bank (ECB) and the Central Bank of Cyprus (CBC) and significantly limited the economic impact of the pandemic in Cyprus. At the level of ECB measures, the emergency measure of the Pandemic Emergency Purchase Programme (PEPP) for example, has made a decisive contribution to reducing the borrowing costs for Cypriot bonds, thus assisting significantly the State in raising substantial capital from international markets in order to finance budgetary needs. In particular, it should be noted that at the end of April 2020 the yield on Cypriot 10-year bonds stood at 2.25%, while on 18 November it was down to 0.24%. More generally, the ECB's supportive monetary policy contributes to maintaining favourable financial conditions and low interest rates, thus promoting sustainable lending that will help restart the economy. At the local level, the suspension of loan instalments provided significant liquidity to businesses and households.

The progress made in recent years, both in macroeconomic and fiscal policy, as well as in the consolidation of the banking system, also contributed in dealing with and mitigating the consequences of the crisis. It should be noted, however, that although the economy entered the crisis with reduced - compared to the recent past - levels of public and private debt as well as a reduced level of non-performing loans (NPLs), these figures continued to be at very high levels. The particularly high levels of private debt and non-performing loans in Cyprus both in



relation to the macroeconomic and fiscal fundamentals of the economy and the euro area average, constitute a major obstacle to the proper functioning of our financial system and the facilitation of economic activity through new lending. In effect, extremely careful and targeted policy planning is needed in order to deal with the economic consequences of the pandemic. Unfortunately, the recent unfavourable development regarding the rejection of the State Budget by the parliament, jeopardises this planning. The CBC encourages a consensual solution which, while not compromising the course of consolidation of the Cypriot economy and its banking system, will at the same time recognise and take into account in policy-making the fact that households and businesses are currently faced with unprecedented economic difficulties as a result of the pandemic.

Regarding GDP developments, the implementation of pre-emptive measures and related decrees in order to address the negative effects of the covid-19 pandemic has had a significant impact on economic activity. In particular, GDP growth exhibited a slowdown in the first quarter of 2020 (1,1% growth) and an unprecedented decline (-12,2%) in the second quarter of 2020. Subsequently, the initial weakening of the pandemic during the summer and the consequent lifting of many restrictive measures led to a reduction in the annual rate of decline in the third quarter (-4,1%, preliminary estimate of the Cyprus Statistical Office).

Although the decline in GDP in the third

quarter was contained compared to the second quarter and to what had been expected, some sectors were hit harder. For example, external demand was significantly affected, with tourist arrivals falling by more than 80%, on average, over this period. On the domestic demand side, consumer confidence improved marginally in the third quarter compared to the second quarter. At that time however, the extent of the second wave of the pandemic in the fourth quarter was not yet known. It should be noted that the negative impact of the pandemic on the labour market was small compared to the impact on GDP due to the government schemes in support of private sector employment.

In the fourth quarter of the year, the current and stronger (compared to the first) wave of the pandemic inevitably prompted the state to introduce new restrictive measures in mid-October and even stricter restrictions in November and December. These measures are expected to prolong the recession for longer than initially anticipated. On the positive side, the confirmation of the country's rating with a stable outlook, announced on 2 October by Fitch Ratings and on 16 November by DBRS, is worth noting. These ratings reflect, inter alia, the developments in the country's financial situation and banking system. The rating agencies also named factors for possible future upgrading, including recovery in growth rates and a return to a sound fiscal position, progress on the issue of NPLs and the strengthening of the banking system. Of course, the implementation of these factors also depends directly on finding a swift

solution to the deadlock which has arisen with regard to the 2021 Fiscal Budget.

The recovery is expected to start in 2021 due to the gradual rise in domestic and external demand, the boost expected by EU funding, and the support of the economy from the ECB's accommodative monetary policy. However, the unforeseen course of the pandemic, the yet uncertain time framework to effectively control and eradicate the pandemic through vaccinations that will soon start throughout the EU, the lingering ambiguity surrounding Brexit negotiations, the country's significant private and public debt burden, and the size of the non-performing loans (existing and new), pose downward risks to the Cyprus economic outlook (it is noted that the CBC's macroeconomic forecasts do not take into account the risk of deadlock in the adoption of the State Budget for 2021). On this basis, GDP forecasts continue to be extremely uncertain, despite promising indications for faster availability of the vaccine. The CBC's updated GDP forecast has been revised upwards for 2020. In particular, a smaller contraction is expected, due to a better-than-anticipated trend in domestic demand during the current year, particularly in the third quarter, which offset the worse-than-expected trend in economic activity and external demand, particularly tourism, in the fourth quarter of the year. In the coming years GDP forecasts have been revised downwards, mainly due to the lower recession in 2020 (base effect) and the variations in working assumptions regarding the course of the pandemic. In the labour

market, unemployment is expected to rise in the first months of 2021, despite its containment so far due to state measures in support of employed persons and corporations. However, this upward trend is expected to be reversed by the projected GDP recovery and, as a consequence, the unemployment rate is expected to return to around the same level as in 2020. Due to great uncertainty, three forecast scenarios for growth have been drawn up this time as well: one baseline scenario, and two extreme ones; one mild and one severe. In particular, based on the mild and severe scenarios for Cyprus, the recession for 2020 is expected to reach -5,5% and -6,7% respectively, while in the baseline scenario it is expected to reach -6,2%. The recovery for 2021 is placed at 4,8% and 1,8% in the mild and severe scenarios respectively, while in the baseline scenario at 4,1%.

On the price front, the Harmonised Index of Consumer Prices (HICP) recorded an annual decrease of 1,1% during the first ten months of 2020 compared to an annual increase of 0,5% in the corresponding period of 2019. In general, this development mainly reflects the unprecedented negative impact of the pandemic on domestic economic activity and overall demand, as well as the significant declines in international energy prices as a result of the sharp decline in global demand for oil. With regard to inflation forecasts, domestic prices are expected to record a decrease of -1,2% in the baseline scenario in 2020 compared to 0,5% in 2019. Gradual increases in inflation are expected for 2021-23, reaching 0,5% in 2021,

0,9% in 2022 and 1,4% in 2023. The path of inflation is mainly due to a worse-than-expected performance in services prices in 2020 and the slower recovery expected in the coming years, with a consequent downward revision in prices.

In relation to the banking sector, timely and drastic decisions were taken both by the government and the Central Bank of Cyprus. These actions were aimed at supporting the real economy and ensuring a smooth restart of economic activity by channelling liquidity from banks to the sectors in need. These decisions laid the foundations for effective mitigation of the economic impact of the pandemic.

However, the current uncertainty and the second wave of the pandemic outbreak have a negative impact on investment decisions and, consequently, on the new lending of credit institutions to the real economy. In addition to the above, the management of legacy NPLs, as well as those expected to arise as a result of the pandemic, is an important challenge and should be one of the immediate priorities of banks, which must be operationally prepared to carry out an increased number of restructurings after the end of the moratorium, minimising the increase of delinquent loans. As a result of the above, the business plans and expectations of banking institutions for further development of their operations and improvement of their profitability are expected to be adversely affected.

It should also be noted that the existence of an effective and stable debt recovery framework is an integral part of a

holistic strategy for the management of NPLs. The legislative framework for foreclosures should provide the necessary incentives to prevent the creation of a culture for strategic defaulters that lead to the socialisation of losses to the detriment of the taxpayer and ultimately to the detriment of the healthy market participants and conscious borrowers. The amendment and updating of the legislative framework from time to time should serve this multiple role. Continuous changes in the legal framework do not help, as they create uncertainty for foreign investors and negative reactions from rating agencies.

Despite the above challenges, banking institutions maintain sufficient liquidity reserves, their capital ratios are above the minimum requirements and the level of coverage of NPLs is close to the European average. These elements along with the operational preparedness mentioned above, are expected to enhance their effort to halt any deterioration in the quality of loan portfolios.

Overall and to the extent possible, Cyprus has so far managed to limit the profound economic consequences of the pandemic thanks to the timely implementation of measures, both at European and domestic level. The effort, especially at the domestic level, should remain strictly targeted. Any measures taken should take into account the unprecedentedly difficult financial situation that the pandemic afflicted on households and corporations, but at the same time they should neither cause a deterioration in existing macroeconomic

imbalances nor undermine the progress made in recent years regarding the the banking sector problems. Progress should also be made towards structural reforms. For example, the reform of the judicial system, the implementation of a more efficient, stable and effective framework for the restructuring of NPLs and the strengthening of the insolvency framework are necessary and immediate priorities.

## Macroeconomic Developments and Projections

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## 1. International Environment: main developments

- *Rebound in economic activity in 2020Q3, due to the retreat of the pandemic during the summer months.*
- *Intensification of the pandemic outbreak since autumn, with expectations for a significant negative impact on the macroeconomic environment over the rest of 2020.*
- *Global inflation remains substantially subdued due to the ongoing adverse implications of COVID-19 pandemic.*
- *Euro area headline and core inflation fluctuated at much lower levels in the first ten months of 2020 compared with the corresponding period of 2019.*
- *Significant drop in the demand and price of oil since March 2020, due to the sharp drop in global economic activity.*
- *Major central banks around the globe continued implementing an expansionary monetary policy. Fiscal support also continued.*
- *Recent announcements regarding the availability of a vaccine have sparked optimism in the markets, whilst its effective distribution in 2021 is expected to lead to a significant recovery in the markets. Nevertheless, a substantial negative overall impact of the pandemic to the global economy is expected.*

## 1.1 External developments

### Economic Growth<sup>1</sup>

Global economic activity has been significantly affected by the covid-19 pandemic. Despite the drop in reported virus cases across European countries during the summer months, a dramatic increase in confirmed cases has been observed since autumn, surpassing those of the first wave.

As a result of the increase in cases, many European governments have readopted restrictive measures which, although not as drastic as those of the March-April period, have led to a deterioration in economic activity.

Central banks around the world continued to support the economy via the expansionary monetary policy measures, adopted earlier in the year. In particular, interest rates remained unchanged at very low levels, whilst bond purchases from the secondary market continued. The measures adopted so far aim at increasing liquidity in order to smooth the operation of financial markets. Markets expect further policy measures in the near future due to the recent deterioration in relation to the pandemic.

In addition to the monetary policy measures, fiscal policy is expected to take a more leading role. In the case of the EU, this is expected to take place mainly via the EU Recovery Fund (NGEU) which is aimed at providing a sustainable recovery, as well as increasing long-term resilience of the EU economies. At the same time, national fiscal stimulus packages are still in place, mainly

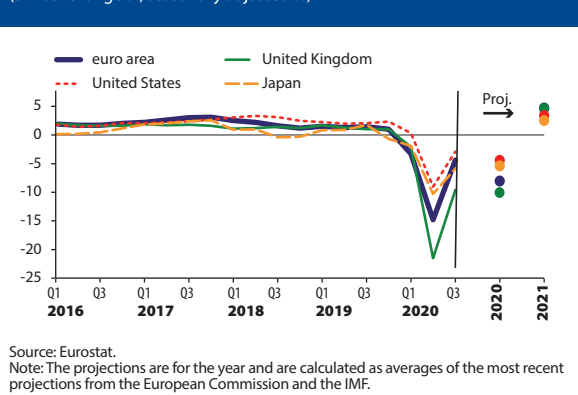
1. GDP projections are estimated as the average of the most recent projections from the European Commission (European Economic Forecast, Autumn 2020) and the IMF (World Economic Outlook, October 2020).

taking the form of loan guarantees and household income support measures.

In the euro area, economic activity appeared to be recovering after the March shock, but the re-emergence of the virus, with a second wave being evident as of early autumn, is expected to have a negative effect on growth, although not to the extent of the first wave of the virus. The relevant consumer and business confidence indicators, as well as the production and services indices, show a contraction in economic growth, albeit to a lesser extent compared with 2020Q2. In addition, due to the policy measures adopted by the ECB and the national governments of European countries, the ECB forecasts show a more contained decline in GDP, that is, from 8,7% to 8% in 2020. Similarly, the average estimate of the scenarios of the European Commission and the IMF suggest a GDP decline of around 8,1% in 2020 (**Chart A.1**). In 2021, the average estimate of the three organisations stands at around 5% GDP growth.

In the US, the GDP decline is expected to be contained, mainly due to the smaller extent of the restrictive measures implemented, despite the more severe effects of the pandemic in terms of confirmed cases and human lives. In addition, the far greater scale of the fiscal package in the US during the year provided a stronger backstop to the GDP decline. In addition, the Federal Reserve's interventions, both by lowering interest rates and by launching a bond-buying program, managed to calm the financial markets. As a result, the US GDP fell by 3,9% in 2020H1, compared with a drop of 7,5% in the euro area

**CHART A.1 GDP in selected countries**  
(annual change %, seasonally adjusted %)





and an 11,1% decline in the UK over the same period. In 2020, US GDP is expected to decline by 4,5%, while a positive growth of around 3,4% is expected for 2021, based on the estimates of the European Commission and the IMF (**Chart 1**, p. 16)

As already mentioned, the UK GDP decline was greater than in other developed economies, reaching 11,1% in the first nine months of the year, despite measures taken by the Bank of England and the UK government. The overall decline in GDP is expected to reach 10,1% in 2020, while in 2021, the recovery is estimated to stand at 4,6%, with the rate being lower compared with the expected recovery of other economies due to the negative effects arising from Brexit.

In Asia, economic activity in China recovered after the shock in 2020Q1, with the country's industrial production increasing compared with 2019. In addition, the country's GDP continued to grow but at a slower pace compared with 2019, due to the general decline in world trade. In Japan, the 2020Q3 GDP growth rate remained negative.

## **Inflation<sup>2</sup>**

Global inflation continued to remain subdued during the period under review. The trend of global inflation is directly affected by the path of global economic activity and the consequent sharp fall in oil prices following the drop in global demand for oil amid the ongoing covid-19 pandemic.

According to the projections of international organisations and analysts, which

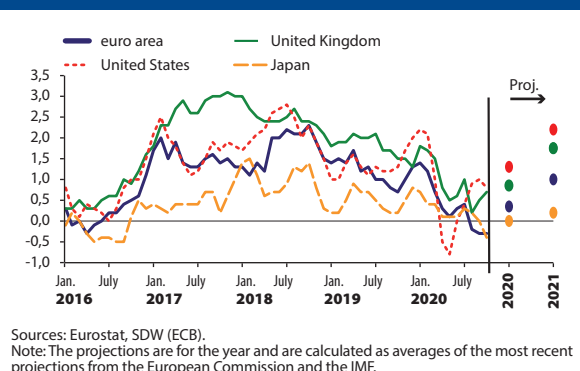
2. Inflation projections are estimated as the average of the most recent projections from: The European Commission (European Economic Forecast, Autumn 2020) and the IMF (World Economic Outlook, Oct 2020).

continue to be characterised by a high degree of uncertainty, inflation in selected major advanced economies such as the US, UK, Japan and the euro area, is expected to fluctuate at much lower levels in 2020 compared with 2019 (Chart A.2). These projections mainly reflect the global recession, the significant drop in demand as well as the considerably lower, on average, oil prices compared with those in 2019. The aforementioned downward pressures are expected to override any price increases in some products due to disruptions or shortages in the supply chain. As for 2021, inflation in most of the aforementioned countries is expected to rebound, mainly driven by the projected global economic recovery and the upward base effect in energy prices.

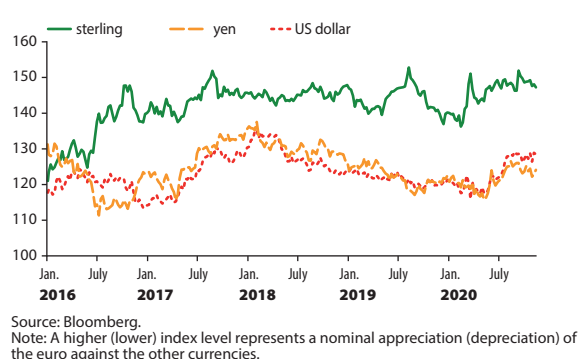
## Exchange rates

The euro appreciated against the US dollar and the Japanese yen from May 2020 until the cut-off date of this *Economic Bulletin* (Chart A.3), whilst remaining broadly unchanged against sterling. More specifically, from May to 13 November 2020, the euro appreciated by 9,4% against the US dollar and by 6,7% against the Japanese yen while, the change against the sterling was negligible. The strengthening of the euro was driven by both the weakening of the dollar following the support measures taken by the US Federal Reserve and the US government which increased the supply of dollars in the market, as well as by the gradually increased willingness of investors

**CHART A.2 Inflation in selected countries**  
(annual change, %)



**CHART A.3 Euro exchange rate against selected currencies**  
(weekly data, 2000=100)



to take up more risk in non-dollar assets in association with their improved expectations of a rebound in economic activity. With regards to sterling, the steady course of the euro was associated with the offsetting of the negative effects arising from the worse-than-expected performance of the UK economy, with the improved expectations for a Brexit agreement.

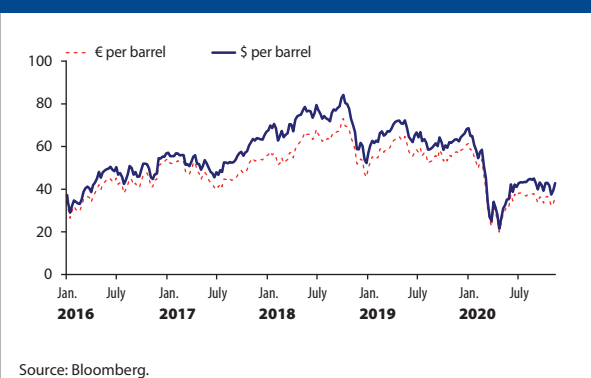
## Oil

Brent crude oil prices rose by about 20% between 15 May and 13 November 2020. This development reflects the gradual increase in oil demand after the temporary easing of the pandemic during the summer, the OPEC's policy of sustaining output cuts as well as the positive economic prospects of discovering effective vaccines (**Chart A.4**). Nevertheless, according to the latest forecasts by the International Energy Agency, oil demand is not expected to return to the pre-pandemic levels before mid-2021, also taking into account the vaccine prospects. In this respect, OPEC is expected to maintain its production cuts in order to preserve the upward trend in oil prices.

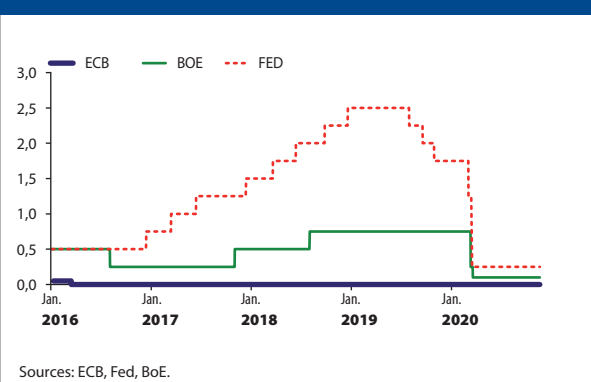
## International key interest rates

In March 2020, the US Federal Reserve cut its key interest rate by 1,50%, bringing it to the 0% -0,25% range (**Chart A.5**). A similar approach was followed by the Bank of England, reducing its key interest rate from 0,75% to a record low of 0,10% as a measure to support the country's economy from the

**CHART A.4 Closing prices of oil (Brent)**  
(weekly data)



**CHART A.5 Official interest rates**  
(% per annum)



effects of the pandemic. The ECB, on the other hand, has left its low interest rate policy unchanged, whilst further expanding its monetary policy easing through non-conventional measures. Non-conventional measures have also been adopted by the US Federal Reserve and the Bank of England.

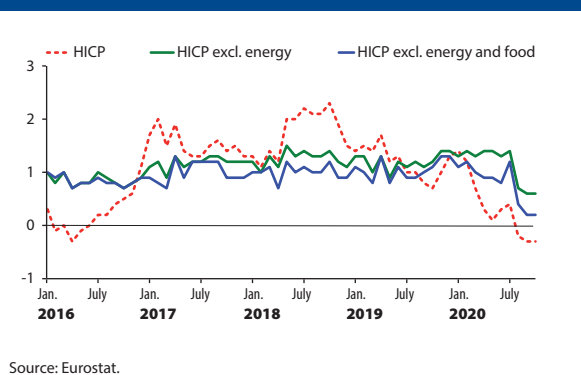
## 1.2 Monetary developments in the euro area

### Inflation

According to the latest available data, euro area HICP inflation stood at -0,3% in October 2020, remaining unchanged compared with September 2020 (Chart A.6). Since August 2020, HICP inflation has been fluctuating at negative levels (for the first time since May 2016), mainly affected by the ongoing adverse economic developments of the pandemic and the resulting negative effects on oil prices. As a result, both headline inflation and inflation excluding energy and food (core inflation) remained, on average, at substantially subdued levels, reaching 0,4% and 0,8%, respectively, in the first ten months of 2020.

Given the latest available data, the negative developments in the global economy and energy prices, the temporary cut of VAT rate in Germany (for 2020H2) due to the pandemic as well as the recent appreciation of the euro, HICP inflation is expected to reach, on average, much lower, but still positive levels, in 2020 compared with 2019. With regard to 2021, euro area HICP inflation is expected to fluctuate at higher levels compared with 2020,

**CHART A.6 Inflation in the euro area**  
(annual change, %)



Source: Eurostat.

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mainly on the back of the projected global economic recovery, the upward base effect in energy prices as well as the expected upward base effect stemming from the end of the temporary cut of VAT rate in Germany one year earlier. More specifically, the most recent euro area inflation projections by international organisations and analysts converge to 0,4% for 2020 and around 1,0% in 2021.

Over the medium term, headline inflation is expected to gradually increase, mainly supported by the continued ECB's expansionary monetary policy, as well as the projected recovery in economic growth.

### **Reference rates and ECB interventions**

As already mentioned, on 29 October 2020, the ECB Governing Council decided to maintain its accommodative monetary policy. Since the onset of the pandemic, the ECB Governing Council has vigorously adopted a package of non-standard monetary policy measures, providing crucial support to the recovery of the euro area economy and safeguarding medium-term price stability. More specifically, the March-June 2020 non-standard monetary policy measures adopted by the ECB Governing Council<sup>3</sup> support liquidity and financing conditions for households and non-financial corporations. They also contribute to maintaining favourable financing conditions for all sectors in euro area countries, amid the historically low ECB key interest rates. The temporary Pandemic Emergency Purchase Programme (PEPP) of the ECB is also expected (among other measures) to

3. For more details, see "Economic Bulletin, June 2020".



continue contributing significantly to the drop of the borrowing costs for euro area countries and to mitigate the effects of the pandemic in general.

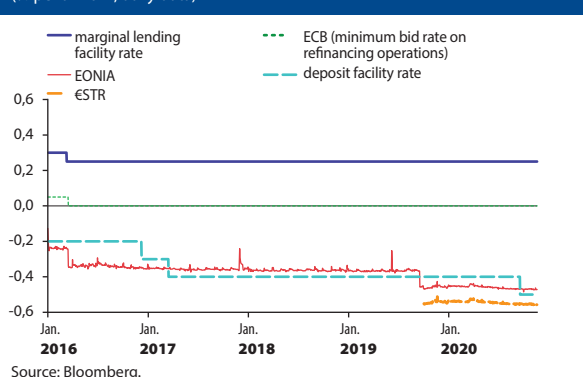
Concerning standard monetary policy measures, the ECB kept its key interest rates unchanged during the first ten months of 2020, to 0,00%, 0,25% and -0,50% for the main refinancing operations, marginal lending facility and deposit facility, respectively. The ECB Governing Council expects the aforementioned key interest rates to remain at their present or lower levels until the inflation outlook robustly and sufficiently converges to its medium-term price stability target, that is close to, but below, 2%.

Regarding the EONIA rate and the new euro short-term rate “€STR”, both remained relatively unchanged from the beginning of 2020 until mid-November, since the ECB's key interest rates did not change during the period under review (Chart A. 7). As a result, on 18 November 2020 (latest available data) the EONIA rate and the €STR stood at -0,47% and -0,56%, respectively.

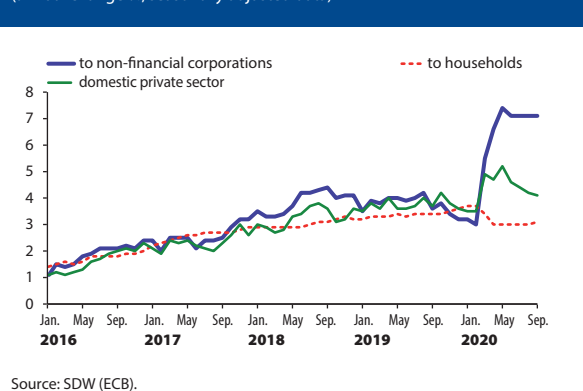
### Credit expansion: loans

Loans to the euro area private sector remained, generally, at high levels during 2020Q3, albeit they decelerated somewhat compared with the early months of the pandemic, reaching 4,1% as at end-September 2020 compared with 5,2% in May 2020 (Chart A.8). The annual growth rate of euro area non-financial corporations' loans continue to significantly affect the annual

**CHART A.7 ECB reference rates and short term interbank rates**  
(% per annum, daily data)



**CHART A.8 Loans to the private sector: euro area**  
(annual change %, seasonally adjusted data)



growth of loans to the private sector, reaching 7,1% in at end-September 2020 compared with 7,4% in May 2020. It is noted that, the ongoing ECB's targeted monetary policy measures as well as granting of government guarantees on loans in most euro area countries seems to have supported the aforementioned NFC loans' annual growth since the onset of the global pandemic. At the same time, the annual growth rate of euro area households loans stood at 3,1% as at end September 2020 from 3,0% at the end of May 2020.

According to the results of the October 2020 euro area Bank Lending Survey (BLS), euro area participating banks expect credit standards for loans to enterprises to tighten during 2020Q4. This mainly reflects concerns about the economic recovery as some sectors remain vulnerable, as well as the uncertainty related to the prolongation of fiscal support measures. During 2020Q4, credit standards for loans to households for housing purchases are also expected to tighten, while credit standards for loans to households for consumption and other lending purposes are expected to slightly ease.

Moreover, net loan demand by enterprises in Cyprus is expected to increase in 2020Q4 compared with 2020Q3. At the same time, net loan demand by households for housing loans is expected to decrease during 2020Q4, while net loan demand by households for consumption and other lending is expected to slightly increase.



## 2. Domestic Environment: main developments

- *Negative domestic HICP inflation during the first ten months of 2020 mainly due to sizeable adverse implications related to covid-19 pandemic and associated decreases in energy prices.*
- *Domestic private sector deposits increased, with deposits of non-financial corporations and households exhibiting different trends.*
- *New lending in the first nine months of 2020 decreased, while positive annual growth rates in net loans<sup>4</sup> were recorded.*
- *A decrease of NPFs<sup>5</sup> was recorded in the first half of 2020 mainly due to sales / transfers of loan portfolios outside the banking system and loan write-offs.*
- *Further small reduction in the historically low lending and deposit interest rates, aided by the maintenance of a favourable low interest rate environment.*
- *Continued uncertainty in the real estate sector, amid a decline in the construction activity, on the one hand, and annual increase in sales contracts and small increase in residential property prices in specific districts, on the other hand, which are supported by government incentives for new housing loans.*
- *Unprecedented contraction in economic activity, due to the pandemic and the restrictive measures taken to contain its spread.*
- *Small negative impact of the pandemic on the labour market due to fiscal measures to support workers.*

4. New lending and capitalisation of interest minus repayments.
5. All credit institutions operating in Cyprus (domestic operations only).



- Significant increase in the government debt-to-GDP ratio in September 2020 compared with the start of the year, reflecting the impact of the pandemic.
- Unprecedented reduction in tourism arrivals and revenues in 2020.
- Large budget deficit in the first nine months of 2020, as a result of the decline in economic activity and the implementation of fiscal measures to mitigate the economic impact of the pandemic.

## 2.1 Domestic Prices, Monetary Aggregates and Labour Costs

### Prices

The Harmonised Index of Consumer Prices (HICP) recorded an annual decrease of 1,4% in October 2020 compared with a decrease of 0,5% in the corresponding month of 2019. This development was mainly attributed to decreases in the prices of all HICP main sub-categories, with the exception of food prices. With regard to the first ten months of 2020, HICP inflation stood at -1,1% compared with 0,5% in the corresponding period of 2019 (Chart A.9 and Table A.1). In general, the aforementioned developments in domestic HICP reflected the negative effects of the pandemic on domestic economic activity as well as the decreases in energy prices.

More analytically, during the first ten months of 2020, services inflation was negative. This development was mainly driven by tourism-related categories such as accommodation and passenger by air prices which recorded large decreases on the back

CHART A.9 Inflation in Cyprus (HICP)  
(annual change, %)

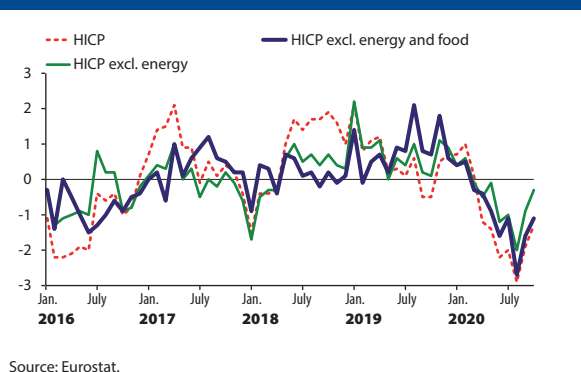


TABLE A.1 Inflation in Cyprus

	Weights <sup>(1)</sup>	Annual change, %				
		Jan.-Oct. 2019	Jan.-Oct. 2020	Oct. 2019	Sep. 2020	Oct. 2020
HICP	1.000,00	0,5	-1,1	-0,5	-1,9	-1,4
Unprocessed food	50,04	2,9	2,8	-1,9	4,5	6,3
Processed food	169,68	-0,1	0,1	-1,5	0,5	0,7
Energy	78,11	-1,7	-8,9	-6,7	-14,8	-13,4
Services	466,96	1,7	-1,0	1,5	-2,5	-1,6
Non-energy industrial goods	235,2	-1,0	-0,7	-0,9	0,3	-0,2
HICP excluding energy	921,88	0,7	-0,5	0,1	-0,9	-0,4
HICP excluding energy and food	702,16	0,8	-0,9	0,7	-1,6	-1,2

Source: Eurostat.  
(1) Based on the weight for 2020.

of the inevitable reduced domestic and foreign demand as a result of the pandemic.

During the period under review, energy prices had a significant negative contribution to HICP, on account of the marked drop in international oil demand and therefore prices, as a result of the pandemic. Moreover, the Electricity Authority of Cyprus (EAC) proceeded with a 10% decrease in the price of electricity (initially for the period April - May 2020 and gradually extended until September 2020) in an effort to alleviate some of the negative effects of the pandemic. The latter development posed further downward pressures on energy inflation during the said months.

Concerning non-energy industrial goods prices, these, on average, recorded annual decreases during the first ten months of 2020 as a result of the reduced demand as well as the increased competition (domestic and e-commerce) and midseason sales/special offers.

In light of the above, core inflation (inflation excluding energy and food prices) registered an annual decrease of 0,9% during the first ten months of 2020 compared with an annual increase of 0,8% in the corresponding period of 2019 (**Chart A. 9** and **Table A.1**, p. 25).

### Monetary Aggregates<sup>6,7</sup>

The spread of the coronavirus pandemic in Cyprus, its impact on the domestic economy

6. For a detailed explanation of the methodology and technical analysis of monetary aggregates, see Technical Notes on p. 75.
7. The analysis on monetary aggregates (deposits and loans) in this section of the *Economic Bulletin* focuses on domestic residents excluding SPEs. SPEs are included in the non-residents category.

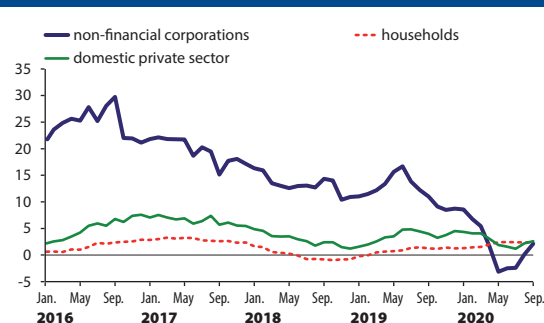
along with the restrictive measures to contain it, affected monetary aggregates as well.

In general, domestic private sector deposits recorded an annual increase which is, however, the result of different trends in the deposits of the main subcategories. At the same time, an increase in net loans (new lending plus capitalisation of interest minus repayments) was recorded. This was mainly due to the loan repayments' suspension measure, despite the decrease in new lending.

Specifically, domestic private sector deposits recorded an annual growth of 2,6% in September 2020 compared with 4,5% in December 2019 and 4% in September 2019 (**Chart A.10**). The slowdown observed since December 2019, with a slight recovery in August and September 2020, covers different trends in the deposits of non-financial corporations and households.

In particular, non-financial corporations' deposits recorded outflows after August 2019. These are attributed to the further reduction of deposit interest rates as well as the expectations for the introduction of negative interest rates or charges on certain deposits. The decline in these deposits in March and April 2020 also reflected the larger needs to cover running expenses, as a result of reduced revenues due to the restrictive measures. As of May 2020, non-financial corporations' deposits increased following the easing of the restrictive measures and the increase in economic activity. Negative investment prospects also affected deposit developments. In contrast, household deposits recorded inflows during

**CHART A.10 Deposits of the domestic private sector**  
(annual change, %)



Source: CBC.

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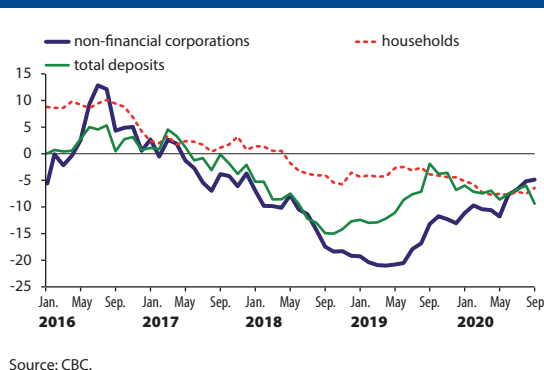
the period April-June 2020, mainly due to "forced / precautionary savings" attributed to the restrictive measures. After July 2020 this trend was reversed. This is in line with the increase in households' consumption after months of reduced spending.

Non-residents' deposits, on the other hand, which have always been highly volatile, continued to record negative annual growth rates. Specifically, the annual growth rate of non-residents' deposits stood at -9,4% in September 2020 compared with -6.8% in December 2019 and -1.9% in September 2019 (Chart A.11).

At the same time, new lending to the non-financial private sector<sup>8</sup> decreased significantly in the first nine months of 2020 compared with the corresponding period of 2019, especially to non-financial corporations. This is mainly attributed to the contraction in economic activity and, according to the BLS, to the tightening of banks' loan approval criteria as well as the reduction of households' loan demand<sup>9</sup>. Since June 2020, there has been a slight recovery in new lending, aided by the government's interest rate subsidisation scheme for new housing and business loans. Nonetheless, it has remained at a lower level compared to the previous year.

Despite the decline in new lending, net loans<sup>10</sup> to the domestic private sector have recorded positive annual growth rates as of June 2020, driven by household loans. This is mainly attributed to the suspension of the payment obligation of loan instalments and

CHART A.11 Deposits of non-residents: Cyprus  
(annual change, %)



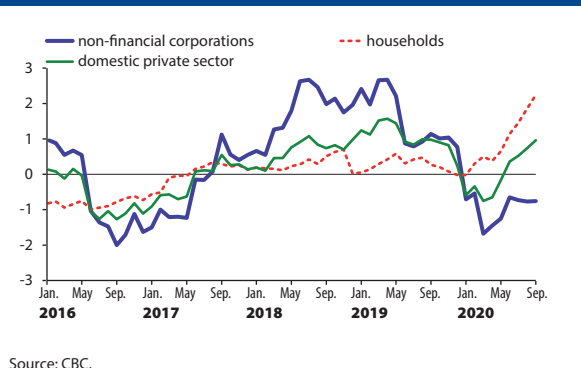
8. New loan contracts (euro-denominated) to euro area non-financial corporations and households.
9. Consolidated domestic results (diffusion index) of the ECB's Bank Lending Survey conducted in April, July and October 2020.
10. New lending plus capitalisation of interest minus repayments.

interest. More specifically, there was an annual increase in domestic private sector loans of 1% in September 2020 compared with 0,2% in December 2019 and 1% in September 2019. In more detail, the annual growth rate of domestic households' loans stood at 2,2% in September 2020, while for domestic non-financial corporations it was negative, reaching -0,8% (Chart A.12). Regarding households, positive growth rates were recorded in two of the main subcategories of household loans. Specifically, at the end of September 2020, an annual increase of 3% and 1,1% was recorded in housing loans and other lending, respectively. The annual growth rate in consumer credit remained effectively unchanged at 0,1% (Table A2).

According to the October 2020 BLS results for Cyprus (Table A.3, p. 30) credit standards for granting loans tightened in 2020Q3 compared with the previous quarter, for both households and enterprises. This mainly reflected the participating banks' credit risk considerations due to the coronavirus crisis. At the same time, net demand for loans increased, compared with the previous quarter, in all loan categories. As for banks' expectations for 2020Q4, the loan approval criteria for businesses and households for housing, consumer credit and other lending are expected to tighten further. For the same period, a further increase in net demand for all loan categories is expected.

As regards NPFs<sup>11</sup>, a significant decrease of €2,3 billion was recorded in the first half of 2020 (latest available data), reaching €6,7 billion. The decrease was mainly due to non-

CHART A.12 Loans to the domestic private sector  
(annual change, %)



Source: CBC.

TABLE A.2 Loans to domestic households <sup>(1),(2)</sup>

	Outstanding balance as % of total <sup>(3)</sup>	Annual percentage change					
		2019 June	2020 Sep.	2019 Dec.	2020 Mar.	2020 June	2020 Sep.
Domestic households	100,0	0,3	0,3	0,0	0,5	1,1	2,2
1. Consumer credit	12,3	0,5	0,8	0,0	-0,4	-0,9	0,1
2. Lending for house purchase	69,1	0,4	0,2	0,3	0,9	1,7	3,0
3. Other lending	18,5	0,2	0,0	-1,1	-0,2	0,9	1,1

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.

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

organic deleveraging activities, namely sales and transfers of loan portfolios outside the banking system. Moreover, loan write-offs in the context of restructurings and non-contractual or "accounting" set-offs aimed at a more representative depiction of loan portfolios, contributed significantly to the contraction of NPFs in the first half of 2020. These usually relate to amounts for which there are pre-existing loan loss provisions.

Given the end of the loan repayment moratorium at the end of December 2020, NPFs are expected to increase in 2021 due to the possible difficulties of certain borrowers affected by the pandemic to service their loans. However, the stricter lending criteria applied for new lending in 2020 which reduce the possibility of new loans becoming non-performing, the expected recovery in economic activity in 2021 and the anticipated availability of an effective medical solution by mid-2021, are expected to partly alleviate these difficulties and contain to some extent the increase in NPFs. In 2022, reflecting the expected positive course of the economy, NPFs are expected to revert to the downward trend recorded before the start of the pandemic.

## Interest rates

The downward trend in domestic interest rates continued in 2020Q3, as a result of the expansionary ECB monetary policy and the additional supportive policy measures adopted to address the negative effects of the pandemic. In general, the low interest rate environment, combined with the interest rate

**TABLE A.3 Summary of BLS results**

Summary of BLS results October 2020	Cyprus		euro area	
	2020 Q3	2020 Q4 (expectations)	2020 Q3	2020 Q4 (expectations)
<b>Credit standards for loans</b>				
Enterprises	Tightening	Tightening	Tightening (significantly)	Tightening (considerably)
Households				
- <i>Housing loans</i>	Tightening	Tightening	Tightening	Tightening
- <i>Consumer credit and other lending</i>	Tightening	Tightening	Tightening	Easing (slightly)
<b>Demand for loans</b>				
Enterprises	Increase	Increase	Decrease (moderately)	Increase
Households				
- <i>Housing loans</i>	Increase	Increase	Increase (significantly)	Decrease
- <i>Consumer credit and other lending</i>	Increase	Increase	Increase (slightly)	Increase (slightly)

Sources: CBC, ECB (SDW).

Note: The results of the table above list the changes in credit standards and loan demand that occurred in the last three months (in this case 2020Q3) and the changes that are expected for the next three months (i.e. 2020Q4). The measure used for the statistical analysis of this survey is the diffusion index for the case of Cyprus, while for the euro area is the net percentage methodology.

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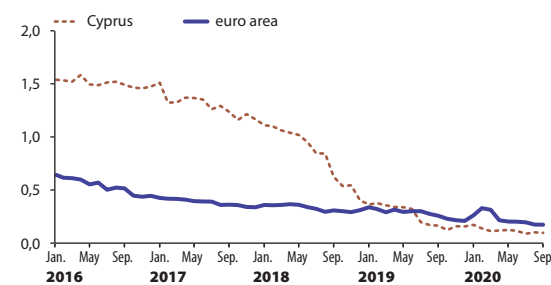
subsidisation measure introduced by the government for new housing loans and NFCs loans undertaken in the period March 2020 - June 2021, continued to support demand for new loans by the domestic private non-financial sector.

In contrast, the excess bank liquidity and the negative interest rate that banks are obliged to pay to hold deposits with the ECB, have led some domestic credit institutions as of March 2020 to introduce negative interest rates for large deposits as well as liquidity fees.

More specifically, the average interest rate<sup>12</sup> on new deposits for households continued to record a downward trend and reached 0,10% in September 2020 compared with 0,16% in December 2019 (**Chart A.13**). It is noted that, as of July 2019, domestic deposit rates are lower than those in the euro area, the latter standing at 0,17% in September 2020 compared with 0,10% in Cyprus. The average interest rate on new deposits for NFCs in September 2020 decreased to 0,05% compared with 0,12% in December 2019 (**Chart A.14**). In summary, from December 2019 to September 2020, the spread between domestic and euro area deposit rates for households and NFCs narrowed by 2 and 13 basis points, respectively.

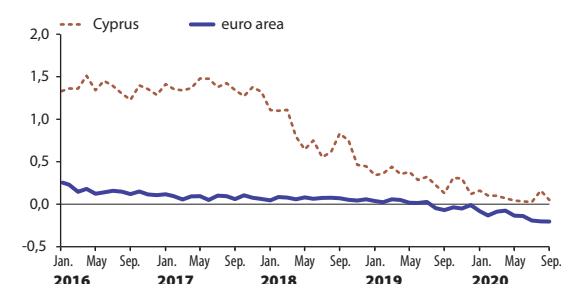
In terms of lending rates, the average interest rate to households for house purchase<sup>13</sup> remained broadly unchanged at 2,12% in September 2020, compared with 2,11% in December 2019 (**Chart A.15**). The interest rate on consumer loans remained at low levels, falling to 3,09% in September 2020 from 3,13% at the end of

**CHART A.13 MFI interest rates on euro-denominated deposits (new business) by euro area households<sup>(1)</sup>**  
(% per annum, period averages)



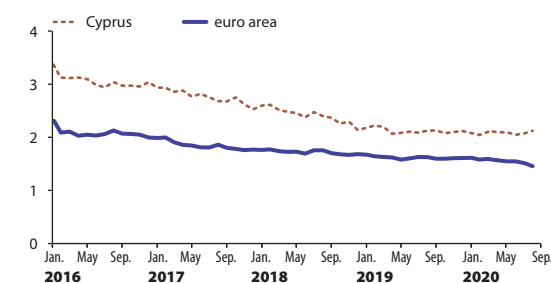
Sources: SDW (ECB), CBC.  
(1) With agreed maturity up to 1 year.

**CHART A.14 MFI interest rates on euro-denominated deposits (new business) by euro area non-financial corporations<sup>(1)</sup>**  
(% per annum, period averages)



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

**CHART A.15 MFI interest rates on euro-denominated housing loans (new business) to euro area households<sup>(1)</sup>**  
(% per annum, period averages)



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

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

13. Euro-denominated loans from Cyprus MFIs with an initial rate fixation of up to one year.



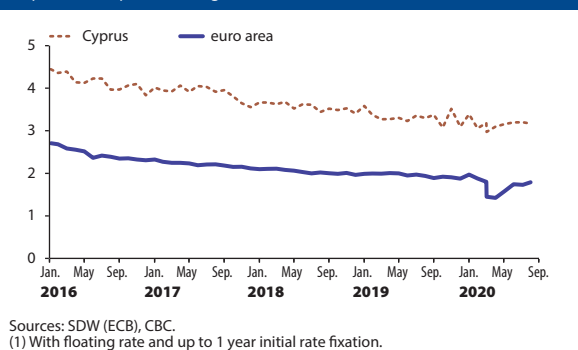
2019. The cost of new borrowing of domestic MFIs to euro area NFCs for loans up to €1 million increased slightly from 3,10% in December 2019 to 3,17% in September 2020 (**Chart A.16**).

In the period December 2019 - September 2020, the spread between domestic and euro area housing lending rates increased by 8 basis points, thus reaching 73 basis points. With regard to NFCs, the corresponding spread increased by 15 basis points and reached 138 basis points. The increase in the spread may reflect the fact that, unlike Cyprus, the rest of the euro area member countries benefited from the introduction of a government-guaranteed loan schemes, which led to a larger decrease in the euro area rates compared with domestic ones.

For the rest of the year, no substantial change in domestic interest rates is expected, given the moratorium on loan instalments, until the end of 2020. In 2021, however, following the termination of the loan moratorium supportive measure, an increase in lending interest rates may be recorded. The main factors which are expected to influence the course of domestic interest rates are the uncertainty regarding the effects of the pandemic on the real economy, the increased default risk faced by banks, the adoption of stricter lending criteria, as well as the possible increase in NPFs. The latter is anticipated due to the inability of businesses and households to service their debt obligations, as a result of the decrease in turnover and the rise in unemployment in 2020.

**CHART A.16 MFI interest rates on euro-denominated loans (new business) up to €1 million to euro area non-financial corporations<sup>(1)</sup>**

(% per annum, period averages)





## Labour costs

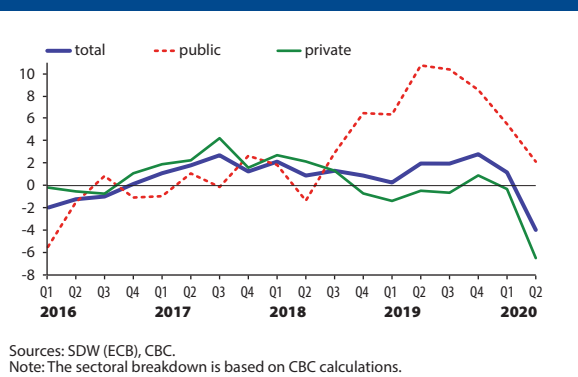
The impact of the pandemic on labour costs became evident as from 2020Q2 following the positive rate of growth recorded in the first quarter of the year. Compensatory fiscal measures were introduced to support jobs and incomes, such as the special allowance schemes for affected private sector workers. Some of the schemes have been extended to March 2021 and, as from June 2020, are mainly targeted towards the tourism sector.

Nominal compensation per employee decreased by 1,4% in 2020H1, following a rise of 1,1% in the corresponding half of the previous year (Chart A.17). Specifically, compensation per private sector employee dropped by 3,4% and was partly mitigated by an increase of 3,8% recorded in the public sector. In addition to the impact owing to the GHS, developments in compensation per public sector employee are attributable to the ongoing gradual restitution of crisis-era cuts in wages and pensions, in effect as of July 1, 2018. Developments in nominal compensation per employee in the private sector are due to wage cuts and are partly mitigated by the impact of the GHS. At the sectoral level, the decrease emanates mainly from the sectors of trade, transportation, hotels and restaurants as well as manufacturing.

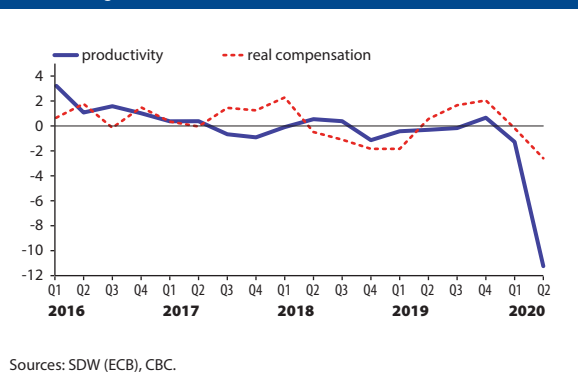
At the same time, price developments in 2020H1 did not burden households' purchasing power as real compensation per employee<sup>14</sup> recorded a year-on-year decline of 1,3%, followed by a reduction of 0,6% in the corresponding half of the previous year (Chart A. 18).

14. It should be noted that the deflator used is that of private consumption rather than CPI.

**CHART A.17 Nominal compensation per employee by sector**  
(annual change, %)



**CHART A.18 Productivity and real compensation per employee**  
(annual change, %)



Regarding productivity, which is calculated as the change in real GDP per employed person, the relevant index recorded a significant annual decline of 6,3% in 2020H1, following a slight reduction of 0,4% in the corresponding half of 2019. This development is attributable to the modest fall in employment in contrast to the significant drop in GDP, reflecting the measures to support workers, (Chart A. 18, p. 33).

The smaller reduction in compensation per employee in 2020H1 compared with the significant drop in productivity translated into a material rise in unit labour costs, an important competitiveness indicator for an economy vis-à-vis competitor economies. This indicator recorded an annual increase of 5,2% in 2020H1, following a rise of 1,5% in the corresponding half of the previous year (Chart A.19a). However, despite the significant increase recently observed, significant cumulative wage reductions as from 2012 and beyond the crisis, helped to maintain the competitiveness of the Cyprus economy over the long term. In particular, the index recorded a cumulative drop of 13% over the period 2013-2016 and, despite the increases recorded since then, remains at lower levels compared with the euro area index since 2013 (by about 15 percentage points in 2019) (Chart A.19b).

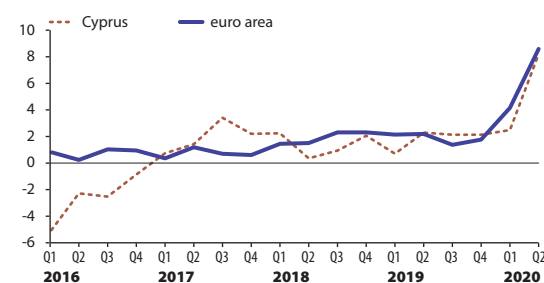
## 2.2 Domestic Competitiveness and the Balance of Payments

### Effective exchange rate

Chart A.20 shows the effective exchange rate (EER) index of the euro in Cyprus, in nominal

CHART A.19(a) Unit labour costs: Cyprus and the euro area

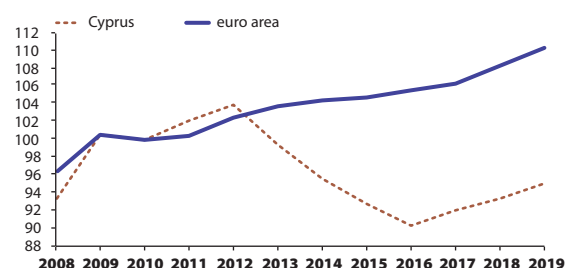
(annual change, %)



Source: SDW (ECB).

CHART A.19(b) Unit labour costs: Cyprus and the euro area

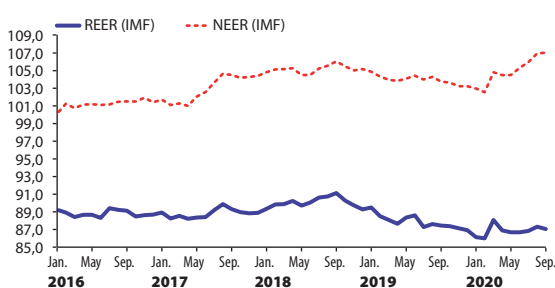
(index 2010=100)



Source: SDW (ECB).

CHART A.20 Real and nominal effective exchange rates (IMF weights)

(base year 2010=100)



Source: IMF.

(NEER) and real (REER)<sup>15</sup> terms, as calculated by the IMF. The NEER index strengthened in the period March to September 2020, in contrast to the REER index that recorded a very small weakening. Overall, the trend of the REER index, as well as the widening of the gap between the NEER and REER indices was influenced by developments in the nominal value of the euro, but most importantly by domestic developments, in particular the lower inflation recorded in Cyprus compared with its trading partners.

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 an economy's competitiveness. Lower unit labour costs 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 it also reflects the degree of competitiveness of the Cyprus economy. The adoption of measures affecting salaries and other benefits both in the public and private sectors during the period of the financial crises, has reduced unit labour costs for the whole economy at levels lower than in the euro area, thus maintaining competitiveness and supporting the recovery of the Cyprus economy in the medium term.

### Balance of payments<sup>16</sup>

The current account deficit deteriorated in

15. The effective exchange rate index in Cyprus in real terms (REER) is calculated on a monthly basis by IMF taking into account the trade relations between Cyprus and its 26 main trading partners (countries).
16. 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.

2020H1, reaching €891,8 million (-8,7% of GDP), compared with a deficit of €839,4 million (-7,7% of GDP) in the corresponding period of the previous year (Table A.4 and Chart A.21). The outbreak of the pandemic was a determining factor for the large reduction of the services balance surplus. This development was partly offset by the reduction of the goods deficit and the primary income deficit. The current account deficit, adjusted for the impact of SPEs, also worsened and reached €1.019,5million (-10% of GDP), compared with -€916 million (-8,4% of GDP) in 2019H1 (Table A.4 and Chart A.21).

More specifically, the trade deficit of goods was reduced to €1.826 million in 2020H1, compared with a deficit of €2.181,4 million in the corresponding period of the previous year, mainly due to the substantial drop in imports for home consumption, despite the contraction in exports of goods. In particular, oil imports decreased due to the decline in oil prices. At the same time, imports of consumer and capital goods, as well as transport equipment decreased, due to the fall in domestic demand owing to the pandemic. It is noted that the trade deficit of goods improved slightly from the net transactions of SPEs.

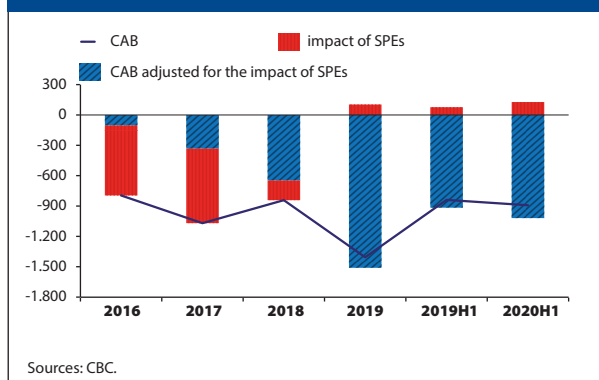
The surplus of the service balance shrunk to €1.228,9 million in the period under review, compared with €1.804,4 million in the corresponding period of the previous year, mainly due to the very large decrease in exports of services (Table A.4). In 2020, the spread of the pandemic and the restrictive measures taken by Cyprus and other

TABLE A.4 Balance of payments (main categories)

	2019H1 (€ million)	2020H1 (€ million)	Change (€ million)
<b>Current account balance</b>	<b>-839,4</b>	<b>-891,8</b>	<b>-52,5</b>
<b>Current account balance adjusted for the impact of SPEs</b>	<b>-916,0</b>	<b>-1.019,5</b>	<b>-103,5</b>
<b>Goods and services balance</b>	<b>-377,0</b>	<b>-597,1</b>	<b>-220,1</b>
<b>Trade balance</b>	<b>-2.181,4</b>	<b>-1.826,0</b>	<b>355,4</b>
Exports of goods	1.660,8	1.600,0	-60,8
of which:			
Exports of goods - SPEs	626,8	584,9	-41,9
Imports of goods	3.842,3	3.426,0	-416,3
of which:			
Imports of goods - SPEs	736,2	645,3	-90,9
<b>Services balance</b>	<b>1.804,4</b>	<b>1.228,9</b>	<b>-575,5</b>
Exports of services	5.795,7	5.285,8	-509,9
Imports of services	3.991,2	4.056,9	65,7
<b>Primary income (net)</b>	<b>-337,2</b>	<b>-81,9</b>	<b>255,3</b>
<b>Secondary income (net)</b>	<b>-125,1</b>	<b>-212,8</b>	<b>-87,7</b>
<b>Current account balance (% of GDP)</b>	<b>-7,7</b>	<b>-8,7</b>	
<b>Current account balance adjusted for the impact of SPEs (% of GDP)</b>	<b>-8,4</b>	<b>-10,0</b>	

Sources: Cystat, CBC.

CHART A.21 Current account balance (CAB) (€ million)



Sources: CBC.

countries had a negative impact on exports of services and especially on the tourism sector. For analysis purposes, exports of services are considered to be important, as Cyprus is a tourist destination and a business centre.

In 2020H1 exports of services recorded an annual decrease of 8,8% (-€509,9 million), mainly driven by the shrinkage of the travel category (-€886 million) which includes revenues from tourism (Table A.5). Current developments and more recent, available data on tourism are analysed in the subsequent sub-section (see Tourism). The transport category also decreased by -€180,6 million. On the other hand, the financial services increased (€510,2 million) reflecting the pickup in the turnover of investment companies as a result of the pandemic. Similarly, other business services increased by €51,9 million in the period under review.

Imports of services increased by 1,6% (€ 65,7 million) in 2020H1. This development is mainly attributed to increases recorded in the financial services (€ 336,6 million) and the category of telecommunications, computer and information services (€125,6 million), partly offset by reductions in the categories of travel (-€283,1 million) and transport (-€162,3 million) (Table A.5). It is noted that in 2020, due to the pandemic, many Cypriots did not travel abroad, a factor that mitigated to some extent the losses in the tourism sector.

The deficit in the primary income account (which mainly includes income from employment and investment) shrank to €81,9 million compared with the corresponding period of the previous year, almost exclusively associated with the developments in portfolio

**TABLE A.5 Services balance (main categories)**  
(€ million)

	2019H1	2020H1	Change
<b>Services balance</b>	<b>1.804,4</b>	<b>1.228,9</b>	<b>-575,5</b>
<b>Exports of services</b>	<b>5.795,7</b>	<b>5.285,8</b>	<b>-509,9</b>
<i>of which:</i>			
Transport	1.558,9	1.378,3	-180,6
Travel	1.092,7	206,7	-886,0
Financial services	1.498,6	2.008,8	510,2
Telecommunications, computer and information services	1.176,6	1.164,1	-12,5
Other business services	150,4	202,3	51,9
<b>Imports of services</b>	<b>3.991,2</b>	<b>4.056,9</b>	<b>65,7</b>
<i>of which:</i>			
Transport	954,3	792,0	-162,3
Travel	632,5	349,5	-283,1
Financial services	860,7	1.197,2	336,6
Telecommunications, computer and information services	920,2	1.045,8	125,6
Other business services	337,9	375,6	37,7

Source: CBC.

and direct investments. The deficit in the secondary income account (which mainly includes current transfers) widened, as a result of the decrease in government inflows from European funds (Table A.4, p. 36).

The current account deficit in 2020H1 was largely covered by government borrowing.

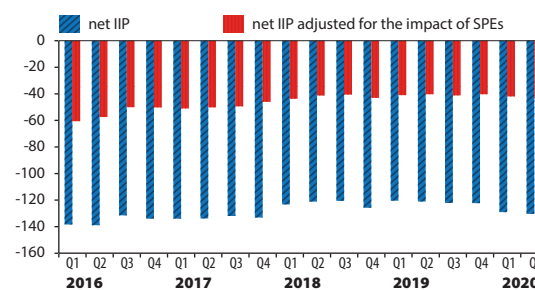
The net international investment position (IIP) at the end of June 2020 was negative, standing at -€27 billion (-129,9% of GDP) (Chart A.22). The IIP was negatively affected by the inclusion of the economic transfer of mobile transport equipment (mainly ships) by SPEs registered in Cyprus. These companies 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 substantial risk to the Cypriot financial system.

Adjusted for the impact of SPEs, the net IIP improved by 86,7 percentage points, standing at -€9 billion or -43,2% of GDP at the end of June 2020, compared with -€9 billion or -40,3% of GDP in 2019 (Chart A.22). It is noted that the deterioration recorded in the net IIP, as a percentage of GDP, is largely due to the GDP contraction in 2020.

## Tourism

Tourism constitutes one of the most important pillars of the Cyprus economy and has been significantly affected by the restrictive

CHART A.22 **Net International Investment Position (IIP)**  
(as a percentage of GDP)



Sources: Cystat, CBC.

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measures taken by the Cypriot government and by many other countries, in the effort to contain the pandemic. Following the successful path of previous years, in 2020 the tourism sector underwent the biggest crisis of the last decade, with arrivals and revenues dropping to record lows. It is already obvious, that the pandemic will have a bigger impact on the tourism sector both in terms of magnitude and duration from that originally estimated. Recovery efforts are now focused on the coming years (see Macroeconomic Forecasts).

On the basis of available data for the first ten months of 2020, tourist arrivals decreased by 83,4% on an annual basis reaching 0,6 million tourists, with all markets recording declines (**Table A.6** and **Chart A.23**). As from 15 March 2020 to 8 June 2020, the Republic of Cyprus prohibited the entry of various categories of travellers, including tourists, in Cyprus territory, while all hotel units ceased their operations. Since then, there was a gradual lifting of the restrictive measures based on the epidemiological picture of each country. Main markets, such as United Kingdom and Russia, have not been included in the list of countries, from which tourists were allowed to travel to Cyprus without any restrictions, as a result of their epidemiological picture. As a result, in the period April to May zero arrivals have been recorded, while in the summer months, which account the most, arrivals decreased sharply. More specifically, arrivals from the United Kingdom decreased by 82,2%, falling to 0,2 million tourists and from Russia tourist decreased by 96,6% falling to 25 thousand tourists.

**TABLE A.6 Tourism**

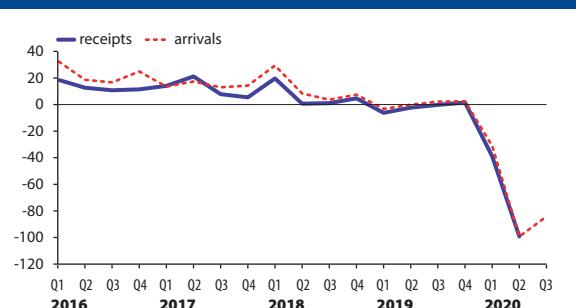
	Tourist arrivals (thous.)	Tourist receipts (€ million)	Expenditure per person (€)
2018	3.938,6	2.710,6	688,2
2019	3.976,8	2.683,0	674,7
annual % change	1,0	-1,0	-2,0
2019 Jan. - Aug.	2.735,8	1.865,8	682,0
2020 Jan. - Aug.	424,9	235,6	554,5
annual % change	-84,5	-87,4	-18,7
2019 Jan. - Oct.	3.697,1	n/a	n/a
2020 Jan. - Oct.	613,0	n/a	n/a
annual % change	-83,4	n/a	n/a

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 there was gradual lifting of the restrictive measures.

**CHART A.23 Tourist arrivals and receipts**

(annual change, %)



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 there was gradual lifting of the restrictive measures.



Similarly, revenues from tourism in the first eight months of 2020 declined by 87,3%, affected by the reduced number of tourist, as well as, the reduction in the daily per capita expenditure by 18,7% (**Table A.6**, p. 39).

Regardless of the above developments, there are ongoing efforts to support and upgrade the tourist product further. The quality of the tourism product has improved from hotel renovations and new infrastructure, such as the construction of marinas and luxury hotels. Furthermore, with the completion and the operation of the casino resort by 2022, tourist arrivals are expected to increase.

To sum up, Cyprus took early measures in response to the pandemic, thus maintaining its reputation as a safe destination. However this was not sufficient to restrain the negative trend in tourism in 2020. For the coming years, challenges are excessive amid the uncertainty surrounding the course of the pandemic.

## **2.3 Domestic Demand, Production and the Labour Market**

### **Quarterly national accounts<sup>17</sup>**

The pandemic reversed the positive GDP growth rates observed since 2015Q1. According to preliminary data for the first nine months of 2020, the GDP contraction reached 5,1%. More specifically, GDP growth rate slowed down to 1,1% in 2020Q1 due to the lockdown effects in the second half of March

17. With the introduction of the ESA 2010 and BPM6 statistical methods, total exports and imports of Cyprus as well as gross fixed capital formation include, inter alia, the transfer of economic ownership of mobile transport equipment (mainly ships) by SPEs, which affect the aforementioned GDP expenditure sub-categories. However, given the double entry accounting system they do not affect the level and growth rate of GDP.



2020. In 2020Q2, GDP recorded a significant annual contraction of 12,2%. According to preliminary Cystat data, the recession in 2020Q3 narrowed to 4,1%, owing to the retreat of the first wave of the pandemic and the gradual lifting of containment measures.

Based on detailed data, available for 2020H1 (Table A.7), the GDP contraction emanated from all GDP sub-categories other than public consumption, which registered an annual increase of 16,6%, mainly owing to the rise in intermediate consumption (see Domestic Fiscal Developments, p. 51). The reduction in private consumption by 3,3%, as a result of the drop in household disposable income, as well as, in investment by 13,9%, were mitigated by the implementation of compensatory measures to support employees and businesses. The suspension of loan instalments until end-2020, as well as, the fiscal compensatory measures have supported the liquidity position of households and businesses, thus curbing the decline in domestic demand. The decrease in exports by 8,1% is attributable to the decline in tourism receipts due to the pandemic and the restrictions on air transport (see Balance of Payments, p. 35). At the same time, the decrease in total imports by 5% mainly reflects the drop in imports of goods for home consumption (see Balance of Payments, p. 35). Overall, the GDP contraction in 2020H1 is mainly attributed to the decline in domestic demand and, to a lesser extent, net exports.

From the sectoral point of view (Table A.8), the GDP contraction in 2020H1 emanates from the decline in activity across most sectors with the main ones being the sectors

**TABLE A.7 National accounts in real terms by category of expenditure**  
(annual change, %)

	2018	2019	2019H1	2020H1
GDP	5,2	3,1	2,9	-5,8
Private consumption	4,7	1,8	2,8	-3,3
Public consumption	3,5	14,2	8,9	16,6
Gross fixed capital formation	-5,2	2,0	38,6	-13,9
Exports of goods and services	8,0	-0,4	-5,6	-8,1
Imports of goods and services	4,5	2,0	6,0	-5,0

Source: Cystat.

**TABLE A.8 Weighted contributions to real GDP growth by economic activity**  
(percentage points)

	2018	2019	2019H1	2020H1
GDP (%)	5,2	3,1	2,9	-5,8
Construction	0,7	0,8	0,7	-0,7
Trade, transportation, hotels and restaurants	2,0	0,7	0,6	-4,1
Financial and insurance activities	-1,4	-0,4	-0,8	-0,1
Professional, scientific and administrative activities	0,8	0,4	0,4	-0,2
Other sectors <sup>(1)</sup>	3,1	1,6	2,1	-0,7

Source: Cystat.

(1) Main sectors included are those of agriculture, manufacturing, public administration, education and health as well as information and communication.

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of trade, transportation, hotels and restaurants (contribution by -4,1 percentage points), construction (-0,7 percentage points) and manufacturing (-0,5 percentage points).

According to preliminary estimates for 2020Q3, the decline in GDP narrowed to 4,1%. The relatively better epidemiological picture following the March-April lockdown led to the gradual lifting of the restrictive measures as from May and, consequently, to a gradual rise in domestic demand. Domestic tourism, due to the reduction in prices and the adoption of relevant measures by the government, contributed, to some extent, towards mitigating the significant losses from external tourism. In 2020Q4, a deterioration is expected due to the worsening of the epidemiological picture and the reinstatement of restrictive measures.

Recent economic indicators relating to 2020Q4, albeit limited in terms of availability, point to a deterioration in the economic outlook, even before the local lockdowns in the Limassol and Paphos districts. More specifically, GDP growth closely follows the path of the Economic Sentiment Indicator (ESI), which indicates a reversal in the recovery path of the Cyprus economy. ESI stood at 80,7 in October 2020, recording a small ongoing decline since August 2020 (Table A.9). In general, the decrease in the index recorded in October compared with the previous month was mainly due to the deterioration in the business environment of services and retail trade.

The deterioration in private consumption is reflected across various economic indicators, however data for 2020Q4 were not

**TABLE A.9 Business and consumer surveys: confidence indicators**

(for sub-indices: difference between percentage of positive answers and percentage of negative answers)

	2019 Dec.	2020 Mar.	2020 June	2020 Sep.	2020 Oct.
ESI	108,5	101,4	79,7	81,4	80,7
Industry	8	3	-28	-28	-29
Services	24	6	-63	-44	-49
Consumer	-7	-23	-24	-29	-29
Retail trade	-5	-5	-29	-25	-28
Construction	2	-9	-13	-18	-11

Source: European Commission.  
Note: Seasonally adjusted data.

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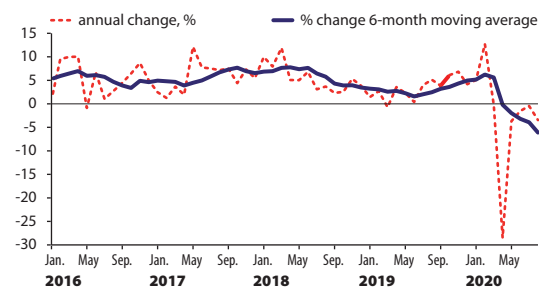
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available until the cut-off date for this *Economic Bulletin*. The turnover index of retail trade (**Chart A.24**) recorded an annual decline of 3,5% in August 2020, following a decrease of 6,1% compared with the previous month. Regarding credit card payments (**Chart A.25**), spending by Cypriot cardholders in Cyprus (adjusted for payments to the government and for petroleum products) recorded an annual increase of 43% in September 2020. Nevertheless, this indicator is no longer representative for monitoring developments in private consumption due to the shift of consumers' attitude towards a more extensive use of credit cards for their transactions owing to the pandemic, thus significantly restricting their use of cash. Continued annual reductions are recorded in motor vehicle registrations (**Chart A.26**) as of June of the current year (-0,6% in September 2020).

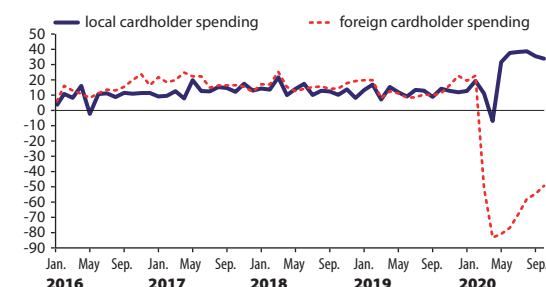
Following the lifting of restrictions on various economic activities in May, construction sites re-opened and various indicators related to the real estate sector started to show signs of recovery, especially in relation to domestic demand for real estate (see Real Estate Market and **Table A.10**, p. 46). Owing to the termination of the Cyprus Investment Programme (CIP) as from 1 November 2020, a decline in external demand for real estate is expected, especially for luxury residences. However, construction activity is foreseen to recover partially in the coming quarters owing to the reactivation of large and multi-year projects that had already started before the outbreak of the pandemic, some of which are of foreign interests. These projects include renewable energy generation

**CHART A.24 Retail sales (excluding motor vehicles)**  
(base year = 2015)



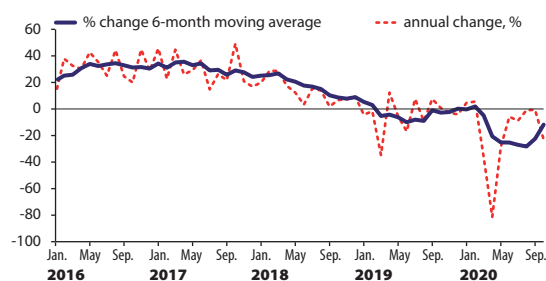
Source: Cystat.

**CHART A.25 Credit card spending in Cyprus**  
(annual change, %)



Sources: JCC Payments System Ltd, CBC.  
Note: The data does not include payments associated with government services and petroleum products.

**CHART A.26 Registration of motor vehicles**



Source: Cystat.

infrastructure, various commercial and mixed developments, marinas, hotel units and the casino-resort.

In line with the significant drop in tourism revenues recorded in the first eight months of the year reflecting the imposition of air travel restrictions (see Tourism, p. 38), credit card spending by foreign holders in Cyprus registered an annual drop of 55% in the first nine months 2020 and a decline of 40% in September (**Chart A.25**, p. 43). Regarding professional services, the available data concerning applications for new company registrations in Cyprus covering the first nine months of 2020, point to continuous annual decreases of 10,3% in September, however less negative since June 2020. This development reflects the effects of the pandemic and could also be related to the stricter supervisory measures that have been adopted in the past, especially in relation to shell companies.

Regarding monetary developments, and as previously mentioned, a significant decrease in new loan contracts to the non-financial private sector, especially to NFCs, has been registered in the first nine months of 2020 compared with the corresponding period of the previous year. This drop mainly reflects the uncertainty regarding the evolution of the pandemic (see Monetary aggregates, p. 26). Consequently, loans to NFCs recorded negative growth rates in the first nine months of 2020, reaching -0,8% in September, which is partly contained by the loan moratorium. On the other hand, loans to households continued to record positive (and slightly accelerating since June) annual

growth rates, standing at 2,2% in September. This is also mainly due to reduced loan repayments owing to the suspension of loan instalments in the period March-December 2020, as well as the government measure for the subsidisation of interest rates for new residential and business loans (**Chart A.12**, p. 29). In the coming years, a gradual recovery is foreseen, with new lending exceeding loan repayments and contributing positively to the GDP path by 2023.

### **Real Estate and construction sector**

In the first ten months of 2020, the real estate sector continued to exhibit a decelerating trend, following the upward trend observed in previous years. Residential property prices recorded modest increases until 2020Q2. However, in 2020Q3 and according to CBC internal data, house price increases decelerated and in some districts even declined for the first time after several quarters of positive growth. House prices are partly sustained by government measures to support employment, boost demand for housing loans as well as by the moratorium on loan instalments. Indicatively, the increase in demand for real estate assets from local buyers, also supports real estate prices. Nevertheless, there is uncertainty regarding future developments in the sector due to increasing downward pressure from the impact of the pandemic and other factors such as the termination of the Cyprus Investment Programme (CIP) and the projected acceleration of foreclosures.

According to Department of Lands and

Surveys' (DLS) data, the recorded real estate transactions were significantly affected by the pandemic, even though their negative course had already begun before its outbreak. Specifically, real estate transactions in Cyprus showed an annual decrease of 23,9% in the period January - October 2020. This decrease corresponds to annual reductions of 16,1% and 33,8% in sales to locals and foreigners, respectively (**Table A.10**). At a district level, only Nicosia recorded an annual increase in the sales contracts during this period (3,1%), which was due to a rise in purchases by locals (8,9%). All other districts recorded a decrease in sales contracts by both locals and foreigners.

According to available data from the CBC Residential Property Price Index (RPPI), property prices recorded increases until 2020Q2. Specifically, residential property prices in 2020Q2 have recorded an increase of 0,9% on a quarterly basis and 2,2% on an annual basis (**Chart A.27**). The differences in magnitude of the increases recorded by type of property (houses and apartments) and by district in previous quarters partly continued during the first two quarters of 2020, during which apartment prices in Limassol recorded higher annual increases compared with the other districts. On the contrary, the annual increases in apartment prices in Larnaca registered a significant deceleration compared with previous quarters. Also, according to CBC internal data, increases in residential property prices decelerated in 2020Q3 and some districts recorded annual decreases after several quarters. Cystat's house price index, which is based on a different metho-

**TABLE A.10 Real estate sector**

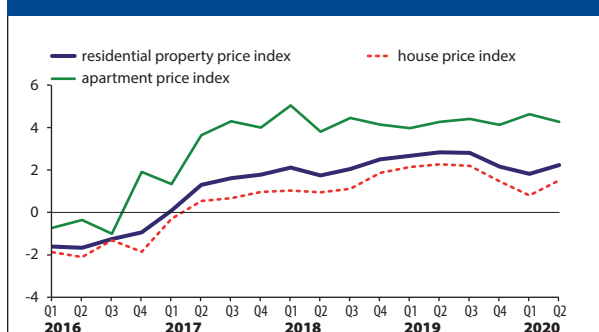
(annual change, %, unless otherwise stated)

	Jan.-Oct. 2019	Jan.-Oct. 2020	Oct. 2019	Sep. 2020	Oct. 2020
Sales contracts (total)	13,7	-23,9	0,2	13,6	30,9
Sales contracts (locals)	22,0	-16,1	19,4	29,2	43,3
Sales contracts (foreigners)	4,7	-33,8	-19,1	-8,8	12,3
Building sentiment indicator (average of index)	-5,7	-11,0	-2,2	-17,8	-11,3
Property price expectations for the next 3 months (average of index)	16,4	2,4	11,0	-4,4	1,6
Price index of construction materials	1,0	-0,6	0,2	-0,8	-0,5

Sources: Cystat, DLS, European Commission.

**CHART A.27 House and apartment price indices**

(annual change, %)



Source: CBC.

dology from the CBC index and is compiled on the basis of transaction data, recorded a quarterly increase of 0,3% and an annual decrease of 2,9% in 2020Q2. Residential property prices are partly supported by the government measures to support employment, incentives for new housing loans and by the moratorium on loan instalments; albeit the ongoing impact of the pandemic, the termination of CIP programme and the acceleration of foreclosures are expected to put downward pressure on prices in the medium term. It is worth mentioning that, according to Eurostat data, house prices in the euro area countries increased by an average of 5,0% on an annual basis in 2020Q2, which indicates a general upward trend in house prices at a European level.

According to the CBC Bank Lending Survey, demand for housing loans decreased significantly in 2020Q2 and increased equally significantly in 2020Q3. This reflects the restrictive measures due to the pandemic (Table A.3, p. 30). On the other hand, in 2020Q2 and 2020Q3 the criteria for housing loans became stricter (Chart A.28). The government's plan to partially subsidise the interest rate of housing loans, as well as the continuing environment of low interest rates, are expected to support demand.

As a result of the restrictive measures imposed due to the pandemic, construction activity has been shrinking. Specifically, the construction activity recorded annual decreases in 2020Q1 and 2020Q2 with the Cystat index of production in construction (category building) recording a decrease of 2% and 25,3%, respectively. Authorised building

CHART A.28 Lending criteria and interest rate on housing loans





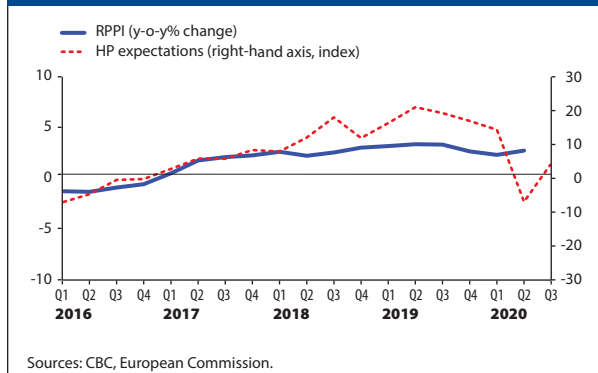
permits recorded an annual decrease of 3,6% in the first eight months of 2020. However, the number of authorised building permits for residential properties recorded an annual increase of 6,1% in the same period, which may reflect the greater resilience of the residential real estate sector compared to other types of real estate properties.

According to the Business and Consumer Surveys (BCS) published by the European Commission, the real estate market reflects the current uncertainty in the sector. Specifically, property price expectations in 2020Q2 stood at -7,67 while in the following quarter it increased to 3 (Chart A.29). At the same time, the index of employment expectations in the construction sector for the next three months recorded a negative sign for the first time since 2016Q2 and reached -1,43 in 2020Q3, compared with 2,83 in 2020Q2. In conclusion, the real estate market seems to rely mainly on domestic demand, as there has been a recovery by domestic investors returning to the market after the first shock of the pandemic, possibly as a result of state incentives in this direction. The real estate sector still faces challenges relating to the reduced demand from foreign investors, as well as the effects of the pandemic on the economy as a whole.

### Labour market

The negative impact of the pandemic was evident in the labour market data for 2020Q2, albeit the consequences were contained by the government support measures, with employment recording an annual decline of

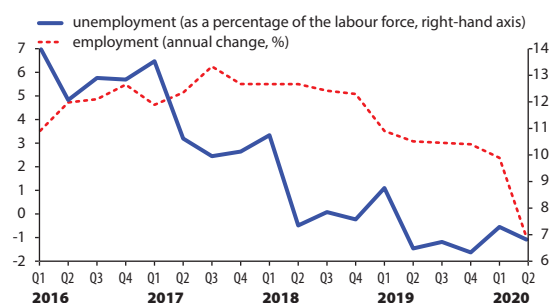
**CHART A.29 Residential property price index (RPPI) vs House Price Expectations for the next three months**



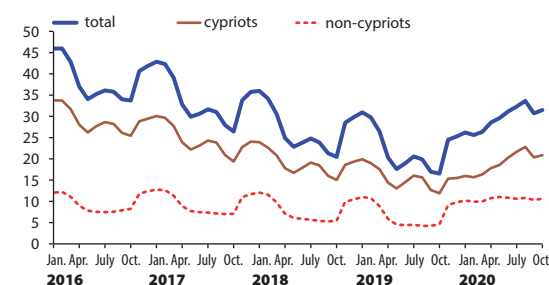


1,1% for the first time since 2014Q4. In 2020H1, employment growth registered a slowdown to 0,6%, driven by the rise recorded in 2020Q1, following an increase of 3,3% in the corresponding half of the previous year (**Chart A.30**). Specifically, employment rose in 2020H1 across all sectors except trade, transportation, hotels and restaurants, owing to the effects of the pandemic and the restrictive measures, including the closure of airports until the beginning of June. Total hours worked decreased significantly by 7% in 2020H1, following a rise of 3% in 2019H1. Hours worked per employed person dropped by 7,6% in 2020H1, following a decline of 0,2% in 2019H1, as a result of the full or partial suspension of company operations during the lockdown period.

The effects of the pandemic are reflected in the registered unemployed data, with the halting of the downward trend being evident as of April and being visible in the October 2020 data. In particular, the number of registered unemployed (**Chart A.31**), almost doubled (from 16.544 to 31.487 individuals). Nevertheless, it is not very reliable to compare data as from March 2020 onwards due to the automatic renewals of registered unemployed and new registrations of unemployed individuals without their physical presence in order to prevent the spread of the virus. According to Eurostat data, which are compiled based on registered unemployment data, the harmonised unemployment rate (seasonally adjusted data) rose to 8% in September 2020 compared with 6,6% in the corresponding month of the previous year. On the other hand, the Labour Force Survey

**CHART A.30 Unemployment and employment**


Source: Cystat (LFS).

**CHART A.31 Registered unemployment**  
(number of unemployed, thousands)


Source: Cystat.

(LFS) data reflect relatively more accurately the developments in unemployment. Unemployment rose modestly in 2020Q2, reaching 6,8% of the labour force, compared with 6,5% in 2019Q2, but it declined compared with 2020Q1 (7,3%) (**Chart A.30**, p. 49). This is firstly explained by the adoption of measures to support jobs in the private sector with the aim being that of maintaining a number of workers (labour hoarding) so that economic activity can resume immediately following the lifting of restrictions. And secondly by the relatively smaller increase in the labour force compared with the corresponding quarter of the previous year (according to LFS data, 1.103 people versus 13.173 people, respectively), due to the fact that people who would have liked to work were not able to look for a job during the lockdown. The latter explains the drop in unemployment compared with the first quarter and is consistent with a significant rise recorded in the inactive population. The youth unemployment rate rose to 17,8% in 2020Q2, up from 14,9% in the corresponding quarter of the previous year, but this only constitutes about 1,3 percentage points of the total unemployment rate for the quarter in question. On the positive side and according to seasonally adjusted data, the unemployment rate in Cyprus has been below the euro area average since 2019Q2.

An important parameter associated with the analysis of labour market developments relates to the path of long-term unemployment given that, in periods of persistently high unemployment, the long-term unemployed find it harder to re-integrate into employment. According to the most recent Cystat data on the

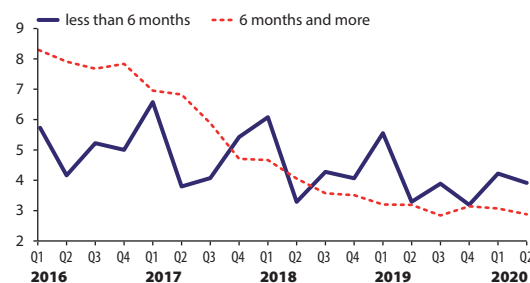
number of registered unemployed with a duration of six months and over, an increase of 13.167 individuals was recorded in October 2020 compared with the corresponding month of the previous year. On the other hand and according to the comparatively more representative data of the labour market situation from the LFS as mentioned above, the unemployment rate with a duration of six months and over decreased to 2,9% in 2020Q2 compared with 3,2% in the corresponding quarter of the previous year (**Chart A.32**). Overall, the available economic data capture the negative impact of the pandemic on the labour market. Nevertheless, the smaller deterioration relative to GDP is mainly owed to the measures taken to support affected workers.

## 2.4 Domestic Fiscal Developments

The crisis caused by the pandemic and the decline in economic activity as well as the necessary measures to support the economy have had a significant impact on public finances. In dealing with the negative effects of the pandemic on the economy, the State has implemented extensive fiscal measures that mainly affect public expenditure. The overall size of the fiscal package is expected to exceed €1 bn or 5% of GDP. The biggest component of these measures relate to the employment support schemes, while other important measures relate to direct subsidies to small and medium-sized enterprises, support to the health system and social benefits.

For the first nine months of 2020, according to Cystat data, the budget balance was at a deficit of 3,2% of GDP compared with a surplus of 2,6% of GDP in the corresponding nine

**CHART A.32 Unemployment by duration**  
(as a percentage of the labour force)



Source: Cystat (LFS).

months of 2019 (Chart A.33 and Table A.11)<sup>18</sup>. The budget deficit is expected to be even higher at the end of the year, reflecting the second wave of the pandemic and the additional fiscal measures announced in November.

For the first nine months of 2020, the decline in economic activity had a significant negative impact on public revenue (Chart A.34, p. 53), particularly on direct and indirect taxes. On the contrary, public expenditure showed a positive growth in the first nine months, mainly due to the fiscal measures adopted to mitigate the economic impact of the pandemic.

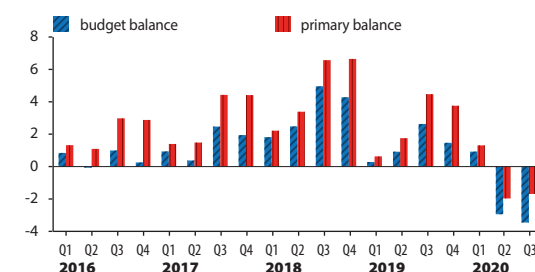
In more detail, the budget balance of the first nine months of 2020 was affected by lower revenue from taxes on production (-12,5% compared with the first nine months of 2019) and current taxes on income (-15,0% compared with the first nine months of 2019), resulting from the decline in economic activity and the reduction of corporate tax revenues, respectively (Table A.11). Revenues from social contribution are almost unchanged, as the expected increase from the higher health contribution rates was offset by their postponement for three months and the impact of the employment support measures – which are not subject to social contributions.

Public expenditure increased compared with the same period of the previous year, mainly due to higher subsidies and the increase in intermediate consumption. Higher subsidies are due to the employment support schemes and the direct subsidies to firms to mitigate the

18. The budget surplus for the nine months of the previous year would have been even higher, at 3,9% of GDP, if we had deducted from the figures the one-off impact that resulted from the amendment of the of the Income Tax Law of 2002, related to the accounting treatment of accumulated tax losses transferred to a credit institution from another credit institution. The amendment affected the treatment of income tax losses of Laiki Bank that were transferred to Bank of Cyprus in 2013, as part of Laiki's resolution.

**CHART A.33 Budget and primary balances of the general government**

(cumulative for the period as from Q1 as a percentage of GDP)



Sources: Cystat, CBC.

Note: The budget and primary balance for 2015Q4 (€175 million) and for 2018Q3 (€1,5 billion) do not include the fiscal impacts associated with the Cyprus Cooperative Bank (CCB).

**TABLE A.11 Accounts of general government**

	Jan.-Sep. 2019 (€ million)	Jan.-Sep. 2020 (€ million)	Change %
<b>EXPENDITURE</b>			
Intermediate consumption	706,1	1015,4	43,8
Compensation of employees	1.857,1	1948,2	4,9
Social transfers	1.979,0	2035,2	2,8
Interest	410,5	365,8	-10,9
Subsidies	31,8	481,7	1.414,8
Other current expenditure	380,6	408,1	7,2
Gross fixed capital formation	250,5	290,9	16,1
Other capital expenditure	405,9	73,2	-82,0
<b>Total expenditure</b>	<b>6.021,5</b>	<b>6.618,5</b>	<b>9,9</b>
<b>Total expenditure as a % of GDP</b>	<b>27,0</b>	<b>31,9</b>	
<b>REVENUE</b>			
Taxes on production and imports	2.514,8	2.201,2	-12,5
Current taxes on income, wealth, etc	1.561,1	1.326,9	-15,0
Social contributions	1.710,0	1.669,4	-2,4
Other current revenue	148,0	124,7	-15,7
Sales	476,4	476,3	0,0
Capital transfers received	66,9	70,1	4,8
Property income	130,5	87,7	-32,8
<b>Total revenue</b>	<b>6.607,7</b>	<b>5.956,3</b>	<b>-9,9</b>
<b>Total revenue as a % of GDP</b>	<b>29,6</b>	<b>28,7</b>	
<b>Primary balance</b>	<b>996,7</b>	<b>-296,4</b>	
<b>Primary Balance as a % of GDP</b>	<b>4,5</b>	<b>-1,4</b>	
<b>Budget Surplus (+) / Deficit (-)</b>	<b>586,2</b>	<b>-662,2</b>	
<b>Surplus (+) / Deficit (-) % of GDP</b>	<b>2,6</b>	<b>-3,2</b>	

Sources: Cystat, CBC.

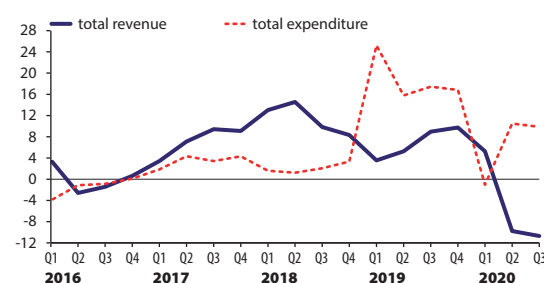
negative effects of the crisis. The increase in intermediate consumption (43,8% compared with the same period of the previous year) mainly reflects GHS-related expenditure and to a lesser extent the health system support to cope with the health crisis. It is noted that the increase in public expenditure was significantly offset by the decrease in other capital expenditure, since the corresponding period of the previous year includes the one-off effect resulting from the amendment of the Income Tax Law.

Regarding government debt (**Chart A.35**), it stood at 122% of GDP in September 2020, recording an increase of 28 percentage points compared with December 2019 (94% of GDP). This is mainly due to the revision of the 2020 funding plan to cover the financing needs created by the pandemic and the necessity to maintain sufficient cash reserves in line with the Public Debt Management Law of 2012. Currently, the state maintains significant cash reserves as it has borrowed about €6,5 bn in 2020 (compared to €2,35 bn expected in the initial funding plan) as opposed to around €1,4 bn debt repayments and the financing of the nine-month cash deficit (€840 bn according to preliminary data by Cystat). In addition, the increase in the government debt-to-GDP ratio was significantly affected by the significant contraction expected in GDP for 2020 (contribution 8,1 percentage points).

Following the projected increase in 2020, public debt is expected to decline significantly in the coming years, reflecting the estimates for the recovery of the economy. It is noted that rating agencies expect a significant reduction in government debt, thus any derailment not associated with the needs created by the pandemic, will have a serious impact on the credibility of fiscal policy.

**CHART A.34 Total revenue and expenditure of the general government**

(cumulative for the period as from Q1, annual change, %)

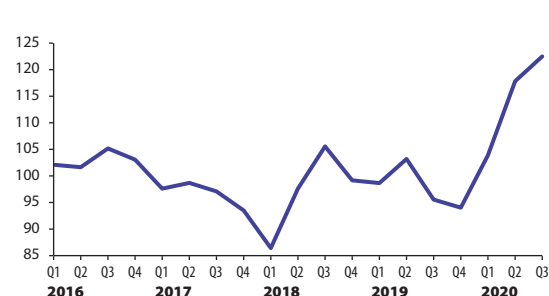


Sources: Cystat, CBC.

Note: Total expenditure for 2015Q4 (€175 million) and for 2018Q3 (€1,5 billion) do not include the fiscal impacts associated with the Cyprus Cooperative Bank (CCB).

**CHART A.35 General government consolidated gross debt**

(as a percentage of GDP)



Sources: Cystat, CBC.

## BOX

### The need to strengthen financial literacy and financial education in Cyprus: results of the sampling survey by the Central Bank of Cyprus (CBC)

#### Introduction

The issue of financial illiteracy is a global phenomenon according to the Organisation for Economic Co-operation and Development (OECD). The containment of financial illiteracy, or on the flip side, the strengthening of financial literacy, has internationally been acknowledged as a key challenge which needs to be addressed in a decisive manner, even in advanced economies. Underlining the importance of financial literacy, Ben Bernanke, a former Governor of the US Federal Reserve, has stated that "financial literacy is a protection shield against a global economy and a financial system that are becoming more and more complex."

According to the OECD, financial literacy is defined as the ability of an individual to combine appropriate knowledge and skills, rational behaviour and attitudes necessary for effective management of his/her financial resources<sup>1</sup>. The lack of the above characteristics is defined as financial illiteracy and constitutes a significant obstacle to citizens' economic welfare and prosperity.

At a conference of the Commonwealth Ministers of Finance and Central Bank

Governors, which was co-organized by the Republic of Cyprus and the Commonwealth Secretariat on 16-17 October 2019 in Washington D.C., the Chairman and CBC Governor, Constantinos Herodotou, highlighted once again the need to effectively address the issue of financial illiteracy. The main topic of the agenda of the Commonwealth Central Bankers' meeting was the excessive level of household debt and possible debt mitigation policy responses ("Mitigating the Consequences of Rising Household Debt").

The seminal speaker at the Central Bank Governors' Meeting was Professor Annamaria Lusardi, a prominent academic and pioneer in the field of financial literacy. The main conclusions of the meeting were the need to improve the level of financial literacy, as a measure to reduce the excessive level of household debt, and hence the need to invest in financial education. Unfortunately, as Professor Lusardi<sup>2</sup> mentioned, only one in three adults worldwide is considered to have sufficient financial knowledge. As she said, in the US for example, only one in three adults understands the basics of managing personal finance and comprehends the notion of compounding interest and its effect on loan instalments.

Financially informed and educated citizens have the ability to manage effectively their personal finances. For example, they can set clear and realistic financial goals and/or are able to contain

1. OECD (2011) Measuring financial literacy: Questionnaire and Guidance Notes for Conducting an International Comparable Survey of Financial Literacy, page 3.
2. Lusardi, A. & Mitchell O.S., (2014). "The Economic Importance of Financial Literacy: Theory and Evidence," Journal of Economic Literature, American Economic Association, Vol. 52(1), PP 5-44. Lusardi, A., (2008). "Financial Literacy: An Essential Tool for Informed Consumer Choice? ", Paolo Baffi Centre Research Paper No. 2009-35.

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1

Introduction

2

Macroeconomic  
Developments  
and Projections

their debt at sustainable levels. Financial education plays a crucial role both at an individual as well as an aggregate level. The availability of full information and hence the existence of well-informed counterparties support free competition, with social and economic benefits for the society as a whole. Furthermore, financial literacy facilitates the understanding of economic policies and enhances the effectiveness of the monetary policy transmission mechanism, thus contributing to a well-functioning and organised economy and society.

### Evidence for Cyprus

Regarding Cyprus, the stock market crisis of 2000 and, more recently, the management of deposits and investment portfolios before the 2013 crisis, have highlighted the fact that a significant part of the population does not seem to have sufficient basic financial knowledge, rational economic behaviour and attitudes as regards financial matters. This makes them vulnerable and exposed to adverse economic shocks. At the same time, they have a comparative disadvantage in situations whereby their counterparties have more information or are in a more favourable financial position.

Sampling surveys which have attempted to measure the level of financial knowledge for specific groups in Cyprus are rather limited. Specifically, the first survey that was conducted in 2010 by the Cyprus Securities and Exchange Commission

aimed at determining the level of knowledge among investors in Cyprus on issues pertaining to the capital market and investment securities. More recently, the Cyprus University of Technology (CUT) conducted a pilot sample survey among Cypriot students<sup>3</sup> on this topic. In addition, the findings of a global survey conducted by the S&P's International Rating Agency in 2014, in which Cyprus also participated, confirmed the existence of financial illiteracy issues in Cyprus, such as lack of knowledge on key financial terms. Andreou and Anifantaki (2019)<sup>4</sup> showed that there is a statistically significant positive relationship between the level of financial knowledge and the frequency of use of electronic banking services (i-banking). One of the most important conclusions of their analysis is that financially illiterate people do not trust i-banking services and hence they are either not using or rarely using them for their transactions.

In conclusion, all the aforementioned surveys confirmed that the low level of financial literacy is a prevailing issue in Cyprus, at least in the groups of individuals and specific areas of financial knowledge and skills examined.

Nevertheless, none of the above sampling surveys represented the general population. Nor was it comprehensive enough in terms of the range of questions asked in order to cover adequately the financial skills /knowledge, behaviour and attitudes as indicated by the OECD guidelines.

3. Andreou C, P. and Philip D. (2018) "Financial knowledge among university students and implications for personal debt and fraudulent investments", Cyprus Economic Review, Vol.12, No 2, pp 3-23.
4. Andreou C, P. and Anyfantaki, S. (2019) "Financial literacy and its influence on internet banking behaviour". Available at SSRN: <https://ssrn.com/abstract=3499104> or <http://dx.doi.org/10.2139/ssrn.3499104>



## CBC Survey

The CBC survey attempted to close the aforementioned gap in the literature through the implementation of an extended questionnaire and a sampling design covering all groups of the population at a national level.

In particular, the aim of the survey was to enhance the scientific and in-depth evaluation of the level of financial knowledge, behaviour and attitudes of Cypriots at national and category-specific levels, based on various demographic parameters such as age, gender, level of education, geographical area, etc. The results of the survey constitute a useful tool in promoting financial literacy in Cyprus, since they can provide important information for the formulation of a targeted National Strategy. In particular, they can direct the take-up of initiatives and actions towards targeted population groups, which according to the survey, seem to lack basic financial education (knowledge / skills, rational behaviours and attitudes).

The CBC survey questionnaire was prepared in collaboration with the academic experts Dr Panayiotis Andreou and Dr Dennis Philip from the CUT and Durham University, respectively, who have specialised knowledge and long experience in the field. The survey was conducted in accordance with the OECD guidelines, so that the results are comparable with those of other countries and can be referenced in the international

literature. The questionnaire consisted of 45 questions. These questions focused on specific demographic characteristics and certain topics that allowed the measurement of the level of financial illiteracy, that is, the level of skills / knowledge, behaviour and attitudes / mentalities.

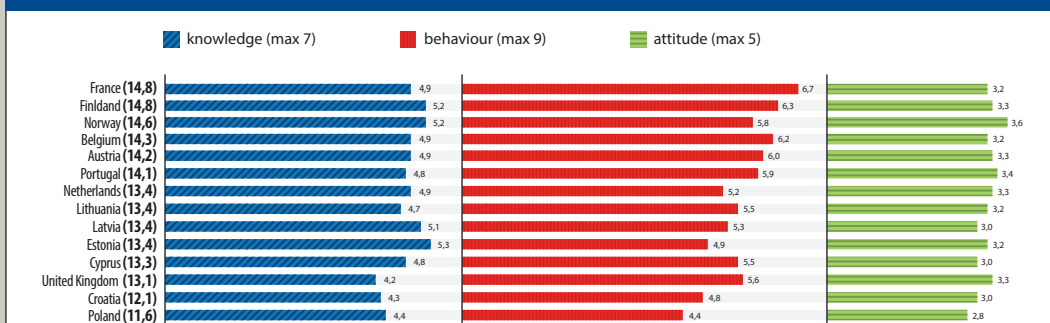
The final sample size of this nationwide survey was 1.000 people in the age range between 18 and 79. The fieldwork was conducted by Insights Market Research (IMR), and was completed in 2018. Using a specific statistical procedure, calibrated weights were estimated for each participant, in order to ensure the correct representativeness of the sample at the general population level. In particular, the specialised statistical methods employed, via the help of an external research partner from the Eurosystem, are consistent with those applied by the European Central Bank in large research projects. The statistical processing, weighting and editing of the micro-data was completed in 2019.

## Key findings of the survey

Some key findings of the CBC sample survey are summarised below. A detailed analysis of the findings will be published and presented in a webinar in due course. Extrapolating the results to the whole population using descriptive and inferential statistics, the survey confirmed a low level of financial literacy in Cyprus. The results of the various sub-group and



CHART 1 Level of financial literacy in selected European countries



Source: Organisation for Economic Co-operation and Development (OECD), 2017.

sub-category analyses are in line with the results of previous surveys and this fact strengthens their reliability and robustness. Indicatively, the conclusion of a low level of financial literacy in young people / students, as well as the low scores on specific key questions of the S&P's survey were confirmed.

The level of financial literacy in Cyprus ("knowledge" / "skills", "behaviour" and "attitudes" / "mentalities") appears to be lower compared with the countries included in the OECD sample and are part of the European Economic Area (Chart 1)<sup>5</sup>.

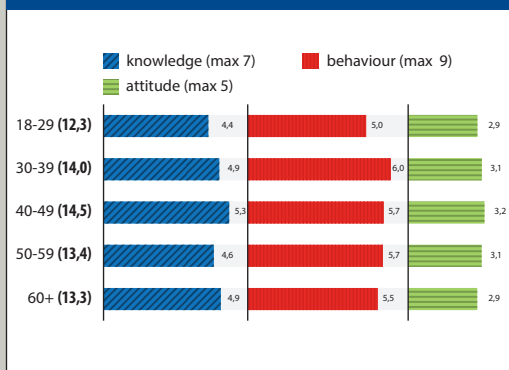
- More specifically, the level of financial literacy in Cyprus has a total score of 13,3 (the sum of the individual scores on knowledge, behaviour and attitude). This is driven by the particularly low performance in the "behaviour score" of young people (aged 18-29).
- Young people (18-29) performed worse in terms of the financial literacy score than all other age groups (Chart 2, p. 58). This holds true for all aspects of the

questionnaire, with the exception of the interest rate and portfolio diversification questions. The problem in youngsters underlines the importance of improving schools' efforts in providing financial education.

- The answers to the portfolio diversification questions from the general population (all age groups) were very disappointing. The results could well be related to the recent crises that the Cyprus economy went through in 2000 (stock market crisis) and in 2012-2013 (financial crisis). In both cases it became evident that the lack of portfolio diversification resulted in serious losses for investors / depositors.
- Financial literacy was also found to be directly related to the level of education. The higher the education level of the participant, the higher the overall financial literacy score (Chart 3, p. 58).
- There is also a positive correlation between financial literacy and

5. The European Economic Area (EEA) consists of the member states of the European Union, Iceland, Norway and Liechtenstein.

**CHART 2 Financial level literacy, age analysis based on the results of the Cypriot sampling**



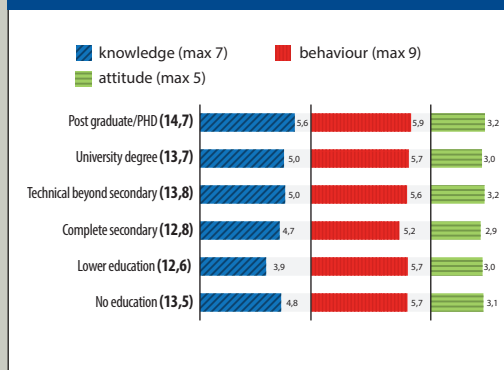
household income. The higher the household income, the higher the overall score.

- One of the most useful findings of the survey is that certain categories of the population, such as the elderly, especially women, and young people (between 18-29 years old) recorded lower levels of financial literacy compared with other categories of the population. This result, which is consistent with the international literature, can be quite useful in the coordinated and targeted effort of the state to financially educate and assist Cypriots in undertaking personal finance decisions.

### Guidelines from international organisations and the next steps for Cyprus

According to the OECD, there are four stages in achieving an effective national strategy for promoting financial literacy.

**CHART 3 Financial level literacy by level of education based on the results of the Cypriot sampling**



The first stage is the identification of the problem and its focus. The second stage is the establishment of institutional and administrative arrangements, whilst the third stage is related to the formulation and attainment of goals as well as the evaluation and financing of the national strategy. The final stage refers to the securement of an effective and innovative provision of financial education.

Various domestic institutions have been offering financial training in Cyprus, e.g. the Cyprus Securities and Exchange Commission (CYSEC) and the Cyprus Association of Financial Analysts (CFA Institute Cyprus), through newsletters or consumer advice (Consumer Associations). In addition, in the context of its corporate social responsibility, the CBC participated in an initiative of the Association of Banks and Junior Achievement Cyprus in co-organising training seminars in primary education ("Economics for Success") and very recently in high schools.

Relevant training lectures or seminars

are also organised by the Ministry of Education, Culture, Sports and Youth (MOEC), CYSEC, CUT, the Cyprus Youth Organization and the Cyprus Economic Society. The recent introduction of a financial education course by the University of Cyprus, as well as the three economic and social policy fora on financial literacy organised by Dr P. Andreou of CUT are also noted. The first two aforementioned fora were effected with the support of the CBC and the third one via a webinar<sup>6</sup>.

The above noteworthy efforts are, however, of limited scope and/or duration and have not been designed in the context of a broader targeted plan or strategy covering all segments of the population.

The findings of the CBC sampling survey could serve as the starting point for designing a National Strategy which effectively promotes financial literacy and financial education through a well-targeted, organised and collective effort.

To this end, an ad-hoc Committee was established following the discussion of setting a National Strategy for Financial Literacy at a recent meeting of the Parliamentary Committee on Educational Affairs and Culture. The ad-hoc Committee consists of members from the Central Bank of Cyprus, which has the coordinating role, Ministry of Finance, MOEC, CUT, the University of Cyprus and CYSEC. The Committee has commenced its work with the aim of formulating and proposing a National Strategy for enhancing financial literacy and financial education in Cyprus.

This development constitutes an important step towards the right direction. A planned and coordinated effort with a holistic scientific and technocratic approach has begun. In this respect, a solid foundation has been laid for the planning and ultimately implementing a National Strategy that will contribute to the literacy and education of the population in financial matters, benefiting both citizens and the society as a whole.

### References

- Andreou C, P. and Anyfantaki, S. (2019) "Financial literacy and its influence on internet banking behaviour", SSRN: <https://ssrn.com/abstract=3499104> or <http://dx.doi.org/10.2139/ssrn.3499104>
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- OECD (2011) Measuring financial literacy: Questionnaire and Guidance Notes for Conducting an International Comparable Survey of Financial Literacy, page 3.
- OECD (2017), G20/OECD INFE report on adult financial literacy in G20 countries.

6. A list of all actions taken will be included as an Annex to the National Strategy Report.

### 3. Macroeconomic forecasts for the Cyprus economy

- *Negative GDP growth rate in 2020 due to the pandemic and gradual recovery over 2021-23, amid unprecedented uncertainty.*
- *Significant contraction in net exports in 2020 and, to a lesser extent, domestic demand, with a gradual recovery in the coming years.*
- *Increase in unemployment until 2021 but to a limited extent, owing to the measures to support employees and companies in the private sector.*
- *Negative inflation in 2020 due to the significant reductions in oil prices as well as in services prices, mainly due to the pandemic.*
- *Subdued inflation in the coming years, despite the expected positive GDP growth rates and the gradual wage increases.*
- *Slightly downside risks in relation to the baseline scenario for GDP and inflation for 2021-23.*

Economic forecasts continue to be characterised by unprecedented uncertainty. Despite promising recent announcements relating to the ongoing efforts to mass-produce an effective vaccine, significant sources of uncertainty remain. These include the epidemiological picture over the medium term, the effectiveness of existing measures to reduce the spread of the pandemic, the magnitude and duration of their effects, the period of time it will take to vaccinate the population, as well as the extent of possible permanent GDP losses.

Given the unprecedented uncertainty in relation to the evolution and impact of the pandemic, the Eurosystem Central Banks continued to work with three scenarios (mild, baseline, severe). Compared with the June 2020 forecasts, the assumptions adopted in the December 2020 projections differ mainly along two dimensions. First, in relation to the time that will be required to implement successfully the medical solution. Second, in the construction of the December 2020 scenarios, an evaluation of the effectiveness of the policies at both national and European level to prevent adverse financial amplification channels has been introduced. Based on the mild and severe scenarios for Cyprus, the recession for 2020 is expected to reach -5,5% and -6,7% respectively, while in the baseline scenario it is foreseen to reach -6,2%. The GDP rebound in 2021 is expected to reach 4,8% and 1,8%, respectively, in the mild and severe scenarios, while 4,1% in the baseline. The balance of risks as regards the baseline GDP forecasts over 2021-23 is tilted slightly to the downside.

The CBC's updated forecasts for GDP have been revised upwards in 2020, pointing to a smaller contraction mainly owing to better than expected developments in domestic demand, particularly in the third quarter. These more than offset the worse than foreseen economic activity at the end of the year due to the second wave of the pandemic but also due to the lower external demand, especially tourism. In the coming years, GDP forecasts have been revised downwards, due to the projected smaller recession in 2020

(base effect) and the changes in assumptions adopted in relation to the path of the pandemic. For 2021, the downward revision in GDP is also partly attributable to the decline in external demand for real estate, owing also to the termination of the Cyprus Investment Programme (CIP) as from 1 November 2020.

Regarding inflation, the CBC's updated forecasts for both HICP and HICP excluding energy and food prices (core inflation) point to a significant downward revision across all years of the projection horizon. This is mainly due to worse than expected developments in services prices in 2020 and the slower recovery path foreseen in the coming years. The analysis for Cyprus that follows in the current publication of the *Economic Bulletin* concerns the baseline scenario.

### National accounts<sup>19</sup>

In 2020, the Cyprus economy is projected to record a significant contraction of 6,2% (**Table A.12**), which would have been higher without the implementation of compensatory measures totalling around 5% of GDP, as well as the measures of the European Central Bank and the Central Bank of Cyprus, previously mentioned. The drop in GDP for 2020 arises from all GDP sub-categories excluding public consumption (17,4%). The latter captures, firstly, the increase in spending associated

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

	2019	2020f	2021f	2022f	2023f
GDP	3,1	-6,2	4,1	3,4	2,7
Private consumption	1,8	-4,1	1,2	1,5	1,2
Public consumption	14,2	17,4	7,1	3,0	1,8
Gross fixed capital formation	2,0	-12,5	1,8	2,4	2,2
Exports of goods and services	-0,4	-13,3	6,0	7,1	6,6
Imports of goods and services	2,0	-8,3	3,4	4,7	4,7

Sources: Cystat, CBC.

19. Due to the volatility in imports and exports of mobile transport equipment (ships and aircraft), it is extremely difficult to forecast the aforementioned series. Therefore, it is assumed that the level of transactions associated with these series for the projection horizon 2020-23 remains broadly fixed at the 2019 levels. Consequently, the rate of change in imports and exports as well as in gross fixed capital formation adjusted for the impact of these transactions does not differ relative to the unadjusted series.

with the purchase of health services by the GHS (intermediate consumption) owing to both the implementation of its second phase and the efforts to address the effects of the pandemic. Secondly, it reflects the ongoing gradual restitution of crisis-era wage cuts (see Quarterly National Accounts and **Table A.12**, p. 62). Private consumption is expected to drop by -4,1%, lower than previously projected. The contraction is due to the reductions in employment and wages, which are partly mitigated by the implementation of compensatory measures to support employment and income (**Table A.12**, p. 62). Despite the partial restoration of disposable income due to the aforementioned measures, a decline in private consumption is still expected owing to the restrictive measures and the closure of various businesses over spring and November (strict lockdown in the Limassol and Paphos districts); thus affecting household savings upwards ("forced saving"). Uncertainty in relation to employment and income is expected to lead to "precautionary savings", even after the restrictive measures are fully lifted, which are expected to remain in place until the smoothing-out of the epidemiological picture. Gross fixed capital formation is projected to record a significant annual contraction of 12,5% in 2020, mainly due to the deterioration in the business climate, with some companies postponing and / or cancelling some of their investment plans (**Table A.12**, p. 62).

The decline in net exports contributes significantly to the projected decline in GDP for 2020. Exports of goods and services are expected to drop significantly in 2020 by



13,3% (**Table A.12**, p. 62) due to the sharp decline in revenues from tourism, partly mitigated by the increase in exports of financial services, in particular receipts from investment companies (see Balance of Payments). The decrease in imports of goods and services (-8,3%), (**Table A.12**, p. 62) is expected to be smaller than originally projected, due to better than expected developments in imports of goods for private consumption, but mainly due to the extraordinary decline in Cypriots travelling abroad. The latter contributed to a reduction in imports of services, being consistent with a significant increase in domestic tourism.

The loan moratorium, being in place until the end of 2020, is expected to support to some extent the liquidity position of households and businesses and, consequently, to partly mitigate the projected decline in private consumption and investment. In the coming years, the historically low interest rates are also expected to support demand for new loans by businesses and households, while the improvement in the economic climate and the rise in consumer confidence are expected to help boost new lending. On the other hand, the expected resumption of loan repayments as of 2021 is projected to offset the increase in new loans. As a result, the rate of change in net loans for businesses is not envisaged to return to an upward trend before mid-2022, while for households a positive rate of change is expected around mid-2023. Due to the revised assumptions that have been adopted in the December 2020 forecasts,



especially in relation to the path of the pandemic, the recovery in net loans is expected to materialise at a later stage compared with the June 2020 forecasts. Regarding NPLs, these are not expected to be adversely affected by the pandemic in 2020, owing to the temporary suspension of loan instalments until the end of the year, as a result of the banking authorities' decisions to provide flexibility in the existing framework relating to the treatment of non-performing loans. It should be noted that a significant decrease in the level of NPLs was recorded in 2020H1; this was mainly the result of various non-organic reductions, such as loan write-offs, sales of NPLs and the transfer of NPLs outside the banking system. In 2021, an increase in NPLs is expected, owing to the inability of some of the borrowers who have been significantly affected by the pandemic to service their loan repayments. As a result of the expected recovery of the Cyprus economy, the stricter lending framework applied by banks aiming to reduce the risk of new NPLs, but also the banks' ongoing efforts to further streamline their balance sheets, NPLs are expected to continue on a downward trajectory as of 2022.

Positive GDP growth rates of 4,1%, 3,4% and 2,7%, respectively, are forecasted over 2021-23 (**Table A.12**, p. 62) and are expected to be driven mainly by the recovery of domestic demand and, to a lesser extent, of net exports. The annual growth in private consumption is expected to hover around 1,3% per annum over 2021-23, owing to the rise in disposable income. However, it is expected to be restrained by the resumption



of loan repayments following the end of the moratorium that is in place until end-2020 (**Table A.12**, p. 62). Gross fixed capital formation is expected to recover partially in the coming years, recording annual increases of around 2,1%, due to the gradual completion of large and multi-year projects that have already begun, some of which are of foreign interests (**Table A.12**, p. 62). The projects cover the sectors of energy, tourism, transport as well as the casino-resort (see Quarterly National Accounts, p. 62). On the contrary, housing investment, especially for luxury homes, is foreseen to drop due to the termination of CIP. Public consumption is expected to record a deceleration over 2021-23, mainly reflecting the completion of the gradual implementation of the GHS in 2020 (**Table A.12**, p. 62).

Net exports are expected to contribute positively to economic growth in 2021-23. Specifically, exports are projected to increase by 6% in 2021, 7,1% in 2022 and 6,6% in 2023 (**Table A.12**, p. 62). The sectors of tourism, transport (especially maritime), as well as telecommunications, computer and information services are expected to contribute positively to the export outlook. Due to the uncertainty regarding the timeframe needed to vaccinate the population both in Cyprus and in our tourist markets, a more gradual normalisation in the tourism sector has been incorporated in the forecasts. This is in line with estimates of various organisations pointing to a slower recovery in global passenger traffic. The ongoing recovery foreseen in tourism in 2022 is also associated with the expected

operation of the casino-resort<sup>20</sup>. Finally, there are ongoing efforts to support the shipping sector, e.g. measures to improve the competitiveness of the Cypriot registry by reviewing pricing policy and simplifying ship registration procedures. Regarding total imports, which are affected by imports for consumer, intermediate and capital goods, these are expected to recover over 2021-23, in conjunction with the gradual improvement in domestic demand (Table A.12, p. 62).

### Compensation, productivity and the labour market

The reversal of the positive GDP path in 2020 is reflected in the course of employment. However, the contraction in employment is smaller compared to the GDP fall due to the government measures aiming to support private sector workers. Nevertheless, the impact of the pandemic is clearly visible in working hours per employed person. Specifically, employment is projected to record an annual decrease of 0,7% in 2020 compared with a rise of 3,1% in 2019 (Table A.13). As previously mentioned, the fall in employment is smaller than previously projected due to the effectiveness of the fiscal support measures. In the years 2021-23, employment is forecasted to record positive rates of change of 1,3% per annum (Table A.13).

The downward trend in unemployment recorded prior to the pandemic is expected to

**TABLE A.13 Labour market projections**  
(annual change,%, unless otherwise indicated)

	2019	2020f	2021f	2022f	2023f
Compensation per employee	1,8	-2,7	2,5	2,2	2,0
Unit labour costs	1,9	3,0	-0,4	0,2	0,5
Productivity	-0,1	-5,5	2,9	2,0	1,6
Total employment	3,1	-0,7	1,2	1,4	1,2
Unemployment rate (% of labour force)	7,1	7,6	7,6	6,8	6,3

Sources: Cystat, CBC.

20. Due to the outbreak of the pandemic, the operation of the casino resort is expected to commence as of 2022 in the December 2020 forecasts, with the baseline scenario including only a partial impact from its operation, as was the case with previous forecasts.

be reversed in 2020, reaching 7,6% of the labour force. The small rise in unemployment compared with the GDP contraction is due to the effectiveness of the measures to support employment as previously mentioned as well as their extension in some sectors till March 2021. These measures are aimed mainly to support the tourism sector, given the resumption of other economic sectors after the end of the spring lockdown. On the positive side, the unemployment rate is already lower than the euro area average (see Labour Market, p. 48) and is projected to return to a downward trend as from 2022, reaching 6,3% in 2023 (**Table A.13**, p. 67). The stabilisation of unemployment in 2021 at the 2020 rate, despite the better than expected outcomes for the current year compared with the June 2020 forecast, reflects the downward revision in the GDP growth rate, especially owing to the assumptions relating to tourism. On a quarterly basis, the unemployment rate is expected to peak in 2021Q2 with a gradual decrease as from the following quarter.

The smaller, compared with GDP, fall in nominal compensation per employee in 2020 (-2,7%) reflects the adoption of measures to support private sector workers and to mitigate the decline in their incomes. At the same time, nominal compensation per public sector employee is expected to rise, mainly due to the ongoing gradual restitution of wage and pension cuts (see Labour Costs, p. 33). The reduction in nominal compensation per employee includes the effect of the increase in social contributions rates towards the GHS (which was suspended for three months as part of the legislative package of

measures to support employers). Regarding wages, a larger decrease is expected in the private sector in conjunction with a slightly more modest rise in the public sector in 2020 (**Table A.13**, p. 67). In the coming years, small annual increases in nominal compensation per employee by 2,5% are expected in 2021 (includes the effect of the rise in contribution rates towards the GHS for the first five months of that year), by 2,2% in 2022 and by 2% in 2023 (**Table A.13**, p. 67). The aforementioned increases until 2023 are affected by the gradual restitution of crisis-era wage cuts in the public sector.

Productivity is expected to decline significantly by 5,5% in 2020, following a broadly unchanged rate of growth in 2019. This development is due to the fact that the pandemic is expected to affect the rate of GDP growth to a greater extent than the rate of employment growth, given the adoption of measures to support workers. In the coming years, productivity is projected to recover, registering positive rates of change of 2,9% in 2021, 2% in 2022 and 1,6% in 2023 (**Table A.13**, p. 67).

Unit labour costs are projected to fluctuate over the forecast horizon (**Table A.13**, p. 67). The significant loss in productivity over 2020, leads to a significant increase in unit labour costs during the year under review (3%) despite the reduction of nominal compensation per employee. For 2021, a decrease in unit labour costs (-0,4%) and annual increases of 0,2% and 0,5% in 2022 and 2023, respectively, are forecasted. In general, similar trends are expected to be recorded by the relevant euro area indicator. As a result, the

unit labour costs index in Cyprus maintains its comparative advantage compared with the rest of the euro area owing to the wage reductions observed in the past and, as a consequence, the improvement in competitiveness recorded in previous years (see Labour Costs, p. 33).

## Inflation

Domestic prices are expected to decline in 2020. Specifically, HICP is expected to reach -1,2% compared with 0,5% in 2019 (**Table A.14**), mainly reflecting the negative impact of the pandemic on economic activity and demand. Significant drops in services prices, especially owing to the situation in the tourism sector, as well as the developments in the energy market, mainly reflecting the sharp decline in international demand for oil due to the pandemic, are foreseen to exert downward pressures on domestic inflation in 2020. In addition, HICP is expected to continue to be adversely affected by the projected decline in the non-energy industrial goods prices (see Prices, p. 25). The aforementioned reductions are partly offset by the projected increases in food prices. Core inflation, i.e. HICP inflation excluding energy and food, is projected to reach -0,9% in 2020 compared with 0,9% in 2019.

Gradual increases in prices are envisaged over 2021-23, whilst remaining at subdued levels. HICP inflation is expected to rise to 0,5% in 2021, 0,9% in 2022 and 1,4% in 2023, mainly driven by the projected recovery of domestic economic activity and rising services prices due to the positive, albeit

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

	2019	2020f	2021f	2022f	2023f
HICP	0,5	-1,2	0,5	0,9	1,4
HICP excluding energy and food	0,9	-0,9	0,2	0,6	1,3

Sources: Cystat, CBC.

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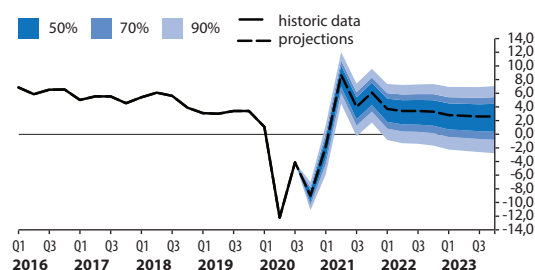
sluggish, recovery in tourism. In addition, HICP inflation is partly affected by the expected increases in energy prices, in line with the oil price assumptions adopted in the December 2020 forecast. HICP inflation is also foreseen to be positively affected by the rebound in wages. At the same time, core inflation is projected to return to its previous positive path, reaching 0,2% in 2021, 0,6% in 2022 and 1,3% in 2023.

### Risk assessment of macroeconomic forecasts<sup>21</sup>

The expected GDP path presented in **Table A.12** (p. 62), as well as the HICP and the core inflation projections (**Table A.14**, p. 70) underpin the baseline scenario. The confidence intervals associated with the baseline forecasts for GDP and HICP, which capture the probabilities deviating from the corresponding baseline scenario, are outlined in **Charts A.36** and **A.37**, respectively. Possible deviations with respect to the baseline forecast for core inflation are shown in **Chart A.38**. The following paragraphs analyse both the downward and upward risks to GDP and inflation, with a risk assessment summary presented in **Table A.15** (p. 72).

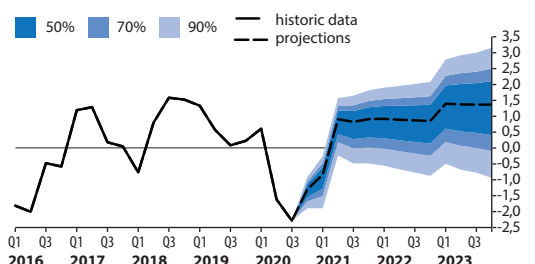
The risks of deviating from the baseline GDP forecasts for the years 2021-23 are assessed to be slightly downwards (downside risks) and are associated with a possible weakening of banks' assets that is linked to a rise in NPLs and thus higher than foreseen losses in the banking sector. In addition, uncertainty about the economic recovery path could lead to a worsening in credit

**CHART A.36 Real GDP fan chart**  
(annual change, %)



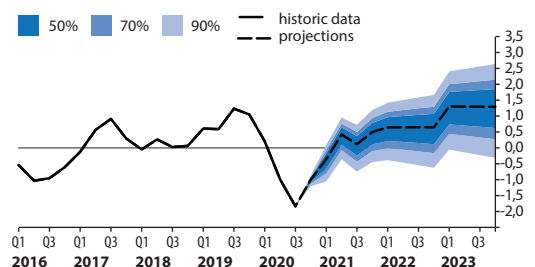
Source: CBC.

**CHART A.37 HICP fan chart**  
(annual change, %)



Source: CBC.

**CHART A.38 HICP excluding energy and food fan chart (core inflation)**  
(annual change, %)



Source: CBC.

21. For further information regarding the methodology of the risk assessment of macroeconomic projections, see *Economic Bulletin*, June 2015, p. 67.

conditions (or even a credit crunch under the severe scenario) thus constraining the granting of new loans, consumption and investment. Downside risks are also associated with a worse than expected outlook regarding the external environment, either due to a more severe recession or due to a slower than expected economic recovery. In this context, pre-existing economic vulnerabilities should be taken into account, such as the continued and / or further imposition of restrictive measures on international trade. A hard Brexit is expected to have a relatively small impact on the outlook for the Cyprus economy given the situation created by the pandemic. This is because a sluggish recovery in the tourism sector has already been incorporated into the December 2020 forecasts and, more generally, due to the time available until end-2020 to finalise a trade agreement, thus providing an opportunity for businesses to adjust to the new conditions. Fiscal support measures should not be withdrawn prematurely. However, the possible adoption of fiscal consolidation measures after tackling the impact of the virus in order to strengthen public debt sustainability, might slow down growth prospects over the medium term, whilst having a positive impact on the sovereign rating. Possible upward deviations from the baseline GDP scenario (upside risks) are associated with a faster and more effective than expected vaccination of the population, which may allow the removal of social distancing measures and therefore an improvement in the economic climate sooner than envisaged. In particular, a boost in

TABLE A.15 Summary of risk assessment

Risk	GDP (2021-2023)	Inflation (2021-2023)
Faster than expected effective vaccination of the population against the virus	+	+
Greater than expected absorption of funds from EU support package	++	+
Deterioration in credit quality impacting NPFs	-	-
Worse than expected credit conditions (further tightening of credit standards or even a credit crunch)	-	-
Possibility of higher than foreseen oil prices	-	+
Weaker-than-foreseen outlook as regards the external environment	-	-
Adoption of contractionary fiscal measures aimed at strengthening public debt sustainability	-	-
Better than expected performance of certain services sectors, e.g. education, health, etc., due to the virus	+	+
<b>Overall assessment</b>	-	-

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

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consumer confidence and business climate could lead to better than envisaged investment plans and a more favourable tourism performance. Upside risks are also associated with higher than foreseen absorption of available funds from the European support package ("Next Generation EU"). Finally, upside risks are linked with possible better than foreseen performance of certain services, e.g. education (Cypriot students remaining in their country), as well as health due to the pandemic.

Risks to inflation for the years 2021-23 are also assessed to be slightly on the downside, in line with the GDP risks. Possible downward deviations from the baseline scenario (downside risks) are associated with a weakening of the quality of banks' assets, as mentioned above for GDP. They are also linked to a possible deterioration in domestic credit conditions, with a consequent negative impact on domestic demand and prices. In addition, a deeper than expected recession and / or a slower economic recovery in relation to the external environment may exert negative price pressures. In this context, the aforementioned geopolitical developments reported for GDP pose a significant downside risk to inflation as well, due to the negative impact on demand, which is expected to outweigh the direct impact on inflation from restrictive measures and tariffs. Possible adoption of contractionary fiscal measures, in particular on the expenditure side in order to strengthen public debt sustainability, could have a negative impact on inflation over the medium term, via a negative impact on economic activity.

Upward deviations from the baseline scenario (upside risks) for inflation emanate from a faster and more effective than expected vaccination of the population, as in the case with GDP risks. By consequence, a better than foreseen implementation of various investment projects and services performance due to a more favourable tourism recovery could have a positive effect on inflation. Finally, higher oil prices than originally envisaged constitute an upside risk. Risks to core inflation are also slightly downwards, as is the case with HICP inflation risks.

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### (A) Domestic monetary aggregates

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.

## **(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.