Eurozone

EY Eurozone Forecast

December 2013

Austria
Belgium
Cyprus
Estonia
Finland
France
Germany
Greece
Ireland
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Malta
Netherlands
Portugal
Slovakia
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Outlook for Cyprus

Severe austerity and credit crunch leave outlook bleak

Published in collaboration with

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Highlights

GDP growth

2013 −7.4%

GDP growth

2014 −8.0%

- After falling by an estimated 7.4% in 2013, GDP is forecast to shrink by a further 8% in 2014 and 2.7% in 2015, against a backdrop of shattered consumer and investor confidence, soaring unemployment, and a credit crunch. The economy is not expected to return to growth until 2017, at which stage economic activity will be 20% lower than the pre-crisis peak.
- Household incomes are coming under enormous pressure from the impact of fiscal consolidation efforts, while the repercussions of the crisis in the private sector are likely to result in a sharp increase in unemployment to around 25% of the workforce by 2015. As a result, we expect consumer spending to continue to decline throughout 2013–17.
- The outlook for investment is even bleaker. Inevitably, much of the fiscal consolidation efforts have fallen on public investment, but private investment is also plunging in response to the near-meltdown of the banking sector in March 2013. With deposits continuing to decline and non-performing loans at very high levels, it will be some time before conditions in the financial sector stabilize and the remaining capital controls can be lifted. Until conditions improve, banks will have very little appetite to lend new money to any but the very safest companies. Firms that do wish to invest their own cash will be unable to do so freely.
- Even with such dismal prospects, the downside risks remain considerable. Further household and corporate defaults would exert downward pressure on consumption and investment and create further capitalization needs for the financial system. Meanwhile, soaring unemployment could undermine fiscal consolidation efforts by cutting tax revenues and forcing up social transfers. In addition, the economy and financial system would be completely destabilized if Greece abandoned its efforts to remain in the Eurozone.
- However, a glimmer of hope is offered by the country's gas reserves, which are expected to boost investment and exports in the long term. Preliminary reports place the gross value of these reserves at US$50b, approximately three times Cyprus's GDP.

Consumer prices

2014 0.8%

Unemployment

2014 24.1%

Severe austerity and credit crunch leave outlook bleak

Large contraction expected in 2013 ...

Having fallen by an estimated 7.4% in 2013, GDP is expected to shrink by 8% in 2014, and 2.7% in 2015, against a backdrop of shattered consumer and investor confidence, soaring unemployment, private sector deleveraging and a credit crunch. A return to growth is not expected until 2017, by which time economic activity will be 20% lower than the pre-crisis peak.

The external sector is expected to provide the only positive contribution to growth in the near term, although this will mainly reflect further declines in imports, which are the result of the ongoing collapse in domestic demand. As the trade balance improves, Cyprus's current account deficit is expected to narrow considerably, with a modest deficit of 0.3% of GDP forecast in 2014–17.

... as consumption plunges

Household income will continue to plunge under the strain of fiscal consolidation measures, including large reductions in public sector payrolls and social transfers, an increase in employees' pension contributions and further increases in indirect taxes. Value-added tax (VAT) has already been increased to 18% in 2013 and is expected to be raised further, to 19%, in January 2014. The impact of the crisis in the private sector is compounding the strain on household finances from fiscal consolidation, which will cause substantial additional job losses.

Against this weak background, we expect consumer spending to continue to decline throughout 2013–17. Most of the adjustment will be in 2013 and 2014, when we expect consumption to decline by over 9% annually.

Unemployment hits historic high ...

Labor market conditions are expected to worsen considerably next year, with the unemployment rate rising above 24%, before peaking at over 25% in 2015. This reflects the sharp contraction of GDP in our forecast. Weak economic activity and a hiring freeze in a public sector that is under fiscal consolidation measures have hit unemployment hard, with the effects particularly pronounced in agriculture and construction.

Table 1

Cyprus (annual percentage changes unless specified)

	2012	2013	2014	2015	2016	2017
GDP	-2.4	-7.4	-8.0	-2.7	-1.0	1.4
Private consumption	-2.5	-10.4	-9.5	-6.6	-3.7	-0.4
Fixed investment	-19.6	-34.0	-33.5	-3.4	1.4	6.3
Stockbuilding (% of GDP)	1.3	-1.9	-1.2	0.0	0.4	0.5
Government consumption	-3.1	-4.9	-8.9	-6.5	0.5	1.0
Exports of goods and services	-2.7	6.8	1.7	3.9	4.5	5.1
Imports of goods and services	-6.4	-11.5	-4.0	0.5	4.2	4.6
Consumer prices	3.1	0.8	0.8	1.1	1.2	1.5
Unemployment rate (level)	11.9	18.7	24.1	25.3	25.0	22.2
Current account balance (% of GDP)	-6.6	-0.8	-0.3	-0.3	-0.3	-0.3
Government budget (% of GDP)	-6.4	-8.4	-8.3	-7.5	-6.6	-5.6
Government debt (% of GDP)	86.6	121.0	164.5	194.2	200.5	200.5
ECB main refinancing rate (%)	0.9	0.5	0.3	0.3	0.3	0.4
Euro effective exchange rate (1995 = 100)	115.5	120.3	119.5	117.6	114.9	113.9
Exchange rate ($ per €)	1.28	1.32	1.29	1.25	1.22	1.20

Source: Oxford Economics.

Additionally, wages in both the public and private sectors have been slashed, reducing household income in the short run. Although this adjustment is painful, the wage cuts are feeding through into lower unit labor costs, helping to improve the international competitiveness of the economy over the longer term and providing a boost to exporters.

... while the economy flirts with deflation

Consumer price inflation has slowed sharply in 2013 and fell into negative territory in October. Given the subdued economic environment, we envisage an environment of low inflation will persist, with inflation to average around 1% annually over the next few years. But, given the rapid declines in economic activity and wage cuts, there is a risk that inflation will slip into negative territory on a more sustained basis. Falling prices would increase the real value of existing debts and place further strain on the highly indebted household and corporate sectors.

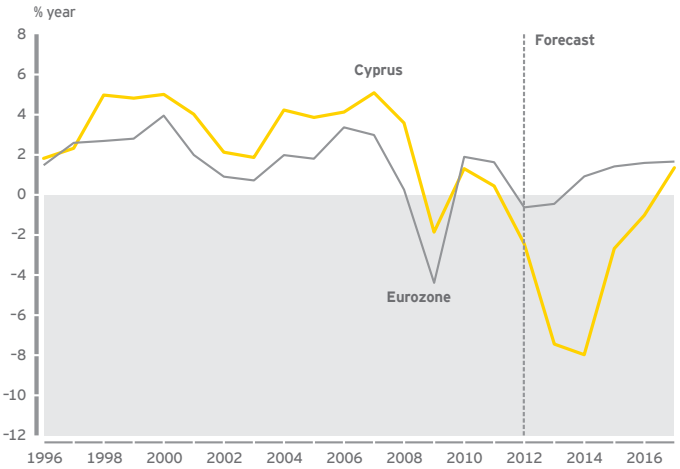
Fiscal consolidation continues ...

In spite of the significant contractionary policy implemented this year, the government deficit is expected to have widened this year. However, a large proportion of this can be attributed to a one-off compensation of retirement funds in a now non-existent bank, which is equivalent to 1.8% of output. The fiscal position in 2014 is expected to be determined by the sharp contractions in economic activity and fiscal consolidation efforts.

From the revenue perspective, declining wages and lower employment will reduce the Government's ability to tax the labor market. Tax revenue is also expected to be hampered by the negative effects of falling household spending, even with the support of a higher VAT rate. On the spending side, further cuts in public sector capital and current spending should outweigh the increased social transfers associated with the constrained economy, leading to a decrease in government expenditure. The deficit is expected to close over the forecast horizon – although at an average of about 7%, it will remain high.

Figure 1

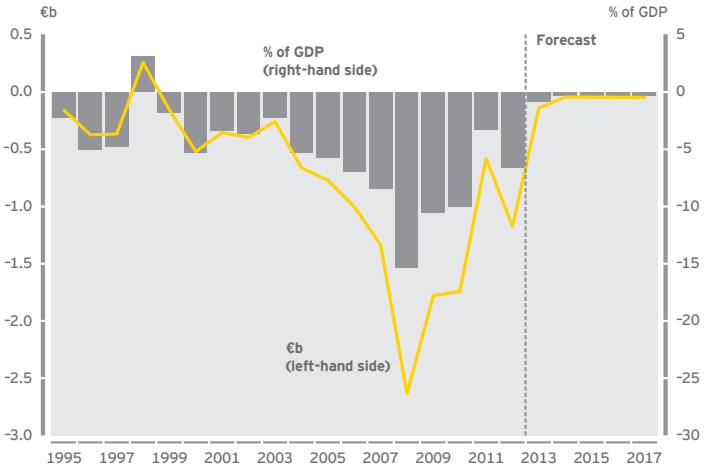
Real GDP growth



Source: Oxford Economics.

Figure 2

Current account balance



Source: Oxford Economics.

Table 2

Forecast for Cyprus by sector (annual percentage changes in gross added value)

	2012	2013	2014	2015	2016	2017
Manufacturing	-6.8	-14.6	-7.7	-1.1	1.4	2.4
Agriculture	-2.4	-5.1	-5.9	-1.4	-2.4	-0.2
Construction	-19.6	-19.7	-14.7	-0.3	1.1	3.4
Utilities	-3.8	-4.2	-6.7	-2.8	-2.2	0.8
Trade	-2.5	-5.1	-5.3	-1.5	-0.9	1.7
Financial and business services	2.0	-6.5	-6.9	-1.4	-0.6	1.8
Communications	-1.0	-4.4	-5.7	1.2	1.3	3.6
Non-market services	-0.4	-7.0	-11.1	-7.1	-2.9	-0.6

Source: Oxford Economics.

... and investment is collapsing

Meanwhile, the outlook for investment is even worse. Inevitably, much of the fiscal consolidation efforts have fallen on public investment. From January to September 2013, capital spending by the central Government was nearly 50% lower on the year (even though spending in 2012 was already dramatically down on 2011). But private investment is also plunging in response to the near-meltdown of the banking sector in March 2013. Although the pace of decline slowed in September, private sector deposits have fallen by 42% relative to their peak in May 2011, indicating a continued lack of confidence in the financial sector.

With deposits continuing to decline and non-performing loans at very high levels, it will be some time before conditions in the financial sector stabilize and the remaining capital controls can be lifted. Although the Government has been easing capital controls, our forecast assumes that they will remain in place beyond the finance minister's stated aim of 2014, due to concerns over the vulnerability of the financial sector. Until conditions in this sector improve, banks will have very little appetite for lending new money to any but the very safest companies. Firms that do wish to invest their own cash will be unable to do so freely.

The dysfunctional banking sector is also preventing the European Central Bank's current expansionary monetary policy stance from being passed onto the real economy. Lending rates on new loans to the small group of businesses that can access credit are being charged at an expensive 6.2%, compared with 2.1% in Germany.

The effects of the credit crunch on firms can be seen starkly in the latest European Commission survey data. In 2013, 38% of firms cited financial constraints as a factor "limiting" production. This is the highest rate in the Eurozone, where the average is 7.4%. While firms are unable or unwilling to invest, Cypriot firms have indicated that, on balance, their productive capacity is insufficient given current orders, even though economic activity is contracting rapidly. If investor confidence were to return more quickly than we currently expect, or the banking system were to return to normality earlier, there is potential for the decline in investment to be less severe than in our baseline forecast, as firms extend their productive potential.

Significant downside risks remain

Even with such dismal prospects, the downside risks remain considerable. Further household and corporate defaults, caused by deflation or falling incomes, would exert downward pressure on consumption and investment and create further recapitalization needs for the financial system. Meanwhile, soaring unemployment could undermine fiscal consolidation efforts by cutting tax revenues and forcing up social transfers.

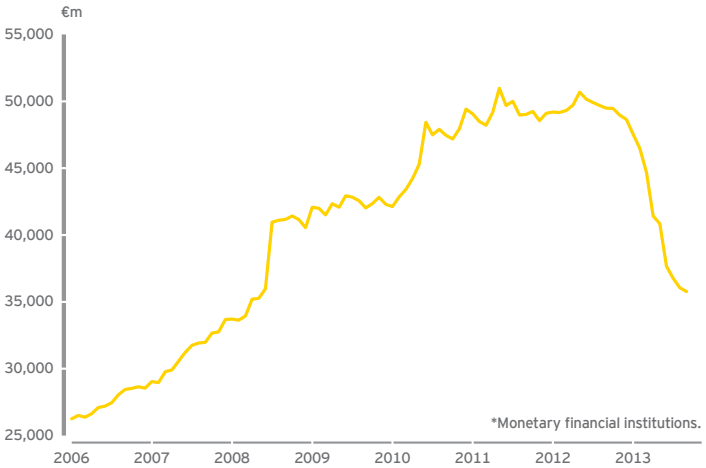
Although the country has not experienced the social unrest seen in other countries undergoing adjustment programs (such as Greece or Spain), the painful effects of the fiscal consolidation measures may lead to reform fatigue. In addition, the economy and financial system in Cyprus would be destabilized if Greece abandoned its efforts to remain in the Eurozone.

Longer-term growth should be powered by gas

However, there is some hope in Cyprus's gas reserves, which are expected to boost investment and exports in the long term. While the estimates of the appraisal drilling results are less than initially predicted, preliminary reports place the gross value of these reserves at US$50b, approximately three times the country's GDP. However, this support is some way off; officials have indicated that production will be delayed until 2021.

Figure 3

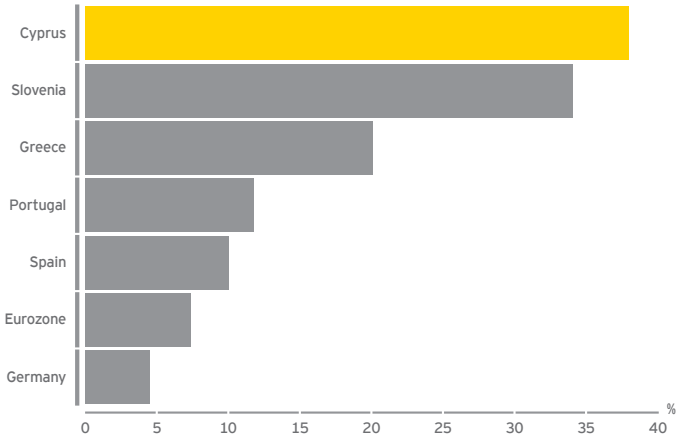
Private sector deposits (with MFIs)*



Source: Haver Analytics.

Figure 4

Financing constraints for companies



Source: Haver Analytics.

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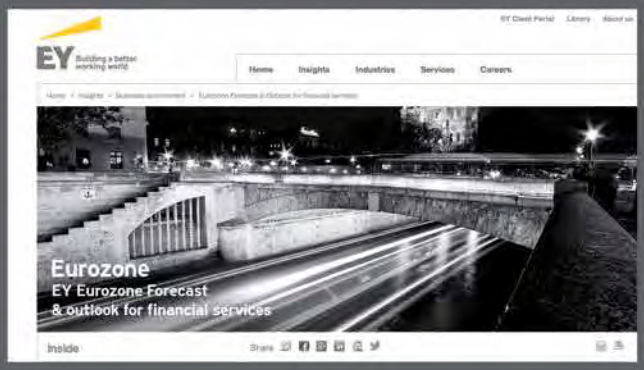

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- Highlights, data and other information from the *Eurozone Forecast*.

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- Rapid-Growth Markets Forecast

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