Uncertainty is killing prospects for 2013

7 leading analysts take part in the Financial Mirror Consensus Forecasts

PAGES 7-9

The Financial Mirror Consensus Forecasts

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The latest Financial Mirror consensus forecast makes depressing reading, with all of the seven panellists surveyed this quarter expecting negative growth in 2012 as well as 2013, and some expecting the recession to be even deeper next year than this year.

This would be the first two-year recession since 1975-76, just after the massive economic disruption that followed the Greek-inspired coup and the Turkish invasion.

The recurring theme this quarter is uncertainty and its negative impact on economic sentiment.

While many of us were crying out months ago for the government to bite the bullet and apply to the troika (European Central Bank, European Commission and IMF) for financing via the European Financial Stability Facility (EFSF), the government left its application until the last minute.

Ironically, this ensured maximum publicity for Cyprus' plight because the application came just as the world's media was descending upon us for the beginning of the Cyprus EU presidency.

Moreover, the fact that the government combined its EU request with a plea to Russia for financing also dragged up memories of the past, leading many foreign journalists to make assumptions about where all those Russian deposits come from.

You could repeat the mantra "We have been on the OECD White List since 2009" as much as you like, but you'd be hard pushed to find anyone who took notice.

More than three months since that application, the government has only just put together its counter-proposals. And it still has to fight with the unions, so we are still in the dark about when exactly

the financing will come through and under what conditions.

Our panellists have noted that this uncertainty is already affecting demand, even for smaller items such as "back to school" purchases. The government's proposals to increase the VAT on tourism will also kick a sector that has had a modest rebound these past two years.

If the troika accepts the government's counter-proposals, their greater emphasis on tax increases rather than spending cuts will only push us further into recession and increase the gap between the well paid public servants and the shrinking private sector.

GDP analysis: recession starts to spread

The breakdown of gross domestic product (GDP) for the second quarter paints a picture of a recession that is not only deepening but threatening to infect the more dynamic sectors of the Cyprus economy, just as they will be hit by an increase in taxes.

Real GDP fell in seasonally adjusted terms by 2.3% compared with the same period of the previous year in the second quarter.

This is the steepest contraction yet, and the fourth straight quarter of both quarter on quarter and year on year decline.

One reason is a slowdown in the single biggest sector of all, namely public services (spot our biggest structural problem), which accounted in 2011 for 22% of gross value added (GVA).

Public services still grew in the second quarter, by 0.6%, but this was the slowest pace of growth for ten quarters.

Consumer-related services slide further

Consumer-related private sector services, meanwhile, fell deeper into recession.

Wholesale and retail trade (12% of GVA), transport and storage (4.8% of GVA), accommodation and food services (6.5% of GVA) are treated together in the quarterly national accounts although they are separated in the annual data.

Together these sectors declined by 3.3% year on year on the second quarter, from 2.9% in the second and 2.9% in the first. Doubtless soaring unemployment, the hike in VAT, worries about the future direction of the economy and slowing growth (though not yet decline) in bank lending ate into demand.

Manufacturing continued the contraction that is now well over a decade old, sliding by 3.7% year on year in the second quarter. However, output data show that the pharmaceuticals sector continues to be the outlier, with output of "chemical products and pharmaceutical products and preparations" up by 6.4% year on year in the second quarter, from 5.1% in the first. On a sectoral basis the biggest decline was recorded by construction, which tumbled by 19.6% over the year earlier, its sharpest decline since late 2009. Things have been so bad for the construction sector that it has not grown since the first half of 2008 and there are few signs that it will do so any time soon.

Business-related services still growing...

There are some pockets of growth in the Cyprus economy. But even here there are signs of a slowdown, suggesting that they are now being touched by the wider recession.

Information and communication services, which accounted for 4.1% of GVA in 2011, was the fastest performer in the second quarter, growing by 5.1%. However, this was down from 6.1% in the first quarter and 6.2% in the fourth quarter of 2011.

Similarly, professional, scientific and technical, administrative and support services (6.3% of GVA) grew by 3.8% but this was down from the peak of 4.6% in the fourth quarter of 2011.

Not surprisingly, the fastest slowdown in the business-related services was in finance and insurance, which is a big sector of the economy at 8.9% of GVA. Growth in this sector slowed to just 1.2% in Q2 from 3% in Q1.

As mentioned before, the real estate figure showing 3% growth in real estate activities (11.5%) of GVA) should not be confused with property sales, since the property market remains in the doldrums. Rather, this figure seems to be imputed from growth in household formation.

...but under threat

What remaining growth there is, therefore, is in the business-related sector.

But if the government gets its way, this sector will soon see higher taxes in the form of the new "social cohesion fund", higher electricity costs via the increase in VAT from 17% to 18%, and permanent (or higher levies for bigger companies) in the form of the company registration fee that was supposed

to be temporary.

The tourism sector, enjoying a tiny bit of rare bit of Arab spring- and EU presidency-related growth, will take an additional hit from the increase in the lower VAT rate applied to restaurants and hotels.

This seems to be the price that businesses will pay for keeping the corporate tax rate at 10%. With all the administrative costs of additional bits of tax here and there, as a small business I personally have to wonder whether it will have been worth it.

GDP BY SECTOR (SEASONALLY ADJUSTED)					
Real % change on same period of previous year					
	2011 Q2	**2011 Q3**	**2011 Q4**	**2012 Q1**	**2012 Q2**
Agriculture, hunting, forestry & fishing	11.0	2.0	-0.8	-4.5	-5.6
Industry excl. construction	-0.4	-7.5	-5.7	-6.7	-6.0
of which: manufacturing	-2.0	-3.5	-4.2	-4.6	-3.7
Construction	-7.5	-12.3	-14.6	-16.2	-19.6
Wholesale & retail trade, hotels & restaurants, transport & comms.	1.5	0.3	-2.2	-2.9	-3.3
Information and communication	4.1	3.7	6.2	6.1	5.1
Financial & insurance activities	2.8	3.1	3.1	3.0	1.2
Real estate activities	4.4	4.2	3.9	3.3	3.0
Professional, scientific, technical and support services	2.4	2.6	4.6	3.9	3.8
Public administration, defence, education, health & social services	1.4	1.5	1.1	0.8	0.6
Other services	3.8	2.3	1.8	-0.3	-1.1
Gross value added	**1.4**	**-0.2**	**-0.8**	**-1.5**	**-2.1**
Import duties & VAT	1.5	-0.4	-0.5	-2.2	-3.5
Gross domestic product	**1.4**	**-0.3**	**-0.8**	**-1.6**	**-2.3**
Household consumption	-0.1	-0.4	-1.7	-1.2	-2.0
Non-profit institutions serving households	-2.4	-3.7	-3.2	-1.3	-0.7
General government consumption	-3.4	0.4	-8.7	0.3	-1.2
Gross fixed capital formation	-10.5	-18.3	-19.0	-17.7	-18.9
of which: investment in housing construction	-18.6	-26.1	-25.2	-19.0	-20.4
Inventories (contribution to growth)	2.4	2.9	-11.2	-19.1	-15.2
Exports of goods and services	7.6	2.6	-1.0	-1.1	-0.9
Imports of goods and services	-1.1	-3.8	-16.0	-13.7	-12.2
Foreign balance (contribution to growth)	3.8	3.1	8.2	6.4	5.5
Source: Statistical Service, Sapienta Economics calculations.					

Alex Apostolides
Economic Historian, European University of Cyprus

Uncertainty has killed off any chance of a slight rebound

The appeal for aid to Europe and Russia occurred in the summer and yet the negotiations to prepare a memorandum are only now beginning. This uncertainly brought a freeze on the traditional purchases of August and September as households refrained from purchases until the memorandum impact on their incomes is ascertained. The result of such a delay was mainly felt in the retail sector, since the traditional summer sale and "back to school" purchases were extremely anaemic. To make matters worse, the government is not accepting the Troika terms, meaning further uncertainty and delay in the measures that will affect households.

This will have a big impact in GDP, investment, stock and employment figures during the fourth quarter, as many small companies might choose to wind down now prior to the onerous need for increased cash flow and payments (ordering of Christmas stock, 13th salary, and now memorandum related taxation) that occurs in the period October to December.

It is imperative to get the deal with the "troika" in place as soon as possible. This is not only due to the urgent needs of bank recapitalisation and government expenditure, but also in order for households to adjust their purchases accordingly. Yet even if the deal is agreed it needs ratification by several European bodies and parliaments, which will substantially delay the first tranche of the loan given to the Republic.

The upcoming elections and the reluctance of the government to be pinned down hurts efforts for a swift resolution, further reinforcing the poor business climate over the future of Cyprus for both internal and external investors.

I am not optimistic that things can be turned around soon. Sadly the social dialogue needed to allow memorandum reforms to pass as smoothly as possible (with the EU, academics, the unions, and business community) are not taking place. This means that clever ways to reduce the impact of the cuts on the government budget are not being explored, and that the social friction when the measures will be announced will be severe. I expect GDP to contract by 2.0% in 2012 and by another 2.5% in 2013.

Symeon Matsis
Private sector economist

Deteriorating business sentiment worsening outlook

The economic sentiment has taken a turn to the worse since the previous forecast and second quarter growth (-2.4%) shows sharper decline in economic activity. The deepening recession is also reflected by a host of other short term indicators, which show an extraordinary degree of loss of production for more than 3 years. At the same time the uncertainty concerning government action on fiscal imbalances and the evolving crisis in the banking sector, point to larger decline in GDP for the whole year, despite the better than expected performance of exports of goods, tourism and other services.

Steep declining trends have continued for purchase of private motor cars, construction activity and manufacturing. These are reflected in the rise of unemployment during the second quarter of 2012 to 49,600 persons or 11.3% of EAP. Despite good export performance, the adverse developments on other magnitudes of the balance of payments mean that current account deficit will remain large for the 7th year in a row. There is no doubt that troika suggestions and specifically the measures for structural competitiveness problems, appear at present the only way out. Indeed Cyprus position in the competitiveness index of the World Economic Forum fell further to 58th position in 2012/13 relative to 34th position in 2009/10.

Hence, I expect that the rate of GDP decline will accelerate to -2.2% for 2012, before it picks towards the latter part of 2013 with unemployment at 10.5%. I do not envisage positive growth in 2013, but after the elections the economy will start picking up, but growth for the whole year is unlikely and unemployment will probably exceed 11%. For 2012 I expect inflation to be 3%, fiscal deficit 4.5% of GDP and public debt will approach 80% of GDP.

Bernard Musyck
School of Economic Science and Administration,
Frederick University

Cutting public spending is not sufficient by itself

Loss of business confidence combined with high uncertainty concerning income and taxation characterise the current economic situation. As time passes, it is clear that the government has done nothing right to create a business climate that would help the economy face the crisis and restructure itself for a better future. Unwilling to bear the political cost, the current administration will be stretching the troika's patience until no room for manoeuvrability will be left.

The construction industry is on its knees, with grave consequences for the labour market; once the exact nature of cuts in the civil service payroll become clear, a drop in consumer spending will lead to further closures in the retail business; the fate of the business service sector still hangs in the balance for as long as our international credibility is not restored.

All in all, I expect a contraction of about 2.1% in 2012 and a further deterioration of the situation in 2013, with negative growth reaching possibly 2.3%.

What remains the most important issue is the prospect for economic rebound after all necessary measures will have been implemented. The depth of the structural changes is crucial; cutting public spending will in itself not do the trick; what the island needs is a general overhaul of its structures with more accountability, transparency and efficiency and a balanced creation and distribution of wealth between the public and private sector.

A good start would be to proceed with a swift move towards more private sector involvement following successful examples in other European countries. The rapid development of e-government and the creation of a viable universal health care system are also urgently needed.

George Theocharides
Associate Professor of Finance, Cyprus International Institute of Management (CIIM)

Immediate outlook is even more discouraging

The latest figures by the statistical service of the Ministry of Finance have confirmed the disappointing and negative direction our economy has been experiencing in the last year. We had unfortunately another quarter of negative growth (0.7%) from the previous one, while the drop from the same quarter of last year is at 2.3%. As it was expected tourism, as well as the legal/accounting activities and telecommunications, performed well in this quarter (positive growth), while secondary sectors of the economy such as construction, manufacturing, and electricity exhibited negative growth.

The worst is that the near and intermediate future seems to be even more discouraging, for a number of reasons. First, the uncertainty that surrounds us regarding the proposed troika memorandum exacerbates the negative situation. As of now, we are not even sure if a memorandum will be signed by the current government, or if this drama will be dragged on until after the next elections. And if a memorandum is signed in the very near future, most likely the measures imposed will prolong the recession. Second, the uncertainty regarding the external environment, namely Greece as well as the other southern European countries, creates even more problems to the business community at home. Consumers and investors are becoming even more risk-averse, diminishing consumption and driving lots of businesses to bankruptcy, increasing unemployment to extraordinary levels.

Third, because of the major problems that our banking sector is facing, liquidity has completely vanished from the market, paralyzing any form of economic activity, and negatively affecting all sectors of the economy. Until the due diligence of the banks is over, and they receive the necessary funds for recapitalisation, I do not see any positive change occurring, and certainly not until the second part of 2013.

Thus, once more my estimates for growth need to be revised downwards to -2.5% for 2012 and -1.0% for 2013.

Fiona Mullen
Director, Sapienta Economics Ltd

Outlook for 2013 worse than before

I am holding my forecast for a real GDP growth contraction of 2% in 2012. This is the growth rate we will arrive at if we contract at the same pace in the second half of the year as we did in the second quarter (a quarter on quarter decline of 0.7%). April to June was the period in which the repercussions of the Greek haircut really started to hit us and the impact is still being felt.

I am more downbeat for 2013 and now expect a contraction of at least 1.8%. The plan to impose an even higher capital requirement (10%) on banks, just as they will be forced to implement stricter requirements for non-performing loans, will hit them very hard, especially in the context of their deteriorating loan books in Greece and uncertainty at eurozone level about whether or not the ECB will directly recapitalise banks. Banks will therefore remain very cautious about lending, and this will hit small businesses, which are already suffering in this climate of late payments, sky-high electricity prices and weak demand.

The big question is how much the well paid public-sector workers will retrench as a result of the cuts in salaries for the higher paid and increase in pension contributions (from 2014) that the government has proposed. Consumer spending is already weak. Car sales have been down in double digits for four years, retail spending in stores has declined in eight out of the last nine months (to June, the latest figures), with anything bought on credit—furniture, electrical items and computer equipment--seeing the biggest decline. Perhaps our only hope is that Cypriots continue to take comfort in their favourite past time, namely eating. Food sales volumes grew by 5.9% year on year on the first half of 2012.

Yiannis Tirkides
Economic Research, Laiki Bank

Property sector will act as a further drag

Economic developments in recent months have been taking a turn for the worse. This is owing to the uncertainties surrounding the economic adjustment programme that will be required of Cyprus for financial assistance from the EU bailout mechanisms and the IMF. A long delay in finalising the programme is causing considerable uncertainty and makes things worse. Liquidity constraints and continued deleveraging on the part of commercial banks are causing a credit crunch with consequences for the real economy.

The economic adjustment programme revolves around three key themes: fiscal consolidation; bank recapitalisation and financial regulation; structural reform to boost competitiveness and support balanced growth. The corresponding measures will have a lasting contractionary effect and no matter how viable we may think the economy is in the long term, there will be considerable pressure in the short and medium terms.

It is now also realised that the property sector may be more of a problem than we initially thought. Banks, in the boom years, lent considerable amounts of money to property development and housing. Property prices, when judged against income levels and corresponding yields, are high and will necessarily have to adjust. This adjustment in a context of an economic adjustment programme will be faster and deeper than initially thought and will have a significant bearing for bank lending ability.

Even though developments both in Europe and in a global context are taking a turn for the better following decisions by the Federal Reserve and the European Central Bank to provide support and liquidity, the recession in the Cyprus economy that started in the second half of last year has a way to go still.

In this context we downgrade our outlook for 2012 and 2013. We expect real GDP to contract by 2.1% in 2012 and by 1.5% in 2013.

Maria Zambarloukou
Group Economic Research Division,
Bank of Cyprus

Economic outlook remains bleak

The downturn of the Cyprus economy, which had fallen back into recession in the second half of 2011, has intensified during the first half of 2012 (with real GDP declining by -2.3% on an annual basis during the second quarter and -1.5% during the first quarter). Declining incomes and increased uncertainty associated with the deteriorating fiscal position, bank losses associated with the second haircut of Greek government bonds and the eventual application of Cyprus for support from the EFSF/ESM have contributed to this.

These trends are set to intensify during the last months of 2012 in view of prolonged uncertainty regarding the terms to be agreed with the troika. These are expected to lead to new austerity measures and have a significant impact on personal incomes and spending.

As a result, the economy is projected to exhibit negative economic growth of about -2.3% during 2012. Although all sectors are being affected by the downturn, the tourist sector's performance has been relatively satisfactory, as it has benefited from the continuing rise in arrivals from Russia.

As regards 2013, the economic outlook remains bleak due to the expected implementation of additional austerity measures (to be agreed with the troika), further deterioration of consumer and investor confidence, declining incomes and rising unemployment. In view of the size of the fiscal adjustment required an additional contraction of GDP is projected of about -3.5%, although there is still a high degree of uncertainty regarding the exact terms to be agreed with the troika.

FINANCIAL MIRROR FORECASTS, Q3 2012	2012	2013
Alexandros Apostolides	-2.0	-2.5
Symeon Matsis	-2.2	-1.8
Fiona Mullen	-2.0	-1.8
Bernard Musyck	-2.1	-2.3
George Theocharides	-2.5	-1.0
Yiannis Tirkides	-2.1	-1.5
Maria Zambarloukou	-2.3	-3.5
FINANCIAL MIRROR CONSENSUS	**-2.2**	**-2.1**