

# Impact of inflation in Cyprus

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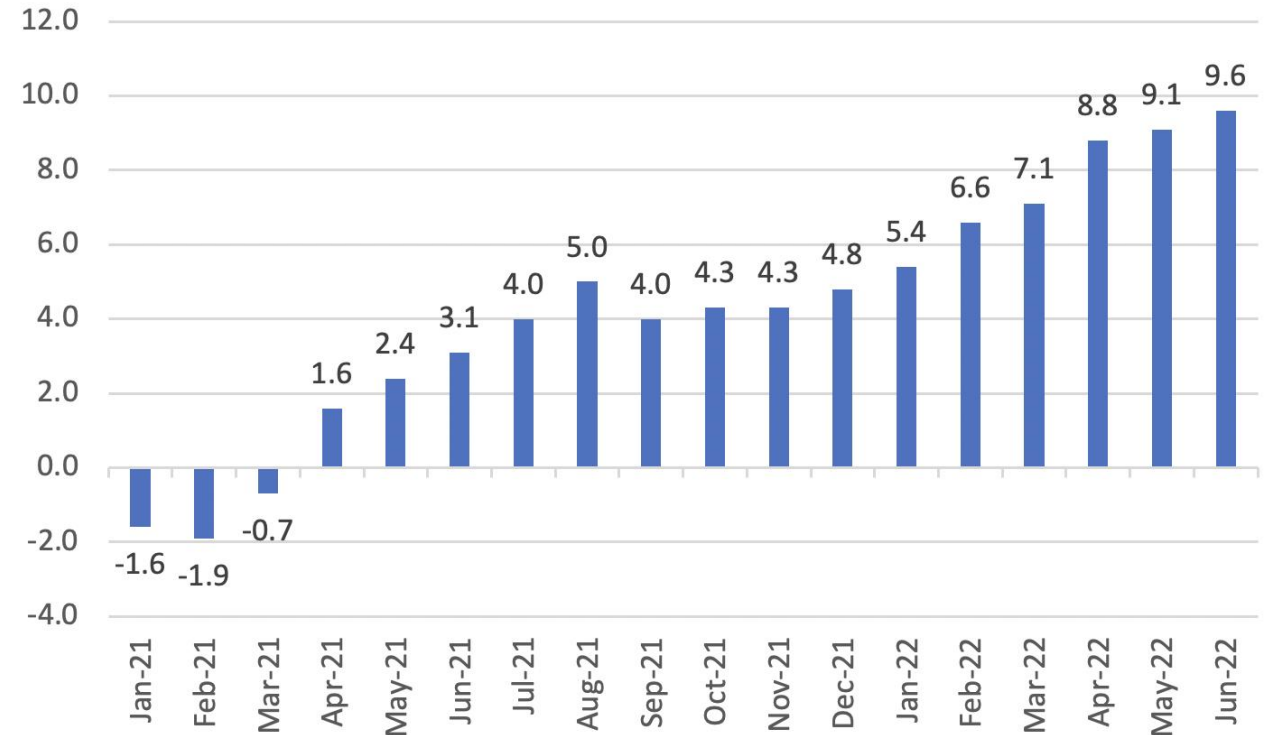
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# State of the economy

- During the first quarter of 2021 inflation rate was **steady below zero** at an average of **-1.4%**
- After Q1 of 2021 inflation rate has had an **increasing trend** reaching its **peak in June 2022** at **9.6%**, the highest after 40 years
- The rapid climb in inflation rate was mainly **due to surging energy and oil prices** after the sanctions that caused supply disruptions from Russia
- Inflation is expected to **keep increasing at a slower rate during Q4 of 2022 and 2023**

Inflation rate in Cyprus from January 2021 to June 2022



# Basket of goods in Cyprus in 2021 compared to that of 2022

| Year  | 2021 <sup>(1)</sup> | 2022 <sup>(2)</sup> | % change |
|---|---------------------|---------------------|----------|
| Gas (per litre)                               | €1.18               | €1.82               | 54.24%   |
| Electricity (kWh)                             | €0.26               | €1.25               | 380.77%  |
| Restaurants (per person)                      | €25.00              | €27.37              | 9.48%    |
| Groceries (1lt of milk)                       | €1.44               | €1.79               | 24.30%   |
| Clothing (pair of jeans)                      | €78.00              | €93.00              | 19.23%   |
| Sports and Leisure (Gym monthly subscription) | €50.00              | €54.84              | 9.68%    |
| Communication ( 1 min. prepaid local tariff)  | €0.09               | €0.45               | 400%     |

<sup>(1)</sup>Average prices of 2021

<sup>(2)</sup>Average prices of 2022 until now

# Impact on consumers

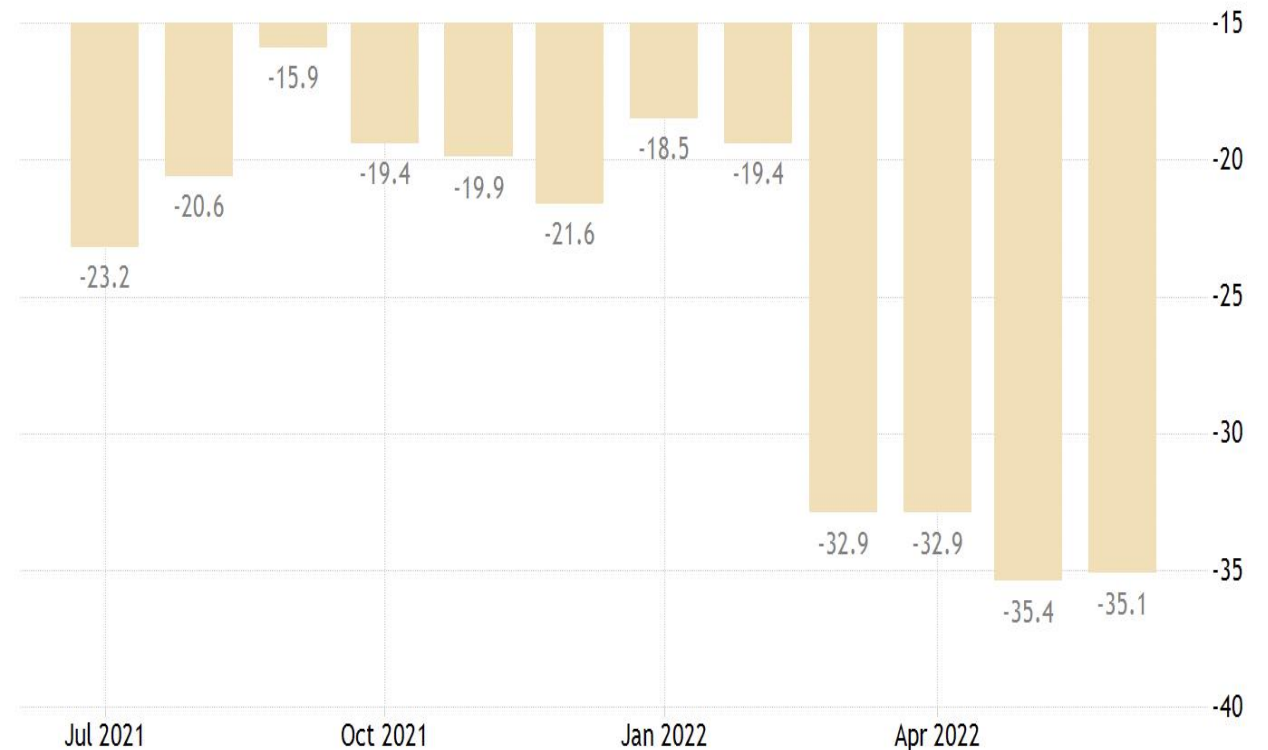


- Consumers have been **heavily impacted** by the increasing prices, especially of **oil and energy**, as both goods are **necessities**.
  - This, therefore, **reduces the purchasing power** and forces medium and low-income households to **cut back their discretionary spending**
  - **Inequality within the society increases** as the surging prices make low-income households left with less disposable income, and high-income households save a smaller amount of their income without changing their spending patterns significantly
  - Inequality is an indicator of development; **its deterioration hinders growth and increases social polarization**
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# Impact on consumers

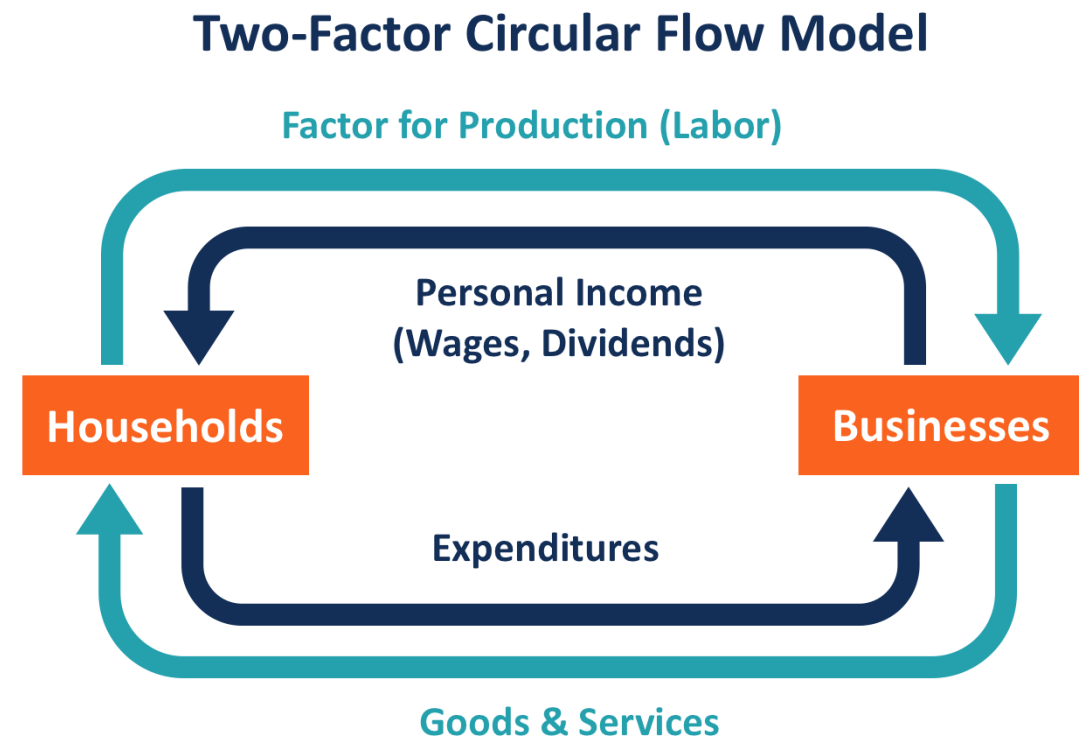
- Inflation clouds consumer expectations and confidence
- When there is high inflation, **expectations** for the future price level are even **more significant**, and therefore, **consumption and consumer confidence falls**
- As depicted on the graph, the high level of inflation that occurred after January 2022 has **reduced dramatically confidence averaging at -34.08 points**
- Confidence will fall further since the ECB proceeded and raised its **interest rates on borrowing, reaching 3.3%** in May as a response to persisting high inflation

Consumer confidence in Cyprus from July 2021 to June 2022



# Impact on businesses

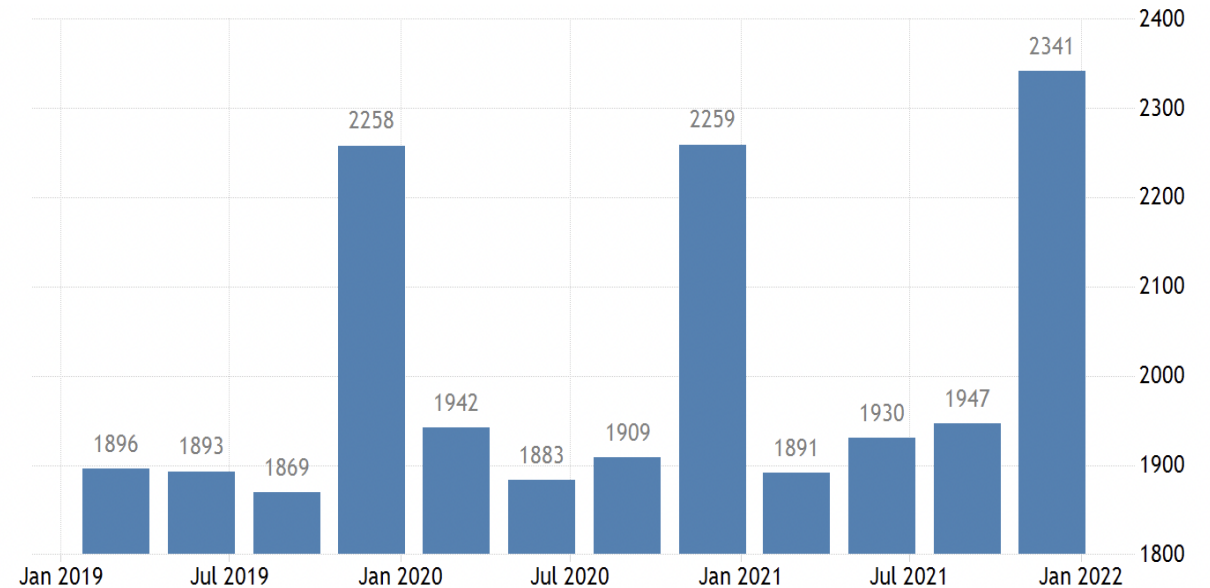
- The circular flow of income suggests that **if households are impacted** by high inflation, **then businesses** through the channel of expenditure **will also be affected**
- Consumers will have less disposable income, and therefore **they will decrease the demand for the goods and services** that businesses provide
- Central bank has **raised the interest rate** as a monetary policy to ease the surging prices, **increasing the cost of borrowing** for the businesses and **discouraging them from investing** in capital accumulation and improvement of their productivity, making them **less competitive**



# Impact on businesses

- **Average monthly wages reached a peak point in January 2022** at €2341, exceeding January 2020 by €83 and January 2021 by €82
- Therefore **fixed costs for the businesses have also increased** as a result of the inflation and the wage-price spiral “vicious circle”
- **Wage price spiral**: when employees demand their wages to be adjusted for inflation, putting upward pressure on their wages and the costs of the company
- Costs have also increased due to **cost-push inflation**, which raises the price of raw materials used in the production processes
- Might have to **layoff workers** because they are unable to cover their labour costs

## Cyprus average monthly earnings of employees



TRADINGECONOMICS.COM | STATISTICAL SERVICE, MINISTRY OF FINANCE OF REPUBLIC OF CYPRUS





# Impact on the government

- Inflation makes it easier for the government to repay its debt:
    - Higher inflation **increases nominal tax revenues** by collecting more VAT and income tax
    - **Collecting higher taxes** becomes a way to increase tax revenues without raising tax rates, favoring the governing party on future elections
    - It also **reduces the real value of debt**, bondholders will see a fall in the real value of their bonds making it easier for the government to pay back its bonds
  - It's **not the only factor** contributing to the reduction on public debt but also through the **utilisation of cash buffers** and the **issuance of new bonds**
  - It is notable that government **increased public expenditure** to support low income households and finance their day to day spending and also implemented a policy to reduce VAT on electricity from 19% to 9%
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# Impact on the government

- The chart illustrates a **declining trend** of the **public debt** after 2020, falling to 103.9% as a percentage of GDP in 2021
- It is estimated that in **2022 public debt will fall further** from the previous year by 10%, achieving to drop off as low as 76.7% of GDP by 2025
- Debt sustainability and sovereign ratings are essential for the Cypriot government, and now, with the decreasing public debt, **sovereign ratings have been improved**
- This allows the government to **issue bonds at a lower risk premium** and, therefore, **lower rate on the bond**
- However, the **expected future interest rate rise** the ECB is likely to proceed to stem the downward impact of faster inflation rate on public debt, it is expected to slightly raise borrowing cost of Cyprus

## Cyprus public debt




Source: Ministry of Finance

# Macroeconomic outlook

| Fiscal policy  | Unemployment  | Real GDP growth   | Investment  |
|--|---|---|---|
| <ul style="list-style-type: none"><li>• From 2020, the government has a supporting role for the households and businesses in order to propel economic growth and maintain their debt at sustainable levels</li><li>• The policies the government will implement will very much depend on the objectives of the Reform and Resilient Programme EU offers, for the member states</li></ul> | <ul style="list-style-type: none"><li>• The government implemented wage subsidization schemes for firms, encouraging them to reduce layoffs and retain the unemployment rate at 7.5% in 2021</li><li>• With the new investments and the economy returning to pre-pandemic levels, new jobs are created</li><li>• Unemployment rate follows a declining trend after 2022, forecasted to reach 5.5% in 2025</li></ul> | <ul style="list-style-type: none"><li>• Covid pandemic forced many governments to impose strict lockdowns measures resulting in a contraction of the real GDP equal to 5%</li><li>• In 2021, restrictions have been lifted, and the economy was able to grow again, reaching a positive output gap</li><li>• After 2022, the output gap is expected to remain positive, allowing the economy to expand its capacity</li></ul> | <ul style="list-style-type: none"><li>• Investment is expected to increase following the shift from Russian investors to Arab and Chinese investors that have already started their expansions in Cyprus, especially in the regions of Famagusta and Limassol</li><li>• China's largest private copper smelter bought a 22 per cent stake in a Cyprus-registered copper mining company for 96.2 million euros</li></ul> |

# Main Conclusions

- The economic environment is highly uncertain, and given the fact that Cyprus is vulnerable to external shocks, it is hard to predict the impact of inflation in the long run
  - The Government should be flexible to adopt appropriate policies and strategies in order to tackle the negative impact on the economy from the unprecedented level of inflation, including by supporting the most vulnerable groups, within the available fiscal space
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- A large yellow triangle is positioned in the bottom right corner of the slide, pointing towards the top right.



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