

The impact of inflation in Cyprus

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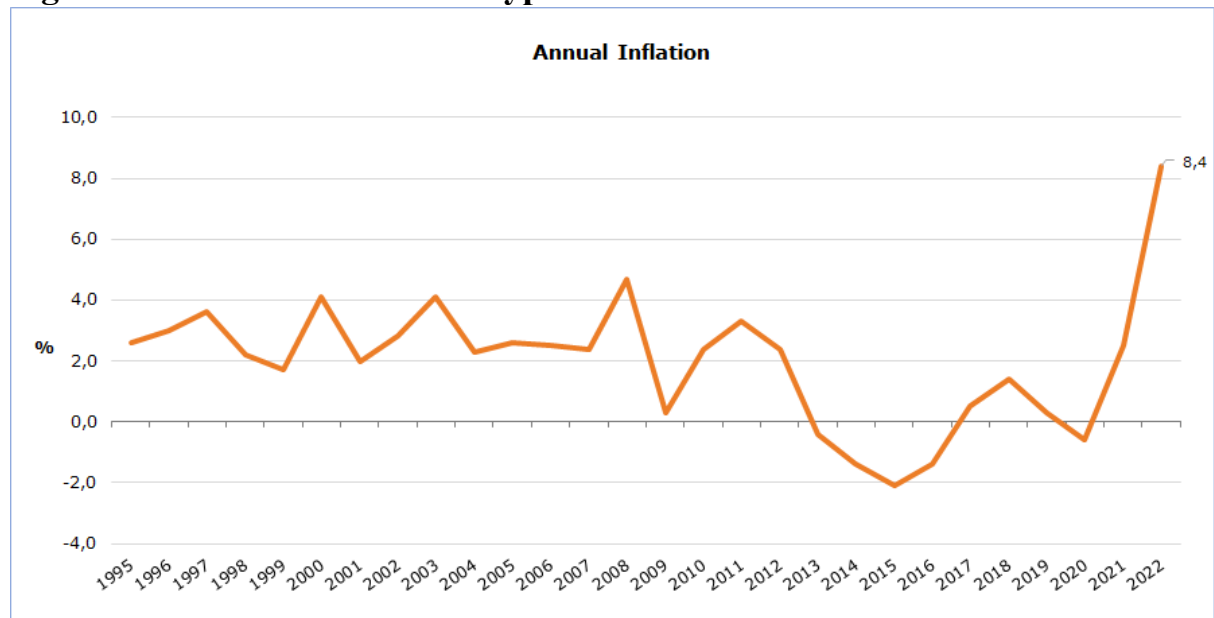
Table of Contents

<i>Introduction</i>	2
<i>State of the economy</i>	3
<i>Impact of inflation on consumers</i>	4
<i>Impact of inflation on businesses</i>	5
<i>Impact of inflation on the government finances</i>	8
<i>Conclusion</i>	9
<i>References</i>	9

Introduction

Inflation in Cyprus surged in 2022, partly due to the tourism sector recovering after experiencing a significant downturn during the COVID-19 pandemic and the increased foreign demand. This recovery contributed to pushing up prices as well as the Russian invasion of Ukraine -in February 2022- which further caused inflation to accelerate greatly due to the prices of oil and energy increasing, following a number of sanction packages imposed on Russia by the EU and the US. Electricity tops the list of soaring prices with a 44.5% yearly increase whereas oil stands at 41.24%, petrol at 26.8% and LPG at 34.55% (Spiros Sideris, 2022). Therefore, inflation was affected by both sectoral and external shocks. As shown by the figure below inflation reached its peak of 8.4% in 2022, portraying the great increase of the price level. Inflation peaked at around 11% in July 2022, with energy prices contributing 3 percentage points (Robert Beyer, May 2023).

Figure 1: Annual Inflation in Cyprus



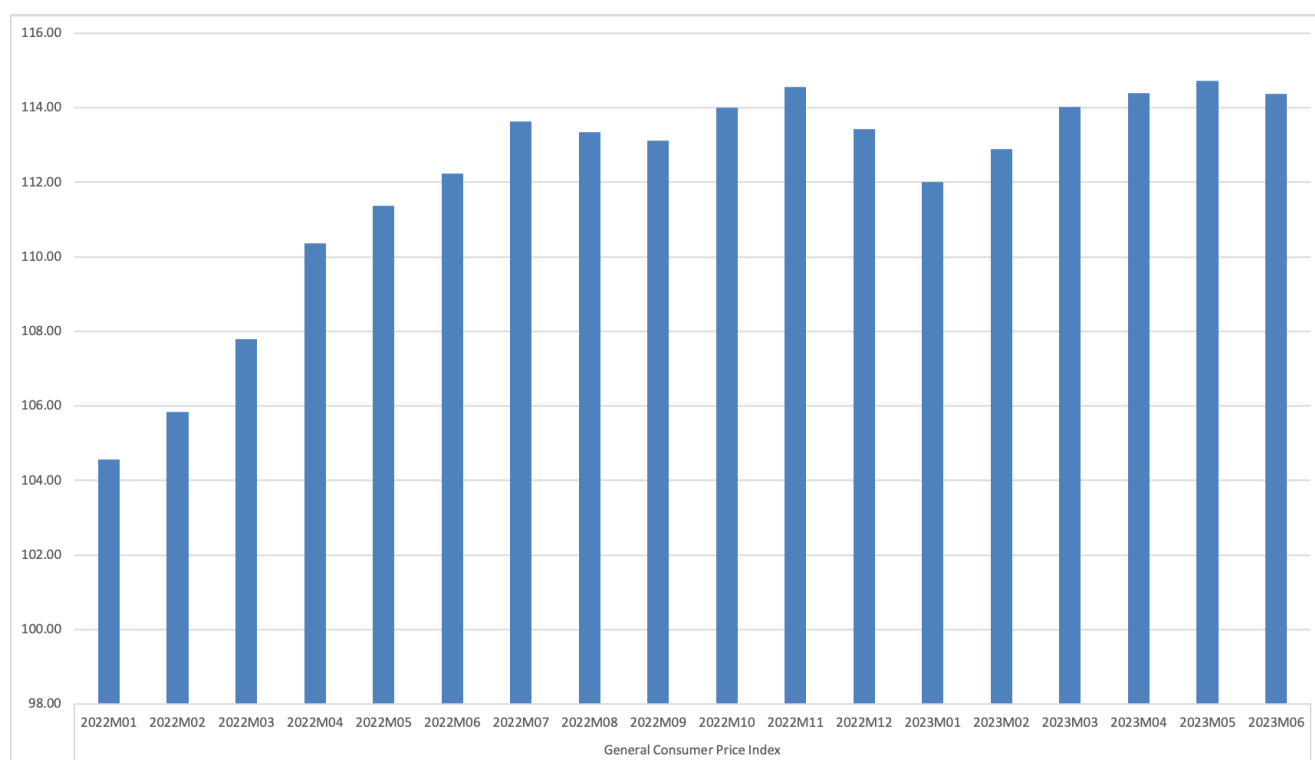
Source: CYPSTAT

State of the economy

In the European Union, the United States of America and in a number of other countries worldwide, inflation has reached its highest level in decades. This was due to both the Ukrainian conflict, which increased food and energy costs as well as the impact of the COVID-19 pandemic. However, it was recorded that in June 2023, inflation in Cyprus reached its lowest level in 25 months at just 1.9%. The Consumer Price Index (CPI) decreased to 114.38 points compared with 114.72 points in May 2023. In 2022, when inflation reached very high levels it was found that the largest changes contributing to an increase of the CPI were in the categories of housing, water, electricity and LPG, transport and food and non-alcoholic drinks. In addition, wage pass-through of inflation is strong in Cyprus and estimating this can help assess domestic price pressures.

The Cyprus economy according to the European Commission's Spring Forecasts 2023, is said to be the fifth best among the EU member states with a GDP growth rate of 1.6% for 2023. This figure is double compared to the EU average, proving that the extremely high levels of inflation suffered by Cyprus in 2022 did not harm the Cyprus economy to a severe extent. Private consumption remained robust despite the rising inflation, supported by the increased foreign demand, employment and wages, underpinned by targeted government measures to compensate for high energy prices. Moreover, exports of services increased, also contributing to the increase of GDP.

Figure 2: Monthly CPI in Cyprus 2022M01-2023M06



Source: Cystat

Impact of inflation on consumers

Inflation severely affects consumer behavior in various aspects. Firstly, it has a regressive effect and thus an increase in the general price level can lead to a decrease of discretionary income. This will consequently lead to a decline in consumers' purchasing power. Therefore, it will decrease private consumption, which will in turn lead to a decrease of domestic demand and thus will reduce GDP growth. Secondly, rising prices and thus living costs affect mainly low-income earners who are vulnerable groups. Inflation can redistribute income among households, firms and the Government, and those that earn fixed incomes will suffer more given that they are able to purchase fewer goods and services with the current income they have available. Thirdly, borrowers, will be better off since the value of money that they have borrowed will be worth less, depending, however, on the interest rate compared to the inflation rate. Fourthly, low-income earners need to spend a greater percentage of their income on necessities such as

food and energy due to the increase in their prices. Having to spend more on necessities suggests that a smaller amount of income is left which can be spent on other goods and services leading to a fall in standards of living as well as an increase in income inequalities. However, low-income earners might not be as severely affected given that they are usually borrowers and high-income earners are savers, helping to improve income distribution.

GDP growth will slow down due to weaker household spending, as well as lower merchandise exports growth. Furthermore, according to Cystat inflation in Cyprus reduced real incomes close to 11% for households in the fifth income quintile but only 6% for those in the first.

In 2022, when inflation reached its peak the shift in consumer behavior was evident. Consumers reacted to the increased prices by paying less visits to supermarkets and being more aware of things they purchase. Data has shown that in “March 2022, compared to March 2021, the number of visits to supermarkets decreased by 14.97%” (Cyprus Mail 2022), and further that the total spending was down by 13.72%.

Impact of inflation on businesses

Fluctuating prices can lead to uncertainty, which can decrease investment and consequently innovation and output. As inflation increases, unemployment could also rise in the long run due to goods becoming less price competitive, thus causing demand for domestic goods may fall. This will lead to less demand for employees in the sector affected. This has negative effects on structural unemployment which is quite severe since this form of unemployment is a more permanent one. Consequently, this will lead to lower levels of economic growth which will translate into higher levels of unemployment.

Businesses can further be affected by the fact that consumers can now spend a smaller percentage of their income on goods and services which may lead to a drop in demand for goods and consequently lead to lower business profitability. Additionally, inflation can result to higher interest rates due the European Central Bank (ECB) setting a monetary policy in an attempt to counter the high inflation in the Euro area and return to the 2% inflation target. As interest rates increase the cost of borrowing increases and thus businesses are discouraged from making new investments resulting in a further decrease in investments and innovation as well, making firms less competitive. According to the 2023Q1 data, investment rebounded strongly, partly supported by the EU recovery funds.

Another impact of inflation, and in particular cost push inflation, is that costs for firms increased. Rising prices of raw materials can discourage production and result to reduced output.

The switch caused in consumer behavior by rising inflation led to Greek Cypriots crossing the borders (green line) and buy goods and services from the occupied territories. This affected businesses in Cyprus. Some businesses now have reduced turnover due to a section of consumers spending less of their income on goods and services in the Cypriot government-controlled areas. This in turn can lead to an increase in the unemployment rate and a further decrease in investment which will slow down economic growth and deteriorate the living conditions of many.

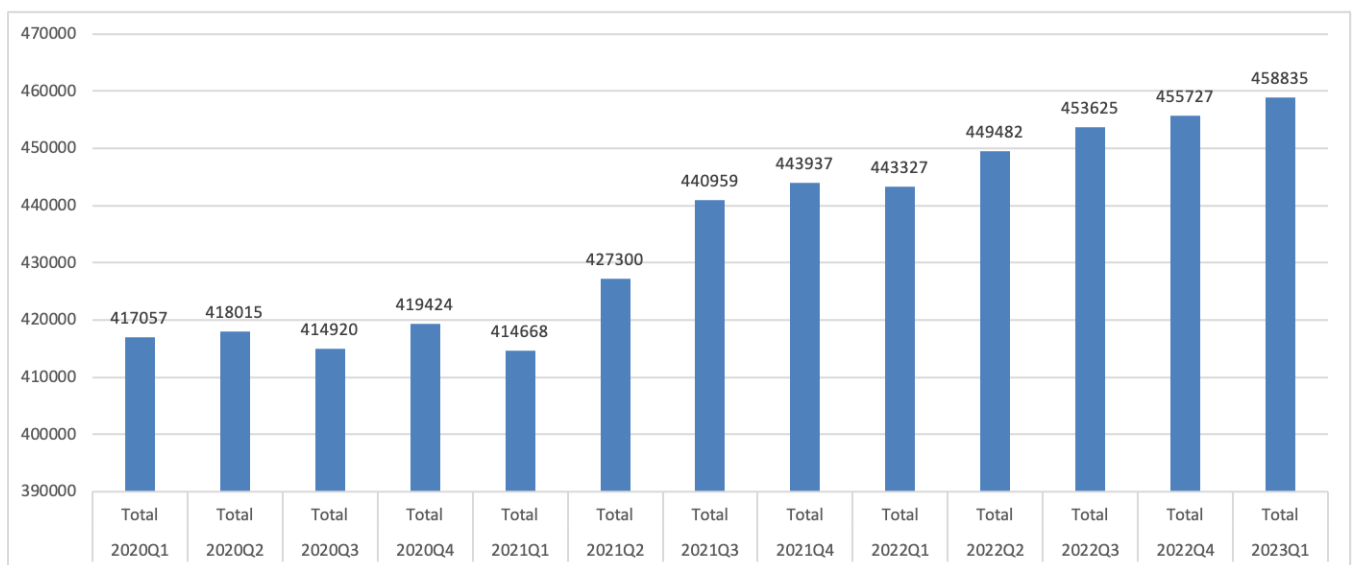
Figure 3 below showcases how earnings were quite low in 2022 when inflation was high but as inflation fell in 2023 earnings increased portraying how inflation affected them. In addition, figure 4 showcases how the economy of Cyprus recovered following the COVID-19 pandemic which was a catastrophe for all economies throughout the world. Employment in Cyprus in 2023 increased to a total of 458,835 in the first quarter of 2023 in comparison to the first quarter of 2022 which was at 443,937.

Figure 3: Monthly earnings in Cyprus- Seasonally adjusted



Source: Cystat

Figure 4: Employment in Cyprus



Source: Cystat

Impact of inflation on government finances

Inflation can worsen the government's finances due to an increase in unemployment, since more unemployment benefits will have to be paid. In addition, since consumers have less income available to spend and businesses have lower profits, there will be less tax revenues for the government (VAT and Corporate tax). Furthermore, higher interest rates due to inflation can make the government's borrowing cost more expensive.

However, inflation may also be beneficial for the government at these times. Higher inflation can lead to fiscal drag and cause a reduction in the real value of the government's existing fiscal debt. Moderate positive inflation can also boost businesses to make higher profits generating more tax for the government.

Central Banks over the world are raising their interest rates, implementing a tight monetary policy in order to bring inflation down to their targets.

In January-May 2022 the tax revenue of the Cyprus government was at 2336.7 whereas in January-May 2023 it was at 2720.9 (Ministry of Finance report) portraying how inflation assisted the government budget. The increase in tax revenue is justified by the increase in the price level and since consumers continued their consumption due to the majority of goods and services being necessities this aided the government's revenue.

Electricity bills were reduced following the Government's decision to lower the VAT on household electricity bills from 19% to 9% from November 2021 to April 2022. The Government announced that it will continue to support households and especially the vulnerable amid the rising inflation. It was further stated that the intention of the government is to extend the reduction of excise duty on fuel. The

current level of the cost-of-living allowance (CoLA) has recently been modified to 66% from 50% and covers the public sector and part of the private sector. Higher CoLA would deepen duality in the labor market and reduce fiscal space. Lastly, it was stated that all policies the government will choose to implement will be dependent on the objectives of the National Reform and Resilient Program. In addition, a decree to amend the VAT legislation was approved so that a zero rate of VAT is imposed on the price of bread, milk, eggs, baby food and baby diapers as well as on feminine hygiene protection and adult diapers. The purpose of these measures is to relieve households especially the vulnerable ones in dealing with increased prices of basic products.

Conclusion

Overall, Cyprus' economic situation is improving with inflation rates falling, investment increasing and tourism continuing to improve and expected to reach the 2019 levels.

In conclusion, the Government has taken sufficient measures and implemented the appropriate policies in order to tackle the inflation surge in 2022. It is crucial for the Government to continue monitoring and implementing the appropriate measures in a timely manner since as stated above Cyprus is subject to both sectoral as well as external shocks.

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