

Persistence and Sources of Shocks in the Cypriot Economy: A Multi-sectoral Model

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Abstract

This paper studies the size of the long-run response of output to different types of shocks known as the persistence of shocks. The multi-sectoral model developed by Lee et al. (1992) was used whereby the impact of shocks to both sectoral and aggregate output growth can be estimated. The empirical analysis uses quarterly data on the gross value added of eight sectors that cover the whole of economic activity in Cyprus, to examine the long-run response of sectoral and aggregate output to macroeconomic and other shocks. The macro shocks relate to oil prices, credit, foreign exchange and the stock market. The main findings suggest that sector-specific shocks are at least as important as macroeconomic shocks in generating output fluctuations at the sectoral and aggregate level. Furthermore, the sectors of financial and insurance activities, professional services, construction and other services are found to be associated with higher persistence of shocks compared to other sectors and therefore experience larger and more protracted output fluctuations when hit by shocks. These findings suggest that more targeted economic policies and reforms might be required to address sector-specific weaknesses and to limit the persistence of sector-specific shocks. Among the macro shocks examined, credit and oil price shocks are found to have the strongest direct influence on aggregate output growth. The persistence effects of credit shocks are channelled into aggregate output via their effects on the value added of financial activities, construction, and professional and other services. The long-run response of aggregate output to oil price shocks is mainly driven by the reaction of economic activity in the sectors of construction and other services.