

Does Balance Sheet Strength Drive the Investment Cycle?

Evidence from Pre- and Post-Crisis Cyprus[±]

Sophia Chen * Yinqiu Lu

International Monetary Fund (IMF)

Abstract

Fixed investment has contributed significantly to the boom-bust cycle in Cyprus since it joined the European Union in 2004. Investment accelerated during a credit boom in mid-2000s, manifested by heavy corporate sector borrowing. Investment collapsed after 2008 when the credit boom ended. Investment and corporate balance sheets further deteriorated during the Cypriot banking crisis over 2012-14. Using firm-level data on investment and balance sheets, we find that corporate indebtedness is negatively associated with investment, although the effect is weaker after the start of the banking crisis, possibly due to the reduced role of credit in driving investment and growth. Our results suggest the need to repair corporate balance sheets to support sustainable investment.

Keywords: Cyprus, Corporate investment, Balance sheet, Leverage

[±] This paper has benefited from comments from Rachel N. van Elkan, Martin Kaufman, Maria Heracleous, members of the IMF Cyprus team, and staff from the Ministry of Finance and the Central Bank of Cyprus. The views expressed in this paper are those of the authors and do not necessarily represent those of the IMF or IMF policy.

* Corresponding Author. Address: International Monetary Fund, 700 19th St, NW, Washington DC, 20431, USA
Email: YChen2@imf.org