EXECUTIVE SUMMARY

This study provides estimates of output losses of the banking crisis in Cyprus for the period 2012-2020. Unlike most studies, where the effects of banking crises are computed ex post using actual data, the crisis in Cyprus is still evolving and the output losses and the period over which the economy will be below its potential output are not known. So our analysis is conducted on the basis of the output gap approach, where projected replaces actual output in the comparison with potential output. Furthermore, we provide alternative output loss estimates to account for the uncertainty about the magnitude and the duration of the recession.

- In terms of output level the loss, computed as the cumulative deviations of actual from potential GDP, over 2012-2014 ranges from about -8.4 €bn to -5.3 €bn (between -56% to -35% of 2011 GDP). Over the period 2012-2020 losses lie between -35.3 €bn to -16.7 €bn (-233% to -110% of 2011 GDP).

- In terms of output growth, computed as the cumulative deviation of the actual from the potential GDP growth rate, over the period 2012-2014 the loss ranges between -29.3 to -20.4 percentage points. For the longer time period 2012-2020 output growth losses range from -35.0 to -20 percentage points.

As the crisis in Cyprus is still underway, it should be stressed that the results computed here are conditional on assumptions about the evolution of actual and potential GDP. Nevertheless, the output losses obtained are comparable to estimates reported elsewhere in the literature, particularly those for the Nordic countries, e.g. 40.6 percentage points for Finland and -34.8 percentage points for Norway, over a period of 7-8 years. The financial liberalisation in these countries led to credit expansion accompanied by expansionary fiscal policies. Similarly in Cyprus the credit boom led to hiking property prices in the period prior to 2009. The transient government revenues from property taxes were used to finance an expansionary fiscal policy. The international financial crisis and afterwards the Greek sovereign debt crisis revealed the vulnerability of the Cypriot economy to these shocks and the pressing need for correcting the generated imbalances.

Research shows that the magnitude of output losses is positively and significantly related to banking sector size, bailout and recapitalisation costs incurred by the government; and to large amounts of liquidity infused in the banking system by the central bank. Banking crises are very difficult to predict, but given the economic burden that they inflict, indicators that are found to signal an approaching crisis should be closely monitored by policymakers. Such vulnerability indicators include rapid growth in domestic credit, inflated asset prices (property or equity) and non-performing loans.