

The effect of Macroeconomic Uncertainty on key economic indicators and bank loans in Cyprus

Elena Andreou and Maria Demetriadou*

Abstract

Since the recent global economic crises and the COVID pandemic, the literature developed an interest in quantifying uncertainty and studying its effects. We focus on the case of a small open economy, Cyprus, where dominant economies may affect its business cycle and we propose the estimation of domestic and foreign uncertainty measures. We use (i) a large panel of Cyprus economic indicators, for domestic uncertainty, and (ii) a large panel of international (EU and non-EU countries) economic variables connected with Cyprus economy, for foreign uncertainty. We follow the econometric methods proposed by Jurado, Ludvigson and Ng (2015) and we incorporate both domestic and foreign uncertainty measures in a Vector AutoRegressive (VAR) model to investigate their dynamic effects. We further adopt the approach of Ng (2021) to adjust the observations during the COVID period. Our JLN-based measures of uncertainty aggregates uncertainty in Cyprus economy derived from various sources into one summary statistic and therefore provide useful information to policymakers to track whether the economy has become more or less predictable; that is, less or more uncertain. We compare these measures of macroeconomic uncertainty with other related proxies, such as the uncertainty indices composed by Rossi and Sekhposyan (2015) based on GDP growth, which we update, as well as, confidence indicators provided by the European Commission. Our estimates imply that quantitatively important uncertainty episodes are correlated with real activity and evaluate theories for which uncertainty shocks play a key role in business cycles. Based on our results, positive innovations to foreign uncertainty lead to a larger and more persistent decline in real activity than domestic uncertainty. However, shocks to domestic uncertainty appear to affect largely the banking sector.

Keywords: Uncertainty, Factor models, VAR, Impulse Response Analysis

*Corresponding Author, Address: Economics Research Centre, University of Cyprus, P.O. Box 20537, 1678, Nicosia, Cyprus. Email: mdemet07@ucy.ac.cy .