A macroeconomic assessment of the Cypriot economy after the haircut

Why has the Cypriot economy faced a smaller than anticipated dip for 2013? What is the relevance of the answers to this question for the shape of Cyprus recession and for its medium to long-run economic growth prospects?

Part of the answer to the first question is related to the apparently fast adjustment of the Cypriot economy and the private (non-bank related) sector in particular, leading to lower production costs for tradeables and non-tradeables and to a fall in prices of final goods and services. The speed of this process of internal devaluation has helped facilitate a smaller than anticipated drop in consumption and GDP as the impact of reduced nominal salaries on consumption has been somewhat alleviated by falling prices, along with the use of past savings. Past savings are being utilized for consumption purposes both because Cypriots perceive that what they are experiencing is a temporary rather than a permanent drop in income, and because they do not consider bank deposits to be completely safe. As a result, they have opted to make use of past savings to smooth consumption during what they perceive as a short term period of reduced income flows. As the permanent nature of lower income levels sinks in, while past savings decumulate, the fall in consumption will be more severe and the recession shape flatter than originally anticipated.

An intriguing possibility in terms of medium to long-run impact is that the deposits haircut has led to a permanent decrease of the marginal propensity to save and the long-run saving rate. This offers a plausible answer to the question asked at the beginning, as the anticipated negative effects on consumption and GDP would be alleviated in the short-run if the propensity to save is now lower thus the propensity to consume higher. Indeed, a fall in the long-run saving rate has likely been one of the major effects of the haircut of private deposits, an effect amplified by the fact that the across-the-board haircut of insured deposits under 100K euro in solvent banks was put on the table by the Eurogroup and initially picked up by the Cypriot Government. On the other hand, the Cypriot Government’s attempt to defend foreign depositors and the foreign business sector (also by opening up capital controls for foreigners with deposits in foreign banks early on), has contributed to a smaller than originally anticipated drop in GDP so far.

The above answers to the first question have important implications for the answer to the second question posed as to the shape of the recession and for Cypriot medium to long-run economic prospects. In particular, the effects of a permanent fall in the saving rate during the long transition to a new equilibrium level of GDP are well known. As a result of the deposits haircut policy, the Cypriot economy will likely have to go on with a much lower saving rate for a very long time. This implies a permanently lower level of income after a long series of, first, negative then, lower than otherwise, GDP growth rates during this long transition. The drop in permanent income, under plausible non homothetic preferences, suggests yet another channel via which downward pressure will be exerted on the long-run marginal propensity to save. While the Eurozone and the IMF need deposit haircuts to remain on the table as an available option for future use, they should stand ready to learn from the Cypriot experience, be honest about the consequences of this sort of policy, and take responsibility for any policy mistakes of their own doing.

The bleak consequences of the above are amplified by the fact that the Cypriot economy has been chronically characterized by a very high private debt to GDP ratio. While most analysts have pointed out the adverse consequences of the lack of liquidity in an economy with limited money supply
growth and in the presence of capital controls, an important medium-run worry comes from the demand-side of loans and the possibility of a prolonged balance sheet recession and deleveraging process. Overall, for all the above reasons, a V-shaped recession for Cyprus is unlikely unless something exogenous drastically changes very soon.

This critical juncture offers, however, Cyprus best chance to implement bold structural reforms and improve its institutions and functioning of the economy with potentially very strong positive impact on economic growth in the long-run. The Cypriot Government and the Troika need also to help implement more targeted policies that will enable a higher degree of flexibility in the private sector (in particular, targeting the high degree of rigidity in the Banking sector and other unionised sectors) and in the public sector (targeting arteosclerotic rigidities due to the elementary and high-school teacher unions for instance.) However, none of the above will suffice to put Cyprus on a sustainable growth path unless its partners come to the rescue with all their might, and with the best of strategic plans to install confidence in the system and help resolve debt sustainability issues. Once Cyprus regains its lost credibility via prompt and decisive action, it will also need its Eurozone partners to commit to do their part.