

Jean-Claude Trichet: The successful entry of Cyprus into the euro area¹

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Conference “Welcoming Cyprus to the euro area”, Nicosia, 18 January 2008.

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Ladies and Gentlemen,

It is a great pleasure for me to attend this conference celebrating your adoption of the euro. Let me first congratulate all parties involved in the successful cash changeover that took place at the beginning of the year. It has been going smoothly. None of this would have been possible without the excellent performance of the Cypriot economy during the convergence process.

1. Cyprus’s economic achievements on the way to the euro¹

Today’s euro celebrations are the result of the successful macroeconomic policies that the Cypriot authorities have pursued in recent years. Cyprus has made significant progress in both nominal and real convergence, owing to successful policies – namely, well-managed monetary and exchange rate policies combined with a range of structural reforms. In the last decade, HICP inflation in Cyprus has been contained, averaging 2.2% in 2007, with the only exceptions being in 2000 and 2003, when inflation rose mainly because of increases in energy prices as well as VAT harmonisation. Short-term as well as long-term interest rates have followed a declining trend in recent years to levels in line with those of the euro area as a whole. This suggests that market participants have confidence in Cyprus’s macroeconomic and fiscal developments as well as in its monetary and exchange rate policies.

The process of nominal convergence has been accompanied by robust economic growth. Real GDP growth in Cyprus has been well above that in the euro area in recent years. Real output growth has been underpinned by domestic demand, and in particular by strong private consumption and, importantly, by strong fixed capital formation. Cyprus’s GDP per capita (in PPP terms) progressed from around 74% of the 1996 average of the 12 countries which initially joined the euro area to around 84% in 2006: this is a significant improvement, and may it continue that way.

In spite of its remarkable progress towards nominal and real convergence, Cyprus has not experienced major imbalances: price and cost competitiveness developments have been favourable since 2004. The fiscal balance (the deficit-to-GDP ratio) has been improving since 2004 and stood at -1.2% of GDP in 2006. Looking at the financial side, Cyprus is experiencing substantial financial deepening, which has been reflected in robust credit activity. Although this process accompanies and supports economic development, it should be carefully monitored, particularly because it is taking place at a very rapid pace.

Membership of the Exchange Rate Mechanism II (ERM II) was another element in Cyprus’s successful convergence. The pound-euro exchange rate at which Cyprus joined the ERM II in May 2005 remained very stable throughout the period of ERM II participation. The EU Council decided that the central parity should also become the final conversion rate of the pound to the euro.

¹ I should like to thank Malin Andersson and Olivier Radelet for their input into this speech, Nick Vidalis and Hans-Joachim Klöckers for their helpful comments, as well as David Clarke for his additional contributions.

2. Cooperation between the Central Bank of Cyprus and the ECB

Let me also say that the ECB has established excellent working relations with the Central Bank of Cyprus over the last couple of years. The Governor of the Central Bank of Cyprus has been a member of the General Council of the ECB since May 2004. As from mid-2007, Governor Orphanides attended the meetings of the Governing Council as an observer, and on 1 January 2008 he became an official member of that decision-making body for monetary policy in the euro area.

The ECB and the Central Bank of Cyprus, together with the National Changeover Board, the European Commission and national and international authorities cooperated closely in many ways to prepare the introduction of the euro. The euro information campaigns played a vital role here. The ECB together with the Central Bank of Cyprus made sure that Cypriots became familiar with the euro banknotes and coins.

The information campaigns consisted of an optimal communication mix that drew on the experience of the communication campaign in 2002, when euro cash was introduced in 12 countries, as well as the campaign for Slovenia prior to its joining the euro area in 2007. It included public opinion polls, advertising and direct marketing. Over 900,000 copies of different publications were distributed by the Central Bank of Cyprus – this is more than one copy per Cypriot! The aim was to enable everyone in Cyprus to check their new euro banknotes: every household received euro banknote “cards”, the same size as a credit card. They show the three main security features of the €50 and €20 banknotes and how to check them.

As a result of these efforts, today we can celebrate a successful cash changeover. I am sure that the excellent relationship between the Central Bank of Cyprus and the ECB will grow even stronger, now that the central bank is a member of the Eurosystem. Indeed, intimate cooperation between the members of the team, the national central banks of the Eurosystem, and the ECB is the key for the success of the single monetary policy in the euro area.

3. Ensuring the sustainability of convergence as a euro area country

The entry of Cyprus into the euro area implies that the benefits of the Single Market will be further enhanced by the single currency. The euro offers a credible framework for price stability in an environment characterised by the absence of exchange rate uncertainty within the euro area. Cyprus will benefit from the stability-oriented policy of the ECB, which will help anchor inflation expectations. Furthermore, for a small open economy such as Cyprus, the euro adoption provides protection against international financial turmoil, which often has a disproportionate effect on smaller economies.

Now, almost three weeks after the introduction of the new currency, I would like to stress that, in the short term, the conversion of prices into euros should not be taken as an opportunity to make unjustified price rises. This is especially important considering that food and energy prices are already exerting upward pressure on inflation in the euro area as a whole. Against this background, measures taken by the Cypriot government together with retailers, importers and manufacturers in order to avoid such adjustments are commendable.

Looking further ahead, in order to fully reap the advantages of the euro and to ensure sustainable convergence, additional efforts with structural reform should be undertaken and appropriate policies implemented. The Cypriot economy needs to continue on a sustainable and credible path of fiscal consolidation based on structural measures, to improve its fiscal performance by reducing its debt ratios and to comply with the medium-term objective quantified in the convergence programme. In particular, public finances should have sufficient room for manoeuvre in order to better cope with the expected substantial increase in age-related public expenditures. Moreover, wage settlements need to remain moderate, taking into account labour productivity growth, labour market conditions and developments in

competitor countries. For example, the indexation mechanism for wages and for some social benefits (cost-of-living allowances) should be reviewed in order to reduce risks associated with inflation inertia and losses in competitiveness. Such measures will not only make Cyprus's economy more resilient to shocks but also create the best conditions for sustainable economic expansion, employment growth and price stability.

Ladies and gentlemen, let me again congratulate you on your successful adoption of the euro and extend my very, very warm welcome to the new member of the Eurosystem family. Warmest welcome Cyprus!