

The euro, thirty days on

Speech by Athanasios Orphanides, Governor of the Central Bank of Cyprus, at the Cyprus-American Business Association's Dinner

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We have lived through a historic 30 days: Just a month ago, the euro, the single European currency, became the legal tender in Cyprus. Adopting the euro, the currency that unites over 300 million of our fellow European citizens and which has become a powerful world currency, opens new possibilities and horizons for our country. The euro places Cyprus at the core of Europe, among the most highly developed countries in the world, and gives us the opportunity to buttress our role as a stable regional financial centre. The euro can facilitate further economic and political integration, speed up the process of welfare-enhancing structural reforms and bring about a more efficient allocation of resources by increasing transparency in the prices of goods and services and the costs of production.

I would like to take this opportunity to review the changeover progress, putting in perspective our achievements in implementing our strategic plan for this demanding process. I would then like to make a few remarks on the benefits and the challenges that this era brings to our economy. Needless to say, successfully addressing these challenges is crucial to benefit from the opportunities presented to us in this new environment.

Let me first start by reviewing the progress of the changeover. I am pleased to say that, so far, the cash changeover has proceeded very smoothly and has surpassed expectations both in terms of acceptance by consumers and the achievement of logistical targets. Some minor mishaps may have occurred, but reported problems were well within our expectations given the size and complexity of the changeover operations.

Following a well-planned effort, all depository institutions were supplied with ample quantities of euro banknotes and coins by year-end and were prepared to serve households and businesses on time. As regards cash payments, the signs were positive from the beginning. According to a European Commission survey, on 2 January 2008, the first working day of the year, 28% of Cypriots had undertaken cash transactions in euro and 12% of Cypriots reported carrying only euro banknotes in their wallets and purses. Just one week later, on 9 January, 82% of cash payments were made with euro

and 60% of citizens were carrying only euro banknotes with them. By last Friday, virtually all cash payments were made in euro and the Cyprus pound was hard to come by.

The changeover to the euro is now effectively completed and as of midnight tomorrow, the Cyprus pound will cease to be legal tender. It is, therefore, an opportune time to say farewell to the pound and pay our tributes to a currency that has served us well for more than 40 years. Undeniably, the path towards our membership of the European Union and the euro area, which began many years ago, was by no means easy. The successful integration of Cyprus in the economically and politically strong euro area may be seen from a historical perspective as one of the biggest challenges and accomplishments in the economic history of the island, as it required the departure from deeply rooted but obsolete attitudes and practices that were no longer appropriate in the modern European and international economic environment. The liberalisation of interest rates as well as the gradual removal of capital controls early in this decade, are examples of the changes that were required for our entry in the European Union and the euro area. These reforms have positively affected both our economy and its citizens.

As I have already mentioned, the adoption of the euro brings a number of benefits and expands the economic prospects and opportunities for our economy. It is well known that monetary union represents the completion of the internal market in the EU, providing full price and cost transparency for goods, services, labour and capital. The single currency eliminates exchange rate uncertainty and related transaction costs within the euro area, which promotes trade and enhances economies of scale, thus leading to a more efficient allocation of resources.

The euro assures monetary stability, with low inflation and correspondingly low interest rates over the long run. The stability of the euro can be most beneficial when facing significant disturbances such as those recently experienced in the energy and financial markets. Especially for a small, open economy like ours, such disturbances have often had a disproportional effect, raising the risks of currency crises.

Another important benefit of euro area membership for small and open economies like Cyprus, relates to its potential to promote trade. By eliminating exchange rate volatility and providing complete price transparency, the euro promotes the conditions under which economic transactions can flourish across borders. Several studies have shown that trade integration has expanded significantly among euro area countries, with a large increase in intra-euro area trade and foreign direct investment (FDI). Exports and imports of goods within the euro area increased from about 27% of GDP in 1999 to

around 32% in 2006. This cross-border trade expansion reflects, to a certain extent, the increased price and cost transparency, as well as the absence of exchange rate risk associated with the euro.

Reflecting the improved economic prospects for our country following the introduction of the euro, international credit ratings agencies have already upgraded their ratings for Cyprus. As a result, the borrowing costs of our country have been reduced.

Finally, I should note a benefit of unique importance to Cyprus, related to our political struggle towards reunification of the island. For any nation, the currency can serve as a powerful symbol of national identity and pride. By adopting the euro, we highlight our European identity and heritage, an identity that unites all Cypriots regardless of ethnic or religious background. The euro can serve as a catalyst towards economic and political reunification of our island.

Following my brief analysis of the benefits stemming from the introduction of the euro let me now turn to the important challenges that we face at this juncture. In particular, I refer to the medium and long-term challenges related to the implementation of economic policy within the euro area.

Since our entry into the euro area, the Central Bank of Cyprus has relinquished its ability to conduct an independent monetary policy. Instead, it participates in the implementation of the common monetary policy decided by the Governing Council of the ECB. Steering domestic interest rates to contain inflation at the national level is no longer possible. At the same time, the need to maintain inflation in Cyprus at low levels becomes even more imperative. Otherwise, a higher domestic inflation within a unified market with a common currency would cause domestic goods and services to be more expensive and hence less competitive, leading to lower economic activity, higher unemployment and larger fiscal deficits.

While the ECB conducts a single monetary policy, fiscal and structural policies remain the responsibility of each member state. Under this regime, any excessive fiscal expansion will inevitably lead to higher inflation and loss of competitiveness. To prevent fiscal laxity by member states, the Maastricht Treaty obliges members to avoid "excessive fiscal deficits." Consequently, sound fiscal policies and complementary structural changes that enhance productivity are the major tools for containing inflationary pressures and preserving our competitiveness within the euro area.

In our case, fiscal policy should be more vigilant and disciplined to maintain a stable macroeconomic environment conducive to sustainable long-term growth. The current

relatively favourable economic conditions in Cyprus provide an opportunity to further consolidate and strengthen public finances, creating room for manoeuvre in less favourable times. As is well known, the recent improvements in public finances are partly due to temporary factors, such as the increase in revenues from real estate which are not expected to continue at such high rates. Thus, greater vigilance in preserving healthy public finances is warranted.

Reforms necessary to face future challenges within the euro area are not limited to those related to public finances. Another area of particular concern, highlighted by ECB President Trichet during his recent visit to Cyprus, relates to the indexation of wages and salaries in some sectors of the economy. This is one of the legacies of the past that can potentially create acute problems for our economy in the euro area. In general, wage increases should be in line with productivity growth and developments in competitor countries. Otherwise, wage increases would lead to higher inflation risks and a loss in our competitiveness. In the public sector in particular, the current wage indexation mechanism implies that increase in inflation would be permanently incorporated in salaries, further increasing the already high state payroll. In addition, the indexation of wages makes labour less flexible as it reduces incentives for workers to move from sectors of low profitability to more profitable ones.

To be sure, keeping wage developments in line with productivity does not imply that wages should be kept low. On the contrary, by striving to maintain and increase our competitiveness we can ensure sustained wage increases in the long run. The focus should be on containing unit labour costs and on increasing productivity. As long as we achieve high productivity, wages will also keep increasing at a high and sustainable rate, consistent with sustainable economic growth.

The public sector should perhaps lead by example and take the initiative in implementing the reforms needed to take advantage of the benefits of the euro. For instance, the simplification of the public sector's procedures, the reduction in bureaucracy, and the streamlining of the services being offered are greatly needed. Some improvements have already been made but much more is needed. We should keep in mind that due to our joining the euro area, our goals have been set higher. The Lisbon Strategy aims to transform the economy of the European Union into the most dynamic and competitive in the world, based on knowledge and its ability in producing high growth with better employment conditions, social coherence and respect for the environment. We should not only applaud but we should also be actively involved in this transformation.

It is crucial to realise that adopting the euro is not sufficient to guarantee economic success. Indeed, there is diversity in the experiences of countries that have adopted the euro before us and it is up to us to draw the right conclusions from those experiences. History suggests that no country secures satisfactory economic growth without the appropriate economic structures and national policies in place. But success stories such as that of Ireland show that there is great potential to prosper by adopting the necessary structural reforms.

Indeed, the potential of our country has been strengthened significantly by the introduction of the euro. Undeniably, the adoption of the euro marks the beginning of a new era, with a potentially better future, a stronger economy, and a standard of living that will be envied by most. The magnitude of the success depends very much on our choices and on the exploitation of the new opportunities presented to us. There may be doubts as to whether we will rise to the occasion. But in the end, drawing from our success with the introduction of the euro, I cannot help but be an optimist that our choices will continue to be the right ones.