

Euro changeover in Cyprus: progress and preparations towards Monetary Union

Ladies and Gentlemen,

I am honoured to be here today in Nicosia in the eminent company of Mr. Papadopoulos, President of the Republic of Cyprus, Mr. Michael Sarris, Finance Minister, Mr. Christodoulou, the Governor of the Central Bank of Cyprus, and ECB Executive Board Member, Mr. Gonzalez-Paramo. It is also a pleasure to note that so many distinguished and qualified speakers are with us today.

As Cyprus draws closer to its target date for joining the euro-area, this conference provides an excellent opportunity to reflect on the broad range of issues that require consideration ahead of euro adoption.

I will try to address these issues in three stages. First, allow me to say a few words on the progress of Cyprus towards euro convergence. My comments will precede the bi-yearly Convergence Reports soon to be released by the Commission and the ECB, which include a detailed assessment of the state of convergence in Cyprus. Secondly, I would like to briefly address some wider issues of economic governance that Cyprus will face within monetary union. Joining the euro area is no easy process, but once a member, making sure that a country flourishes in EMU brings its own formidable challenges. Finally, I intend to touch upon some remaining issues concerning practical aspects of the changeover and to stress the importance of a comprehensive communication strategy to help Cypriot citizens learn more about the euro.

How is Cyprus progressing on the road to the euro?

I can state with conviction that euro area enlargement is beneficial for both future and current euro area members. Indeed, of all the candidate countries for euro adoption, Cyprus in particular should be well familiar with the advantages of the single currency. Your country has long shared close ties with the EU and the Cyprus pound has a long-standing tradition of close alignment with the euro.

As you know, the Treaty requires Member States to achieve a high degree of nominal convergence prior to adopting the single currency. Satisfying the accession criteria requires an effort, but one that is ultimately rewarding nevertheless.

Indeed, efforts in this country have shown results and I am pleased to note that progress towards nominal convergence in Cyprus is encouraging. Certainly, without pre-empting future decisions on euro adoption, one can say that Cyprus should be in the vanguard of the euro candidates' group.

This assessment reflects notable progress in the area of public finances. The budget deficit has been reduced by four points from 6.3 percent of GDP in 2003 to 2.3 percent of GDP in 2005, and the government debt has been brought onto a declining trend. As a result, last July the Council decided to abrogate the Excessive Deficit Procedure. More good news came at the

beginning of this month, when the Commission forecast for the current year a further reduction of the deficit to just below 2 percent of GDP and a further decrease of the debt. This indicates that Cyprus is on the right budgetary track, although the long-term sustainability of public finances remains a source of concern.

As regards exchange rate stability, the Cyprus pound has remained fairly stable against the euro since joining ERM II in May 2005. This has supported a continued convergence in long-term interest rates.

The development of inflation has also been relatively positive. However, ensuring durable, stable consumer prices via appropriate macroeconomic policies and wage developments will remain an important priority for Cyprus.

Need for further fiscal adjustment and reform

This economic assessment indicates that Cyprus is well on its way to meeting the Maastricht convergence criteria. Nevertheless, as I have stressed on many previous occasions, countries entering the euro area require strong budgetary policies and structural reforms that produce well functioning markets. Since national monetary and exchange rate policies will no longer be available to euro-area members, candidate countries must ensure sustainable convergence in order to maintain competitiveness once in EMU. Cyprus will be no exception to this rule.

Let me emphasise at this point that the need to achieve public finances close-to-balance is not just a legal requirement of the Stability and Growth Pact, but a critical and economically sound approach.

This is of particular relevance for Cyprus given that past experience in the country reveals an asymmetric evolution of public finances in cyclical booms and downturns. The counter-cyclical responses of fiscal policy during slowdowns were not followed by decisive fiscal retrenchment in good times, creating large public deficits and increased government debt. It took a concerted effort to correct them during the upside of the cycle, evidenced by the fiscal consolidation effort of the last two years. Despite the progress resulting from this effort, Cyprus' task is not yet complete. The country now needs to pursue further vigorous fiscal consolidation, in order to bring the debt below the 60% of GDP threshold.

Allow me to raise an important issue on the subject of achieving balanced budgets. Until now, the correction of the deficit in Cyprus has been accomplished primarily through increased revenues and several one-off measures. Meanwhile expenditure increases have remained largely unrestrained. At periods of high growth, this approach may not be so problematic. But in periods of slow growth or recession when revenues decrease, high permanent spending puts the country's budgetary position at risk.

The challenge that lies ahead is therefore to reverse the current expenditure trends. As such, I welcome the initiative of the Ministry of Finance to introduce, as of this year, a medium-term budgetary framework covering the period of 2007-2009. I also support the proposal to directly link the medium term targets set in the Convergence Programmes to the annual budgetary targets. This is a commendable step towards restraining expenditure and should result in better fiscal management.

In a similar vein, avoiding pro-cyclical policies in 'good times' will also help Cyprus achieve a balanced position. It would enable fiscal policy to play an efficient role during downturns, by allowing automatic stabilisers to operate fully. In this way, fiscal policy could contribute to offset the pervasive effects of international shocks, to which the very open Cypriot economy is highly exposed.

In order to prosper as a future member of the euro-area, I would urge you to continue on the route of budgetary consolidation. By taking a prudent approach to fiscal policy, achieving public finances close to balance by the end of the decade is a realistic goal for Cyprus.

Sustainability of public finances remains a concern, prompting need for reform

Let me now turn briefly to more structural aspects and in particular, those related to the impact of demographic change.

As you may be aware, the ageing of Europe's populations will place the long-term sustainability of all EU Member States' public finances under pressure to some extent. However, the projected budgetary costs of your country's ageing population put your Cyprus in the high risk category.

Gross debt remains elevated at above 60 percent of GDP, and the projected high increase in pension expenditure over the coming years is likely to weigh considerably on public finances. In view of this, the implementation of measures aimed at containing the budgetary impact of ageing within the announced timeframe will be crucial in reducing the risks to the sustainability of public finances.

It is true that positive first steps towards much-needed reform have already been taken. I am aware that the government has increased the retirement age of civil servants from 60 to 63 years, while legislation to apply this policy to some semi-governmental organisations is currently in progress. Nonetheless, the measure is yet to be extended to cover the entirety of semi-governmental organisations and the education sector. In addition, more attention could be given to further extending the retirement age to 65 years. I am aware that on this issue no consensus has yet been reached, and I would encourage all parties involved to continue working together to move forward. Ultimately, reinforcing the sustainability of public finances will be the best guarantee of future pensions.

This is equally true of maintaining a well functioning health system. Cyprus now seems to have started preparatory work on the reform of the health service and it would be wise to take the next step and implement an integrated strategy for the National Health Insurance System.

I understand that social security and healthcare reforms can be a sensitive and difficult issue to address. Nevertheless, policy action is needed here in order to help secure the long-term sustainability of public finances and as a result, guarantee these social models for future generations.

Practical aspects of introducing the euro and challenges posed

I now come to the next item in my presentation, namely the state of practical preparations for the introduction of the euro in Cyprus. We know from experience that currency changeover requires the careful planning and laying of groundwork. In this respect, the national

changeover plan adopted by the government in July of this year constitutes a good foundation, covering most of the necessary issues. However, it is still short of detail in many respects and several important elements of the plan require further definition. Let me illustrate my point with four examples:

- First of all, the national changeover plan still lacks a detailed time schedule for the frontloading and sub-frontloading operations;
- Secondly, the organisation of the backflow of national cash remains to be defined. We know from the first-wave experience that the return of legacy currency constitutes a significant challenge;
- Thirdly, a detailed legal framework for the dual display of prices and other amounts still needs to be properly formulated;
- This brings me to my fourth point, namely that Cyprus still needs to put in place a comprehensive strategy to reassure the public over possible price increases during the changeover. Recent opinion polls reveal that 83% of Cypriots fear being cheated during the transition to the euro. Compared to the 73% average of other recently acceded Member States, this figure is particularly high.

Let me elaborate on this last point in some detail. During the first-wave changeover, the perception that prices were being unduly increased became the focus of much attention. This issue simply cannot be overlooked in view of its important, political repercussions. The communication activities that I will detail in a moment should go some way to address these fears. However, a credible and comprehensive "fair pricing strategy" is also needed and should be based on three elements.

First, retailers should be prepared to enter into fair-pricing agreements with consumers. This will signal their intention not to take advantage of the transition to the euro by increasing prices on a non-transparent basis. Such agreements or codes of conduct could be negotiated at national level, involving both retailer and consumer associations.

Secondly, in order to ensure the credibility of the commitments taken, the implementation of such agreements should be monitored. This is not only a task for consumer organisations, which should definitely carry out some price checks, but also for the consumers themselves. Citizens ought to be assertive and should not be prepared to accept unjustified price rises. To facilitate monitoring, specific channels could be created, allowing them to signal abuses during the changeover period.

Active information and communication on fair-pricing constitutes the third key element of any "fair-pricing" strategy. The authorities and parties involved must not only act, but also be seen to act. Appropriate media visibility will enhance awareness among retailers that abusive price increases will not be easily accepted by consumers.

Finally I would also suggest that the public administration sets a good example by organising the changeover in a manner that is cost-neutral or even favourable for citizens and enterprises. For example, monetary amounts which are adapted to convenient amounts in euro (e.g. in tax laws or price lists for public services) should not give rise to price increases.

Communication about the changeover is vital

I want to conclude now on a key issue. The value of communicating to the public what euro introduction really means and how it will affect their work and their lives cannot be underestimated. Delivering clear, up-to-the-minute information as part of a good communication strategy is an essential condition for enabling the public to embrace the euro changeover with complete confidence.

In order to identify such information needs, the European Commission carries out regular Eurobarometer opinion polls. Examining the results of the September 2006 Eurobarometer polls indicates that better communication on the euro is indeed necessary. For example, results reveal that:

- The support for the euro is at a historically low level in Cyprus. Only 29% of the respondents expect very or rather positive consequences for their country while 56% expect very or rather negative consequences. This is far below the other new Member States.
- A majority of Cypriots wants to be informed as soon as possible about the euro introduction. About 60% expressed the wish to be informed as soon as possible. This is by far the highest value of all countries covered by the survey.
- The Central Bank, the Government and the European Institutions are highly regarded as sources of information. (This is fairly positive and could facilitate communication efforts in the future).
- In addition to high expectations of price increases, 71% of Cypriots fear that the euro will lead to inflation. This figure again represents by far the highest value of all recently acceded Member States.

The results of this opinion poll underline the need to intensify, as a matter of urgency, information and communication activities aimed at the general public in Cyprus.

At the European Commission we undertake a whole range of information and communication activities in order to increase public knowledge of the euro and EMU. Facilitating a smooth changeover in Cyprus and in other candidate countries is a top priority for us.

However, the Commission is also very much in favour of decentralised campaigns. In order to be credible and effective, information and communication activities must reflect the culture, language and concerns of citizens. As such, Member States have a central role to play. The Commission cooperates closely with Member States to make their campaigns a success, entering into Partnership agreements with each country and establishing a twinning programme between 'old' and 'new' Member States.

We will obviously review and further develop our communication strategy in 2007 in collaboration with the Cypriot authorities. As you know, this will be the crucial year for euro preparations. I am convinced that our joint information and communication activities will help increase the level of awareness on the euro in Cyprus and facilitate preparations for euro adoption.

Closing remarks

Let me finish by restating that Cyprus has made important progress in reaching its current level of nominal convergence towards the euro. Nevertheless, it is important to keep in mind the remaining work to be done. The experience of first wave countries clearly shows that Member States that invested heavily in careful, pro-active and extensive preparations were rewarded by a smooth transition to the single currency. Ultimately, the quality and pace of further budgetary consolidation and reform efforts will have far reaching consequences for Cyprus' new life in the euro-area and will ensure that your country prospers in Monetary Union. This is the aspiration of everyone here and today's conference presents a unique chance to exchange views and work together to bring Cyprus and the euro area closer together.

Thank you very much for your attention.