

# **Euro Area Enlargement Reflections From a New Member**

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# OUTLINE

- Euro adoption in Cyprus : Key Issues on the run up
- Challenges of early day membership
- Requirements for sustainable fast growth
- Conclusions and Reflections for future entrants

# Cyprus Entry: The Right Move

- Cyprus managed well, and benefited from, the adoption of euro (fiscal discipline - price transparency - convergence of interest rates - elimination of exchange cost and risk - enhanced market confidence - access to foreign capital - ability to confront adverse shocks).
- Euro adoption may also play a catalytic role in current efforts to find a viable & lasting solution of the Cyprus problem: common currency, sound framework, convergence prospects.
- A sharp contrast between the fears before (psychological) and smoothness after the adoption: with right policies poised for continued fast growth and social progress.
- Lessons learned relevant to smooth integration of future entrants in the EMU and improved policy performance and more effective functioning of the euro area.

# Cyprus Entry: The unfinished Agenda

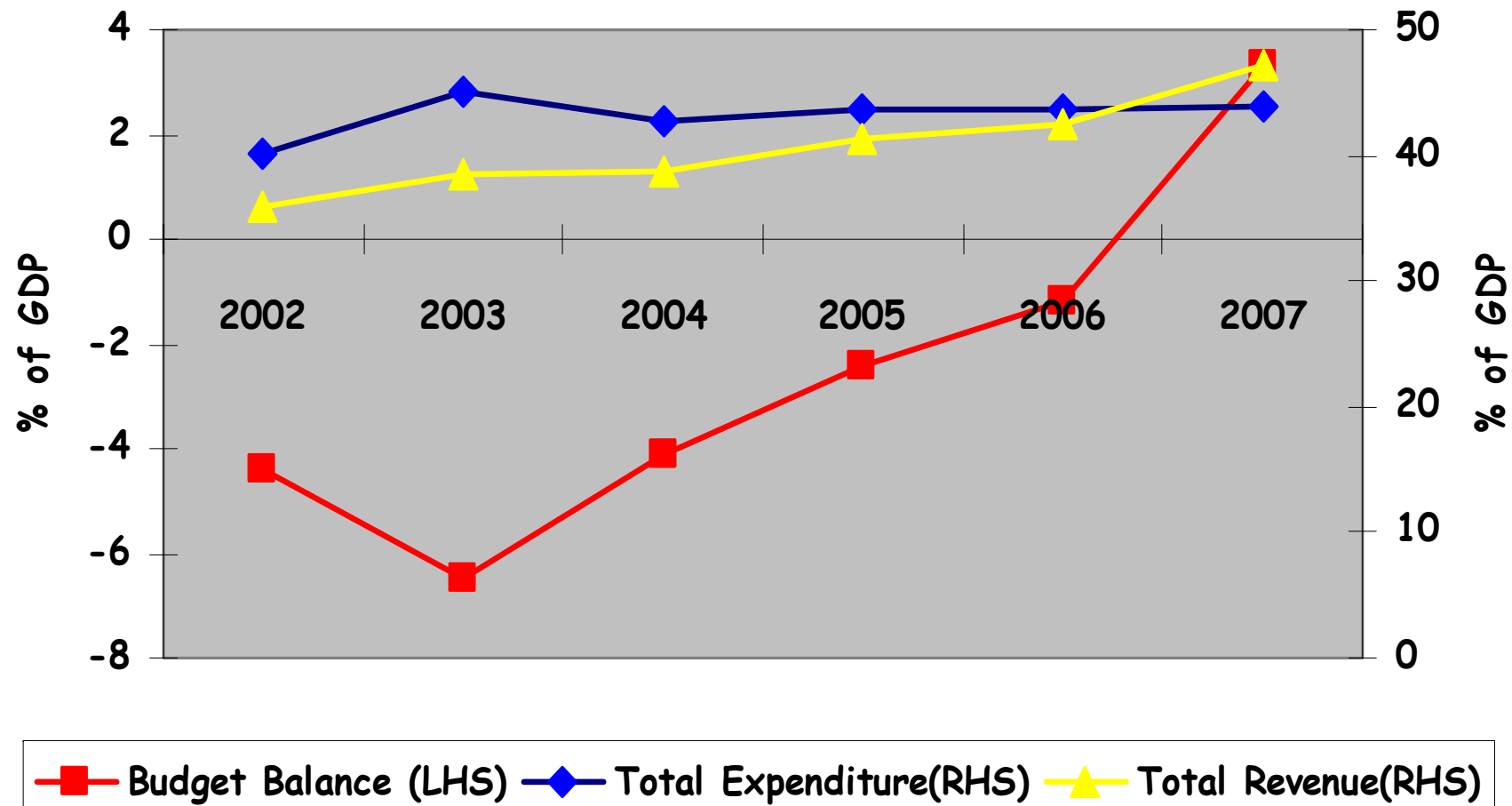
- While euro adoption promotes stability and strengthens growth prospects, some major challenges remain. Agenda ahead includes:
  - (i) safeguarding long term fiscal sustainability
  - (ii) implementing further structural reforms to enhance competitiveness
  - (iii) preparing the economy for successful reunification



# Budgetary Policies

- Stability & Growth Pact framework & peer pressure for fiscal discipline proved useful for Cyprus: a sharp turnaround, from 6,3% deficit (2003) to 3,3% surplus (2007).
- However, pressure was perceived by political parties & general public to be directed at short term fiscal targets (fiscal deficit < 3% of GDP).
- Public debate has been much less intensive on other important relevant issues such as (i) avoiding pro-cyclical fiscal behaviour (ii) expenditure control and reallocation (iii) respecting the long term fiscal constraint.

# Improved Budget Balance: Revenue Driven



# Safeguarding Strong Public Finances

- Important to intensify communication campaign on, and address, these vital issues (now noted in the revised SGP)
- Need for tighter homegrown fiscal rules and better budget institutions to safeguard effective public expenditure control, especially after entry
- Yet, no apparent case for changing the budget balance criterion for the assessment of the fulfillment of the Maastricht criteria and accession to the euro area for future entrants

# A bigger role for Public Debt

- Peer pressure for reducing public debt on a sustainable basis was felt but it did not drive domestic policies
- Reduction of public debt was more a by - product of fiscal consolidation than the result of cautious policies to ensure long-term fiscal sustainability
- Importance of public debt as a convergence criterion, in the context of SGP, should be upgraded & better communicated to the public

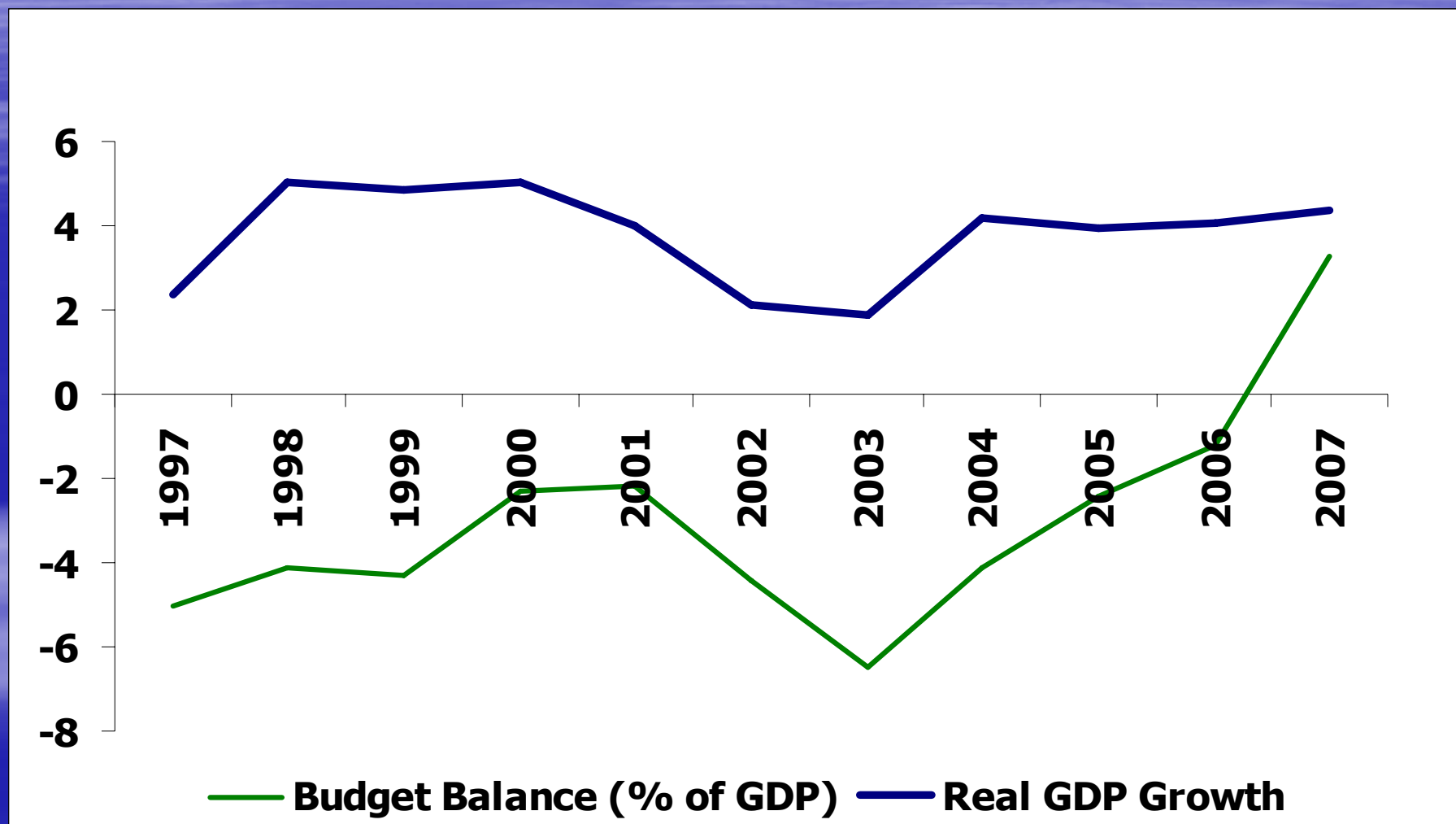


# Fiscal Consolidation Supports Growth

Does budgetary consolidation hurt growth?

- Experience in Cyprus supports the view that economic growth & fiscal consolidation are compatible & mutually reinforcing.
- Euro related macro stability, financial inflows, private sector initiative.
- More controversial question in catching up countries with a significantly lower GDP per capita - alleged dilemma between nominal & real convergence.
- Yet, fast growth in these countries is consistent with larger deficits for investments and a declining debt-to-GDP ratio.

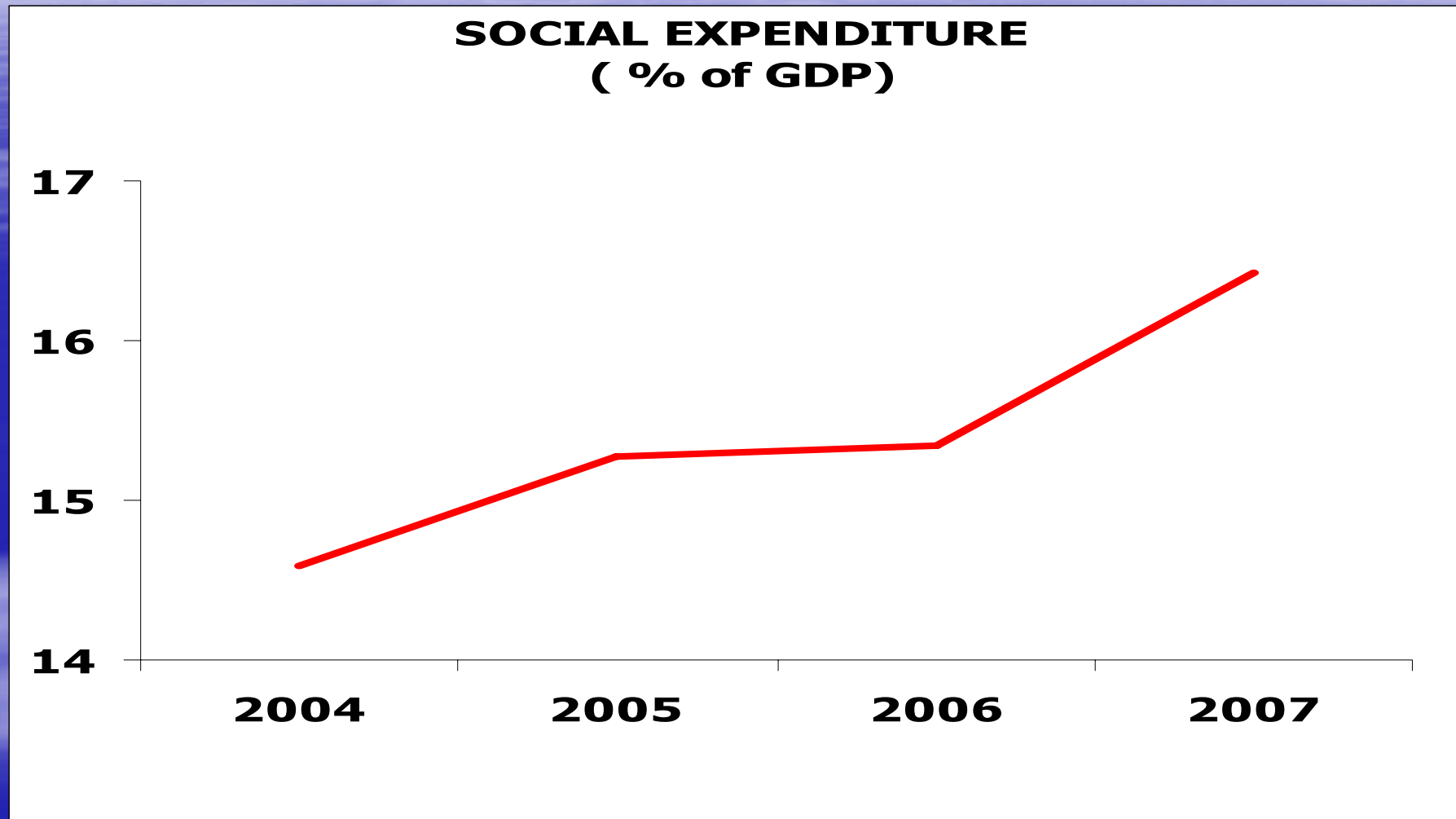
# Budget Balance and Real Growth



# Social Policies: Perceived Dilemma and the Real Issue

- Political debate in Cyprus focused on the perceived dilemma between fiscal consolidation & upgrading the social role of the state.
- Yet, social expenditure grew as deficits declined: rearranging priorities.
- Better targeting social spending proved an effective policy instrument to reconcile fiscal & social objectives.
- However, more social spending does not always lead to the desired outcomes - quality of spending & effectiveness of social policies in terms of improved social indicators, still an important issue in the EU & Cyprus.

# Social Expenditure Growth



# Inflation Perceptions

- Widespread perceptions that the introduction of the euro would lead to unjustified price increases: the main challenge to be addressed by communication campaign.
- Imported inflation and wage/cost pressures complicated the picture.
- Dual display of prices, Fair Pricing Code & intensive price monitoring during the euro changeover proved to be useful policy instruments & helped mitigate the problem together with organised consumers.
- However, some adjustment behaviour from retailers was evident.
- More focus of policy initiatives on sensitive products (low priced, frequently bought items and paid in cash) would have been warranted.
- Strengthening conditions of competition and consumer vigilance: decisive.



# Exploding Monetary Aggregates

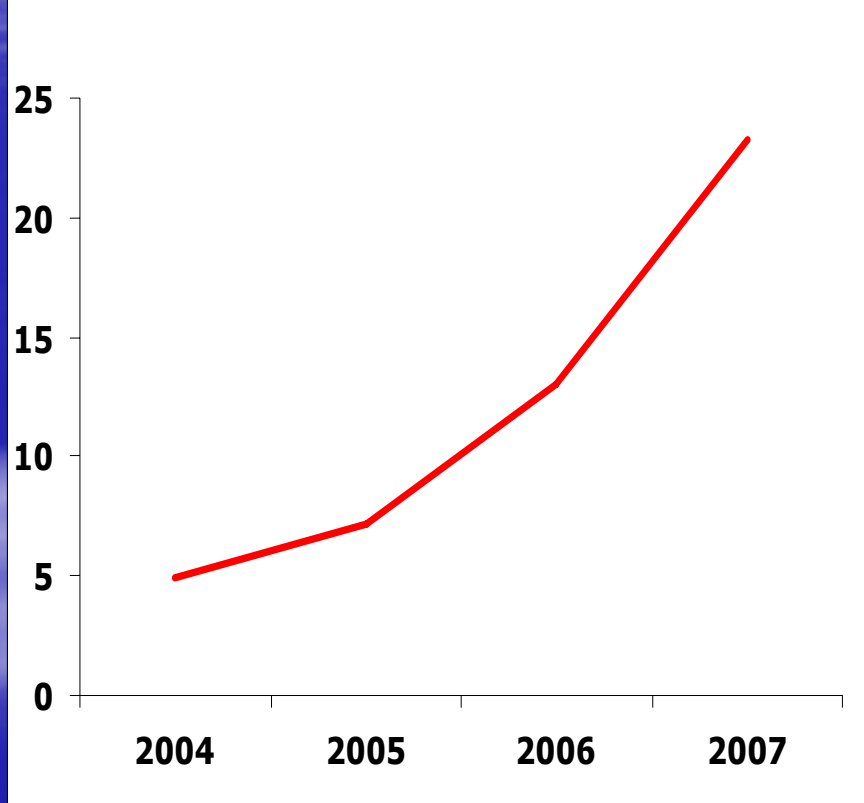
- Credit growth accelerated in Cyprus - reason for concern, together with imported inflation.
- Much lower real interest rates compared to interest rates warranted by local conditions, one of the factors leading to excessive credit expansion and real asset price boom.
- Significant capital inflows and real interest rates close to zero: how efficient is the financial system in allocating incoming funds for faster growth?

# Containing Monetary Aggregates

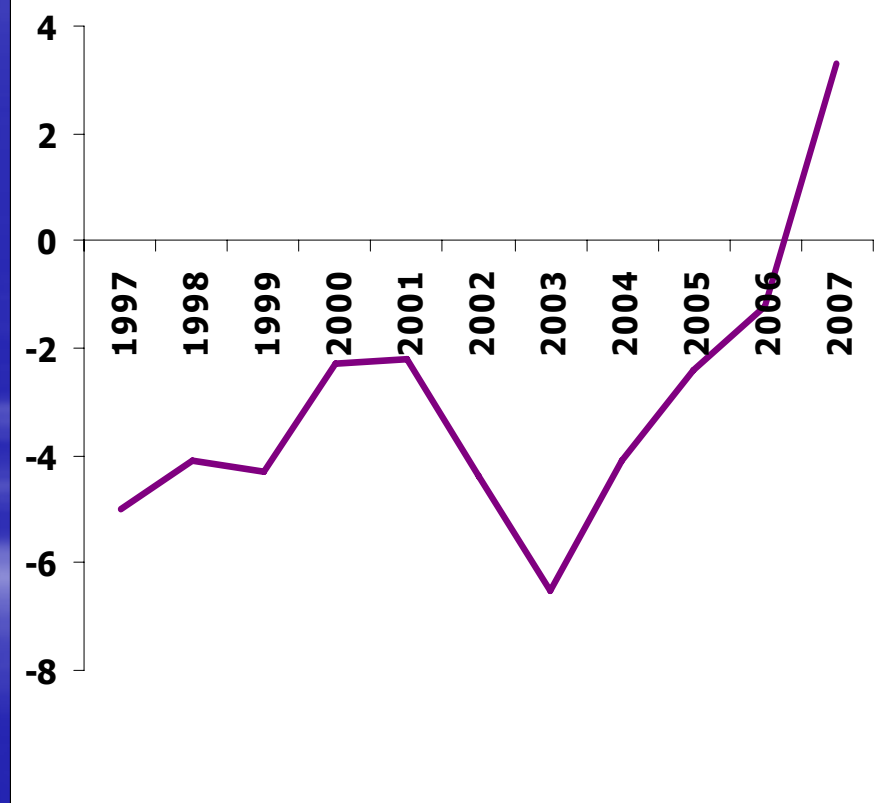
- Attempts to offset loose monetary conditions through stricter prudential measures for bank lending did not prove effective.
- Could an even more restrictive fiscal policy address this problem? Possibly yes, but how politically realistic is the imposition of higher fiscal surpluses, with the euro likely to be blamed?

# Credit Expansion and Budget Balance

**CREDIT EXPANSION**  
(annual % change)

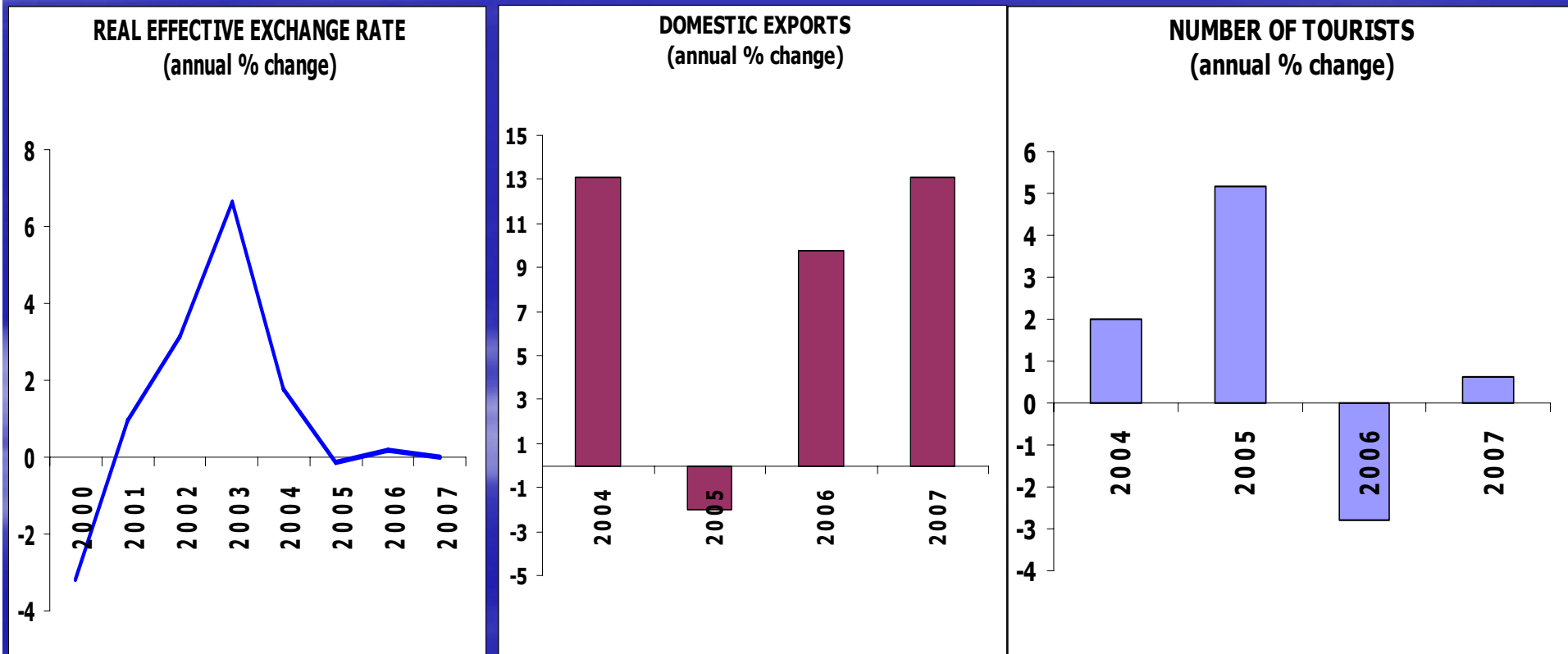


**Budget Balance**  
(% of GDP)



# Real Effective Rate Appreciation

- In recent years, the Cyprus pound has appreciated in nominal and real effective terms, but not since 2005



# Impact of Currency Appreciation

- Challenge for Cyprus, but the economy coped well (exports and tourism)
- Deterioration of the C/A balance due to rapidly expanding domestic demand -imports & increase of oil & commodity prices- rather than, appreciating currency
- Nevertheless, appreciating currency accentuates the need for structural reforms to offset negative effects on export price competitiveness
- In view of the 14 year exchange rate stability (peg), the 2 year ERM II obligation was probably not very meaningful



# Wage Developments

- Wage restraint & flexibility necessary for success in euro area, especially as inflation accelerates.
- Some moderation in wage developments in the broad public sector in Cyprus was helpful in this respect.
- Signs of wage growth differentials across sectors reflecting differences in productivity.
- Employment of foreign labour helped in making labour markets in Cyprus more flexible and limiting labour costs- supporting growth.
- Some form of stronger social agreement for wage moderation would have been helpful - necessary for future entrants into the euro area.

# Structural Reforms: Enhanced Growth Prospects

- Peer pressure for structural reforms less effective, notwithstanding new Lisbon Agenda.
- Need for collective reflections how to reinforce Lisbon Agenda & structural reforms in EU & euro area (re-allocation of spending, implementation of financial sector action plan and completion of single market in services).
- But supported by national efforts (labour markets, public sector reforms, social insurance, health systems) .
- Structural reforms: the unfinished agenda – main challenge ahead of us.
- Generally more flexibility in the labour market (hiring & firing) and more flexible goods and factors markets would enhance growth prospects and facilitate the absorption of economic shocks.

# Conclusions - Reflections

- The road to EMU was an exciting and positive experience for Cyprus: foundations for sustained growth.
- Despite initial scepticism, Cypriots welcomed accession to the Euro zone and adapted quickly.
- Perhaps too much emphasis on practical issues of transition and price abuses at the expense of deeper reflection: productivity and competitiveness.
- Avoiding price wage spiral and implementing politically demanding reforms the key to realising growth potential.
- T/C community is supportive and euro framework helpful for reunification.
- Likely to also be an exciting & rewarding experience for future entrants: a few reflections for them and for reunited Cyprus.



# Reflections

- Reflections on inflation criterion:
  - Satisfying the inflation criterion: the main challenge for future entrants
  - Yet satisfying the criterion on the road to the EMU, does not guarantee low inflation after entry
  - Current focus on sustainability aspect justified in substance - but it introduces room for subjective judgement
- Reflections on future enlargement:
  - Adoption of the euro and participation in the EMU brings advantages to old & new members
  - Technical preparations & nominal convergence but especially structural reforms (targeted at enhancing the flexibility and efficiency of markets) necessary preconditions to exploit benefits
  - Current rule-based framework has proven its effectiveness, notwithstanding criticism & some limitations

# Reflections

- Reflections on euro adoption in future reunified Cyprus:

- Participation in the euro area: helpful to future reunification of Cyprus
- In political terms, it helps strengthen the common European vision of G/C & T/C
- In economic terms, the policy framework of the euro area sends a signal that future reunified Cyprus would adhere to principles of sound macroeconomic management
- Some transitional arrangements may be necessary, but they should be limited in scope and time and mostly for technical, not protective reasons