Preparing for the euro: Lessons Learned and Challenges Ahead

Perspectives from the Monetary Policy Strategy in Cyprus

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• Overview of the Cypriot economy

• A prudent monetary policy strategy: price stability through exchange rate stability

• Policy challenges on the road to the euro

• Lessons learned and challenges ahead
• Price stability in Cyprus consistently pursued through exchange rate stability

• A credible fixed (or nearly fixed) exchange rate regime since the independence of Cyprus

• Peg to a strong currency or a trade weighted / geographically composed basket of currencies
CPI Δ% in Cyprus and euro area

- Cyprus
- Euro area
Elements of a successful regime

• Close monitoring of monetary aggregates and, in particular, credit to private sector.

• Close monitoring of the current account deficit.

• Building and retaining credibility: No devaluation, even during periods of adverse economic conditions (e.g. 1974, 1992, 1997 & 1999)

• Judicious utilization of non-traditional policy tools
  • capital controls
  • credit growth ceilings
Monitoring money and credit

M2 & claims on the private sector (end of year data, Δ%)

- Imposition of credit ceilings to control inflation
- Imposition of credit ceilings to temper stock market exuberance
- Relaxation of credit ceilings to encourage growth

Graph showing the changes in M2 and claims on the private sector from 1961 to 2006, with key events marked on the graph.
Monitoring the current account deficit

Current a/c deficit (% of GDP)

Credit growth and the current account deficit

The chart illustrates the relationship between credit growth and the current account deficit as a percentage of GDP from 1960 to 2004. The x-axis represents the years, and the y-axis shows the percentage of GDP. The chart includes three lines:

- Blue line represents the current account deficit as a percentage of GDP.
- Dark blue line represents M2 growth as a percentage of GDP.
- Pink line represents claims on the private sector growth as a percentage of GDP.

The data shows fluctuations over the years, with periods of negative and positive growth. The chart highlights the interplay between credit growth and the current account deficit, indicating potential economic trends during this period.
Challenges on the road to the euro

- EU accession-induced reforms
- Liberalization of capital movements
- Abolition of interest rate ceilings
- Reform of monetary policy instruments
Exchange rate stability

- 50 bp cut on 10/08/01 & adoption of ±15% margin
- 100 bp increase on 30/04/04
- 50 bp cut on 09/06/05

Fluctuation %

+2.25%

0.00%

-2.25%
Abolition of the statutory interest rate ceiling
01/01/01

Unilateral peg to the euro 01/01/99

50 bp cut on 10/08/01

EU accession

100 bp increase on the eve

Entry into the ERM II 02/05/05

50 bp cut on 09/06/05


ECB
CBC
Challenges ahead

• Inflationary credit and money expansion

• Easing of monetary conditions implied by convergence of interest rates and reserve requirements with euro area by January 1, 2008

• Risk of increase in inflation perceptions:
  • Concerns regarding euro-related increases
  • Food and energy price increases

• COLA prevalence in wage contracts can perpetuate these temporary inflation problems