Cyprus: An Optimum Optimorum?

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Abstract

Cyprus joined the European Union in the 2004 wave, shortly thereafter qualified for admission to the EuroArea, and has in fact been a full member of the EuroArea since the beginning of this year. The case for a country to join a currency union has traditionally been seen as one in which there is a trade-off between gains from trade (as membership of the currency union implies a reduction in trade-related transactions costs) and efficient stabilization policy (as joining the currency area implies the abandonment of a separate monetary policy). By this criterion Cyprus is exceptionally well-placed to benefit from joining the EuroArea. Economists are known for denying the existence of a free lunch, so we must scrutinize more carefully whether this is indeed so. Cyprus certainly faces some economic problems, but the most prominent of these are not obviously exacerbated (and probably the contrary) by membership of the EuroArea.

Keywords: Cyprus, Capital Inflow, Feldstein-Horioka, Monetary Union.

1. Optimal currency area criteria

Cyprus appears to be a very well qualified member of the European currency area. The case for a country to join a currency union has traditionally been seen as one in which there is a trade-off between gains from trade (as membership of the currency union implies a reduction in trade-related transactions costs) and efficient stabilization policy (as joining the currency area implies the abandonment of a separate monetary policy). Thus traditional criteria indicate that a country will do well to join with others in a currency area if it is well-integrated in terms of trade links with those other countries, and experiences business cycle fluctuations in line with those experienced by these other countries. In fact research has shown that strong trade links generally induce a sympathetic business cycle so that these two criteria are not strongly independent. On this basis

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Cyprus is a paradigm new entrant. Her strong trade links indicate significant benefits from the use of a single currency with her partners whilst the business cycle sympathy that this is liable to induce signals that the monetary policy coming from Frankfurt should not be too uncomfortable to live with. In any case the scope for Cyprus to exercise independently an efficient and effective stabilization policy through the use of monetary policy on its own might not be high: the placid experience of the period of membership of ERM 2 and even of the preceding years must owe much to the market’s fore-knowledge of Cyprus’ intentions in respect of joining the European Union and subsequently the EuroArea. Thus it seems that the optimality of Cyprus’ membership of the EuroArea is secure. Economists are known for denying the existence of a free lunch, so we must scrutinize more carefully whether this is indeed so. Cyprus certainly faces some economic problems, but the most prominent of these are not obviously exacerbated (and probably the contrary) by membership of the EuroArea.

2. The demographic timebomb

One of these problems is the demographic timebomb that Cyprus faces – in common with, though worse than, most of the EuroArea membership. One of the constraints that membership of the EuroArea implies is the need for a country to adhere to the Stability and Growth Pact (SGP) in respect of its fiscal policy. Currently Cyprus is well within the target values of the SGP, but ageing of the population is liable to put pressure on budgets as tax revenues (relative to what they might have been) fall and expenditures on age-related programmes (pensions are but one component) rise. Still, even here membership of the EuroArea seems unlikely to make matters worse than they otherwise would be. Population ageing is not a temporary shock for which a temporary rise in the public sector deficit could be recommended as a suitable solution (it is not, for example, a matter of avoiding a purely temporary and costly rise in taxes). In this sense the problem cannot be avoided by an accommodative fiscal policy and Cyprus is no worse off inside the EuroArea than outside. (In fact the SGP recognizes population ageing as a valid “excuse” for very temporary infractions of the criteria whilst permanent solutions are set in place).  

1 The foundations of the “new” (post reform) SGP include a number of sensible reforms like this. In fact the SGP can be regarded as having promoted some very good work by the EU’s Economic Policy Committee on the very topic of population ageing.
3. The unification of Cyprus

In due time there will be some problems to be solved as and when Cyprus is re-unified. The difference in scale of the two forbids using Germany’s reunification as an example and in any case it is too soon to dwell on what the costs of unification in the Cypriot case might be. But, once again, it does not seem reasonable to suggest that membership of the EuroArea will increase whatever costs will have to be borne as a result of reunification. They would have to be borne anyway. Nor is it entirely fanciful to suppose that Cyprus should be able to command considerable (and substantive) EU sympathy in such a context.

4. Real problems?

If membership of the EuroArea seems unlikely to exacerbate the two problems just mentioned, are there any respects in which membership of the EuroArea could pose a problem? There are perhaps just two that stand out. One is the fact that Cyprus is a very open economy, and open not just to the EuroArea. This is certain to mean that occasions will arise when changes in the Euro-dollar exchange rate will put additional pressure on Cyprus compared to some other EuroArea economies. The current conjuncture is an example. As the Euro strengthens against the Dollar economies with a greater-than-average exposure to the dollar will incur some problems of adjustment. Once again this should not be overstated. If Cyprus were not a member of the EuroArea changes in the cross-exchange rates of her trading partners would cause problems: moreover, most recent evidence (e.g. Kose et al. (2008)) suggests that business cycle experiences among the advanced countries have been converging rather than diverging.

A much more likely – and more “interesting” - problem could arise as Cyprus’ actual membership of the EuroArea removes the last vestiges of misgivings about devaluation risk from investment by EuroArea agents in Cyprus. One of economics’ most long-standing “puzzles” has been the so-called Feldstein-Horioka puzzle. Feldstein and Horioka (1980) posed as a test for capital mobility that investment in a country should not be limited by that country’s savings – i.e. that in the equation following the parameter $\beta$ should be zero: $I/Y = \alpha + \beta(S/Y) + \varepsilon$. Here $I/Y$ is a country’s investment ratio (investment in ratio to GDP), $S/Y$ its savings ratio and $\varepsilon$ an error term. Their estimation of this equation (using cross-section data) found that far from being indistinguishable from zero the estimate of $\beta$ was indistinguishable from unity. Subsequent studies using data from later time periods have repeatedly found estimates of $\beta$ to be uncomfortably
high. Among the many speculations as to why this should arise when the casual evidence around us is that capital is very highly mobile is the simple one that exchange rate risk deters capital from being fully mobile. This speculation seems to have obtained some concrete confirmation in recent work by Blanchard and Giavazzi (2002) which shows that data for members of the EuroArea – Portugal being a prime example - can indeed support the original speculation. This obviously helps to explain why capital inflows into some of the new EuroArea countries have increased substantially. On the face of it this is a thoroughly good thing as investment opportunities previously unrealized because of the constraint imposed by domestic savings can now be fulfilled. There is, however, a likely concomitant downside, which is that the influx of capital and the induced investment boom will lead to inflation; given the fact that the recipient country is in a currency area, the induced inflation will be concentrated in the non-tradeables sector initially.

But wage-wage inflation will ensure that the country becomes uncompetitive in its tradeables sector. This can cause difficult adjustment problems since labour will be displaced and the “boom” may have to yield eventually to some unemployment. Monetary policy by definition is not available to assist in a stabilizing deflation and fiscal imbalances may be aggravated. The fact that Cyprus has a lax fiscal regime towards foreign investment (and has escaped being branded as a “tax haven”) and a history that persuades investors that they can deal in English is likely to assist the capital inflow. Once again we should take account of the fact that knowledge of Cyprus’ exceptional status has already precipitated a condition of persistent capital inflow, so that some of this effect has already been realized. Table 1 shows the amounts of Foreign Direct Investment (FDI), portfolio and other foreign investment in Cyprus in recent years.

How bad is this problem? Indeed is it a problem at all outside the confines of economists’ models? One thing that can be said is that it may be quite persistent: for not only is a mildly contractionary monetary policy not available to quieten the inflation, but monetary policy will in effect become more expansionary as the real rate of interest implied by the nominal rate set in Frankfurt and the inflation rate realized in Cyprus will fall, inappropriately.
TABLE 1

FDI, portfolio and other net foreign investment in Cyprus

<table>
<thead>
<tr>
<th></th>
<th>Euro millions</th>
<th>Percentage of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign Direct Investment</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Abroad</td>
<td>-107.1</td>
<td>-555.4</td>
</tr>
<tr>
<td>In Cyprus</td>
<td>532.1</td>
<td>873.0</td>
</tr>
<tr>
<td>Net</td>
<td>425.0</td>
<td>317.7</td>
</tr>
<tr>
<td>Portfolio Investment</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Assets</td>
<td>-282.2</td>
<td>-1469.2</td>
</tr>
<tr>
<td>Liabilities</td>
<td>105.6</td>
<td>2377.9</td>
</tr>
<tr>
<td>Net</td>
<td>-176.6</td>
<td>908.6</td>
</tr>
<tr>
<td>Other Investment</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Assets</td>
<td>-800.0</td>
<td>-2473.4</td>
</tr>
<tr>
<td>Liabilities</td>
<td>879.7</td>
<td>2002.7</td>
</tr>
<tr>
<td>Net</td>
<td>79.7</td>
<td>-470.7</td>
</tr>
</tbody>
</table>

This is the so-called “Walters critique” (Walters 1986): the nominal rate of interest is fixed in nominal terms across the EuroArea, but the real rate necessarily varies inversely and hence inappropriately with the rate of inflation across the member countries. The excess inflation will be cooled gradually by the increase in the real exchange rate, as Cyprus’ fixed nominal exchange rate (against the Euro) accompanies a rising price level and the country loses competitiveness against foreign goods. It seems that this deflationary impulse should in the end overcome the Walters critique effect of the de facto expansionary monetary policy but it may take a long time.2

Figure 1 illustrates the situation in a phase diagram. Along the axes are plotted the inflation rate \( z \) (on the vertical) and the real exchange rate, \( R \) (on the horizontal). A rise in inflation relative to the EuroArea average (shown as \( z_{EA} \)) will reduce the real rate of interest in Cyprus, adding to inflationary pressure. On the other hand, a rise in inflation relative to the EuroArea average will cause a rise in the real exchange rate (fall in competitiveness) and so lead to a cooling of the economy. The corresponding arrows of motion define the phase diagram: evidently the system as shown is neither globally (nor saddlepoint) stable, nor is it

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2 In control theory language the reason for thinking this is that the real exchange rate exerts an “integral effect” whilst the inflation rate has a “differential effect”.
necessarily unstable. There could be oscillation. One might imagine the “excessively” benign impact effect of Cyprus’ accession to the EuroArea to place it in the NorthWest quadrant with increasing inflation and falling competitiveness.

FIGURE 1

*Phase diagram illustration of the “Walters effect” and its limits*

To resolve this situation with alternative policies is a possibility – but one that can be quite difficult to manage: in principle fiscal and wage policy can be used, but as the experience of Ireland has demonstrated the use of wage policy sometimes involves the use of fiscal policy in an opposing direction (when wage restraint is bought at the cost of not tightening fiscal policy). Still, the Irish problem – if it is a version of this that Cyprus may at worst experience – tends to be more of a problem in economists’ heads than in that of the “ordinary man”. Economists routinely penalise excess inflation to an extent that may be due more to the analytical tractability of symmetric utility functions than to real-world considerations.

The burden of all this is to say that if Cyprus experiences a problem in joining the EuroArea it is more likely to be one due to an excessively benign impact than otherwise.
References


