Can Cyprus Cope Inside the EMU?†
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Abstract
The purpose of this paper is to investigate whether Cyprus was ready to join the euro area and whether it can cope with the challenges inside the Economic and Monetary Union (EMU), given the loss of monetary policy autonomy. We examine the performance of the economy of Cyprus towards the road to the EMU, in terms of satisfying the Optimum Currency Area (OCA) criteria and achieving nominal and real convergence. We find that Cyprus satisfied the OCA criteria to a satisfactory degree and achieved full nominal convergence and relatively high real convergence. However, Cyprus needs to preserve fiscal consolidation given the recent inflation pressures and accelerate structural reforms with emphasis on the labour market, thus enhancing productivity and flexibility and offsetting possible adverse effects on competitiveness resulting from the real effective appreciation of the euro. Reforming the social security system is also imperative in order to improve the long-term sustainability of public finances.

Keywords: Optimum Currency Area, EMU, Real Convergence, Nominal Convergence.

1. Introduction
The creation of an economic and monetary union in the EU, was motivated by the ambitious goal to establish a single market in Europe.1 The single market project envisaged removing all remaining barriers to the free movement of goods, services, people and capital and was seen as a

† The views expressed in this paper are those of the authors and do not necessarily reflect the views or opinions of the Ministry of Finance or the Government of the Republic of Cyprus.

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1 A monetary union is a situation where several countries have agreed to share a single currency. In the context of the EU, economic and monetary union is the process of harmonising the economic and monetary policies of the member states of the Union with a view to the introduction of a single currency, the euro.
prerequisite for raising living standards in Europe. It was argued that the full benefits of the internal market would be difficult to achieve with the relatively high business costs brought about by the existence of several currencies and volatile exchange rates. In addition, many economists and central bankers believed that national monetary autonomy had been inconsistent with the Community’s objectives of free trade, free capital movements and fixed exchange rates. In a widely quoted and influential report, the European Commission (1990) argued that “without a completely transparent rule of the law of one price for tradable goods and services, which only a single currency can provide, the single market cannot be expected to yield its full benefits—static and dynamic.” It was further stated that the single currency would deepen integration, by lowering exchange-rate-risk premia and uncertainty, make cross-border business more profitable, and lower transaction costs, thereby saving the equivalent of approximately 1% of EU-15 GDP. Research undertaken by Allington et al (2005), tested the hypothesis that greater market integration, followed by a common currency, had rendered the “law of one price” (a benchmark for completing the single market) valid for the EU. Their results indicated that the euro had a positive effect on price convergence for tradable goods among EMU members relative to non-EMU members, over and above a general EU-wide trend towards price convergence. According to the authors, this is explained by the fact that a common currency eliminates transaction costs and exchange rate risks and, through price transparency, increases trade and competition, thereby contributing to lower price dispersion, after adjusting for transport costs. It is noted that transaction costs were very large; before the adoption of the euro they were estimated at 0.3% to 0.4 % of GDP in the EU (around 20–25 billion euro).

Political reasons also underlined the creation of the EMU. Majone (2007) argues that “a common monetary policy vis-à-vis the rest of the world would produce gains in prestige and political power. Many proponents of monetary union saw the single currency as a political project to liberate Europe from its dependence on the dollar. This was the idea of creating a “European monetary personality” as it was called, and a currency able to rival the dollar on world monetary markets.” Likewise, the Dutch Prime Minister Wim Kok, declared in a speech, that “EMU can develop into a cornerstone for Europe’s further political integration--forming the foundation for Europe’s increased power in the world.” This was in fact one of the fundamental reasons underlying the creation of the EMU; it was, essentially, a political undertaking. To underline that reality, is not to deny the compelling economic rationale for EMU, but to emphasize that there is a political dimension as well.
However, the valid reasons discussed above for having a common currency with other countries, cannot deny the view that giving up the monetary policy tool can prove challenging for a country. Theoretical and empirical literature acknowledge that there are certain preconditions to be satisfied, in order to fully reap the benefits of entering a common currency area. A country needs to prepare its economy well and have sufficient adjustment mechanisms that will compensate for the loss of the monetary policy autonomy.

In the next section we discuss the main challenges a country faces by entering a common currency and then we detail the preconditions for success in the EMU. In Section 3 we explain the evaluation approach used for examining the economic performance of Cyprus on the path to the EMU and in Section 4 we provide the results from this evaluation. Section 5 concludes whether Cyprus was ready to join the EMU and whether it can cope inside the euro area.

2. Challenges

The main cost for a country joining a common currency area is the loss of the monetary policy autonomy. The economist Robert Mundell (1961) pioneered the theory of the optimum currency area\(^2\), citing the following Optimum Currency Area criteria (OCA criteria) for a successful currency union\(^3\):

1. Labour mobility (physical ability to travel, lack of cultural barriers to free movement etc.) and flexibility (readiness of labour market institutions to adjust to different situations), in order to lessen the negative impact of an asymmetric shock.\(^4\)

2. Wage flexibility, in order to deal with asymmetric shocks effectively.

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\(^2\) An optimum currency area is a geographical region in which it would maximize economic efficiency to have the entire region share a single currency. It describes the optimal characteristics for the merger of currencies or the creation of a new currency. The theory is used often to argue whether or not a certain region is ready to become a monetary union, which is one of the final stages in economic integration.

\(^3\) The argument also works the other way around; the less these criteria are satisfied, the stronger the case for retaining different currencies under a flexible exchange rate regime.

\(^4\) Asymmetric shocks are unexpected disturbances to national output that affect a country differently from another one.
3. Openness and close trade links between the members of the currency union, which raise the symmetry of economic cycles of those countries.

4. An automatic fiscal transfer mechanism to redistribute money to areas/sectors which have been adversely affected by the first three characteristics (it usually takes the form of taxation redistribution to less developed areas of a country/region).

The above criteria are considered as necessary preconditions (and challenges at the same time), in order to overcome the loss of the monetary policy autonomy. If these challenges are not dealt with effectively, the “one-size-fits-all” monetary policy can lead to divergencies, thereby complicating further policy setting in Europe. As Eichengreen (1997) stated, “the diminution of autonomy follows from the loss of the exchange rate and of an independent monetary policy as instruments of adjustment. That loss will be more costly when macroeconomic shocks are more “asymmetric….” Indeed, the inability to manipulate the exchange rate when shocks are felt differently can prove quite costly for a country.

Adjustment mechanisms, such as sufficient degree of labour mobility and flexibility as well as wage flexibility are needed in order to compensate for the loss of exchange rate policy. As Jean-Claude Trichet (2005), President of the European Central Bank, said: “…. they can influence the speed with which market forces can operate and provide lasting adjustment after an economic shock.” Currently, the labour mobility in the euro area is considered to be relatively low, because of institutional and administrative factors, thereby affecting an efficient allocation of productive resources. At present, wage rigidities also prevail in certain countries in the euro area.

The degree of openness of a country with the other members of the currency area can also be a decisive factor for success, due to the link between trade integration and economic cycle synchronisation. According to recent theory though, this link is ambiguous. On the one hand it is suggested that the more integrated (less trade barriers) a country is with the other members countries of a currency union, the more their business cycles become synchronised, due to an increase in the intra-industry trade. On the other hand, a theory developed by Krugman (1991), suggests that as trade barriers are reduced, opportunities for economies of scale and specialisation in production (where countries have a comparative advantage) increase. Consequently, countries’ production structures become less diversified and thus increasingly vulnerable to asymmetric shocks.

Empirical evidence has shown two things. First there is the so-called ‘euro effect’; the single currency has had a positive impact on trade (trade
creation and not trade diversion) between euro area countries.\(^5\) In other words, there has been endogeneity of trade inside the EMU.\(^6\) Secondly, Frankel and Rose (1998) found a strong positive relationship between the degree of bilateral trade intensity and the cross-country bilateral correlation of business cycle activity. That is, greater integration historically has resulted in more highly synchronized cycles, which is opposed to Krugman’s theory.

Regarding the fourth criterion, the automatic fiscal transfer mechanism theoretically does not apply in the euro area (meaning that fiscal transfers are not allowed). Nevertheless, the Stability and Growth Pact allows member states to allow the automatic stabilisers to help mitigate the problems stemming from asymmetric shocks (e.g. increase in budget deficit in times of a recession). The more the public finances are consolidated, the more these automatic fiscal stabilisers can be utilised.

### 3. Evaluation approach

Given the theoretical consensus regarding the OCA criteria, it is natural to judge the suitability of different European countries for joining the EMU against these criteria. However, such a procedure should be undertaken with caution, since the OCA criteria seem to be jointly endogenous as it was mentioned earlier, i.e. the structure of the economies is likely to change within the EMU. In other words, countries that join the EMU may satisfy the OCA criteria ex post even if they do not ex ante (Frankel, Rose, 1998). Nevertheless, it is important that a country satisfies the criteria before it enters a monetary union, so that the transition from a flexible exchange rate regime to a common currency is smooth. The analysis will also help to draw important lessons about what policies need to be implemented, in order to improve performance within the EMU.

In addition to satisfying the OCA criteria, for a more efficient economic and monetary union, it is necessary for the member state economies to achieve a high degree of nominal convergence before adopting the single

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\(^5\) However, a higher rise in the reciprocal trade between European countries is attributed to the European institutional integration that started in 1958. Thus, the high degree of reciprocal openness had already been exhibited before the advent of the euro (De Grauwe and Mongelli, 2005).

\(^6\) It means that a monetary union may have endogenous effects; i.e. the creation of forces that promote for example, trade integration, business cycle synchronisation or labour mobility, within the union.
currency. The ‘Maastricht convergence criteria’ were established for exactly this reason and were designed in such a way to ensure that a Member State’s economy was sufficiently prepared for the adoption of the single currency. They provide a common baseline for the stability, soundness and sustainability of public finances for euro area candidates that reflect economic policy convergence and resilience to economic shocks. This resilience stems from the fact that the more consolidated the public finances are, the more room there is to implement pro-active and anti-cyclical budgetary policies, thus supporting economic growth in times of recessions. For the purpose of this paper, we will examine the recent trends of the Cypriot economy in terms of government deficit, public debt and inflation.

Another precondition or benchmark for a successful participation in the euro area is the achievement of real convergence; the progress made in “catching up” in economic performance, measured by real GDP growth and real GDP per capita in Purchasing Parity Standard (PPS). Real convergence is not mandatory for accession in the EMU (unlike the Maastricht criteria) but rather it is considered as an essential process for an economic and monetary union. This is so because real disparities usually imply price differentials, thereby making the implementation of a common monetary policy more challenging to implement (different competitiveness levels require different nominal exchange rates). In this respect, we will examine the level of convergence of Cyprus compared to the average real GDP per capita in the euro area.

4. Cyprus’s economic performance towards the EMU

i) Limited flexibility of the labour market but positive developments from employment of foreign and Turkish Cypriot workers. In terms of labour mobility and flexibility, Cyprus is characterised by relatively strict employment protection legislation (EPL), in particular hiring and firing laws. Strict EPL is deemed to adversely affect the job prospects of new labour market entrants, by reducing job hiring and turnover. Moreover, the relatively rapid growth of the public sector (the number of public sector employees amounted for around 18% of total labour force in 2007) is limiting the flexibility of fiscal policy to adjust in times of asymmetric shocks, as the proportion of inelastic expenditure to total expenditure has

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7 Within the EMU, the nominal convergence is promoted by the preparation of National Stability Programmes, as required by the Stability and Growth Pact.
risen steadily. In 2007, expenditure on public sector personnel amounted for around 30% of the total expenditure of the Government of Cyprus. However, it seems that labour market conditions in Cyprus generally have been conducive, with the unemployment rate declining to 4.0% of the labour force and employment rate rising to close to 70% in 2007. Employment has continued to expand strongly, sustained, to a considerable extent, by a continued inward immigration and the employment of Turkish Cypriots. A decisive contributing factor to the increase in employment was the decision of the Government of the Republic of Cyprus to allow the temporary employment of foreign workers in certain sectors of the economy, given the labour market shortages created by the fast economic growth. During the last decade, the number of immigrants has risen steadily and, by 2007, legal immigrants totalled over 65,000 or 17% of the labour force (see Table 1). These developments have contributed towards a more flexible labour market.

<table>
<thead>
<tr>
<th>TABLE 1</th>
<th>Labour market developments</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>2000</td>
</tr>
<tr>
<td>Unemployment Rate (%)</td>
<td>4.9</td>
</tr>
<tr>
<td>Number of Foreign Workers</td>
<td>26398</td>
</tr>
<tr>
<td>Share of Foreign Workers Relative to Total Labour Force (%)</td>
<td>8.7</td>
</tr>
<tr>
<td>Employment Growth (%)</td>
<td>2.2</td>
</tr>
</tbody>
</table>

Source: Statistical Service of Cyprus.

Currently the EU is promoting the model of “flexicurity”, which is a combination of more flexible hiring and firing practices (flexibility for employers), high benefits for the unemployed (security for the employees) and active labour market policies. Moving in this direction would allow for enhanced flexibility in the Cypriot labour market, while, at the same time, providing more security to the employees. This constitutes a serious challenge for policymakers in Cyprus at the current juncture.

ii) Strong trade links with euro area countries have rendered business cycles highly synchronised. The Cypriot economy has relatively strong trade links with EU member states, as shown by Figure 1. Indicatively, in 2007, the share of imports from EU-25 in total imports was 68.0% and the share of

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8 If we take into account the estimated number of illegal foreign workers, then their total number is more than 100,000 or well over 20% of the labour force.
exports from EU-25 in total exports was 68.1%. Therefore, Cyprus seems to satisfy - a priori - the criterion for strong trade linkages. Given that the Cypriot economy is generally characterised as relatively open (share of total imports and exports to GDP was around 105% in 2007), these linkages are expected to play a major role in business cycle synchronisation. This positive development is expected to be further strengthened due to the “euro effect” on trade, mentioned above, thereby synchronising more the economic cycle of Cyprus with the economic cycles of other members. This in turn, is expected to limit the incidence of asymmetric shocks in Cyprus. On the other hand, the fact that the tourism sector in Cyprus is mainly dependent on tourists from UK, a country which has not adopted the euro yet, could prove challenging in the future (a shock in UK might affect Cyprus differently than the other euro area countries).

### FIGURE 1

*Trade with EU-25: share in total imports (%) - share in total exports (%)*

![Graph showing trade with EU-25](image)

*Source: Eurostat.*

iii) Wage flexibility remains relatively limited. With regard to wage flexibility, Cyprus presents a mixed picture. Wage setting in the public sector and for semi-government organisations is highly centralised, with wages not linked closely to productivity and performance. In the private sector, wage

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* Due to lack of data regarding trade between Cyprus and the euro area countries, we used as a proxy the available data for trade between Cyprus and the EU-25.
determination is more decentralised, with widening wage differentials, reflecting the diverse performances and productivity of different sectors. The increasing employment of migrant labour as well as the relatively low implicit tax rate on labour (under 25% compared to around 36% in EU27) has contributed to greater wage flexibility in the private sector in recent years. A particular element in wage setting covering the public sector and most of the private sector is the wage indexation with a 6-month lag of wages to consumer prices. Nevertheless, it is a widely accepted notion that wage indexation in Cyprus has contributed towards maintaining industrial peace and social consensus. Moreover, in the low inflation and relatively high growth environment experienced by Cyprus during the recent years, wage indexation has not proved damaging, especially since productivity developments are taken into account during wage negotiations. However, wage indexation might become a challenge, given the prospect of incidences of asymmetric shocks.

iv) High degree of real convergence and decreasing price disparities with other euro area countries. During the past 10 years, the Cypriot economy expanded at an average rate of 3.6% and consequently, its per capita real GDP has increased to around 83% of the average euro area level in 2007, from around 76% in 1998. This development can be attributed to the growth of the Cypriot economy at higher rates than the euro area average (see Figure 2) and the containment of inflation at low levels (see Figure 3). The “catching up” of the Cypriot economy with the euro area countries is reducing price differentials. With the adoption of the euro and the resultant elimination of transaction costs, price differentials are expected to decrease even more, thereby making the implementation of a common monetary policy less challenging. Figure 2 also reveals the high degree of business cycle synchronisation between euro area countries and Cyprus, which is assessed as a very positive development.

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10 This observation confirms a pattern observed in some other countries; economic growth and falling inflation do not necessarily rule each other out. For example, during the accession process to the monetary union, even potentially risky countries like Greece, Portugal, Spain and Italy, managed to combine falling inflation and higher economic growth.
FIGURE 2
Real GDP growth, 1998-2007

Source: Eurostat.

FIGURE 3
Harmonised consumer price index, 1997-2007

Source: Eurostat.

v) Productivity challenges ahead. Notwithstanding the satisfactory growth performance and considering the significant real effective appreciation, a number of challenges must be addressed in the coming years, such as productivity improvements which have been less impressive, with labour
productivity per person employed estimated to be around 77% of the average for the euro area. The growth rate of labour productivity is estimated at a very modest 1% per annum over the period 2002 to 2007 (see Table 2), though this is also due to negative cyclical factors. The productivity level of the public sector remains relatively low, despite the employment of highly educated people and has experienced little growth in recent years. With respect to the relatively low level of productivity observed in certain areas of the private sector, this is attributable to various factors. One such factor is the relative shift of labour resources toward low value added sectors, such as construction and household services, thus negatively affecting the overall productivity performance of the economy.

TABLE 2

<table>
<thead>
<tr>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>9703</td>
<td>-1.2%</td>
<td>-2.8%</td>
</tr>
<tr>
<td>Mining and Quarrying</td>
<td>60798</td>
<td>7.6%</td>
<td>5.0%</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>26145</td>
<td>0.8%</td>
<td>0.3%</td>
</tr>
<tr>
<td>Electricity and Gas</td>
<td>159834</td>
<td>2.5%</td>
<td>1.1%</td>
</tr>
<tr>
<td>Construction</td>
<td>23915</td>
<td>5.3%</td>
<td>0.3%</td>
</tr>
<tr>
<td>Wholesale and Retail Trade</td>
<td>24603</td>
<td>3.2%</td>
<td>1.9%</td>
</tr>
<tr>
<td>Restaurants and Hotels</td>
<td>21991</td>
<td>1.6%</td>
<td>-1.6%</td>
</tr>
<tr>
<td>Transport and Communications</td>
<td>46924</td>
<td>1.8%</td>
<td>4.5%</td>
</tr>
<tr>
<td>Financial Intermediation</td>
<td>52203</td>
<td>1.4%</td>
<td>2.9%</td>
</tr>
<tr>
<td>Real Estate, Renting and Other Business Service</td>
<td>90594</td>
<td>6.2%</td>
<td>-1.2%</td>
</tr>
<tr>
<td>Public Administration and Defense</td>
<td>38146</td>
<td>2.8%</td>
<td>0.4%</td>
</tr>
<tr>
<td>Education</td>
<td>29592</td>
<td>2.1%</td>
<td>0.6%</td>
</tr>
<tr>
<td>Health</td>
<td>26537</td>
<td>2.8%</td>
<td>-0.1%</td>
</tr>
<tr>
<td>Communication and Social and Personal Service</td>
<td>26363</td>
<td>2.5%</td>
<td>0.3%</td>
</tr>
<tr>
<td>Private Households Services</td>
<td>5995</td>
<td>10.6%</td>
<td>-0.4%</td>
</tr>
<tr>
<td>Total Economy</td>
<td>33990</td>
<td>2.7%</td>
<td>1.0%</td>
</tr>
</tbody>
</table>

Source: Statistical Service of Cyprus.

vi) Consolidation of public finances will allow stabilisers to address asymmetric shocks. Cyprus consolidated the public finances during the years 2004 and 2007; even experiencing a general government surplus of 3.3% in 2007 (see
Figure 4). Concurrently, with the generation of rising primary surpluses the debt-to-GDP ratio followed a downward path during recent years (see Figure 5) and for the first time fell below the reference value of 60% of GDP in 2007 (59.8%). This in turn fulfilled the Maastricht criterion on public debt. In addition, these fiscal surpluses, combined with high growth, allowed policymakers to avoid - to a certain extent - the political pressures for pro-cyclical fiscal behaviour. In view of these favourable budgetary developments, the Medium Term Objective has been revised from a deficit of 0.5% of GDP to a balanced budget. Thus, Cyprus will be given the room in its public finances to effectively utilise the automatic stabilisers in a case of an asymmetric shock. On the other hand, the phenomenon of the relatively high inflation observed during 2008 in Cyprus (higher than the euro area average), which is associated with exogenous factors (such as oil and food prices) and endogenous factors (rapid credit expansion and low real interest rates), becomes even more problematic in a monetary union. Accordingly, there is greater need now to combine more prudent fiscal policies with fiscal structural reforms, including the introduction of the Medium Budgetary Framework (given that the monetary policy is no longer available to use to combat inflation at the national level). This will enable public expenditure to be managed more effectively over the medium term, using a program/performance-based methodology.

**FIGURE 4**

*General government budgetary position (% of GDP), 1997-2007*

Source: Eurostat.
vii) Problem of sustainability of public finances. However, Cyprus faces a “high risk” with regard to the long-term sustainability of public finances, in view of the budgetary impact of an ageing population. The projected demographic changes, with the old-age dependency ratio doubling over the coming decades in the EU and Cyprus, have led to growing concerns on the long-term sustainability of the public finances. This challenge represents a key priority for the Cypriot authorities, especially in view of the fact that the demographics are predicted to turn unfavourable and affect negatively the financial position, as shown in Figure 6. Therefore, it is urgent for Cyprus to implement structural reforms, such as parametric changes of the social security system.
5. Conclusions

Cyprus joined the single currency area in 2008; nearly 10 years after Europe’s leaders took the historic decision to introduce the single currency on the 2nd of May, 1998. While the euro has proved to be a resounding success, countries participating in the euro areas have benefited to different degrees. Generally, those countries continuing to meet the OCA criteria have benefited the most from the single currency, experiencing relatively rapid and sustainable economic growth based on sound public finances and maintenance of competitiveness. Conversely, those countries characterized by labour market rigidities, fragile public finances and lack of structural reforms have had macroeconomic stability and competitiveness problems, hindering their economic growth performances.

In Cyprus, the high participation in the labour market, sustained by the increase in the net migration, resulted in the reduction of labour shortages in some sectors of the economy. However, the growth of the public sector is limiting the flexibility of fiscal policy to adjust in times of asymmetric shocks. Inside the single currency area, these considerations are very crucial and specific policies to increase labour market flexibility must be undertaken. The flexicurity model, which has been successful in Scandinavian countries, may serve as a policy guidance for policymakers in Cyprus.
Wage setting mechanisms in Cyprus are mixed with public sector wages determined centrally and not linked with productivity, while private sector wages are more determined by market forces, with increasing migrant labour contributing to greater wage flexibility. Therefore, it is warranted that public sector wages are brought more in line with productivity (based on performance). The wage setting mechanism of wage indexation has helped to preserve industrial peace and social consensus. On the other hand, wage indexation can prove challenging in incidences of asymmetric shocks and very high inflation.

At the same time, Cyprus has exhibited strong trade ties with EU countries, which will help to synchronise its cycle with these countries. These links are expected to be strengthened even more by the “euro effect” on trade, thereby limiting even more the incidence of asymmetric shocks in Cyprus.

Furthermore, Cyprus has achieved a relatively high degree of real convergence, which helped to reduce - to an extent - price differentials between Cyprus and the other euro area countries, thereby making the implementation of a common monetary policy less challenging.

However, there are productivity challenges ahead that must be taken into account. Apart from the observed low productivity of the public sector, the private sector has also exhibited low productivity in certain areas. Thus, there is much scope for raising productivity levels and performance, which will require structural reforms. These reforms should, inter alia, enhance incentives for shifting resources to sectors and activities generating higher value added. Competitive conditions in goods and services markets must be further strengthened. In addition, the heavy administrative burden of regulations must be reduced, the employment of modern technology and equipment must be encouraged and the Government, in partnership with leading private sector entities, must devote more resources to research and development and to innovation and diffusion of the latest technologies. In the public sector, productivity performance should be improved by linking wages with productivity, including the introduction of a new performance appraisal system.

Fiscal balances exhibited a noteworthy performance the recent years, especially in 2007 (budget surplus together with less that 60% debt-GDP ratio). However, the recent rise of inflation in Cyprus is putting more pressure on fiscal consolidation and on income policies to contain inflationary pressures, given that the monetary policy cannot be used to alleviate the problem. Moreover, the demographic time bomb looms large, so a series of structural reforms, including the pension scheme, need to be implemented in order to achieve an enduring consolidation of public
finances. Avoiding doing so, will greatly affect the expenditure side and, as a consequence, the Cypriot economy will not be able to fully utilise the automatic stabilisers in the incidence of an asymmetric shock.

In conclusion, the above analysis showed that Cyprus exhibited a strong economic performance towards the road to the EMU, but at the same time there seem to be some weaknesses in the adjustment mechanisms, such as mobility and flexibility in the labour market. In the present global economic environment, marked by a significant acceleration of the pace of structural changes, the resilience to economic shocks is more important than ever. Therefore, it is imperative that Cyprus proceeds with the necessary structural changes as soon as possible, so that it will be able to raise its productivity and competitiveness and in the process enjoy sustainable high growth. Reforms in the labour market are of paramount importance in order to ensure that shocks will be dealt with effectively, given the absence of the tool of monetary policy. If Cyprus does not proceed with these changes, it will be able to exploit the benefits of joining the EMU only to some extent and lessen the costs of the loss of monetary autonomy to a certain degree. Indeed, Cyprus has created a solid ground for further future economic development, but this will not come easy as structural changes are often costly and resisted by pressure groups. Policymakers are aware that “there is no such a thing as a free lunch” but this should not in any way deter their efforts to proceed with the necessary reforms.

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