

Monetary Policy Strategy and the Euro: Lessons from Cyprus

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Abstract

This paper examines how the fixed exchange rate policy followed in Cyprus for more than forty years helped to deliver price stability amid high growth rates and low unemployment, and contributed to the successful adoption of the euro. The paper identifies some critical elements for the success of this strategy. Free from political interference, the Central Bank managed to maintain a stable and strong currency even in the most adverse economic conditions. This helped to anchor inflation expectations, and boosted the credibility of the Central Bank. This policy was strengthened and supported by the overall policy framework of the authorities. Crucially, in cases of imbalances, the Central Bank resorted to the temporary use of non-traditional tools such as credit ceilings. The paper shows how this strategy was used to confront new challenges during the EU accession process. Although the fixed exchange rate strategy remained in essence unchanged, it became more focused on the European orientation of the economy, by switching to new anchor currencies (the ECU and the euro) well before accession. At the same time, a well thought-out programme of structural reforms was underway in preparation for accession to the EU. Once in the EU the fixed exchange rate policy was maintained, albeit with greater flexibility so as to meet the challenges of the newly liberalised environment.

Keywords: monetary policy, exchange rate policy, euro, inflation, Cyprus.