

Immigration and Wage Flexibility in Cyprus and the Adjustment in EMU

Polyvios S. Eliofotou

European Commission

Abstract

Assessed vis-à-vis the usual macroeconomic and Lisbon benchmarks the Cypriot labour market performs better than the EU average. However, labour supply shortages, particularly in low-skill occupations, and the automatic inflation indexation of the wage-setting mechanism, constitute important challenges that need to be addressed. Given the tight labour supply conditions, maintaining the supply of labour, through immigration flows and enhancing the domestic labour supply, would be paramount for ensuring wage moderation. Moreover, Cyprus' euro area participation and the need to safeguard competitiveness, as potential losses in competitiveness in the new environment have a severe impact on the real economy and call for reforms in the area of labour market, including the wage indexation mechanism. There is no conclusive evidence that the cost-of-living-allowance (COLA) has contributed to a self-feeding inflationary spiral. However, this might have been due to strong productivity growth in the past decades which has offset wage growth thus, keeping inflation low. Therefore, more flexibility in the labour market, including of real wages, may be key in safeguarding competitiveness and ensuring a smooth ride inside EMU, as the catching-up phase of Cyprus relative to the EU is completed.

Keywords: Cyprus' labour market, immigration, wage flexibility, wage bargaining, wage indexation, cost of living allowance, adjustment in the Euro area.