

Law-of-One-Price Deviations Before and After the Euro: The case of Cyprus[†]

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Abstract

Did Cyprus become more integrated with Europe after adopting the euro? How did this process affect its prices relative to its European partners? Does the degree of integration relative to European Union (EU) economies as implied by Cypriot price differences vary across goods? What can explain this variation in Cypriot price differences? We provide some answers to these questions using a panel of thousands of good-level prices before and after the adoption of the euro. Comparing the densities of law-of-one-price (LOP) deviations for Cyprus relative to other Eurozone (EZ) and non-EZ EU economies before and after it adopted the euro, informs us about the changing degree of integration of Cyprus with other EU economies during this important period. We infer that Cyprus (a) became significantly more integrated with EU economies between 2005 and 2010, and (b) the Cypriot distribution of LOP deviations relative to these economies shifted to the left indicating that Cyprus became relatively cheaper during this period. This leftward shift of the mean price level faced by Cypriot consumers coexists with a large degree of heterogeneity across categories, and a more detailed look reveals many prices of imports falling while domestic production for certain categories was becoming relatively more expensive. Even so, by 2010, the empirical distribution for Cyprus becomes statistically indistinguishable from that of core EZ economies like Germany, implying a fast pace of relative price adjustment for Cyprus during the process of euro adoption and indicative of the high degree of flexibility characterizing the Cypriot economy.

Keywords: Cyprus, integration, euro, law-of-one-price.

[†] We thank Nicoletta Pashourtidou for valuable comments and suggestions.

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