CENTRAL BANK OF CYPRUS

Preparing for the euro: Lessons Learned and Challenges Ahead

Perspectives from the Monetary Policy Strategy in Cyprus

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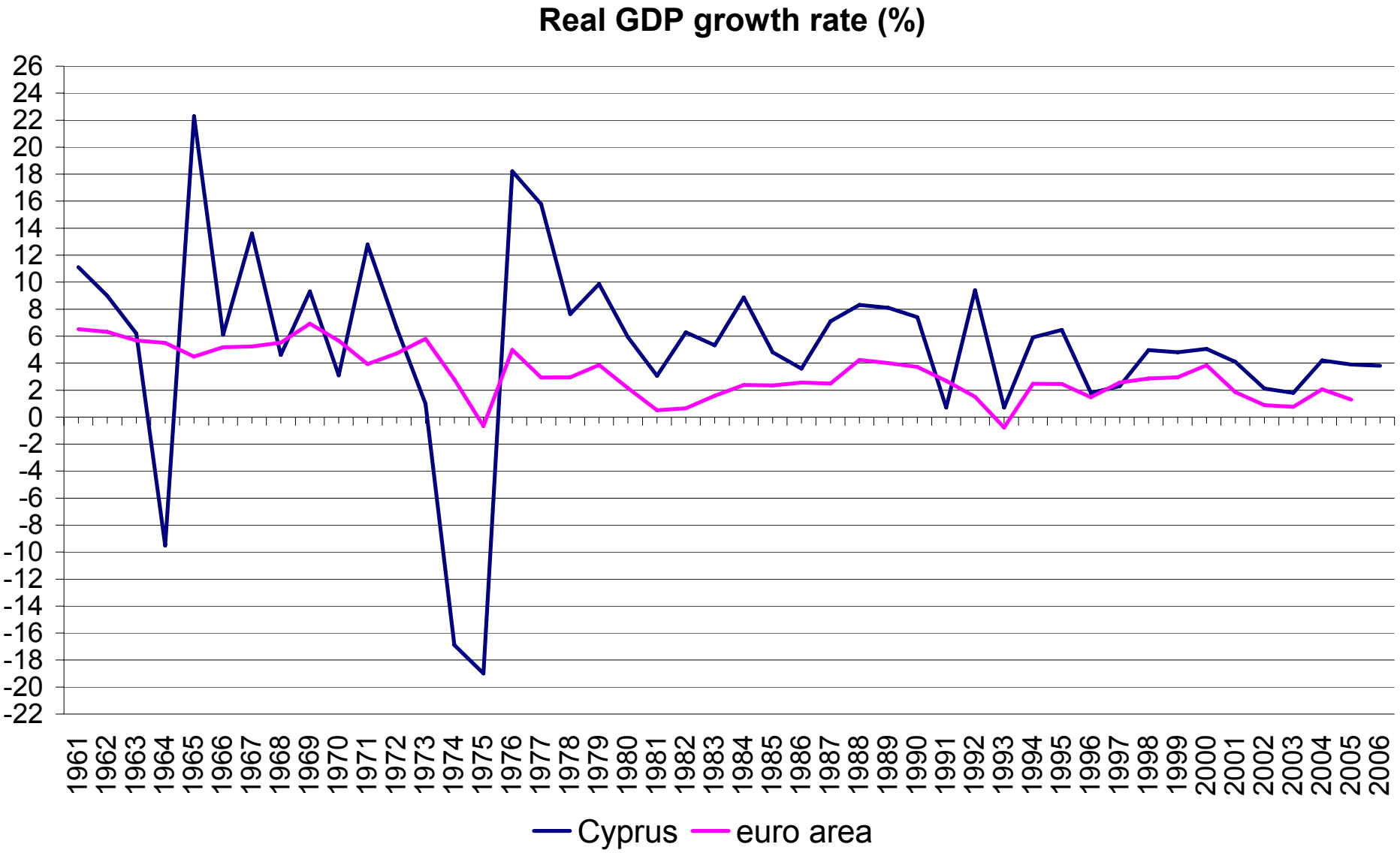
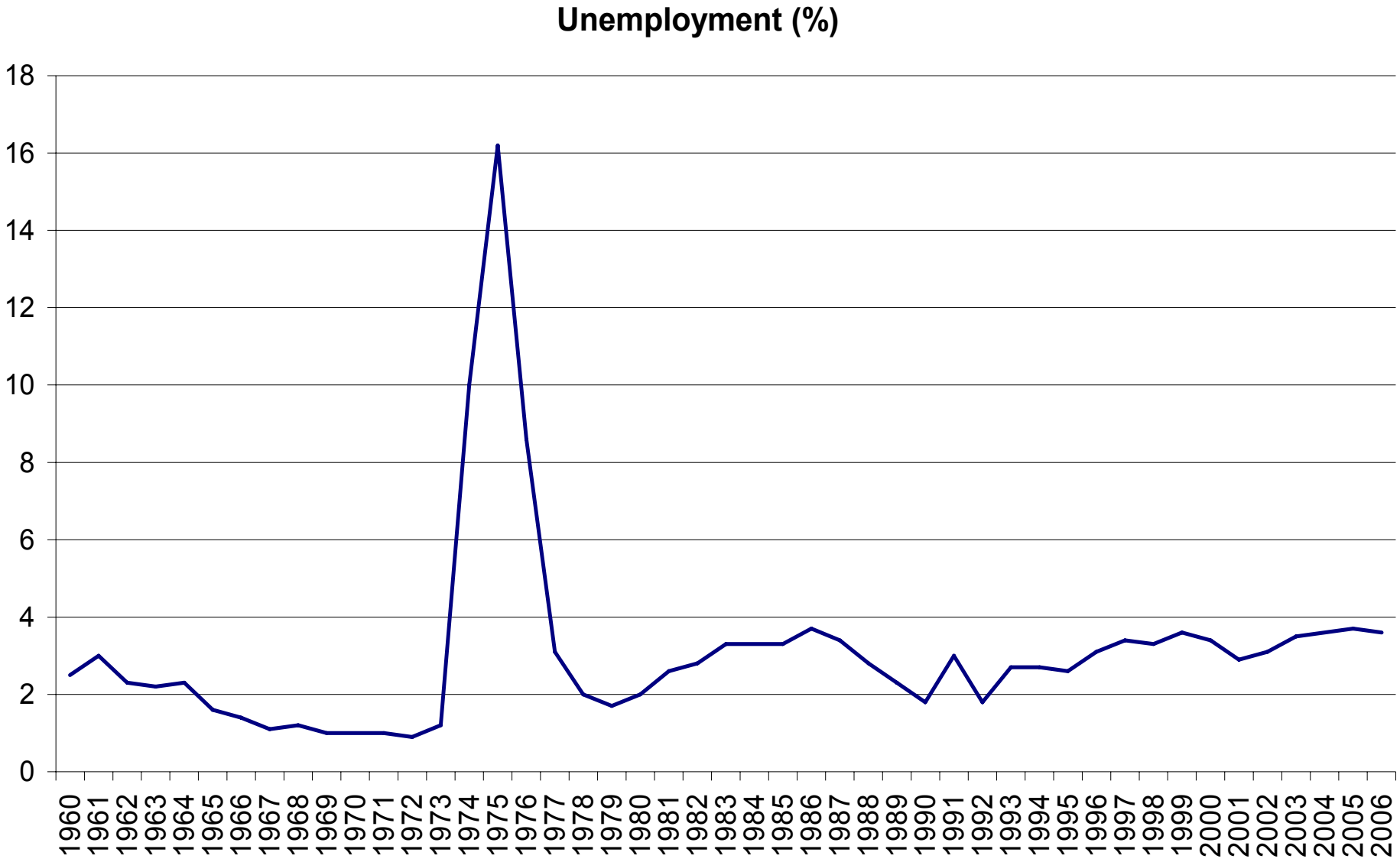
Outline

- Overview of the Cypriot economy
- A prudent monetary policy strategy:
  price stability through exchange rate stability
- Policy challenges on the road to the euro
- Lessons learned and challenges ahead

Economic activity



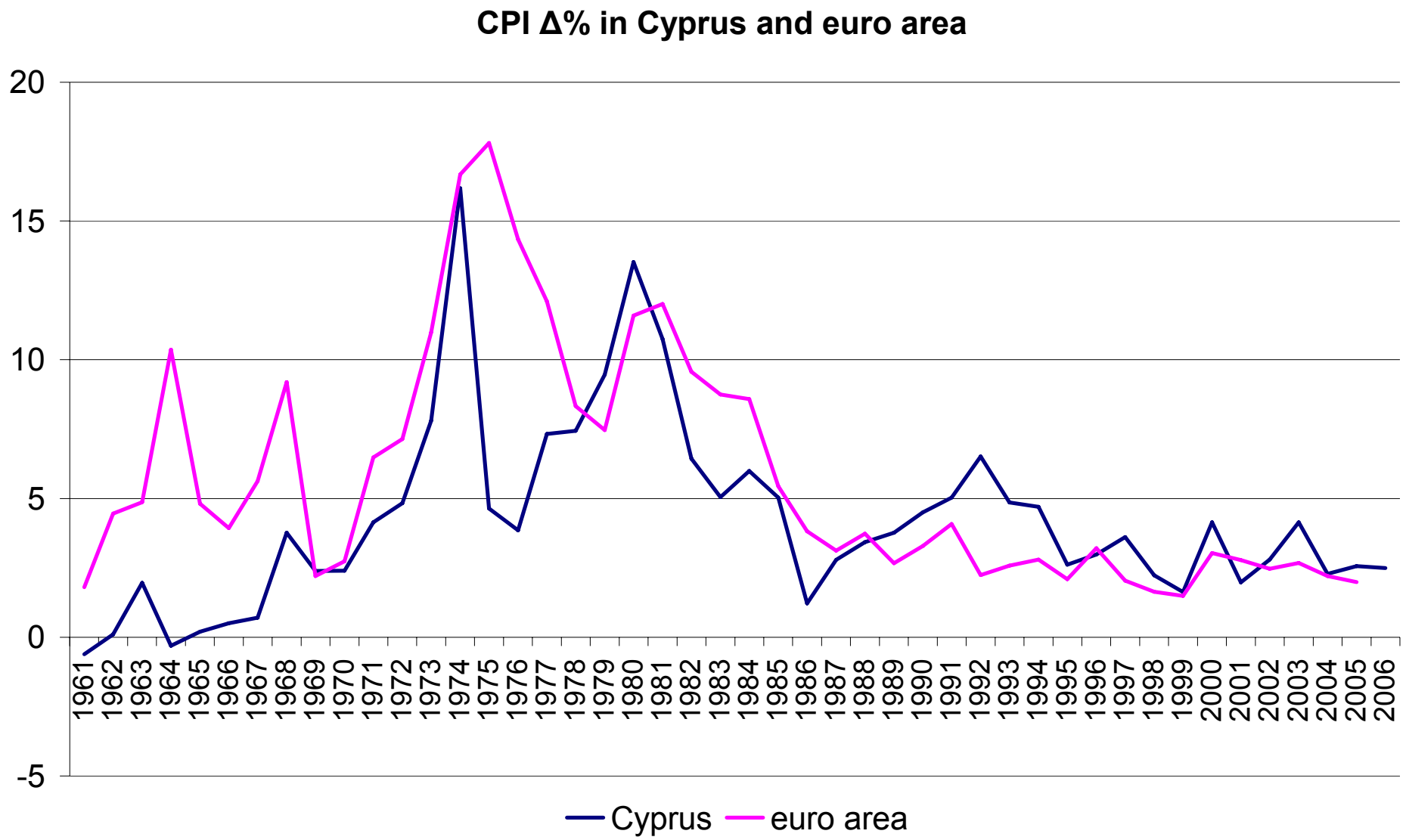
Unemployment



Price stability through exchange rate stability

- Price stability in Cyprus consistently pursued through exchange rate stability
- A credible fixed (or nearly fixed) exchange rate regime since the independence of Cyprus
- Peg to a strong currency or a trade weighted / geographically composed basket of currencies

Inflation


CPI Δ% in Cyprus and euro area
20
15
10
5
0
-5
1961
1962
1963
1964
1965
1966
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1972
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1974
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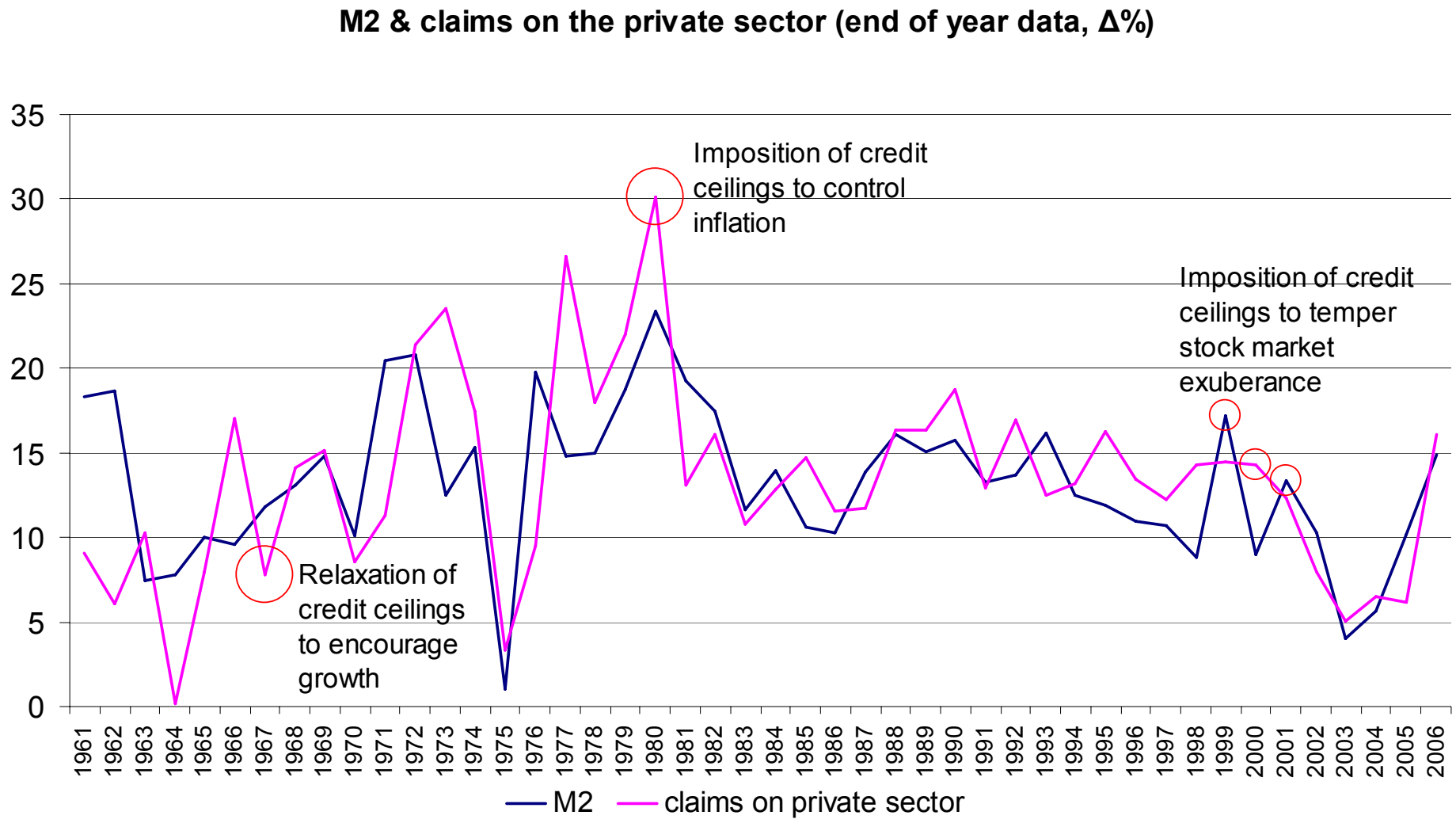
2004
2005
2006
Cyprus
euro area

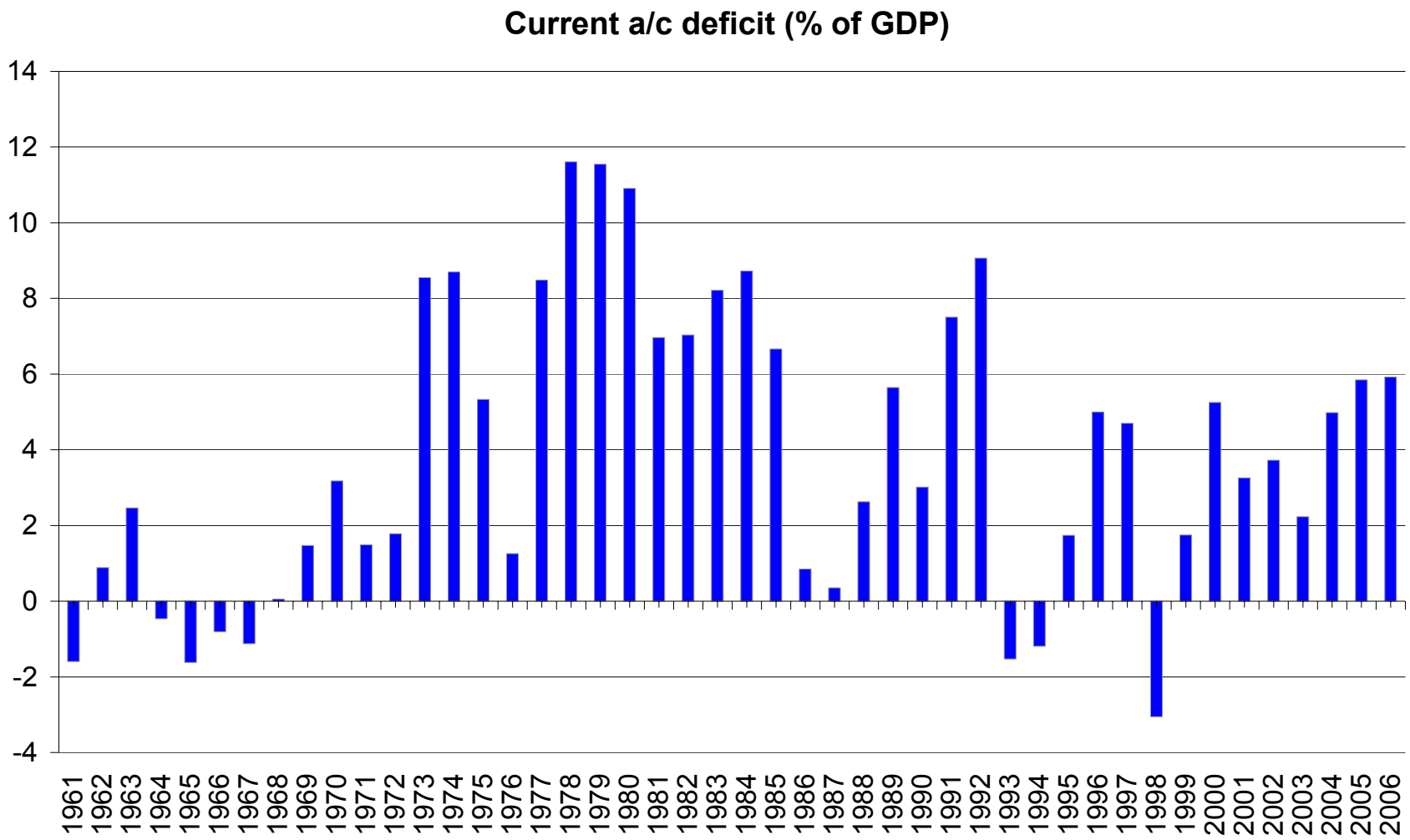
Elements of a successful regime

- Close monitoring of monetary aggregates and, in particular, credit to private sector.
- Close monitoring of the current account deficit.
- Building and retaining credibility: No devaluation, even during periods of adverse economic conditions (e.g. 1974, 1992, 1997 & 1999)
- Judicious utilization of non-traditional policy tools
  - capital controls
  - credit growth ceilings

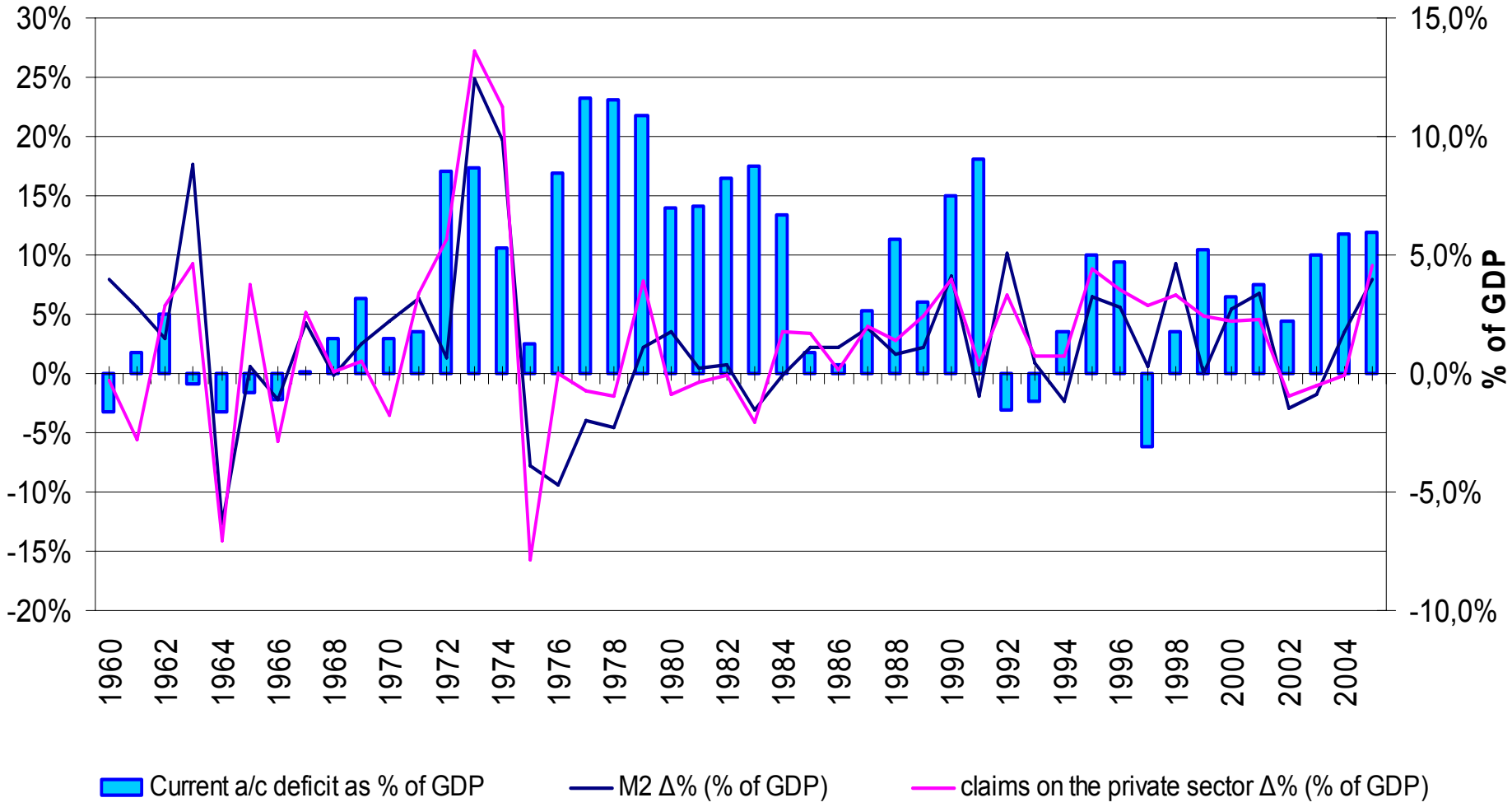
Monitoring money and credit



Monitoring the current account deficit



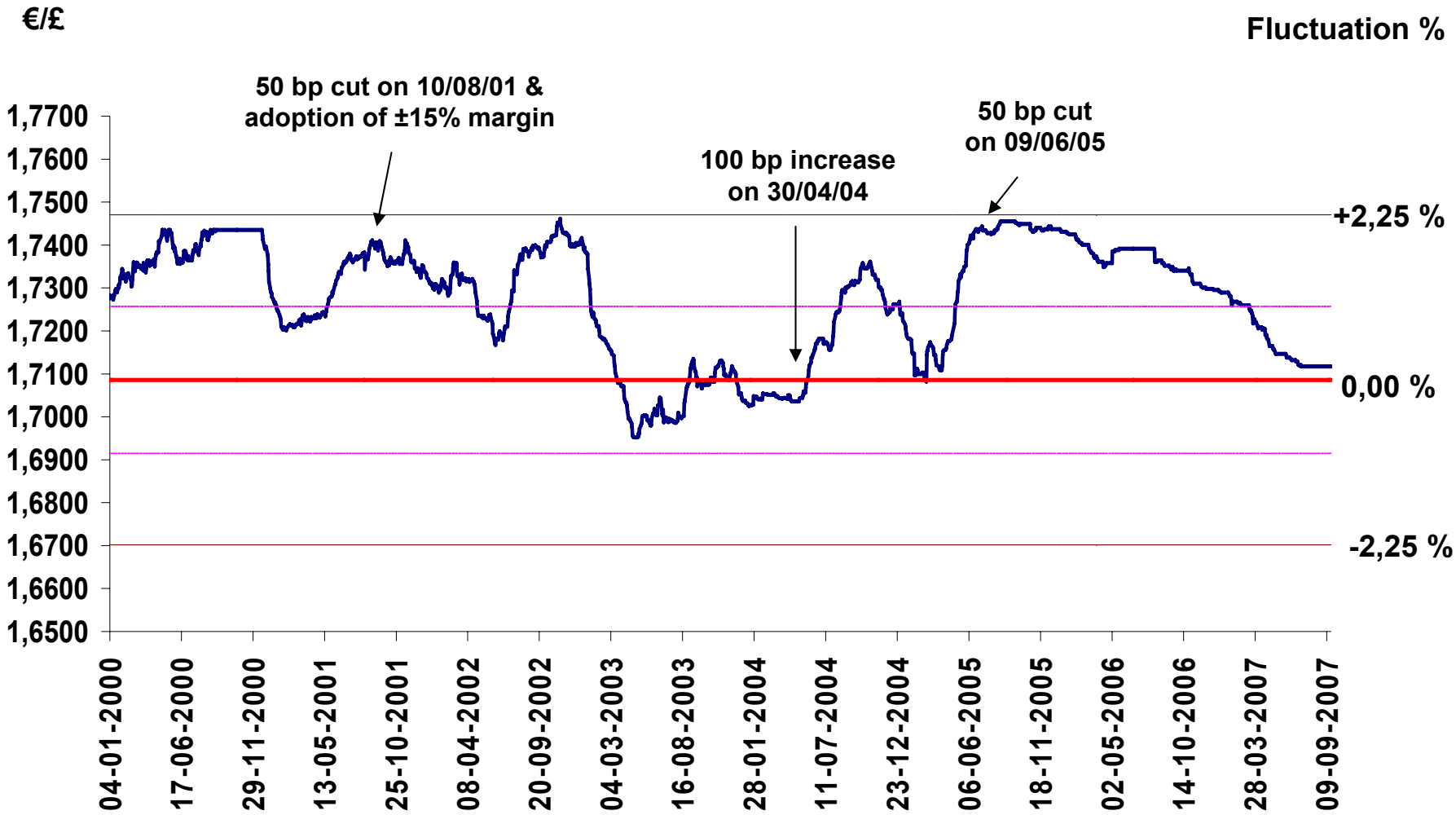
Credit growth and the current account deficit



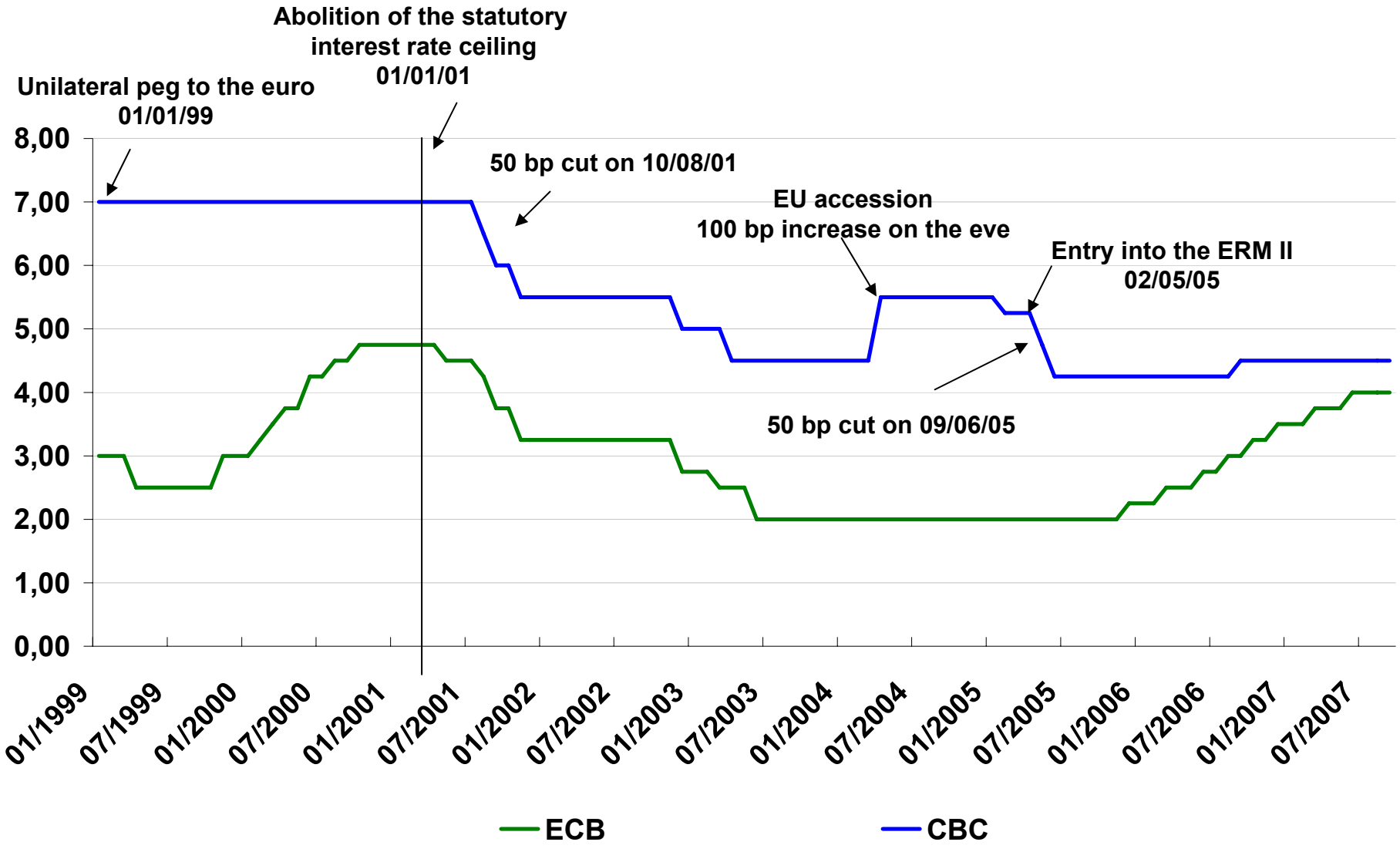
Challenges on the road to the euro

- EU accession-induced reforms
- Liberalization of capital movements
- Abolition of interest rate ceilings
- Reform of monetary policy instruments

Exchange rate stability



Official interest rates



Challenges ahead

- Inflationary credit and money expansion
- Easing of monetary conditions implied by convergence of interest rates and reserve requirements with euro area by January 1, 2008
- Risk of increase in inflation perceptions:
  - Concerns regarding euro-related increases
  - Food and energy price increases
- COLA prevalence in wage contracts can perpetuate these temporary inflation problems