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The process towards the European Monetary Union with special emphasis on the introduction of the European currency in case of Cyprus

B AC H E LO R T H E S I S

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List of Charts:

List of Abbreviations

ATM	Automated Teller Machines
BEPG	Broad Economic Policy Guidelines
CBC	Central Bank of Cyprus
COLA	Cost of Living Allowance
EC	European Community
EEC	European Economic Community
ECB	European Central Bank
ECOFIN	The Heads of the Economic and Financial Affairs
EC Treaty	Treaty establishing the European Community
ECU	European Currency Unit
EMI	European Monetary Institute
EMS	European Monetary System
EMU	Economic and Monetary Union
EP	European Parliament
ERM	Exchange Rate Mechanism
ESCB	European System of Central Banks
EU	European Union
EURATOM	European Atomic Energy Community
GDP	Gross Domestic Product
HICP	Harmonised Index of Consumer Prices
MTO	Medium Term Objective
MTBF	Medium Term Budgetary Framework
NCB	National Central Bank
NMS	New Member States
SEPA	Single Euro Payments Area
SFA	Stock- flow adjustment
TEU	Treaty establishing the European Union
TF- IC	Task Force on Euro Information Campaign

I. Introduction

The wish for a common currency and mutual cooperation in a centralised monetary policy led to establishment of the Economic and Monetary Union, with main institutional settings like the European Central Bank, responsible for the supervision of the economic performance of the whole euro area and the smooth implementation of the monetary policy in accordance with the European Union legal framework. Ten years after the launch, the Eurozone has verified itself as the largest multinational currency union providing high degree of economic and monetary stability on the basis of a sound single currency. In the course of time the euro won recognition as the major international and most accepted currency unit like the US dollar and the Japanese yen.

New ten members joined the European Union in 2004- Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia, followed by Bulgaria and Romania in January, 2007. These express the preference to make use of the benefits granted by the European economic policy, the single market, and the common currency. To adopt the euro, the newly acceded states have to carry out measures, especially to meet the Convergence criteria laid down in Article 121(1) of the EC Treaty hence to comply in economic and legal aspects with the euro area.

After the accession of Slovenia in 2007, Cyprus and Malta were the next members of the last enlargement process desiring to enter the Eurozone in 2008. Accordingly the participation in the European Union, the Cypriot policy has been effective oriented on attainment of all required criteria. After confirmation of the European authorities, the island entered on the 1 January 2008 the European Monetary Union.

Structure

In relation to these considerations, the main idea of the presenting thesis is to deal with the research question: *To what extent is actually Cyprus prepared for the introduction of the common currency based on the legal framework of the European Union?*

The paper is divided into five core sections searching to get an answer of the above mentioned question and explaining the whole process to the Economic and Monetary Union.

Section II introduces with a brief historical overview the roots of the Economic and Monetary Union and the fundamental ideas behind the establishment of this entity.

Section III explains the meaning of the euro as a single legal tender for Europe, in terms of its advantages and the role on the world economic stage in comparison with the US dollar and Japanese yen.

Section IV deals with the monetary policy-making of the European Central Bank as a key element to the sucessful fulfillment of the Convergence requirements. The section begins with the monetary policy framework of the European System of Central Banks, set out in the Article 105 to 113 of the EC Treaty and then draws special attention to the monetary strategy of the European Central Bank, responsible for the achievement and maintaining of its primary objective- the price stability. The idea of price stability is attained through considerate implementation of independent and accountable monetary and exchange rate policies by the European Central Bank, enclosed monetary policy instruments and procedures as open market operations, standing facilities, minimum reserves or foreign exchange operations.

Section V overlooks in detail the fulfillment of the Convergence criteria- price stability, government budgetary position, exchange rate stability, long-term interest rates and legal compatibility of national legislation with the European law. The records are gathered from the Convergence Report 2007 on Cyprus, issued by the Directorate-General for Economic and Financial Affairs accompanied by the legal framework of the EC Treaty.

Section VI outlines the stand of the further preparatory measures undertaken by the Cypriot governing institutions concerned with Council Regulation 1103/97, Council Regulation 974/98 and Council Regulation 2866/98. These provisions are building the basis for proper application and irrevocably fixing of the conversion rates of the other currencies in the Exchange Rate Mechanism II vis-à-vis the euro. The next preparation phase involves the right choice among three changeover scenarios for implementation- big bang, big bang with "phrasing out" and Madrid scenario and the execution of the adopted by the Ministry of Finance and Central Bank of Cyprus National Changeover, Cash Changeover and Communication Policy Plans. Last but not least, is considered the public opinion of the NMS about the coming entry in the euro area. The statistics, provided by the Eurobarometer survey conducted in 2007, compare the reflections and views in Cyprus and the other New Member States.

The assignment concludes with summary of the main findings related to the economic and monetary developments in Cyprus on the road to the Eurozone.

II. The origin of the Economic and Monetary Union

The story of the Economic and Monetary Union (EMU) goes back more than a half century. The main aim of the six- establishing European Economic Community (EEC) countries and the European Atomic Energy Community (EURATOM) - Belgium, Germany, France, Italy, Luxembourg and the Netherlands was set out in the Treaty of Rome from 1957 to create a common market, an area of free circulation goods and uniform trade relations with the rest of the world. The EMU had to struggle with many obstacles on the way to its completely establishment. Nowadays, despite of the growing number of accession countries, it provides a constant level of sustainability and growth boosting the economic and monetary integration. The long road to the European Economic and Monetary Union can be divided in three main phases:

Phase I: The Werner Plan-1970

The Bretton Woods system made it possible for the economic countries to assure their international monetary stability as it set out the dollar as a supreme currency in the world. However, the Treaty of Rome has considered neither regulations about the mutual monetary cooperation nor a limited dialogue about economic affairs. Consequently the first sign of weakness has appeared at the end of the 1950s. Between 1968 and 1969 turbulences on the economic markets were the cause for the currency depreciation of the French franc and the currency appreciation of the German mark, which influenced the stability of the other currencies. This led to the consideration that better coordination of economic policies and even closer monetary collaboration were required.[1] Therefore, the EC Heads of State or Government meeting in December 1969 in Hague has confirmed the desire to move forward to the establishment of Economic and Monetary Union as a main goal of the European integration. The Werner Committee was arranged in March 1970 to observe the practical steps regarding the successful development of the Community into an economic area, which can guarantee stability and growth and show the right direction to the monetary integration. The board consisted of one central banker, one representative of the Commission, other members of the EC economic policy committees and was chaired by Pierre Werner, the Luxemburg Prime Minister.[2]

The Werner group framed the progress to EMU in three main stages and stressed on the need for economic convergence before proceeding to fully monetary integration. Its major purpose was "[…] to achieve full liberalization of capital movements, the irrevocable fixing of parities and even the replacement of national currencies with a single currency […]"[3], to coordinate tighter the economic and monetary policies based on experiment to narrow the bilateral exchange rate limits of the EC currencies in permitted fluctuation margins. After the collapse of the Bretton Woods system the plans were postponed. The convertibility of the dollar into gold was sanctioned and so started the period of the "dollar standard"[4]. The Community currencies were moving up and down within the limits of the intra- Community exchange rates named "the tunnel"[5]. Since 1972 the European countries have been latched onto their rates against each other, but at the same time they were pegging against the dollar in the so called "snake in the tunnel"[6]. The oil shocks and the consequent higher inflation rates were the reasons for the problems in payments. After that the system did not exist any longer. France resigned in 1974, after Italy and UK had already quit. The "snake"

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1 See: SCADPlus: "Towards a single currency: a brief history of EMU", available at: http://europa.eu/scadplus/leg/en/lvb/l25007.htm, downloaded on 01.05.2008

2 Townsend, Malcolm (2007): "The Euro and Economic and Monetary Union- an historical, institutional and economic description", John Harper Publishing, London, p. 30-31

3 See: SCADPlus: " Towards a single currency: a brief history of EMU"

4 Giordano, Francesco/ Persand, Sharda (1998): "The political Economy of Monetary Union- towards the Euro", Rouledge, London and New York, p. 7

5 Townsend, Malcolm (2007), p.31

6 Snake is an instrument for controlling floating of the currencies

remained mainly on the German area, but the inflation resulted from the external oil shocks prescribed the end for Germany too.[7]

Phase II: The European Monetary System -1979

After the breakdown of the first attempt to build a closer Economic and Monetary Union, the President of France and the Chancellor of the Federal Republic of Germany, Valery Giscard d´Estaing and Helmut Schmidt laid down a draft at the European Council meeting in Bremen on 6 and 7 July 1978 for establishing monetary cooperation called European Monetary System (EMS), which intended a higher degree of monetary stability in Europe. The provisions were set out in a resolution adopted from the European Council on 5 December 1978 in Brussels stipulating that: "[…] the purpose of the European Monetary System is to establish a greater measure of monetary stability in the Community. It should be seen as a fundamental component of a more comprehensive strategy aimed for lasting growth and stability, a progressive return to full employment, the harmonization of living standards and lessening of regional disparities in the Community […]." [8]

The EMS was build on exchange rate mechanism (ERM) determined to enforce stable exchange rates among the participants within fluctuation margins ±2.25 % by intervention; excepted was only the Italian lira with permission of 6% fluctuation margin. The currencies of all member states, except United Kingdom took part in the ERM. The adaptation of central rates (called also realignments) was a task of reciprocal cooperation of all countries which expressed the preference to coordinate their exchange rate policies vis-à-vis and to achieve greater degree of economic convergence. The EMS adopted a unit of account used already by the European Development Fund since April 1975 and by the Coal and Steel Community since January 1976 - called ECU (European Currency Unit), presenting the weighted average of the EMS currencies.[9] However the ERM could not comply with the Community's necessity to develop an area of monetary and exchange rate stability. The first four years of the mechanism's existence were accompanied by second oil crisis, high and deviating rates of inflation. The intra- Community exchange rate

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7 Giordano, Francesco/ Persand, Sharda (1998), p.7-8
8 Townsend, Malcolm (2007), p. 43
9 Townsend, Malcolm (2007), p. 44-43

stability took long up to 1987, whereas the German mark rose by a cumulative 23% against the ECU while the Italian lira devalued by 28%.[10] The implementation of the Single Market Programme in 1985 has proved that the capability of the internal market could not be fully exhausted. The reasons were high transaction costs linked to the currency conversion and insecurities of the exchange rate fluctuations; sum up under the name the "impossible triangle" consisting of free movement of capital, exchange rate stability and sovereign monetary policies, incommensurate with the conditions for long term growth.[11]

Phase III: The Delors Report- 1989

In the early 1988 was decided that the economic and monetary integration should go ahead to facilitate a well functioning internal market by the end of 1992. The Community took into consideration the earlier experiences with the monetary framework drafted during the EMS and the accompanied developing of the ECU.

On 27 and 28 June 1988 took place a meeting of the European Council in Hanover, which pursued the further progressive aim to realize Economic and Monetary Union. The Committee was composed by the chairman- President of the European Commission and former finance minister of France, Jacques Delors and governors of the central banks of the Member States. The Delors Report outlined three conditions for monetary union: "total convertibility of currencies, liberalization of capital flows- with full integration of financial markets and locking of exchange rates".[12] The Report had to be implemented in three stages. The First Stage had to introduce the preparatory measures to the monetary union. The Second Stage had to create European Monetary Institute (EMI) later transformed to the European Central Bank (ECB) and the Third Stage is focused on the subject of achieving high level of economic convergence and thereafter introduction of common currency.

Stage One: Single European Market

The Stage One of EMU was approved on 1 July 1989 in Madrid on European Council meeting. It was meant to combine greater degree of exchange rate cohesiveness with financial market integration. To attain these goals were consented two Decisions. The

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[10] Townsend, Malcolm (2007), p. 53-54

[11] See: SCADPlus: Towards a single currency: a brief history of EMU"

[12] Giordano, Francesco/ Persand, Sharda (1998), p. 8

first searched to ensure price stability, sound public finances, and overall balance of payments and open competitive markets. The supervision was executed twice a year on the basis of the economic performance of each country. When a country threatened the economic stability in the Community, the Committee prepared recommendations for improving the economic efficiency.[13] The second Decision implied provisions regarding "[…] issues falling within the competence of the central banks and affecting the stability of the financial institutions and markets […]"[14] All Community currencies should become part of the ERM to make profit on a later stage from the ECU. The implementation stages were discussed on intergovernmental conference in 1991 in Maastricht, on which was put the emphasis on the different priorities between France and Germany. France demanded on bindingness to a precise timetable. On the contrary, Germany accentuated the want for increasing convergence and strict rules for entrance.[15] The other countries like Italy tried to achieve more flexibility in the prohibitive conditions. The solution was however a compromise decision with clear and binding timetables as well as five Maastricht criteria.

Stage Two: The European Monetary Institute (EMI)

The Stage Two started in 1994 in accordance with the provision laid down in Article116 of the Treaty establishing European Union (TEU). On the one hand, the Community institutions pointed out "the code of conduct"[16] for the adherence of the convergence requirements settled in the Stage One to secure national budget, to avoid excessive deficits procedures and to reduce the unemployment rate via price stability, stable public finances, labour market flexibility and wage moderation. On the other hand, the participating states had to fulfill certain legal provisions concerning the independence of their central banks. The details of the EMU were worked out from 1995 to 1996 regarding schedules for the transitions periods and the stages involved in the euro adoption process.[17] The European Monetary Institute began to work quite effectively since the start of the second stage.

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[13] Townsend, Malcolm (2007), p. 60-61
[14] Townsend, Malcolm (2007), p. 61
[15] Giordano, Francesco/ Persand, Sharda (1998), p. 9
[16] Townsend, Malcolm (2007), p. 76
[17] Giordano, Francesco/ Persand, Sharda (1998), p. 9

The contemporary coordination of the economic policies is conferred in the Broad Guidelines for Economic Policies, set out in Article 99 TEU. These annual guidelines have no binding rather general character like the status of Council recommendations. They show the direction to effective and progressive attainment of the medium- term goal of public finances, applied furthermore on national level.

Stage Three: ECB and the euro

The EMU was officially launched on the 1 January 1999. The conduct of the monetary policy was confined to the European System of Central Banks (ESCB) and the European Central Bank (ECB) as a part of its competences. The conversion rates for fast changeover in the member states were determined by the Council. The old ECU was replaced through the euro due to old remembrance of its losing value against the national currencies. The legal framework for the euro (Article 123 (4) EC Treaty) was drawn up to ensure the basic monetary law, concerning the euro definition, fixing of the exchange rate of each single currencies and its replacement to the basket ECU.[18] The fully transition to the Stage Three was completed by fulfillment of the already mentioned Maastricht criteria, assuring the measures which have to be undertaken by the accession countries on their way to the monetary union till the introduction of the European notes and coins.

III. The meaning of the euro as a single currency

The dream of the European citizens became true- a single currency facilitating payments in whole Europe as well as in Paris, Madrid or Berlin. It is the common currency of 458 million people who can enjoy its benefits. It has been already successfully introduced in 15 countries in Europe: Belgium, Germany, Italy, Spain, France, Italy, Luxemburg, the Netherlands, Austria, Portugal, Finland and Greece. After the Eastern enlargement process in 2004, Slovenia, Cyprus and Malta are the first countries, which could fulfill the Convergence criteria for entry and get equal membership in the euro area.

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[18] Townsend, Malcolm (2007), p. 78-81

1. Advantages of the single currency

The main reasons for the introduction of the euro as already discussed have political and economic roots; first Europe should be enlarged in terms of creating a closer union among its countries; second it has to boost into monetary growth and stability. Furthermore, the successful adoption of the euro assures the most important indicators for effective monetary policy – low inflation and interest rates, sound fiscal finances and no exchange rate fluctuations.

The most observable gain of the euro is elimination of transaction costs by exchanging from one currency to another and hence the achievement of high degree of price stability which do not allow external monetary shocks leading to uncertainties about future revenues. The EU established a Single Euro Payments Area (SEPA) enabling the European consumer, companies and other actors, to obtain payments in euro regardless of momentum residence under the same conditions, rights and obligations. It is a huge benefit towards the monetary integration to make use of its own country monetary policy without to consider any cross-border transaction risks and bills.[19] Another indirect advantage of the common currency for the European citizens arises from the elimination of price fluctuations between the national markets. The prices in the Eurozone remain stable as a result of the strict economic observance before accession. The euro enables national markets to get more integrated and to reach cross-border price transparency due to the low inflation rates and the real and nominal convergence within the EU borders.[20] In this case there is the possibility of trade expansion between the countries in the euro area in terms of purchasing or selling opportunely goods from one state to another without extreme price differentials. If price uncertainties increase, the real interest rate grows as well, that presupposes lower financial investment opportunities not only on the particular national market but in the whole area. The risk of higher premium

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[19] See: European Commission, European Economy No5/2007: "Annual Report on the Euro Area 2007" available at: http://ec.europa.eu/economy_finance/publications/publication10169_en.pdf, downloaded on 02.05.2008

[20] Nauschnigg, Frantz (2003): "The Use of the Euro and Other Foreign Currencies in Central and Eastern Europe: A Survey of the Austrian National Bank", Austrian National Bank, Vienna/ Austria in : Alpen, Dagmar/ Luchtmeier, Hendrik (eds.): "The Euro in Eastern Europe: Options for The Monetary and Currency Regime", International Network for Economic Research INFER e.V., INFER Studies Vol.8, p. 92-93

compensation, demanded by the foreign agents owing to the loss of confidence in the common currency, emerges. The suppliers of low- risk investments tend to drop out of the credit market to find other more attractive investment projects, what leads probably for the Community or each state to capital shock.[21]

From the above mentioned approaches could be sum up that the euro is not only a common currency; but it creates an "optimum currency area" which provides price stability and makes the monetary union a wanted investment and capital area with secure money supply and no devaluation expectations.

2. The euro in the world economy

The role of the euro as a global economic player was questioned since the creation of the third stage of EMU due to the overwhelming domination of the American dollar as world economy currency unit without any competition. There has been no economy power yet which has reached or even overtaken the economic performance of the United States and therefore rivaled its currency. In spite of all negative presuppositions, the features of the euro brought a lot of international gains for the monetary area in sustaining the economic growth of Europe. The euro has become in the last time one of the most significant single currencies in the state's foreign exchange assets, in the global import and export due to the turmoil in the international money market caused by the crisis in the US economy.

Compared to the USA and Japan the euro area is a relatively open economic entity, but with similar shares of global trade goods and services tending to displace the use of the dollar and the yen in the trade denomination. The estimated value of goods and services imports and exports for 2006 stood at around 42% of GDP, on the contrary Japan indicated 32% and the USA 28% of the GDP. In the global exports the Eurozone reported a value of 18%, approximately near at the 12% of USA, the 6% of Japan and the 10% of the ten largest oil exporting countries. As a consequence of the increased trade ties with China since the last enlargement process, its openness rose

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[21] De Grauwe, Paul (2000):" Economics of Monetary Union", Oxford University Press Inc., New York, fourth edition, p.61-66

since 1998 by ten percentage points.[22] The euro strengthened anew its position in 2007 against the dollar and the sterling as a result of the expected interest rates widening between the ECB, UK and the USA. Because of the crisis in the subprime loans market the US dollar lost furthermore on mortgage loans and its value weakened continuously as well against the euro, reaching $1, 4809 per euro (November 2007) compared to $1,4169 (October 2007).[23]

This competitiveness of the Eurozone provides the adequate environment for firms to attain a leading role in the world market, related to improvements of their ability for world competition involving a larger products variety, higher productivity and lower prices contributing to the single market integration. The euro area emphasizes the financial openness with the international assets and liabilities, going beyond 150% of GDP compared to 115% for the USA and 90% for Japan.[24] It enhances the cross-border portfolio investments due to the elimination of exchange rate risks (a remarkable increase was measured over the period 1997-2006: 16 percentage point for equities and by 46 percentage points for fixed income securities), the elimination of technical trading barriers and the diversification benefits arising from holding a variety of foreign assets. Accordingly it was established a common trading platform e.g. Euronext through the cross-border merger of the Amsterdam, Brussels, Lisbon and Paris exchanges and integration in post-trading market infrastructure, which have decreased portfolio investment trade obstacles.[25]

The euro is preferred as a financial currency in many other countries not participating in the monetary union, as Denmark, Sweden, the United Kingdom and third countries, choosing the euro as anchor in their exchange rate policy or for investments in foreign exchange reserves in euro; these international transactions were dominated so far by

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[22] See: European Central Bank: Monthly Bulletin May 2008, 10th Anniversary of ECB 1998-2008, available at: http://www.ecb.de/pub/pdf/other/10thanniversaryoftheecbmb200806en.pdf, p. 89, downloaded on 06.06.2008

[23] See: Central Bank of Cyprus (2007): “Monetary policy report” Economic research and statistic division, Economic Research department, available at: http://www.centralbank.gov.cy/media/pdf/MPRPE_MONPOLICYDEC07V3.pdf, p.4, downloaded on 17.06.2008

[24] See: European Central Bank: Monthly Bulletin (2008), p.92

[25] See: European Central Bank: Monthly Bulletin (2008), p. 95

the US dollar. The worldwide dominance of the euro and the ECB are highly interdependent.

Moreover, the Eurozone assures its position as the most competitive importer and exporter of goods and services boosting the economic growth in the whole area due to the stability of exchange rate fluctuations promoting trade ties.

IV. Monetary policy- making of the European Central Bank

The EC Treaty conferred in Articles 105 to 113 the central banking functions in the European Union under the name “Eurosystem” which have to be carried out mainly by the ESCB. The ESCB has neither legal status, nor decision-making actors; it is represented by the ECB and the National Central Banks (NCB’s) as authorities with legal personality. The ESCB creates an “organic link” between the ECB and the NCB’s.[26] It assures that the goals drafted in the Treaty will be considerate observed und implemented in accordance with the objectives of the Eurosystem. The centralized monetary framework of the ECB determines ECB as the main decision-maker in the execution of the monetary procedures. The implementation of its competences consists of four main elements: achieving and maintaining the primary objective of price stability, executing monetary policy protecting from external shocks in the whole euro area, securing high degree of independence and transparency, and responsible decision-making bodies as the ECB Executive Board, Governing Council and General Council.[27] During its existence, the ECB has evidenced that it is able to combat unexpected long-term inflation developments and to secure the price stability in the area with the aid of its monetary instruments.

Therefore the relevance of the monetary policy idea is based on the approach of “sound money”; a mix of the convergence criteria and the primacy of the price stability. After the failure of the monetary policy in France and other countries owing to high inflation rates, the “sound money” proposal became even more attractive. In

[26] See: Scheller, Hanspeter K. (2006):“European Central Bank: History, Role and Functions”, European Central Bank, second revised edition, Frankfurt am Main, available at: http://www.ecb.int/pub/pdf/other/ecbhistoryrolefunctions2006en.pdf, downloaded on 03.05.2008

[27] See: European Commission: Directorate-General for Economic and Financial Affairs (2004): “EMU after five years” European Economy Report No.1, available at: http://ec.europa.eu/economy_finance/ publications/publication7792_en.pdf p.66, downloaded on 03.05.2008

consideration to the German model of central banking, the other participating governments were agreed to accept and transform on European level the independence as the best manner in tackling with the inflation.

1. The monetary strategy of the ECB

The ECB is the second largest developed economic area in the world after the Federal Reserves in the United States. The monetary strategy of ECB was worked out and made known in October 1998 by the ECB Governing Council soon after its operational launch. It consists of quantitative definition of price stability related to possible risks, well known as a "Two-Pillars-Strategy".[28] The monetary strategy of the ECB has to fulfill some important general principles helpful on the way to achieving and maintaining of the primary objective. Probable changes in the price stability would influence the monetary policy for the future. Therefore the strategy should be forward-looking and reliable regarding medium- term instability on order to avoid undesirable fluctuations in the economy, attained via right monetary indicators.[29]

1.1. Price stability

The Treaty establishing the European Community determines in Article 105 (1) the primary objective of the ECB in a modern economic thinking as follows:

"The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2. The ESCB shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources, and in compliance with the principles set out in Article 4."[30]

Why is actually the price stability such an important aspect in the monetary policy?

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28 See: European Commission/ Directorate-General for Economic and Financial Affairs (2004): "EMU after five years", European Economy Report No.1

29 See: European Central Bank (2004): "The Monetary Policy of the ECB 2004", Frankfurt am Main, available at: http://www.ecb.int/pub/pdf/other/monetarypolicy2004en.pdf, p.49-50, downloaded on 03.05.2008

30 See: Article 105 (1) of the Treaty establishing the European Community

First of all, a lot of monetary studies have concluded that to account for a higher economic performance and increased level of living standards, the price stability should follow a precise determined direction to get a lasting outcome. The monetary policy can influence successfully in no other way the price level over the medium term of a particular economy. To specify more accurately this explanation, the Governing Council pronounced on 13 October 1998 a quantitative description of the price stability as a major element of the ECB's monetary strategy. It was characterized as "[…] a year-on- year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2% [...]" and indicated that the "[…] price stability is to be maintained over the medium term […]."[31] The clearly defined regulation of this term improves generally the transparency of the monetary policy framework and gives a benchmark against which the society can hold the ECB for a responsible authority. This theoretical approach looks like the goal of the US Federal Reserve, laid down in the Federal Reserve Act providing "[…] maximum employment, stable prices and moderate long-term interest rates […]"[32], but with no concrete granted content.

The beginning experience of the ECB procedures moved smoothly and showed that the redefinition of price stability was a correctly and suitably concluded affair. Aiming the inflation so near on the 2 % reference value gives the central bank space for bank maneuver to keep inflation even low, but in positive range without jeopardizing the euro area economy with deflation. The second reason for the revised definition of the price stability refers actually to "[…] possible […] measurement bias in the precise index, caused by a lack of adequate adjustment for changes in quality […]"[33], what means that inflation is running at 2 % level, but in fact it is 0 %, what presupposes deflation. The ECB Governing Council was aware of this problem and accordingly accentuated the need for a margin of error with the aim of 2 % inflation. The Governing Council indicated as well that "[…] a positive rate of change in price

[31] Issing, Otmar, European Central Bank (2003): "Background Studies for the ECB's Evaluation of its Monetary Policy Strategy ", Frankfurt am Main, p. 11

[32] See: European Commission: Directorate-General for Economic and Financial Affairs (2004): "EMU after five years", European Economy Report No.1

[33] Kaltenthaler, Karl (2006): "Policymaking in the European Central Bank. The Masters of Europe's Money", Rowman and Littlefield Publishers Inc., USA, p. 74

level may have a beneficial effect in facilitating the real adjustment of the economy to various shocks in the presence of downward nominal rigidities […]"[34], which has to compensate to some extend eventual rigidity in the euro area product and labor markets. The last factor involving this change rests upon the supposition that maintaining a low inflation in positive ranges over the medium term, would give the less developed counties the opportunity to catch up with the industry countries.

The redefined price stability term brought subsequently a lot of positive economic effects. Kaltenthaler (2006) emphasizes that the avoiding of long-term inflation and deflation would secure high levels of employment and economic growth.[35]

The price stability provides the most significant gain to the public and private consumers: it allows predictable decision-making for the public and enterprises about their consumption and investment opportunities. Thereon the market productivity is influenced by the efficiently supply and management of resources, leading to increased economic potential. As well investors demanding "inflation risk premium" can take advantage of the price stability by avoiding dangers bonded with holding nominal assets for a long term.[36] The more the real interest rates have sound positions, the more attractive becomes the monetary policy for investment incentives enhancing the common economic welfare. A further noteworthy benefit of the price stability is to warrant individuals and companies, when the current economic situation presupposes high inflation, to make a competent investment decision concerned to the diversion of their resources for improving the financial assets environment. Under the circumstances of price stability there is no chance for the inflation or deflation to affect or distort the tax and welfare systems. The price stability reduces the real economic costs, which in some way would lead to enhancement of the social systems; especially the price stability has a significant impact on the redistribution on wealth and income resources to maintain the social cohesion.[37]

This overview has anew approved that the definition of price stability has been an essential component of the ECB's strategic framework.

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[34] Kaltenthaler, Karl (2006), p.74

[35] Kaltenthaler, Karl (2006), p. 74

[36] See: Scheller, Hanspeter K.(2006), p.46

[37] See: Scheller, Hanspeter K.(2006), p.46

1.2. The analysis of risks to price stability: (The Two- Pillars – Strategy)

The ECB aspires to create a monetary policy which is forward-looking and has as well great benefits for a long period of time. In order to create a medium-term oriented policy there have to be considered all risks to price stability to preserve a sound policy providing all available information about the euro area economy situation using some analytical tools. The Governing Council decided that the function of the prominent role of money is strongly connected to the achievement of this goal. Therefore there are used two forms of analysis to support the economic assessment.

1.2.1. Monetary analysis

The first form of analysis is the so called "monetary analysis"- the key task of all worlds' central banks. It is addressed mainly on the measurement of long-term price movements and the consequently arising risks to price stability. The framework of the monetary analysis relies on detailed knowledge about small-scale money supply and monetary indicators, which are examined and published by the staff of the ECB. On the basis of this study could be determined the factors driving to economic development in the monetary and credit aggregates and forecasting the long-term price changes.[38] It means that the ECB investigates the growth of the money supply, mostly but not wholly on broad money shock or on the reference value M3, to estimate consequently how inflation will develop in medium to long term growth. The idea of using the money supply as a predictor of inflation comes from the monetarist understanding grounded on the reliable relationship between the size of the money supply and inflation. In the economy theory there is a view that the "[…] rapid and large growth in the money supply in an economy will lead to inflation […]".[39] But the strict monetary logic determines that to control inflation effectively should be set a money supply target, which could arrange monetary policy in the necessary direction. However, ECB developed a "reference value" for the money supply growth over a specific period of time, used to drive the inflationary threats. For this reason M3 is a kind of inflationary indicator. Accordingly the monetary

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[38] Issing, Otmar (2003), p.23

[39] Kaltenthaler, Karl (2006), p. 75

analysis is used as a “cross check” to observe the data of the “economic analysis pillar”.[40]

1.2.2. Economic analysis

The second form of analysis in the Two-Pillars- Strategy intends to a broad perception of the dominating economic situation. It involves wide studying between the aggregates demand and supply in the good and service markets, by which special attention is paid to the labour market changes. The broadly investigation implies also wide collection of price and costs indicators and their main components. The specific nature of shocks on the demand or supply side is checked in details if they have domestic or external roots. Considering the opinion of ECB, this form of analysis is appropriate to find sufficient information about factors which affect the price level in short to medium term.[41]

2. Implementation of monetary policy as a main task of ECB

In order to implement its primary purpose the Eurosystem makes use of its monetary policy instruments and procedures to execute the single monetary policy. The ECB aims to ensure the implementation of its monetary policy, a well functioning money market enabling regular banks to assure their liquidity needs in a smooth and well-organised way, to permit them dealing with end-of-day balances and to reduce transitory liquidity fluctuations.[42]

The operational framework of the Eurosystem is conferred in the principles set out in the Article 105 EC Treaty referring to follow the objectives of the Eurosystem to ***“[…] act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources […]”***[43] and at the same time considering the other important principles as operational efficiency, equal treatment of financial institutions, decentralized implementation of the Eurosystem’s monetary policy operations through the NCB’s, simplicity, transparency, continuity,

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[40] Kaltenthaler, Karl (2006), p. 75
[41] Townsend, Malcolm (2007), p. 160
[42] See: Scheller, Hanspeter K. (2006), p.86
[43] See: European Central Bank (2004): “Monetary Policy of the ECB 2004” p. 72

safety and cost efficiency.[44] The ECB settles on that high degree of priority has to be paid to the operational framework of its monetary policy because it "[…] enables monetary policy decisions to feed through as precisely and as quickly as possible to short term money market rates […]"[45] to guarantee the same treatment of financial institutions and the adjustment of rules and procedures. There are three core types of operations: open market operations, standing facilities and minimum reserves, which I briefly discuss in the following subsections contributing to the successful application of the monetary policy.

2.1. Open market operations

Open market operations play the most vitally role in managing interest rates, liquidity situation in the market and signaling the monetary policy. The ECB launched the open market operations to govern the decision-making on instruments, terms or conditions. It is distinguished between four types of open market operations: refinancing operations, longer-term refinancing operations, fine-tuning operations and structural operations.[46]

2.2. Standing facilities

Another main instrument of the ECB's monetary policy system is to set interest rate on its standing facilities, which affords the allocation and assimilation of overnight liquidity, announced the general monetary policy stance and bound overnight market interest rates. There are two standing facilities hold in a decentralised manner by the NCB's that could be negotiable counterparties on their own initiative: the marginal lending facility and the deposit facility.[47]

2.3. Minimum reserves

The ECB may require credit authorities to hold minimum reserves on accounts with the NCB's. This minimum reserve system tries to stabilize the money market interest rates, produce or expand the structural liquidity shortage and contribute to the control of monetary expansion. The size of minimum reserve of each credit authority is framed according to the liability position of its balance sheet. To stabilize sound

[44] See: Scheller, Hanspeter K. (2006), p. 87
[45] See: European Central Bank (2004): "Monetary Policy of the ECB 2004", p.72
[46] See: European Central Bank: Monetary Policy- Implementation
[47] See: European Central Bank: Monetary Policy- Implementation

interest rates, the minimum reserve system gives the ability to institutions in accordance with the reserve requirement to determine the daily reserve holdings over a one month maintenance period.[48]

2.4. Foreign exchange operations

A further important issue of the ECB's monetary system is the conduct of the external competences by means of exchange rate policy. The exchange rate policy and the monetary policy are highly interdependent; they certainly influence the objectives of each other. From the beginning of Stage Three, the ESCB is able to carry out foreign exchange interventions. The most significant issue in the Eurosystem is the intervention on foreign exchange markets, influenced by exchange rate movements between the euro and other currencies, e.g. the US dollar or the Japanese yen or in the framework of the intra-Community Exchange Rate Mechanism II (ERM II)[49]. Special emphasis is laid on this form of operation which is the more noteworthy for my thesis.

2.4.1. Institutional framework

The ECB should conduct its foreign exchange operations as set out in Article 105 (2) of the EC Treaty and Article 3 of the Statute of the ESCB in accordance with the provisions laid down in Article 111 of EC Treaty. The Article 111 distinguishes between two situations, namely whether there are formal agreements on an exchange rate system between the euro and the other currencies or not. The first one refers to Council's competent decisions of such agreements relative to the primary objective of the ECB in maintaining price stability and ensuring the common position of the Community at the international stage; the second alternative forecasts general orientations for the exchange rate policy formulated by the Council based on recommendation of the European Commission or the ECB, or after consulting the ECB.

2.4.2. Exchange Rate Mechanism II (ERM II)

The Exchange Rate Mechanism II is intended to provide an institutional framework which has to manage the connections between the euro and other currencies in

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[48] See: European Central Bank: Monetary Policy- Implementation

[49] See: Scheller, Hanspeter K. (2006), p.91

Europe do not taking part in the ERM II from 1 January 1999 onwards and replace at the same time the EMS. The ERM II is drawn on two legal documents: the Resolution of the European Council of Amsterdam from 16 June 1997 on the establishment of an exchange rate mechanism in the third stage of Economic and Monetary Union and the Agreement from 1 September 1998 between the European Central Bank and the national central banks of the member states outside the euro area laying down the operational procedures for the ERM, as amended by the Agreement of 14 September 2000.[50]

The exchange rate strategy is a major element on the way to the monetary union that has the goal to avoid excessive nominal exchange rate fluctuations between the currencies, to look about stability and convergence policy. The participation in the ERM II is voluntary for countries not entering the European Union, but for such member states with derogation, it is recommended to participate for at least two years no matter if the country has already achieved convergence with the rest of the euro area or not. [51] Article 124 EC Treaty expects of each non-euro area member state to "treat its exchange rate policy as a matter of common interest" and to regard it as "experience acquired in cooperation within the framework of the EMS".[52] Accordingly the membership in ERM II attends to guard the states inside and outside the euro area from unwanted pressures on the exchange markets. On this account central rate is set with permitted fluctuation margins 15 % above and bellow the rate, monitored by the General Council of ECB with the aim to make certain the coordination between the monetary and the exchange rate policy.

3. Independence and accountability of the ECB

One of the most significant aspects of the ECB's policy structure is its independence from political and social influence. This operational independence model adopted from the German Bundesbank classifies the ECB as the worlds' most legally independent central bank. The EC Treaty explicitly identifies in Article 108 the

50 See: Scheller, Hanspeter K. (2006), p.92

51 See: SCADPlus: Exchange Rate Mechanism (ERMI II) between the euro and the participating national currencies", available at: http://europa.eu/scadplus/leg/en/lvb/l25082.htm, downloaded on 11.05.2008

52 See: Scheller, Hanspeter K.(2006), p.93

statute of the central bank independence which has not to take instructions from governments: *"When exercising the powers and carrying out the tasks and duties conferred upon them by this Treaty and the Statute of the ESCB, neither the ECB, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body. The Community institutions and bodies and the governments of the Member States undertake to respect this principle and not to seek to influence the members of the decision-making bodies of the ECB or of the national central banks in the performance of their tasks".*[53]

Consequently the ECB independence can be summarized in three main appearances: political, personal and financial independence. The political independence involves: "[…] the ability of a central bank to choose the course of action independently without yielding to the pressures of others as to what that action should be […]".[54] The next essential aspect determining the ECB autonomy is the personal independence related at the same time to the political independence, when "[…] the members of the ECB are selected for political, ideological, and/or national reasons, one would have to question the overarching independence of the ECB to pursue its price stability mandate unfettered by national or political constraints. The ECB's decision-makers will have to assume a transnational identity and act in the interests of Europe first instead of national interest […]".[55] The last type of the central bank's independence refers to the financial independence from "[…] either the obligatory financing of government debts (internal) or exchange rate arrangements or obligations (external) such as those that existed under the Bretton Woods and the more recently within the EMS […]".[56]

Despite the concrete distinction among the diverse types, the high degree of independence remains quite controversial among the European politicians and commentators. Some of them share the same opinion that the independence of the central bank, especially the institutions themselves are not accountable to the

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53 See: Article 108 of the EC Treaty

54 Howarth, David/ Loedel, Peter (2003): „The European Central Bank. The New European Leviathan?", Palgrave, Macmillan, New York, p. 128

55 Howarth/ Loedel (2003), p. 130

56 Howarth/ Loedel (2003), p. 133

European society. It is important to say that the ECB is obligate to give answers to politicians and the society; otherwise it will lead to policy-making that does not reflect the principles of the society in its operational framework. That's why the statute of the ECB is settled on in the Treaty to prevent fears connected to the assumption of those who find the bank's autonomy troubling. Since its foundation the ECB has confirmed to remain operationally independent, but it has to be as well an accountable and transparent authority. The accountability extends over the responsibility for the monetary policy-making and the transparency is determined by the ties to the public, in terms of providing information to the society how the ECB really comes to its decisions.[57]

The Treaty agrees hence that the ECB is an accountable institution due to its relationship to the European public at a whole, especially through the European Parliament (EP) as a main representative of the EU citizens. Each quarter the ECB is obliged to submit a report about its monetary policy and the economic conditions in the Eurozone. The EP has in contrast no power to demand any changes in the policy conduct of the ECB; it can just request the central bank and expect an answer. Accordingly the ECB publishes a monthly bulletin, which illustrates the economic issues in the Eurozone and its policy stance.[58]

The future of the ECB's independence and accountability depends only on the ability of the monetary union to function effectively not only on EU level but also to make use of its external monetary influence to decrease consequently the legitimacy problem regarding the accountability and transparency.

4. The enlargement process and the future of the ECB

One of the greatest challenges for the ECB is to cope with the enlargement process from 2004. The expanded union presents an enormous obligation and responsibility for the policy-making in the ECB as soon as the NMS have fully met the Maastricht criteria for entrance in the Eurozone. Special attention has to be paid on the impact of the enlargement process on the contemporary EU stance due to the comparatively

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[57] Kaltenthaler, Karl (2006), p. 70-71
[58] Kaltenthaler, Karl (2006), p. 71-72

poorer and less advanced economic situation in the newly acceded countries. The ECB's Governing Council is challenged by the task how to manage the policy in the most efficient way thus to maintain the primary objective of price stability within the euro area without threading the smooth operational course of action in the ECB.

The acceded countries pose first of all divergent per capita income, which the ECB has to deal with in the best way, in order to adjust the decision- making process to the new circumstances and to satisfy the expectations of sound monetary policy. The central bank should avoid political pressures in the two groups of countries, enabling central bank governors from the NMS to counteract the demands in terms of income level increasing. All these differences on the transition process have to be avoided before the monetary policy becomes accomplishable.[59]

Secondly, the huge number of participating states will restructure the institutions of the ECB in an extremely scope. It assumes that the most important institution- the Governing Council will become too inefficient concerning its size to govern in the best manner. The western central bankers have to challenge with the objective to achieve compliance about monetary policy views with the NMS representatives with reference to conceptualization goals, strategies and operations to maintain the same economic level in the EMU for the future.[60]

Anyway, all these statements have the same intent: to give possible explanations what is the best way to retain the efficiency in the monetary policy-making without threatening the growth in the advanced industrialized economies.

V. Conditions for entry in the European Monetary Union

1. The common legal framework

Member states with derogation are allowed to join the euro area and to introduce the euro as an official single currency, when they fulfill the legal requirements and the institutional arrangements, well known as Maastricht criteria, formulated and laid down in Article 121 in the Treaty in the beginning of the 1990s. The fulfillment of the Maastricht criteria is reviewed by the EU Council on the basis of convergence

[59] Kaltenthaler, Karl (2006), p. 157-158
[60] Kaltenthaler, Karl (2006), p.158

reports made by the European Commission and the European Monetary Institute, which grant the right of entry. The Commission makes a recommendation on which foundation the Council decides by qualified majority whether a particular member state with derogation has met the requirements for the adoption of the single currency and accordingly cancels its derogation.[61] The Convergence criteria aiming to sustain the economic performance of Europe rely on the following conditions: the price stability, government budgetary position, exchange-rate stability, long- term interest rates and legal compatibility.

- *Price stability*: The first intent of Article 121 (1) EC Treaty stipulates "*the achievement of a high degree of price stability […] will be apparent from a rate of inflation, which is close to that of, at most, the three best performing Member States in terms of price stability*". Article 1 of the Protocol on the Convergence criteria sets that the average annual rate of inflation should not be more than ½ percentage points of that of the three best performing EU countries in terms of price stability.[62]
- *Fiscal sustainability*: The composition of government revenues and expenditure, the budget deficit and public debt have a considerable impact on the economic growth and inflationary pressures. So the EU institutions have defined the annual government position in the second intent of Article 121(1) of the Treaty as "*the sustainability of the government financial position […] will be apparent from having achieved a government budgetary position without deficit that is excessive as determined in accordance with Article 104 (6)*", where Article 2 of the Protocol on the Convergence criteria determines that the annual fiscal deficit should not exceed 3% of the GDP and the total outstanding government debt not go beyond 60% of the GDP, to ensure appropriate national fiscal policies and sustainable public finances. When the inspection of the fiscal debt and deficit show, that the specific conditions are

61 Levitt, Malcolm/Lord, Christopher (2000): "The political economy of monetary union", Macmillan Press Ltd., Houndmills, Basingstoke, Hampshire and London, p.82-83

62 See: Directorate- General for Financial and Economic Affairs (2007): "Convergence Report 2007 on Cyprus- Technical Annex", A Commission service working paper SEC 623, available at: http://ec.europa.eu/economy_finance/publications/publication10346_en.pdf, p. 3-4, downloaded on 27.05.2008

not achieved, a ratio is allowed to be sufficiently dimished approaching the reference value at the satisfactory pace.[63] The implementation of this legal criterion was accompanied by many challenges faced by the member states since 1999. The most countries had difficulties to manage and maintain "close to balance or in surplus"[64] as it is determined in the "preventive arm"[65] of the Stability and Growth Pact;

- *Exchange rate stability*: The third intent of Article 121 of the Treaty demands *"the observance of the normal fluctuation margins provided for by the exchange - rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State"*. Article 3 of the Protocol on the Convergence criteria indicates that the applicant countries joined the ERM II are required to keep the exchange rate of their national currencies in normal fluctuation margins for at least two years without severe tensions till the end-examination and not to devalue it during this period;
- *Convergence of long-term interest rates*: the fourth intent of Article 121 (1) of the Treaty necessitates that *"the durability of convergence achieved by the Member States and its participation in the exchange rate mechanism of the European Monetary System […] reflected in the long-term interest rate levels"*. Article 4 of the Protocol on the convergence criteria requires that the nominal long term interest rates should not exceed more then two percentage points of the average rate of the three best performing EU members over a 12-month period, based on the inflation rate.[66]

To get part of the euro area demands as well legal compatibility review of the national legislation, especially the statute of the national central bank with the EU legislation, carried out by Articles 108 and 109 of the Treaty and the ESCB Statute. The Statute of ESCB involves an examination of conformance with the prohibition of

[63] See: Directorate- General for Financial and Economic Affairs (2007): "Convergence Report 2007 on Cyprus- Technical Annex",p.6
[64] See: European Central Bank (2008): Monthly Bulletin: 10th anniversary of the ECB, p. 74
[65] Preventive arm: procedures aiming to avoid the appearance of excessive deficit
[66] See: Directorate- General for Financial and Economic Affairs (2007): "Convergence Report 2007 on Cyprus- Technical Annex", p.8

monetary financing according to Article 101 of the Treaty, the prohibition of privileged access under Article 102, compliance with the ESCB's tasks set out in Article 105 (1), central bank independence laid down in Article 108 EC and the integration of national central banks to ESCB.[67]

2. Convergence Report on Cyprus

The Council of Ministers accepted the 1 January 2008 as a target date for the introduction of the euro in Cyprus. As a consequence, Cyprus requested on 13 February 2007 an assessment of the Convergence criteria stand from the European Commission and the European Central Bank. The House of Representatives resolved in March 2007 the economic and legal convergence of the island. The report enacted that Cyprus has achieved the needed compatibility with the EU's legal framework for entry in the euro area. At a meeting of the Heads of the Economic and Financial Affairs Council (ECOFIN) on 21 June 2007 was finally granted the permission for the euro introduction, based on the current economic performance.[68]

The island is determined in the report of the Ministry of Finance from August 2007 as "small open and dynamic economy, with tourism and other service sectors constituting the engine powering the economy".[69] The negative economic developments during 2007 had not a significant impact directly on the Cypriot economy due to the stability and high growth within the euro area. Cyprus reached in 2006 GDP per capita at around 94 % of the average performance of EU 27, what actually implies a high level of real and nominal convergence with the European Union. The country showcased an increasing growth during 2006 (3.8 % in real terms) compared to EU 25 (3 %) and it is expected an enduring continuity after this performance, affecting mainly the labor market accompanied by higher

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67 See: Directorate- General for Financial and Economic Affairs (2007): "Convergence Report 2007 on Cyprus- Technical Annex", p.2-3

68 See: Ministry of Finance/ Central Bank of Cyprus (2007):"National Changeover Plan. From the Pound to the Euro", available at: http://www.euro.cy/euro/euro.nsf/All/C0474198FFDB3759C2257344001E 8F93/$file/National %20Changeove r% 20Plan%2022%20August%202007.pdf?OpenElement, p. 8, downloaded on 05.05.2008

69 See: Ministry of Finance/ Central Bank of Cyprus (2007):"National Changeover Plan. From the Pound to the Euro", p.6

unemployment rates. The economic outlook announced a declining unemployment rate of 4.5 % (2006) because of foreign workers inflows in the main sectors.[70] Moreover the strong necessity for financial and other business services, health and education and real-estate properties has boosted the economic growth in 2006 and balanced the below-potential expansion of the tourism sector. At the same time significant enhancements were estimated in the agricultural exports and dwellings which contributed to a more regulated growth.[71] The bank sector remained during 2006 a strong and dynamic competitor. In comparison with the last year there were approximated rapidly rises by the monetary and credit aggregates caused by borrowing foreign currencies in the transition period. The Narrow Money (M1) recorded in October 2006 an annual growth rate of 25%, while M2 extended annually to 14.9 % compared to 9.3% in the corresponding period of 2005. The bank credit to the private sector heightened by 15½ % in the same time. It is remarkable that the share of foreign currency- mainly in euro, borrowed by residents has rosen from 9½ % in 2003 to 17, 4% recorded in 2006.[72]

2.1. Price stability

Cyprus has usually relatively low inflation rates, but under the impact of external price shocks and exchange rate fluctuations, were estimated between 2000 and 2003 incalculably volatilities; the recorded inflation rates were peaking the 6% reference value. The inflation varied between 2004 and 2005 in the range of 3.9% to 1.4%, caused by significantly low prices of food products and decline in the telecommunications and pharmaceutical sectors. In 2006 because of higher energy prices the inflation has reached the level of 2.8%. In the course of 2007 it was running low anew with the falling of oil prices and under the influence of other external factors such as low import prices of specific goods, especially clothes and footwear. By the implementation of the Convergence criteria the island indicated in March 2007

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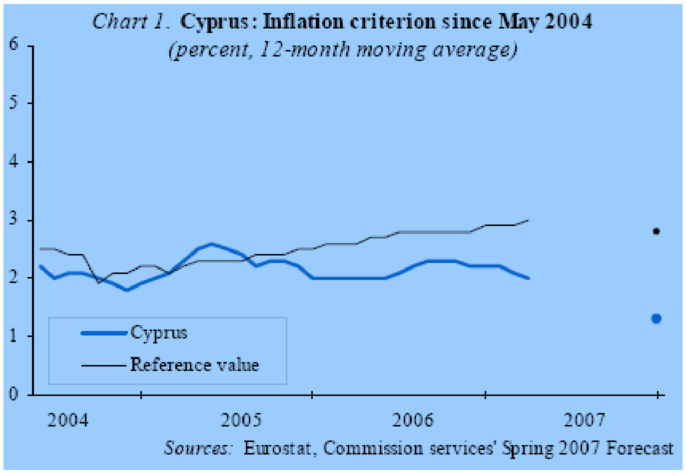
[70] See: Ministry of Finance/ Central Bank of Cyprus (2007):”National Changeover Plan. From the Pound to the Euro”:2007, p. 6

[71] See: Ministry of Finance (2006): “Convergence Report of Cyprus 2006-2010”, p. 6, available at: http://www.mof.gov.cy/mof/mof.nsf/All/075F9FBBE7D0683AC225723B0031535B/$file/Convergence%20Programme%202006-2010.pdf, downloaded on 10.06.2008

[72] See: Ministry of Finance (2006): “Convergence Report of Cyprus 2006-2010”, p. 7

an inflation rate of 2 % (see Chart I) below the reference value of 3%, measured on the average inflation of the best performing countries Finland, Poland and Sweden.[73]

***Chart I:** Cyprus: Inflation criterion since May 2004 (percent, 12 month moving average)*



Source: Directorate- General for Financial and Economic Affairs: "Convergence Report 2007 on Cyprus- Technical Annex", available at: http://ec.europa.eu/economy_finance/publications/publication10346_en.pdf

The stable inflation rate affects since the late 1990s the wage increases and the consumer prices continuously, except the 2002-2003 (due to a strong pick-up in the wage growth and weak labour productivity), (see Chart II). Regarding this issue, Cyprus has created a complicated "[…] backward-looking system of wage setting based on a Cost of Living Allowance (COLA) […]"[74] to fit twice a year the moderate wage level to the inflation rates of the previous six months. The COLA has to cope with the task to soften the wage pressures in the coming years, resulting from tax harmonization in the run-up to the EU membership in order to prevent eventual foreign workers rises on the national market. The next important aspect affecting the price stability on the island is the import prices of some goods, especially the energy prices. Increases on the energy price level contribute to the HICP inflation: 2

73 See: Directorate- General for Financial and Economic Affairs (2007): "Convergence Report 2007 on Cyprus- Technical Annex", p.12-14

74 See: Directorate- General for Financial and Economic Affairs (2007): "Convergence Report 2007 on Cyprus- Technical Annex ", p.13

percentage points were measured in 2006. It decreased close to zero in September 2006 and was to some extent negative.[75]

***Chart II**: Price and wages*

Source: Central Bank of Cyprus: "Annual report 2007", available at: http://www.centralbank.gov.cy/media/pdf/ANNUAL_REPORT_2007_EN.pdf

Therefore, can be concluded that Cyprus has made an enormous progress in the combat with the underlying pressures, causing inflation. With the aid of exchange rate stability and reliable monetary policy the country assures the national economic growth. The further success in attainment of medium-term developments is accompanied by moderate wage and labor discipline, imports of goods and resources especially energy, growing competition in some products on the European single market and well managed price levels and taxes. To keep inflation in the low reference value has an impact on the one side on interest rates in easing the credit growth and avoiding second- round effects from indirect taxes increases. On the other side the fiscal policy makes as well profit from the low inflation in terms of preventing the building-up of excessive demand procedures.[76]

2.2. Government budgetary position

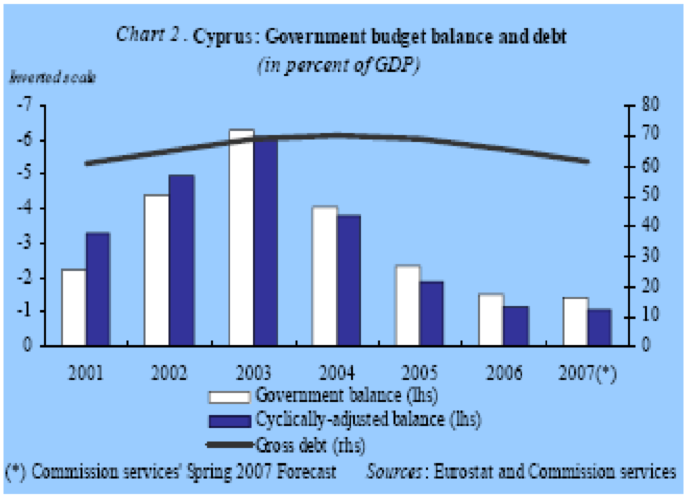
Considered to its finances, Cyprus has undertaken some enhancements from 2003 onwards. The Council declared that Cyprus was in excessive deficit in 2003

[75] See: Directorate- General for Financial and Economic Affairs (2007): "Convergence Report 2007 on Cyprus- Technical Annex", p. 14

[76] See: Directorate- General for Financial and Economic Affairs (2007): "Convergence Report 2007 on Cyprus- Technical Annex", p. 16

amounted on 6.3% of the GDP and growing government debt at 72.2% of the GDP. These findings let the Council issue a recommendation, which aimed to correct the deficit bringing it in the normal reference value of 3% and the fiscal debt to the 60%. Due to strong fiscal modifications in 2004 and 2005 the deficit was rapidly decreased in 2006 on 1.5% that is somewhat lower with 0.8 percentage points than in 2005 (2.4%). In 2006 the budget deficit value was approximated at just below the 2% and it remained nearly unchanged: 1.4% (2007).[77] The government debt was accompanied by an upward trend until 2004 reaching the 70.3% of the GDP (from 58.8% in 2000), but it continuously declined: from 65.3% in 2006 on 61.5% of GDP in 2007 (see Chart III). Stock-flow adjustments (SFAs) causing the increase of the government debt were the highest in the EU approaching about 2.5% of GDP from 2000 to 2004.[78] The SFAs were principally combined with accumulation of financial assets by the government as deposits in sinking funds with the Central Bank, used for repayments of long-term credits amounting to 7% of the GDP by the end of 2005. The future Convergence Programme of Cyprus from December 2006 foresees a further rapidly decrease of the debt amounting approximately 46% of GDP by the end of the Programme phase in 2010.

Chart III: *Cyprus: Government budget balance and debt (in percent of GDP)*



Source: Directorate- General for Financial and Economic Affairs: “Convergence Report 2007 on Cyprus- Technical Annex”

77 See: Directorate- General for Financial and Economic Affairs (2007): “Convergence Report 2007 on Cyprus-Technical Annex”, p.17

78 See: Directorate- General for Financial and Economic Affairs (2007): “Convergence Report 2007 on Cyprus-Technical Annex”, p. 18

As a result of the satisfying convergence performance Cyprus has attained a significant progress. By means of fiscal consolidating reforms as public revenues raises, tax evasion and control over the growth of consumption expenditure the country tries to keep the same level of economic stability. It policy measures lead consequently to enhancements in the long-term sustainability of public finances and the achievement of the 0.5% medium-term objective.[79]

2.3. Exchange rate stability

The next important condition implies the exchange rate stability of the single national currency. Cyprus is participant in the ERM II since 2 May 2005 with a central parity of 0.585274 pounds per euro.[80] The Cypriot monetary and exchange rate policies are meant to keep the macroeconomic stability and low inflation by pegging its currency either to an anchor currency, part of the basket of currencies or to a single currency- the ECU/euro. Since the participation of the island in the ERM II, the monetary policy framework remains effectively unchanged. The fact that the Cyprus pound has been pegged to the ECU during 1992-1998, and then to the euro, without any pressures, advises that the economy is able to deal internally with a fixed exchange rate regime.[81] Over the period of participation the national currency experienced some long-term fluctuations against the euro, but it remained fluctuating in the upper 2% half band, close to the central rate. The permitted wider fluctuation band of ± 15% was actually not transferred into the practice. At the end of the orientation period (27 April 2007), the Cypriot pound has steadily weakened to 0.5% above the central parity (see Chart IV), so the average spread to the central parity was estimated on 1.6% in the stronger half of the fluctuation band and with minimum und maximum differences between 0.5% and 2.1%.[82] According to the requirement of stable exchange rate to the euro, the CBC has cut the official interest rates to comply with the established exchange rate of the euro. It went trough some adjustments regarding interest rates in the operational framework on 1 September 2006. Subsequently the

[79] See: Ministry of Finance/ Central Bank of Cyprus (2007):"National Changeover Plan. From the Pound to the Euro", p. 6

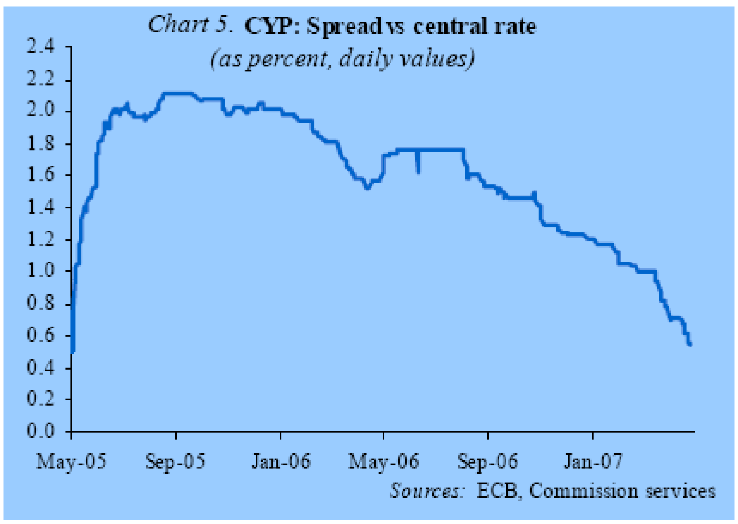
[80] See: Directorate- General for Financial and Economic Affairs (2007): "Convergence Report 2007 on Cyprus-Technical Annex", p.20

[81] See: Ministry of Finance (2006): "Convergence Report of Cyprus 2006-2010", p. 2-3

[82] See: Directorate- General for Financial and Economic Affairs (2007): "Convergence Report 2007 on Cyprus-Technical Annex", p.20

CBC resolved to "[…] bid rate on the main refinancing operations as the basis for the pricing of credit institution loans in Cyprus pounds, instead of the interest rate on the marginal lending facility that had been used previously […]" [83] to achieve as a result "gradual harmonization with the euro area practice" with minimum bid rate of 125 basis points. After the entry in the ERM II essential decreases were monitored by the money market interest spreads vis-à-vis the euro affecting the liquidity owing to significant capital inflows.

***Chart IV:** CYP: Spreads vs. central rate (as percent, daily values)*



Source: Directorate- General for Financial and Economic Affairs: "Convergence Report 2007 on Cyprus- Technical Annex"

Despite all monetary and economic developments on the international financial market, similarly the pound confirmed continuously its place against the other leading international currencies as the sterling and the dollar.

2.4. Long- term interest rates

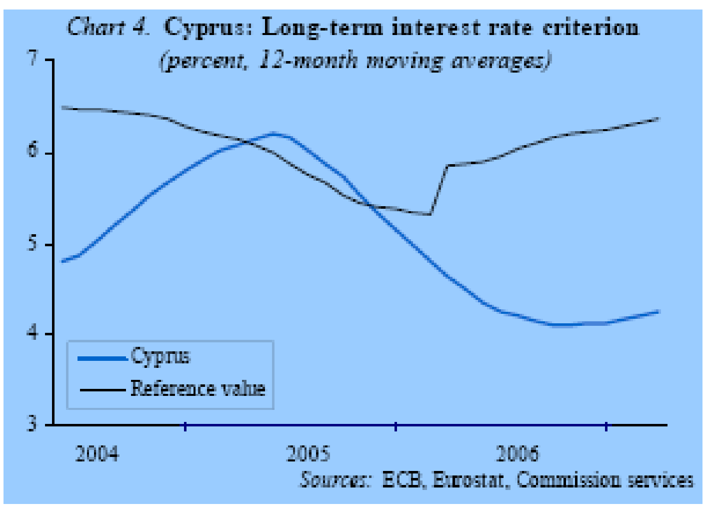
The long-term interest rates in Cyprus are used to examine the […] primary market yields on a benchmark government bond, due to a lack of a liquid secondary market for government bonds […].[84] The measured reference value for 2007 was determined

83 See: Directorate- General for Financial and Economic Affairs (2007): "Convergence Report 2007 on Cyprus- Technical Annex", p. 20

84 See: Directorate- General for Financial and Economic Affairs (2007): "Convergence Report 2007 on Cyprus- Technical Annex", p. 22

on the 4.2%, which was with 2.2 percentage points under the average of 6.4% in the three best performing countries Finland, Poland and Sweden. It declines continuously since 2005 onwards (see Chart V) hence to reach this rate under the reference value. As a result this aspect has an important impact on the euro area, in the form of spreads, what declares on the other side the backward risk priced in markets. Shortly before the ERM II entry spreads declined from the 230 basis points on the long-term governments bonds to about 30 basis points in the early 2007. [85] Consequently this development provides representative evidences of higher capital inflows ahead of the ERM II entry, an enhanced fiscal performance, and increasing confidence in the financial markets about the convergence process.

Chart V: *Cyprus: Long- term interest rate criterion (percent, 12- month moving average)*



Source: Directorate- General for Financial and Economic Affairs: "Convergence Report 2007 on Cyprus- Technical Annex"

This economic security over the interest rate led to an increase in the lending especially in the private sector due to the coming euro adoption and so that there can be measured rises in monetary aggregates. The annual growth of the money supply M2 in Cyprus was estimated on 19, 5% (2007) compared to 13, 7% the previous year.

[85] See: Directorate- General for Financial and Economic Affairs (2007): "Convergence Report 2007 on Cyprus- Technical Annex", p. 22

The bank credits to the private sector reached 29, 2% (3.187, 8 Million) in 2007, which is quite higher than in 2006 (16, 1%: 1.510,4 Mio). The Cypriot population preferred the euro deposits owing to the slowdown in local currency and which was offset by the higher interest rates existing in Cyprus in comparison to the corresponding European interest rates.[86]

2.5. Legal Compatibility

The Central Bank of Cyprus was created in 1963 by the Central Bank of Cyprus Law, soon after Cyprus got its independence in 1960. This basic law was substituted by the Central Bank of Cyprus Law of 2002 (138(I) 2002) amended later by the CBC Law of 31 October 2003 concerning remarkable inconsistencies. The amendment was adopted by the Parliament on 15 March 2007. The Law has the intention to abolish or modify some articles concentrating mainly on the role, competences and deeper integration in the ECB, ESCB and EC Council as conferred in the Treaty. However, the provisions requiring an amendment were regulations about monetary policy (Article 6(2) a, 27 and 28 on definition of monetary unit), monetary instruments and operation implemented by the ESCB (Article 39 (2), 41, 42, 46 (2) and (3) and 65), execution of foreign exchange policy (Article 6 (2) b) the European notes and coins issue affairs (Article 29, 30, 31 (2)).[87] The central bank institutions were divided according to the requirements of the ECB in three decision-making bodies: the Board of Directors, the Governor and the Deputy Governor.

The primary objective of the CBC is achieving and maintaining of the price stability like the ECB at its disposal a set of monetary policy instruments and the second one concerns the implementation of general economic policies on the island, primarily by carrying out open market operations intending to satisfy the liquidity needs of the banking system. The CBC has to draft the national legal documents in accordance with the European Central Banks General Documentation on Eurosystem Monetary Policy Instruments and Procedures as well to prepare the technical infrastructure (IT

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86 See: Central Bank of Cyprus: “Annual Report 2007”, p. 36, available at: http://www.centralbank.gov.cy/media/pdf/ANNUAL_REPORT_2007_EN.pdf, downloaded on 20.06.2008

87 See: Directorate- General for Financial and Economic Affairs (2007): “Convergence Report 2007 on Cyprus- Technical Annex”, p.10

systems) for the monetary functions.[88] After this amendment the personal independence of the CBC members was notably strengthened. In case of unforeseen vacancy a new Board member should be systematic appointed for the office period of 5 years, as opposed to the remainder of the term of office of the leaving Board member.[89]

The EU legal framework expands the obligations of the Cypriot central bank and consequently makes it legislation compatible with the objectives of the Treaty and the ESCB Statute.

2.6. Convergence Programme of Cyprus 2007-2010

An updated version of the Convergence Programme of the Republic Cyprus outlines a forecast of the expected monetary developments from 2007 to 2010, as a consequence of the proper implemented fiscal and structural reforms included in the National Lisbon Programme. Due to the Council's recommendation about the excessive deficit procedure under Article 104(7) of the EC Treaty, the Programme focuses on the further proceedings with the consolidation of public finances over the medium term to achieve enduring budgetary position und to replace the government debt under the reference value of 60%. The Cypriot Government appreciates the fiscal consideration as a binding, feasible and credible to pursue the requirements for stable internal and external economic stability.[90] The Programme emphasizes the same aspects, concerning the expansion of the real GDP, unemployment growth rate, inflation rate and the account balance. The potential growth estimates should increase on the average of 4% of GDP in the next years and should remain permanent in these margins due to exports of goods and services, tourist arrivals and enhancements in the tourist quality products. The labor market foresees further employment benefits resulting from the increased participation of foreign workers, higher involvement rates of female Cypriots and old aged people. The unemployment rate should reach 4.4 percentage points in 2010 due to the tight labor market conditions, what imply a small decrease compared to 2007: 4.8% (see Table I). The current account balance

[88] See: Ministry of Finance/ Central Bank of Cyprus (2007): "National Changeover Plan. From the Pound to the Euro", p.48

[89] See: Directorate- General for Financial and Economic Affairs (2007): "Convergence Report 2007 on Cyprus-Technical Annex", p.10-11

[90] See: Ministry of Finance (2006): "Convergence Report of Cyprus 2006-2010", p.1

should fall between 2009-2010 around the 4 % reference value, considerable lower than the - 5.8% in 2007.[91]

Table I: *Selected Economic Indicators 2007-2010*

annual % change	**2007**	**2008**	**2009**	**2010**
Real GDP growth rate	3.9	4.1	4.1	4.1
HICP	2.5	2.4	2.0	2.0
Unemployment rate (% of Labour Force) (Labour Force Survey)	4.8	4.7	4.6	4.4
Current account balance (% of GDP)	-5.8	-5.4	-4.8	-4.2

Source: Ministry of Finance:" Convergence Programme of the Republic of Cyprus 2006-2010", http://www.mof.gov.cy/mof/mof.nsf/All/075F9FBBE7D0683AC225723B0031535B/$ file /Convergence%20Programme%202006-2010.pdf, p.13 Downloaded on 04.06.2008

On the basis of these economic indicators, fiscal policy has to sustain the Medium Term Objective (MTO) and to restructure measures as public spending in favour of capital expenditure, research and education foreseen in the Broad Economic Policy Guidelines' (BEPGs') and the Cyprus' Lisbon Programme, which are pointed to enhance the economy's growth potential. These policy improvements are supported by four objectives:

- The adoption of a Medium-Term Budgetary Framework (MTBF) institutionalizing expenditure regulations, which have to provide more independence to ministries with large expanses and simultaneously improve their responsibility for achieving essential quantifiable objectives;
- Establishment of a social welfare system supporting those who are in greater need to fulfill the approach of "more for fewer people"[92];
- The reformation of the public sector, resulting in leaner and more efficient government services and leading to a policy with increased overall productivity and restricted expenditure growth;
- Further tax collection enhancements within the present system pointed on coping with tax evasion and administration.[93]

[91] See: Ministry of Finance (2006): "Convergence Programme of the Republic of Cyprus 2006-2010", p.11

[92] See: Ministry of Finance (2006): "Convergence Report of Cyprus 2006-2010", p. 2

The forecasted structural reforms are aimed to enhance the market mechanism hence to develop a strong and flexible economy able to improve the productivity and competitiveness on the island and therefore to contribute to higher growth and living standards for its citizens. Special signification is focused on the role of the private sector as the key element to the macroeconomic stability.[94]

VI. Further preparatory measures for euro adoption in Cyprus

The exchange from one currency system to another is a comprehensive affair which needs dealing with at many stages of the transition process. The preparation at national level aims to ensure the sucessful implementation of the new currency and sufficient level of public acceptance. The drawing up and the execution of the changeover plans are tasks of the member states which have to be prepared in line with the EU acquis communitaire. The country itself has to define the steps that have to be undertaken in diverse sectors to facilitate the smooth transition from the Cypriot pound to the euro.

1. The Community legal framework

The primarily legal framework for the introduction of the European currency was conferred in three Council regulations: Council Regulation (EC) 1103/97 of 17 June 1997, Council Regulation 974/98 of 3 May 1998 and Council Regulation 2866/98 of 31 December 1998.[95] These provisions are automatically applicable in member states taking part in the Eurozone. The legal background for these regulations was approved by European Council conference in December, 1995 in Madrid, known nowadays as "Madrid scenario".

The Council Regulation (EC) No 1103/97 of 17 June 1997 is the so called "urgent" provision concerning the introduction of the euro, which has to be approved in the probably earliest stage of founding the euro area. It relied on certain provisions

93 See: Ministry of Finance (2006): "Convergence Report of Cyprus 2006-2010", p. 2
94 See: Ministry of Finance (2006): "Convergence Report of Cyprus 2006-2010", p. 3
95 See: European Commission/ Directorate General for Economic and Financial Affairs (2006): "European Economy. Occasional Papers", available at: http://ec.europa.eu/economy_finance/publicati ons/publication7552 _en.pdf, p.8, downloaded on 05.05.2008

related to the introduction of the euro and amended by Council Regulation (EC) No 2595/2000 of 27 November 2000 amending Regulation (EC) No 1103/97. It involves a wide concept of provisions regarding the substitution of all remarks and legal instruments of the ECU with the euro. The so called principle "continuity of contracts" has the main purpose to improve the legal assurance and to provide cautions signs to the economic agents when existing contracts have been challenged. Another significant point of the Regulation is the dealing with set of rulings about the translation rates between the euro and the national currencies: it should exist only one conversation rate for all participating countries.[96]

The Council Regulation (EC) No 974/98 of 3 May 1998 assigns the main monetary law provisions for the euro area. It is determined as the second part of the common legal framework for the adoption and application of the euro. It establishes the euro as a legal tender for the member states from January 1999 and replaces the national currencies at the irrevocably fixed exchange rate. The regulation has been amended by Council Regulation (EC) No 2596/2000 of 27 November 2000 to provide a legal framework for the future introduction of the euro in other member states.[97] The final stage of the changeover process laid down in this regulation is the introduction of the euro, especially issuing the European notes and coins.

The Council Regulation (EC) No 2866/98 of 31 December 1998 determines exact the exchange rate parities between the euro and the participating currencies. The regulation has to be amended as a country with derogation enters the Eurozone. The provision comes into force with the day of euro adoption. This practice is launched with the entrance of Greece in the monetary union.[98]

2. Changeover scenarios

The right choice of changeover scenario is a very delicate matter on the road to the monetary union. When a country expresses the preference to join the euro area, a

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[96] See: European Commission/ Directorate General for Economic and Financial Affairs (2006): "European Economy. Occasional Papers", p. 9-10

[97] See: European Commission/ Directorate General for Economic and Financial Affairs (2006): "European Economy. Occasional Papers", p.12-13

[98] See: European Commission/ Directorate General for Economic and Financial Affairs (2006): "European Economy. Occasional Papers", p. 14

further stage of the preparation for the euro introduction is to select between three available scenarios, namely the big bang, big bang combined with “phrasing out” or the Madrid scenario. In the next subsections I illustrate two of them, which I think are more relevant for changeover process in Cyprus.

2.1. Big bang

It is assumed that the most NMS would prefer the implementation of the “big bang” changeover scenario, because of the experience of the old-member states with this issue. A remarkable instance is the exchange of Ostmarks to Deutschmarks in Germany on 1 July 1990 oder the adjustment of the sterling in 1971 transforming from pounds, shillings and old pence to pounds and new pence.[99]

The “big bang” approach involves an alternative with no transitional period, which means that the euro banknotes and coins become the official currency of the newly acceded country from the first day of introduction. Meanwhile the national banknotes and coins are either quickly withdrawn particularly in well prepared countries or are used for payments for a period of six months after euro launch. Afterwards citizens and enterprises can continue to exchange their legacy cash at banks without any costs, even the central bank will go on to exchange the national currency in euro without any cost or time limit too.[100]

Therefore the “big bang” scenario implies on the one hand obligatory conditions to economic administrative operators and to the private sector, but on the other hand it is the more preferable scenario regarding the swift implementation of the euro. The general public can quickly accept the statute of the new legal tender and make immediately use for payments purposes.

2.2. Big bang with „phrasing out“

The other possible alternative would be the big bang scenario with “phrasing-out” permitting a one year period during which new legal instruments as contracts might be adjusted to the national currency. The benefit of this approach is that it does not aspire the immediate introduction of the euro; it allows well practical flexibility as the

[99] Scobie, H.M. (1998): “European Monetary Union. The way forward”, edited and co-authored, European Economics and Financial Centre, London; London/ New York, Routledge, p.3

[100] See: European Commission/ Economic and Financial Affairs: „The Euro. Scenarios for adopting the euro”, available at: http://ec.europa.eu/economy_finance/the_euro/joining_euro9411_en.htm, downloaded on 06.05.2008

smooth adaptation of IT-systems.[101] In spite of the adaptiveness provided by the "phrasing out", there can emerge additionally some difficulties on a later stage, when the IT- systems have been running in the national currency and related payment operations have been at once executed in euro.[102]

3. The Law adopting the Euro of 2007

According to the above mentioned regulations a legislative committee under the chairmanship of Attorney Generals Office in cooperation with the Ministry of Finance and the Central Bank of Cyprus prepared in 2005 an action plan settled on the all required measures concerning the sucessful adoption of the euro. The Law Adopting the Euro of 2007 came into force on 21 June 2007 intending further enhancement of the current Enabling Law complying with the Community Regulations. The Enable Law provides provisions obliging the suppliers to dual display of prices giving clarity and certainty to the general public, observatory expanded pools protecting in effective way the consumers and the public in terms of supervision of the legality of transactions and examination of any possible infringements with the Law provisions. The Enable Law considers as well provisions including the dual circulation period of the both currencies and the rounding up of the prices, e.g. the share capital of companies or the change in interest rate denomination.[103] The amended provision tends to cover as much as possible the requiring regulation. The new legal provision was made known to the citizenship in different ways, e.g. seminars, distribution of printed material, articles in newspapers. A special emphasis has been given to enterprises and to certain organisations as the Accountants Associations, the Association of Informatics Companies and the Cyprus Informatics Company.[104] After the introduction of the euro the monitoring process

[101] See: European Commission/ Economic and Financial Affairs: „The Euro. Scenarios for adopting the euro"

[102] See: European Commission/ Directorate General for Economic and Financial Affairs (2006): " European Economy. Occasional Papers", p. 19-20

[103] See: Ministry of Finance/ Central Bank of Cyprus (2007): "National Changeover Plan. From the Pound to the Euro", p.17-18

[104] See: Ministry of Finance/ Central Bank of Cyprus (2007): "National Changeover Plan. From the Pound to the Euro", p. 36-37

implying the provisions included in the Enabling Law will be intensified to maintain or improve the achieved outcomes.

4. The Cyprus's Changeover Plans

4.1. The National Changeover Plan

The National Changeover Plan in Cyprus was worked out by the Ministry of Finance and the Central Bank of Cyprus and framed on decisions of the Council of Ministers from 29 December 2007 presenting suitable measures of the Cypriot strategy for entrance in the euro area, and a Decision from 2 November 2005 fixing the target date for euro introduction. The National Changeover Plan puts an emphasis on a complete policy framework which provides remarks about limitation on price increases, information to the business and financial sector and as well to the population. The Plan reflects the practice of the current members of the Eurozone and considers a possible collaboration with Malta.[105]

The basic preparatory stages included in the National Changeover Plan report refer to some tasks, implying that:

- the Cyprus economy has to be opposed on the challenges bonded with the entry in the monetary union. The Government has to consider appropriate measures to avoid a sudden raise in the common price level during the dual circulation period from pound to the euro;
- the country has to ensure that it will maintain the economic stability and struggle to achieve an advanced level of macroeconomic stability, revised by the provisions in the Stability and Growth Pact;
- the assistance for technical support in the accounting and software equipment requires the appropriate legal framework;
- a well functioning cash change plan is especially an essential preparatory step to make the purchase of euro banknotes and coins easier by facilitating the quick withdrawal of the Cyprus pound;

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[105] See: Ministry of Finance/ Central Bank of Cyprus (2007): "National Changeover Plan. From the Pound to the Euro", p.4-5

- all citizens on the island have to be systematic informed about the coming happening and
- a high degree of close collaboration with the EU authorities has to be achieved. [106]

The enforcement of the National Changeover Plan was a successful concern; specific prosperity was ascertained by the institutional and legislative framework, in the field of public and bank sectors. For the observance of the preparatory measured included in the institutional framework were several committees arranged, as the National Advisory Board (National Changeover Board), Political Committee for the changeover of the pound to the euro, Coordinating Committee, Joint Communication Committee, Technical committees of the Ministry of Finance and the Public Service sector and Technical Committees of the Central Bank of Cyprus.[107]

4.2. The Cash Changeover Plan

The cash changeover is the most evident part of the whole transition period. The most important preparatory stages of the introduction process are outlined in the "Cash Changeover Plan" drafted by the CBC. [108] It assumes each step from the issue of the euro banknotes and coins to the proper and safe distribution of the legal tender on the territory of Cyprus, involving the role of the banking sector with the chief responsibility to facilitate the payments of the public and companies in a smooth way, as follows:

Acquisition of euro banknotes and coins: First of all the CBC aspires the ample supply with quantities of each euro denominations to convince that the economy will still work quite efficiently, while it borrows at the same time the needed amount of banknotes from the Eurosystem through the Bank of Greece according European Central Bank Guideline ECB/2006/9. In contrast the CBC coins by itself in

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106 See: Ministry of Finance/ Central Bank of Cyprus (2007): "National Changeover Plan. From the Pound to the Euro": 2007, p. 9

107 See: Ministry of Finance/ Central Bank of Cyprus (2007): "National Changeover Plan. From the Pound to the Euro", p.13

108 See: Central Bank of Cyprus (2007): "Cash Changeover Plan", Version 7, available at: http://www.centralbank.gov.cy/media/pdf/EURPE_CASHCHANGEOVERREVISED.pdf, p.2, downloaded on 07.05.2008

cooperation with the Finnish Mint. The necessary quantity currency capacity is determined from a method used already in the rest of the EU member states.[109]

Distribution of euro banknotes and coins: A further step observed by the CBC Cash Changeover Plan is the supply of all banks with sufficient quantities of the euro banknotes and coins before the official launching date to enable bank transactions, especially in the retail sector. The public is also considered during the conversion period. It bankrolls with Automated Teller Machines (ATM) network providing satisfactory amount of the euro from the 1 January 2008.[110]

Exchange of Cyprus pounds: The CBC considers moreover the easy, in a timely manner exchange of the Cyprus pounds into euro, without any direct or indirect charges within the period of six months; by the end of 2008, 95% of the Cyprus's banknotes and 60% of the coins have to be withdrawn.[111]

The enforcement of all these goals is bonded with highest security measures in cooperation with the competent institutions in Cyprus to avoid possible criminal acts.

All these preparatory procedures can be confirmed or contested enclosed statistical data gathered after the introduction period. A survey among the Cypriot citizens was conducted by the evening of 12 January 2008, two weeks after euro adoption, which outlines that 90% of all payments were made by the new currency. Nine of ten people in Cyprus had primarily euro cash in the purses, thereof 93% for banknotes and 87% for coins. The number of citizens which make payments with euro was approximately 74%. Two weeks after the euro introduction were done in average 250 000 ATM withdrawals in Cyprus.[112] Many people made use of the possibility to substitute its "old" legal tender on bank counters with the euro (near 336 000 operations).

4.3. The Communication Policy Plan

To introduce successfully the European currency the governing institutions in Cyprus built a Joint Communication Committee composed by members of the Ministry of Finance, the Central Bank of Cyprus, the Press and Information Office and the

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109 See: Central Bank of Cyprus (2007): "Cash Changeover Plan", p.2-4

110 See: Central Bank of Cyprus (2007): "Cash Changeover Plan", p. 7

111 See: Central Bank of Cyprus (2007): "Cash Changeover Plan", p.10- 12

112 See: Europa/ Press Releases (2008): "The Cypriot and Maltese changeover are almost complete", available at: http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/36&format=HTML&aged=0&language=EN&guiLanguage=en, downloaded on 07.05.2008

Representatives of the European Commission in the country to organize in the most efficient way an information campaign concerning the launch of euro and the withdrawal of the Cyprus pound. The CBC's euro information campaign forms a fundamental element of the national information campaign specified in the "Comprehensive Strategic Communication Plan for the adoption of the euro in Cyprus" issued by the Ministry of Finance in cooperation with the Central Bank of Cyprus.[113] The paper stipulates an action plan to inform about the euro campaigns, prepared in advance by the Task Force on Euro Information Campaign (TF-IC) for the countries with derogation operating under the observance of the ECB. The institution taking accountability for the CBC euro information campaign is the Bank's Communication Committee for the adoption of the euro, justified by the Governor of the Central Bank on 18 January 2005.[114]

The basic purposes of the Communication strategy are as follows:

- to enable the Cypriot citizen to win more trust in the euro and European institutions, which affair would contribute to the access in the euro area;
- to provide the necessary information about the stand of the accession process and to support the adjustment of the Cyprus economy to the euro area;
- to publish, consulate and promote the advantages and disadvantages for the Cyprus's economic concerning inflation, employment, public finances, growth and macroeconomic policy;
- to announce the implications of the new currency to the current events;
- to oppose in the most efficient way possible price increases during the exchange period;
- to get engaged in the vulnerable communities dealing with the future difficulties for low income groups, uneducated people, persons with damages and the Turkish part of Cyprus and at least

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[113] See: Central Bank of Cyprus/ Eurosystem: "Communication Policy", available at: http://www.centralbank.gov. cy /nqcontent.cfm?a_id=4425&lang=en, downloaded on 07.05.2008

[114] See: Central Bank of Cyprus/ Eurosystem: "Communication Policy"

- to make familiar with the new currency as explaining the practical stages for introduction.[115]

All these intentions are formulated in accordance with the current economic situation on the island and reflect the idea of the European identity as well as the attempt to maintain the national character. The fulfillment of these objectives takes place in four main stages traced back to 2005 enabling the Cypriot population to get more confident with the new situation.

The first stage comprises the period from March to May 2007 and was thought to bring off sufficient information to the general public, to deliver messages coming from the Europartners and to sustain the business sector. The goal followed by the second phrase from June 2007 was to request reliable information about fixing of the exchange rate and the target date. During Stage three and four (from 1 January 2008) were visualized the benefits from the exchange rate policy, sufficient information about the process itself was provided and general information about the ending of the dual circulation period.[116]

The Cypriot authorities would like to put across with the Communication Plan the fundamental messages related to the new currency, the new opportunities, changes and expectations in the common European future.

4.4. Public support for the entry in the euro area

I think it would be interesting to compare the people's opinions in the newly acceded countries from the EU enlargement process from 2004 in order to observe, what do they think about the entry in the euro area and how do they appreciate the introduction of the euro in their own country, on the basis of the expected assumption that the euro would bring a lot of benefits to the consumers?

"How successful would be the introduction of the single currency depends on diverse aspects like whether the people living in this country believe in its stability, moreover it depends on the implementation of appropriate policies. It is also important whether

[115] See: Ministry of Finance/ Central Bank of Cyprus (2007): "National Changeover Plan. From the Pound to the Euro", p. 24-25

[116] See: Ministry of Finance/ Central Bank of Cyprus (2007): "National Changeover Plan. From the Pound to the Euro", p.28

the people have confidence of the safety and integrity of the new currency and the smooth cash changeover to the euro […].”[117]

The Eurobarometer published a survey in March 2007 which presents the citizenship's opinions from the NMS, concerning views and impressions about the euro introduction. At first glance the people expect more positive happenings for their country than for themselves personally (58%)[118] Especially in the countries as Hungary, Malta and Cyprus is showed a significant increase in the percentages of citizen's optimistic expectation compared to 2006. The Cypriot people hope that the new currency would tighten and restore the public finances compared to the last year performance what will hence affect the price stability on the island: 47% approve the coming of the new currency.[119] The citizens express the privilege to be better informed about the fully execution process. There was estimated an increase in the level of self-perceived information in Cyprus; 53% of the Cypriot population were feeling well or very well-informed. The main reasons for the enhancements come from the euro information campaigns as well the intensifying of the citizen's self-education before the upcoming changeover.[120] Significant increases were monitored in Hungary (44%, +9) and Slovakia (51%, +4) too; the levels of self-perceived knowledge remained (nearly) unchanged in Czech Republic and in the Baltic countries. A further important step is the providing of information in each country via trustfully channels. The survey identifies, that the most convictional sources of information about the changeover plans and the adoption of the euro are the national banks and than the European institutions.[121] It arises out that considerably more citizens are happy than unhappy about the future modifications in the monetary policy: in Slovakia and the Czech Republic is noticed a small reduce of support not exceeding the surveys margin of error, but in the Baltic region is widespread the view

[117] See: European Central Bank (2007): "The adoption of the euro and economic performance in Monetary Union", available at: http://www.ecb.int/press/key/date/2007/html/sp071126_2.en.html, downloaded on 07.05.2008

[118] See: Eurobarometer (2007): "Introduction of the Euro in the Member States", Analytical Report, Publication: May 2007, p.29, available at http://ec.europa.eu/public_opinion/flash/fl_207_en.pdf, downloaded on 07.05.2008

[119] See: Ministry of Finance/ Central Bank of Cyprus (2007): "National Changeover Plan. From the Pound to the Euro", p. 29

[120] See: Eurobarometer (2007): "Introduction of the Euro in the Member States", p. 19

[121] See: Eurobarometer (2007): "Introduction of the Euro in the Member States", p. 22-23

of frustration regarding the euro. Support fell the most in Lithuania (by -10 percentage points), Estonia (-4) and Latvia (-3) as well. In Poland is registered unchanged support at 52%.[122] In Slovakia, the Czech Republic, Poland and Malta prevail the views against the replacement of the national currency with the euro, because of loosing the national identity.

The main lessons from the survey sum up that the citizens in the most eastern states need to get more information about the upcoming adopting process in order to be well prepared before the changeover procedure comes into force in their countries. The active categories of people (self-employed and employee) are quite optimistic and positive than the inactive- elder people over 55 years and least educated.

122 See: Eurobarometer (2007): "Introduction of the Euro in the Member States", p. 29-30

VII. Conclusions

With the entrance in the monetary union on the 1 January 2008 starts a period for Cyprus towards the modern economic history-making challenged by increased decision- making power and responsibilities vis-à-vis the EU.

These final observations have the intention to give a briefly reply of the foreword posed research question: *To what extent is actually Cyprus prepared for the introduction of the common currency based on the legal framework of the European Union?*

Cyprus has been successfully and enduring prepared with the aid of the Ministry of Finance and the Central Bank of Cyprus for the introduction of the single European currency with appropriate economic and practical measures to become as a consequence an equal participant and competitor in the monetary union. Currently the island aspires to greater degree of growth and stability to make sustainable use of the benefits offered by the Eurozone. Cyprus has achieved compliance with the sophisticated conditions for entrance laid down in the Community legislation and with the many economic indicators and procedures, avoiding external risks and shocks to the Community. Factors as price and exchange rate stability, long-term interest rates and sustainability of the government budgetary position were effectively fulfilled. Therefore the country has achieved a high degree of stability, providing more incentives to foreign investments allowing the access to the big European capital market. The positive economic developments in Cyprus during the last years have proven the macroeconomic stability on the island despite the increasing uncertainties on the external international financial market. Cyprus has achieved comparatively low inflation rate, high economic growth values, low unemployment rates and long-term sustainability in its public finances, boosting the economy in the proper direction.

The countdown to the euro adoption began in 2007. The Central Bank of Cyprus has prepared efficiently all involved parties for the introduction of the new legal tender. It contributed to the smooth implementation of the euro banknotes and coins, provided sufficient information to the general public and secured with suitable measures the supply of the new euro denominations across the state. Consequently Cyprus has been prepared in the most efficient and appropriate manner for the European currency and it is welcomed from the European institutions as an honour member of the euro area.

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