The current framework of exchange rate policy in Cyprus and recent developments

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I Introduction

During recent years Cyprus has embarked on a comprehensive effort to implement significant and demanding reforms aimed at liberalising and modernising the economy. The driving forces behind this effort are the intensified challenges stemming from globalisation and, perhaps more importantly, the ongoing process for EU accession. This effort is multidimensional and involves a number of economic policies, including financial reforms and adjustments related to the exchange rate policy framework. This paper focuses on issues related to the design and implementation of exchange rate policy in Cyprus within the context of the ongoing economic reforms. It also presents the parameters that determine the evolution of exchange rate policy throughout the period of the accession process and up to the time of the eventual adoption of the euro, without, however, attempting to make a judgement on how the Cypriot authorities should or are likely to proceed during the period.

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Since its independence in 1960, Cyprus has been experiencing notable economic development. Growth during these years has been impressive and according to the European Commission (2001a), per capita GDP reached 83 per cent of the EU average by the year 2000.[1] High growth rates were achieved within an environment of low levels of fiscal deficit, inflation and unemployment and, in general, against a background of overall macroeconomic stability. Furthermore, despite some remaining rigidities, such as capital controls and a widely applied wage indexation system, the overall economic environment is distinctly market-oriented with limited government participation and intervention.

Even though this positive economic and structural background places Cyprus in a relatively favourable position, macroeconomic challenges, in view of accession, continue to remain very demanding, particularly against the background of an increasingly integrated global environment and potentially increasing capital flows, due to the ongoing capital account liberalisation process. In particular, implementing a suitable exchange rate policy in Cyprus while, at the same time, maintaining disciplined and supportive policies in other economic areas, such as monetary and fiscal policy, continues to be a major challenge.

After presenting a brief history and recent developments pertaining to exchange rate policy in Cyprus in the next section, the third section analyses the challenges for exchange rate policy in Cyprus in view of EU accession and eventual adoption of the euro. The analysis is undertaken within the context of a general discussion on the challenges that all accession countries face. The fourth section presents some concluding remarks.

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[1] Developments in 2001 and the projected outlook for growth in Cyprus and the European Union, as described in European Commission (2001b), suggest that real convergence for the period 2001-2003 continues for Cyprus, as its real GDP growth is expected to outperform that of the European Union by a significant margin.

II A brief history and recent developments

Exchange rate policy in Cyprus has historically been geared towards maintaining macroeconomic stability through the linkage of the Cyprus pound with a currency anchor, be it a single currency or a basket of currencies. Given, among other things, the smallness and openness of the economy, this was considered to be an appropriate exchange rate policy framework for Cyprus. As suggested by the overall economic performance of the country, the policy of using the exchange rate as a means to contain inflation and inflationary expectations has served the economy well, not only in terms of maintaining price stability, but also in terms of contributing to the country's development process through the solidification of a stable and supportive macroeconomic environment.

The currency anchor of the Cyprus pound has changed a number of times since independence. During the period 1960 – 1972, the Cyprus pound was pegged to sterling. Subsequent to Bretton Woods, this link was terminated in 1972 and the Cyprus pound was linked for a short period to the dollar. The Cypriot currency was subsequently linked to an import-weighted currency basket during the period 1973-1984 and to a trade-weighted currency basket during the period 1984-1992.

Cyprus's aspirations to become a member of the European Union led to a reconsideration of the choice of currency basket in 1992. On June 19 of that year, the Cyprus pound was unilaterally pegged to the ecu, at the central rate of 1CYP=1,7086 ecu and with fluctuation margins of ±2,25%. This unilateral pegging reflected the desire to link the economy more closely to the economies of the EU. It is true that, from a static point of view, the ecu basket did not fully reflect Cyprus's composition of trade. Nevertheless, the choice of the ecu-anchor was in part necessitated by the objective to tie the Cyprus pound to a currency representing a group of countries, the prime goal of which was price and overall macroeconomic stability in the EU. Besides reinforcing Cyprus's economic ties with the EU, it was hoped that such an exchange rate policy would contribute further to the maintenance of price and macroeconomic stability in Cyprus as well as safeguard the international competitiveness of the Cyprus economy. One could argue that these aspirations have by and large been realised.

Following the successful ecu-peg policy, the Cyprus pound was pegged to the euro on 1 January 1999, the first day of the introduction of the new european currency.[2] The central parity rate was maintained at 1CYP=1,7086 euro. Initially, the fluctuation margins were also maintained at ±2,25%. On 1 January 2001, however, wider bands of ±15% were also introduced in order to enable the Central Bank to absorb any shocks from possibly destabilising capital movements and deter speculative capital flows, particularly as capital account liberalisation progressed. At the same time, the narrower "softer" bands of ±2,25% were temporarily maintained to help anchor prices and expectations.

The introduction of the wider bands of ±15% coincided with the implementation of two important structural reforms in Cyprus. First, and foremost, the abolition of the long-lived statutory interest rate ceiling, which was accompanied by a relaxation of all restrictions on medium and long term foreign borrowing by Cypriots, and second, the introduction of a new process for the determination of the daily bilateral rates of the Cyprus pound, namely, the "fixing" process.[3] This process has replaced the administrative method of determining the daily value of the Cyprus pound that existed before.

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[2] The macroeconomic implications for the Cypriot economy of pegging the Cyprus pound to the euro are analysed in Kyriacou and Syrichas (1999).

[3] Under this process, the Central Bank and the commercial banks meet once a day, and through auction the parity of the Cyprus pound against the euro, the dollar and sterling is determined. The resulting rates are considered as important benchmarks for the domestic market.

Developments in 2001 led to a modification of the policy framework. In particular, following the abolition on 1 January 2001 of restrictions on medium term and long term borrowing with maturities of over two years by residents, capital inflows rose significantly as residents increased their borrowing in foreign currency, mostly euro, taking advantage of the interest rate differential between euro-denominated and pound–denominated loans. This exerted upward pressure on the exchange rate and has exposed borrowers to increased exchange rate risks. These developments prompted the Central Bank to abolish the “softer” narrow bands of ±2,25%, effective from 13 August 2001, so that only the ±15% margins are currently in place, in line with the Exchange Rate Mechanism II (ERM II).

The policy decision of 13 August 2001 was taken concurrently with another important decision to reduce interest rates by 50 basis points in order to mitigate the anticipated impact of the prolonged global economic slowdown on the Cyprus economy. The decline in interest rates in Cyprus also reduced the interest rate differential between euro-denominated and pound-denominated loans, which further slowed down foreign currency borrowing by residents. Interest rates were subsequently reduced further in September and November 2001 by 50 basis points each time.

III The road ahead in view of the EU accession and the adoption of the euro

As mentioned earlier, macroeconomic challenges, including exchange rate policy issues, continue to be demanding for Cyprus, particularly in view of the process of EU accession and the eventual adoption of the euro in the near future. In this context, the position of the EU on exchange rate policy in view of accession is of paramount importance and is presented next in this section, followed by an analysis of the strategic options for accession countries in general. This section concludes with a reference to the case of Cyprus, without attempting to evaluate the possible strategic exchange rate options for Cyprus or derive a conclusion on what the authorities should do or on how they are likely to proceed.

III.1 The EU position[4]

All accession countries are obliged to join the eurozone some time after accession, provided they fulfil the Maastricht convergence criteria; that is, after they have achieved a very demanding degree of macroeconomic stability. In addition, it is expected that, by the time of the adoption of the euro, candidate countries will have converged with the EU in terms of real per capita incomes and with respect to achieving a sufficient level of implementation of market-oriented structural reforms. In fact, the achievement of a sufficient degree of real convergence can be considered as a crucial economic pre-condition for the adoption of the euro by the new members, as this will lead to their economies being more harmonised, flexible and integrated with the rest of the eurozone economies after the adoption of the euro.

The EU perceives the process leading to the adoption of the euro by new members as one consisting of three phases. The first is the pre-accession phase, ending on the day of accession. The second phase starts immediately upon accession and the final phase marks the date when national currencies are replaced by the euro and new entrants become full participants of Economic and Monetary Union (EMU).

During the first phase, the EU does not have any formal requirements for the exchange rate policy regimes of candidate countries. Each country is free to chose any regime it considers appropriate. In fact, a wide-variety of regimes among candidate countries have been adopted, ranging from currency board arrangements to free floating. During the pre-accession period, the EU expects candidate countries to place more

[4] This sub-section draws in part on ECB (2000).

emphasis on structural reforms and the overall economic policy framework and to step up their efforts to comply with the Copenhagen criteria for accession, particularly the economic criterion which requires "the existence of a functioning market economy able to cope with competitive pressures and market forces within the Union" (ECB 2000, p.45)

In the second phase, the new EU entrants will have the status of "Member States with a derogation", that is, they will be members of EMU with a derogation as regards the adoption of the euro, until the Maastricht criteria are fulfilled. They will still have flexibility in the choice of exchange rate regime, but they will be obliged to treat their exchange rate policy as a matter of common interest. For instance, competitive devaluations are not allowed during this phase. At least two years before the adoption of the euro, and when they have achieved a sufficient degree of real convergence with the euro area, new entrants are expected to join ERM2 II.[5] Successful participation in ERM II for at least two years is considered sufficient for satisfying the Maastricht criterion for exchange rate stability.[6]

Here it should be stressed that the EU considers fiscal discipline to be of the utmost importance, particularly in member states as well as countries soon to be members of the euro zone. This is highlighted by the fact that two of the five Maastricht nominal convergence criteria pertain to fiscal policies, that is a fiscal deficit ceiling of 3% of GDP and a benchmark ceiling for public debt of 60% of GDP.

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5 This mechanism aims at guiding the exchange rate relations between the euro and the currencies outside the euro area. New EU entrants outside the euro area participating in ERM II negotiate the central rates for their currencies against the euro and allow their currency to fluctuate within a +/- 15% band, unless they agree on a narrower fluctuation band.

6 While formally membership in ERM II for two years is considered as a requirement for satisfying the relevant Maastricht criterion for exchange rate stability, there is also the view, which is largely advocated by the UK, that this criterion can be satisfied by maintaining exchange rate stability of the currency against the euro, without formal participation in ERM II.

The third phase marks the day of the euro adoption. The adoption of the euro is considered by the EU to be the end-result of a long and demanding process of real and nominal convergence. This is a reflection of the view that a successful currency union requires macroeconomic convergence and integration of the participating member states. In this sense, any considerations or attempts for early unilateral euroisation by candidate countries are not welcome by the EU as they violate the pre-defined and orderly path for the adoption of the euro and they conflict with the economic reasoning behind EMU.

III.2 The strategic options for candidate countries

Cyprus and the rest of the accession countries face a demanding challenge in choosing the appropriate exchange rate and monetary policy mix over a time horizon that will lead to adoption of the euro. This challenge has to be addressed within the broad parameters set by the European Union, as described above, as well as within the context of individual domestic economic conditions.

At the outset, it should be noted that experience from emerging markets suggests that only the extreme forms or the "corner solutions" of the wide spectrum of exchange rate regimes tend to be viable; that is, freely floats and credible hard pegs, such as currency boards, dollarisation / euroisation and currency unions. Intermediate regimes, such as soft pegs, are considered to be crisis prone. Specifically, they are vulnerable to speculative attacks and the volatility of the international financial markets, particularly in today's environment of increasingly integrated capital markets and open capital accounts (see, for example, Fischer 2001).

The choice of the exchange rate regime determines simultaneously the monetary policy framework, in particular the degree of monetary policy independence. This is in effect a corollary of Mundell's incompatibility triangle. According to this theory, no economy can have all of the following three elements simultaneously: (a) a fixed exchange rate regime (b) an independent monetary policy and (c) a fully liberalised capital account.[7] Given the world-wide trend for capital account liberalisation and within the context of a tendency towards "corner solutions" for exchange rate regimes mentioned earlier, countries need to eventually chose between two alternatives: either a fixed or a floating exchange rate regime. In the first case, monetary policy depends on the monetary policy of the anchor currency's central bank, whereas in the second case monetary policy is independent. The pros and cons of these "corner solutions" of exchange rate regimes are briefly outlined below.[8]

In general, free floating regimes have the advantage that the resulting rates should, at least in principle and in the long-run, reflect economic fundamentals, given the transparent and largely efficient international foreign exchange rate markets. Furthermore, monetary policy under the floating exchange rate regime is autonomous, i.e. independent from the monetary policy of another country, and thus can potentially be chosen to be the best fitted policy according to domestic economic conditions. Finally, free floating exchange rate regimes provide no opportunities for speculators to make profits at the expense of the central bank as the bank will not, in principle, intervene in the market (at least very infrequently).

On the other hand, a disadvantage of free-floating regimes is that markets seldom avoid misalignments in the short and medium-run and are sometimes driven by "market sentiments" rather than economic fundamentals. Flexible rates tend to fluctuate erratically, especially if a country lacks a clear, coherent and credible monetary policy

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[7] For instance, a country with a fixed exchange rate regime cannot decide to have a more restrictive monetary policy stance than the economy of the anchor currency. In such a case, the resulting widening of the interest rate differentials would instigate a flow of funds into the domestic economy which could in turn raise the monetary base thus nullifying the initial policy action.

[8] These arguments, which are widely analysed in the literature, are presented in some detail in Latter (1996).

strategy. In fact, the autonomous monetary policy implied by the floating exchange rate regime may at times be abused due to the fact that the pressure for appropriately prudent monetary and fiscal policies may not be sufficiently strong under this regime. If this is the case, the credibility of monetary policy is also affected, with negative implications for its effectiveness and for overall macroeconomic stability.

Fixed rates have the advantage that, if credible, they provide businesses with a less uncertain environment thereby helping to enhance the prospects for investment and international trade. The lack of monetary autonomy under the fixed exchange rate regime can be an advantage for the domestic economy if the anchor currency is a credible currency and therefore the domestic central bank, in a sense, “borrows credibility” from the central bank of the anchor currency. The fixed rate imposes a constraint on domestic monetary policy in that if the monetary stance is out of line with that of the anchor currency, unwelcome flows may occur which requires central bank intervention that can be destabilising. This is often regarded as a useful and credible mechanism for discipline against adopting policies which significantly diverge from those of the anchor country. This credibility argument is even more relevant in cases where financial instruments and markets are insufficiently developed for the operation of a market-based monetary policy in the domestic economy.

On the other hand, if a fixed rate lacks complete credibility it may be vulnerable to a speculative attack, which can be triggered by a shock or an event which is beyond the control of the domestic authorities. A successful speculative attack could lead to financial instability, loss of reserves and eventual abandonment of the fixed rate. Another main disadvantage of a fixed exchange rate regime is that the lack of autonomy of monetary policy could lead to problems on the real side of the economy. This is likely to occur if the domestic economic conditions are not “synchronised” with the economic conditions of the economy of the anchor currency. Finally, the frequent interventions of the central bank in the foreign exchange market in order to support the fixed rate may introduce complications for monetary policy conditions that require regular sterilisations which, under certain circumstances, could become less effective and could lead to destabilisation.

According to the economic literature as well as country experiences, free floating, or regimes close to it, tend to be in general more appropriate in cases where there is more need for monetary policy independence. These cases are more likely to be those in which the following conditions are, to a large extent in place: large economy; low degree of openness in terms of trade in goods and services; high degree of nominal rigidity in domestic prices and costs; low degree of factor mobility; less diversified structure of production and demand; and high incidence of asymmetric shocks. Hard pegs, on the other hand, are usually advocated for small and open economies, which are highly integrated in trade and business cycle trends with the economy of the anchor currency and have relatively flexible market structures and low incidence of asymmetric shocks. Needless to say, it is extremely unlikely that any country will clearly meet all the conditions for either alternative. Therefore, in practice, decision-making is not a clear-cut choice and requires a careful evaluation of the pros and the cons of each alternative at a particular point in time.

The above discussion underlines the assertion that there is no single exchange rate regime that is optimal for all accession countries. Each country needs to evaluate its strategic options based on the domestic economic conditions and within the framework defined by the European Union, as described earlier. Such analysis for the case of Cyprus, both for the present and until the adoption of the euro in the near future, is conducted below.

III.3 The case of Cyprus

As mentioned earlier, exchange rate policy in Cyprus has been historically geared towards maintaining macroeconomic stability through the linkage of the Cyprus pound with a currency anchor, be it a single currency or a basket of currencies. Given, among other things, the smallness and openness of the economy, this was considered to be an appropriate exchange rate policy framework for Cyprus. The narrow fluctuation margins of ±2,25% with reference to the ECU and then the euro until the 1 January 2001 were imposed in order to contain inflationary expectations and enhance the credibility of macroeconomic policies. Overall, this policy has been successful, even though it is fair to note that the existence of capital controls contributed, in part, to this success.[9]

The acceleration of the relaxation of capital controls in Cyprus prompted, as anticipated, a modification of the exchange rate policy framework, as the economy gradually begun to be exposed to the risks of potentially increasing capital flows.[10] In line with the discussion of the previous section, the gradual relaxation of capital controls has set in motion the mechanics of Mundell's "incompatibility triangle". Thus the Cypriot authorities had to choose between two options: either to move towards the direction of a floating-type exchange rate regime, or adopt a currency board, which is the only available

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[9] It should be noted, however, that capital controls seemed to have been, in effect, instrumental in smoothing variations around a sustainable equilibrium rather than in maintaining an unsustainable equilibrium. Had the exchange rate been significantly out of line vis-à-vis the broad economic fundamentals of the country, capital controls would not have been able to prevent an adverse impact on the foreign exchange reserves over a prolonged period of time.

[10] It should be noted, of course, that according to the planned time-schedule for the capital account liberalisation, the most sensitive controls to be relaxed for instance the free borrowing of non-residents in Cyprus pounds and the free maintenance of accounts by residents with foreign financial institutions, have been postponed until the time or close to the time of accession.

choice of hard peg for the Cyprus pound under the circumstances.[11] In other words, the authorities had to either introduce the maximum flexibility feasible or "harden" the fixed peg of the Cyprus pound against the euro. The authorities opted for the former and decided to move from the fluctuation margins of ±2,25% to the fluctuation margins of ±15%, in line with ERM II. They therefore opted for the highest degree of flexibility allowed under ERM II, rather than for the alternative zero flexibility option of a euro-based currency board arrangement.

The above decision was reached following an evaluation of the pros and cons of the two available choices, even though the precise timing of the decision was to an extent determined by economic developments. More specifically, as noted earlier, following the abolition of restrictions on medium term and long term borrowing by residents, as of 1 January 2001, capital inflows rose significantly, exerting pressure on Central Bank to abolish the "softer" narrow bands of ±2,25%, effective from 13 August 2001, so that only the ±15% margins are currently in place.

The decision to opt for more exchange rate flexibility was motivated by the apparent need for the Cypriot economy to have a different stance on monetary policy than the European Central Bank. For instance, in 2001 growth in Cyprus was significantly higher than in the euro zone. Even though inflation in Cyprus did not appear to be of concern during that year, the current account deficit remained at relatively high levels. This raised some concerns about the macroeconomic policy stance and, therefore, interest rates, despite their decline during the course of the year, remained – for a good reason -- significantly above those prevailing in the eurozone. The availability of market-

[11] The other two non-feasible options of a "hard" fixed exchange rate regime is the currency union (i.e., the joining of the euro zone) and euroisation (i.e., the official unilateral adoption of the euro as a legal currency).

based tools for monetary policy and the existence of a newly liberalised financial environment, which are instrumental in effectively and efficiently conducting monetary policy under an exchange rate regime with considerable flexibility, have certainly facilitated the undertaking of this decision. In addition, it should be noted that the widening of the exchange rate bands at ±15% also helps alleviate possible speculative pressures even though, theoretically, the risk still exists.

As stressed earlier, the challenges for exchange rate policy in Cyprus continue to be demanding. As a candidate country Cyprus will have to adopt the euro some time after accession. Until that time, that is, during the transition period, exchange rate policy in Cyprus will have to be conducted within the parameters determined by domestic economic conditions and EU requirements, as described above. The road ahead is certainly not easy, particularly in view of an increasingly globalised and liberalised economic environment.

As already mentioned, any judgement on the how the Cypriot authorities should or are likely to proceed in the future is avoided in this article. Speculation on the specifics of any possible exchange rate policy strategy decision also lies beyond the scope of this paper. Instead, the aim of the article is simply to illustrate the intricacies involved in conducting exchange rate policy in view of accession and elaborate on the factors that will determine the next steps for all candidate countries, in general, and for Cyprus, in particular. Implicitly, the article also draws attention to the fact that in order to better tackle exchange rate policy challenges, supportive policies need to be in place e.g. fiscal discipline and market-oriented reforms.

IV Concluding remarks

Within the context of the comprehensive reforms that are currently being undertaken in Cyprus, largely in light of the EU accession process, the exchange rate policy framework has recently experienced a number of changes. These changes largely pertain to the strategic design of the exchange rate policy, a design that has to be formulated within the framework of the EU accession process and in line with domestic conditions as well as against a background of a gradual relaxation of capital controls and potentially increasing capital flows.

The road ahead with respect to macroeconomic policy decision making, particularly exchange rate policy, is complex and intriguing and merits continuous and careful attention. The demanding challenges for exchange rate policy in Cyprus will persist in the near future, and perhaps even increase in a progressive way, particularly as the capital account liberalisation runs its course.

Cyprus is not alone in facing macroeconomic challenges associated with the transition to the currency union. All accession countries face similar challenges and in many aspects more difficult ones, as they also have to address simultaneously the serious issue of achieving real convergence with respect to the eurozone economy.

It is envisaged that Cyprus will remain committed to facing the exchange rate policy challenges in a determined and prudent way, safeguarding, at the same time, discipline in other areas of macroeconomic policy that need to be supportive of exchange rate policy, such as fiscal and monetary policies. Such a prudent approach sets the stage for the success of the overall efforts towards EU accession and the eventual adoption of the euro at the earliest possible time in an orderly and successful manner.

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