

Adoption by Cyprus of the single currency on 1 January 2008

2007/0090(CNS) - 16/05/2007 - Document attached to the procedure

Article 122(2) of the Treaty requires the Commission and the ECB to report to the Council at least once every two years, or at the request of a Member State with a derogation, on the progress made by the Member States in fulfilling their obligations regarding the achievement of economic and monetary union. This report has been prepared in response to the request of Cyprus, submitted on 13 February 2007. It contains a more detailed assessment of the state of convergence in Cyprus:

Price stability: the average inflation rate in Cyprus during the 12 months to March 2007 was 2.0%, below the reference value of 3.0%, and it is likely to remain below the reference value in the months ahead. Cyprus has traditionally enjoyed relatively low, although at times volatile, inflation, reflecting the sensitivity of its small and open economy to external price shocks. Moderate core inflation suggests that underlying inflationary pressures have remained limited, against the background of a negative output gap and moderate increases in unit labour costs (between 1 and 2% annually since 2004). Wage pressures in recent years, in the context of tightening labour market, were mitigated by an increasing share of foreign workers in the labour force and exemplary wage discipline in the public and private sectors. Inflation is expected to remain low in the coming months largely due to a favourable oil price base effect. Inflation performance over the medium term will, to a large extent, depend on the development of energy and other import prices and on the containment of possible wage and demand pressures in a context of strong cyclical conditions and interest rate and reserve requirement convergence.

Government budgetary position: the general government deficit peaked at 6.3% of GDP in 2003, but was reduced markedly in the following years, to 1.5% of GDP in 2006, following the implementation of a strong fiscal adjustment in 2004 and 2005. For 2007, the Commission services' Spring 2007 Forecast projects an almost unchanged deficit (1.4% of GDP). Government debt followed an upward trend between 2000 and 2004 but has been on a declining path since 2005. It decreased to 65.3% of GDP in 2006, and according to the Commission services' Spring 2007 Forecast, will continue to decline in 2007, reaching some 61.5% of GDP.

Exchange rate stability: the Cyprus pound has participated in ERM II since 2 May 2005, i.e. for 24 months at the time of adoption of this report. During the period of the assessment not covered by ERM II participation (27 April – 1 May 2005), the pound stayed close to the future central rate. Since ERM II entry, the pound has consistently traded in the upper half of the fluctuation band, close to the central rate, and it has not experienced severe tensions.

Long term interest rates: the average long-term interest rate in Cyprus in the year to March 2007 was 4.2%, below the reference value of 6.4%. Average long-term interest rates in Cyprus have been below the reference value since November 2005. Longterm interest rates in Cyprus have decreased substantially in the past few years as have spreads to the euro area. Low yield spreads vis-à-vis the euro area indicate that the residual country risk priced in by markets is limited.

Legal compatibility: all outstanding incompatibilities have been addressed in a Law amending the Central Bank of Cyprus Laws of 2002 and 2003 adopted by Parliament on 15 March 2007.

To conclude: in the light of its assessment on the fulfilment of the convergence criteria, the Commission considers that Cyprus has achieved a high degree of sustainable convergence.