

Cyprus



President: Demetris CHRISTOFIAS	Population (2007 est.): 778,684
Finance Minister: Charliaos STAVRAKIS	GDP (2007): €15.6 billion
Central Bank Gov.: Athanasios ORPHANIDES	GDP/capita: €19,900
	GDP by sector:
Joined the EU: 2004	Agriculture 2.7%
Adopted the Euro: 2008	Industry 19.2%
Currency prior to Euro: Cyprus Pound	Services 78%
	Life Expectancy (women / men): 82 / 79
	2005 2006 2007 2008*
Real GDP growth rate	3.9% 4.1% 4.4% 3.7%
Inflation	2.0% 2.2% 2.2% 4.5%
Unemployment Rate	5.3% 4.6% 4.0% 3.9%

* forecast

Cyprus in the EU and the Euro Area

Since Turkey occupied the north of the island in 1974, the Turkish Cypriot and Greek Cypriot communities have been separated by the so called Green Line. In this background information, and for the purposes of the Euro Challenge task, the term Cyprus refers only to the Greek Cypriot part, and it is this part alone that the analyses should focus on. No discussion is required with regard to the political tensions involved in the division of the country.

Cyprus joined the European Union on May 1, 2004. On 1 January 2008 it adopted the Euro, which will replace the Cyprus pound. The EU has long been Cyprus's major trading partner and EU membership has thus helped further boost its trading capacity. This is particularly important for Cyprus as its economy largely depends on trade and almost all products are imported from foreign producers, many of which are European. EU membership has also spurred growth in private consumption and investment, while inflation has slowed owing to a number of EU accession-related reforms.

Economic Overview of Cyprus

Cyprus is strategically located between three continents and this contributes to the prosperity of the country, in particular in regard to trade. Cyprus has recently made substantial progress in economic reform in preparation for EU accession and joining the Euro, all of which has resulted in the moderation of inflation problems and a sharp reduction in the fiscal deficit. Cyprus has a market economy dominated by the service sector, which accounts for 78% of GDP. Tourism, financial services, and real estate are the most important sectors. Erratic growth rates over the past decade reflect the economy's reliance on tourism, which often fluctuates with political instability in the region and economic conditions in Western Europe. Nevertheless, the economy

of Cyprus grew by an average of 3.6% per year between 2000 and 2006. Tourist receipts have recovered and the standard of living has significantly improved in past years.

However, like many of its neighbors, the maintenance of long term fiscal sustainability in Cyprus will depend on its ability to mitigate aging related pressures on public expenditure. In addition, further budgetary problems are expected to arise following the introduction of a new National Health Care system in 2008, while there are also issues to address in regard to falling export rates and housing inflation. In 2009, economic activity is foreseen to decelerate further and grow by almost 3%. GDP would continue being driven exclusively by domestic demand. Private consumption would still be robust supported by rising disposable income, which reflects sustained employment and wage growth.

Some Economic Challenges Facing Cyprus

International Competitiveness

External competitiveness is essential to the maintenance of Cypriot economic growth and the recent small fall in exports presents a moderate concern in this respect. Part of the problem relates to the recent wage setting policies. Although higher real wages have helped smooth labor relations, they have also led to increased costs of production, which have been passed on to consumers, leading to a decline in the international competitiveness of Cypriot products. Competitiveness could be largely restored through limiting further wage increases, in particular through a mechanism which tied real wage increases to productivity developments.

Aging Population

As the population ages, a declining portion will remain in employment, contributing to the tax base, while an increasing portion will enter retirement, drawing on pensions, all of which will ultimately prove financially unsustainable under the current system. Possible reforms would include amendments to the pension system, in particular with regard to social security benefits. Prompt action in this respect would allow a more gradual phasing in of reforms, thus making it easier for individuals to adapt savings plans in the long term.

Housing Inflation and Credit Risks

As credit became more widely available and house prices increased substantially, it is likely to lead to much greater levels of borrowing. Such a cycle carries the risk that too many borrowers will ultimately over-estimate their capacity to repay their loans, particularly once increases in house prices begin to abate, such as happened in the United States. As a consequence, increasing numbers of loans will begin to default with the result that credit will tighten, with spillover effects on the consumer spending and the wider economy. As consumption is forecasted to be in a declining trend and real estate markets show a first slow down, the effects become more challenging.