Box 5

THE EURO AREA FOLLOWING THE ENTRY OF CYPRUS AND MALTA

On 1 January 2008 Cyprus and Malta adopted the euro, leading to an increase in the number of euro area countries from 13 to 15. The irrevocable conversion rate between the Cypriot pound and the euro was set at CYP 0.585274 and between the Maltese lira and the euro at MTL 0.4293. These rates are identical to the central rates agreed on 2 May 2005, when the Cypriot and Maltese currencies entered the Exchange Rate Mechanism II (ERM II).

Cyprus and Malta are very small economies in comparison to the euro area. Consequently, the statistical and macroeconomic features of the euro area do not change significantly following the latest enlargement (see Table).

Key economic characteristics of the enlarged euro area

	Reporting period	Unit	Euro area excl. Cyprus and Malta	Euro area incl. Cyprus and Malta	Cyprus	Malta
Population and economic activity						
Total population [1]	2006	millions	317.4	318.5	0.8	0.4
GDP	2006	EUR billions	8436	8455	15	5
GDP per capita	2006	EUR thousands	26.6	26.5	19.0	12.5
GDP per capita (PPP)	2006	EU-13=100	100.0	99.5	85.3	68.6
GDP (share of world GDP) [2]	2006	%	14.7	14.7	0.0	0.0
Sectors of production [3]						
Agriculture, fishing, forestry	2006	% of total	1.8	1.8	3.0	2.9
Industry (including construction)	2006	% of total	26.6	26.5	19.7	23.2
Services (including non-market services)	2006	% of total	71.6	71.6	77.3	74.0
Monetary and financial indicators						
Credit to the private sector [4]	2006	% of GDP	126.6	126.6	130.7	116.5
Stock market capitalisation	2006	% of GDP	76.0	76.0	84.2	68.0
External trade						
Exports of goods and services [5]	2006	% of GDP	21.6	21.6	47.2	87.6
Imports of goods and services [5]	2006	% of GDP	20.9	20.9	51.3	91.4
Current account balance [5]	2006	% of GDP	-0.2	-0.2	-5.9	-6.7
Labour market						
Labour force participation rate [6]	2006	%	70.6	70.6	73.0	59.2
Unemployment rate	2006	%	8.2	8.2	4.6	7.3
Employment rate [6]	2006	%	64.6	64.6	69.6	54.8
General government						
Surplus (+) or deficit (-)	2006	% of GDP	-1.6	-1.6	-1.2	-2.5
Revenue	2006	% of GDP	45.6	45.6	42.6	41.6
Expenditure	2006	% of GDP	47.2	47.2	43.8	44.1
Gross debt outstanding	2006	% of GDP	68.6	68.6	65.2	64.7

Sources: Eurostat, IMF, European Commission, ECB and ECB calculations.
1) Annual average.
2) GDP shares are based on a purchasing power parity (PPP) valuation of country GDPs.
3) Based on real value added. Data for Cyprus and Malta refer to 2004.
4) Credit comprises loans and holdings of securities as well as holdings of shares and other equities.
5) Balance of payment data. Euro area data are compiled on the basis of transactions with residents of countries outside the euro area (i.e. excluding intra-euro area flows).
6) Share of the working age population (i.e. those aged between 15 and 64).

In terms of population, including the combined Cypriot and Maltese populations of 1.2 million, the euro area is one of the largest economies in the world, with a total population of 318 million in 2006.

Euro area GDP amounted to €8,436 billion in 2006, while the GDP in Cyprus and Malta was €15 and €5 billion, respectively. Thus, the combined GDP of these two countries accounts for about 0.2% of the GDP of the enlarged euro area. In 2006 the GDP per capita in PPP terms of Cyprus and Malta stood at 85% and 69% of the euro area average, respectively. In recent years, real GDP in Cyprus has grown faster than in the euro area, whereas Malta has made less progress in catching up.

The production structures of Cyprus and Malta are broadly similar to those of the euro area, although there are certain differences. In both countries, agriculture contributes more to the total value added than in the euro area. The share of services is higher in Cyprus, reflecting its relatively high dependence on tourism and financial services, while that of industry is lower. The financial sector in Malta is generally less developed than in the euro area, as reflected in the lower contribution of outstanding credit to the private sector and the lower level of stock market capitalisation as a share of GDP. In contrast, in Cyprus, both of these financial indicators are higher than in the euro area, reflecting the importance of the financial sector.

Both Cyprus and Malta are small and very open economies, which already traded extensively with the euro area and the European Union (EU) prior to adopting the euro. In 2006 the euro area countries accounted for 51.5% of Cyprus' imports and 29.6% of its exports, while they accounted for 51.0% of Malta's imports and 37.0% of its exports.

The labour markets in Cyprus and Malta differ from that of the euro area. The labour market in Cyprus is relatively flexible with a low unemployment rate, high labour participation and a high employment rate compared with the euro area. However, the labour market in Malta is characterised by low participation and a low employment rate. Since 2004, Cyprus and Malta have benefited from complete freedom of movement for persons within the EU, which has improved their capacity to absorb local shocks. Indeed, in recent years, both economies have been able to benefit from increased integration of foreign workers in their labour markets, which has helped to avoid bottlenecks in certain segments of the economy.

The general government deficits in Cyprus and Malta have declined in recent years, reaching 1.2% and 2.5% of GDP in 2006, respectively, compared with a deficit of 1.6% in the euro area. The ratio of general government debt to GDP is relatively close to that of the euro area (at around 65% of GDP in both countries).

For Cyprus and Malta, entry in the euro area means that the benefits of the Single Market are further enhanced by the single currency, which offers a credible framework for monetary policy and price stability in an environment that is characterised by the absence of exchange rate uncertainty. In order to fully reap the advantages of the euro and allow adjustment mechanisms to operate efficiently within the enlarged currency area, further efforts should be made with structural reform and appropriate policies should be implemented.

In the short term, following the euro changeover, the conversion of prices into euro should not provide an opportunity to raise prices in an unjustified manner, especially in a situation where food and energy prices are already exerting upward pressures on inflation in the euro area as a whole.

Looking further ahead, it will be important for the economies of Cyprus and Malta to continue on sustainable and credible paths of fiscal consolidation based on structural measures and to improve their fiscal performances by tangibly reducing their debt ratios. It will also be important to maintain moderate wage developments that take into account labour productivity growth, labour market conditions and developments in competitor countries. In Malta, attention must also be paid to overcoming the structural constraints on economic growth and job creation, notably by fostering labour participation. In both countries, the strengthening of competition in product markets and improvements in the functioning of the labour market are key elements in this regard. In Cyprus, for example, the indexation mechanisms for wages and some social benefits (cost of living allowances) should be overhauled in order to reduce risks associated with inflation inertia.

Such structural reforms will not only make the economies of Cyprus and Malta more resilient to shocks, but will also create the best conditions for sustainable economic expansion, employment growth and price stability.