Convergence and Reunification in Cyprus: Scope for a Virtuous Circle.

By Willem Noë* and Max Watson**

Summary

The issue of Cyprus reunification did not lapse with the No vote on the Annan plan in the Greek Cypriot community in April 2004. Reunification remains a central challenge – not only for political reasons but because economic convergence offers important gains for both the Greek Cypriot South and the Turkish Cypriot North. Productivity and income levels in the North are much lower than in the South. However, changing external circumstances, with the right policies, could trigger strong and sustained convergence, bridging the wide economic gap between the two communities. Given synergies and complementarities between North and South, the scope for a virtuous circle is clear: both would benefit from sustained convergence and reunification. To realize these gains, markets must function well, and a major contribution to this can be achieved through harmonization with the acquis communautaire in the North. After reunification, sound macroeconomic frameworks and institutions will also remain essential – not only to comply with EU commitments but to safeguard sustainable growth, avoiding risks of a transient boom. A key priority lies in the public finances, where there are both immediate and medium-term challenges. The North needs to press through modernization of the public sector – with the current private sector boom providing an ideal setting for reform. In the South, the key is the authorities’ strong commitment to fiscal consolidation – important in its own right, but also to prepare for adoption of the euro and to create room for the investment associated with convergence and reunification. Meanwhile, a comprehensive economic assessment of the reunification challenge can help foster a shared vision of mutual gains; translate this into policy blueprints; and define key needs for external assistance.

The South-North gap

After independence in 1960, Cyprus achieved rapid growth as a mainly agricultural economy, although there were already marked regional variations. At the time of the de facto division in 1974 – into a Greek Cypriot (G/C, or South) and a Turkish Cypriot (T/C, or North) community – per capita GDP in the North was about half that in the South. The discrepancy in labour productivity was even larger, with the level in the North estimated at slightly below 40% that in the South. During the following
two decades, the economy of the North moved from a largely agricultural base

The economy of the South: stable, developed and service-based

After 1974, the South achieved strong and stable growth. GDP rose on average by close to 5% over the period 1977-2000 as a modern, market-based economy emerged. Particularly from the mid-1980s it shifted from agriculture and light manufacturing toward an increasingly services-oriented structure, focusing on tourism and services such as trade (e.g. shipping) and financial sector activities (including an extensive 'offshore' sector). The financial system, notably banking, is highly developed. At the same time, rapidly growing tourism became a mainstay of the economy, accounting for about 20% of GDP in 2004, when the South received 2.3 million visitors. The private sector largely dominates the economy and the business climate is favourable (European Commission, 2002a). Over recent years the tertiary education sector has been expanding – with universities and other higher learning institutions established since 1990, and plans for further expansion.

The South broadly followed a market- and export-oriented development strategy, despite an industrial policy that often provided a protectionist and interventionist approach to industry and financial markets. Moreover, from the early 1990s liberalization increasingly took hold. This accelerated in the approach to EU membership, as the government opened up key sectors, including air transport, electricity, telecommunications and postal services.

This favourable growth experience owes much to policies, and especially to a long period of macroeconomic stability (Eichengreen et al., 2004). Inflation was contained, benefiting from a credible exchange rate anchor in the form of an exchange rate peg – from 1960 initially to a single currency (GBP, USD), then to a...
currency basket, and currently to the euro. The relatively flexible labour market has almost continuously been operating close to full employment, with unemployment generally varying between 3 and 5%. Labour market shortages and wage pressures were partly deflected by seasonal immigrant workers, with a foreign labour share steadily increasing over time to 12% of the gainfully employed labour force by 2003.

The macroeconomic policy picture is not unblemished, however. The single most challenging macroeconomic issue is to bring the bringing government deficits under control again. The South has a mixed record here, although recently progress has been made towards its target to reduce the deficit from a peak of 6.3% of GDP in 2003 to below 3% of GDP by 2005. This commitment, taken on in the convergence programme (CP) and updated CP in the framework of the Stability and Growth Pact, aims to maintain macroeconomic stability and prepare for introduction of the euro – and it would also help create a favourable basis for reunification.

The economy of the North: large scope for catch-up

As indicated by the persistent development gap over the last three decades, the North’s economic potential clearly has not yet been fully tapped, given its economic assets such as fertile agricultural land, exceptional beaches, major historical sites, extensive tourist accommodation, and key infrastructure (including a main port).

This disappointing performance has been attributed to a range of factors, including international non-recognition (Ayres, 2003) economic isolation, and limitations on direct trade with the EU since 1994 following a decision of the European Court of Justice on certification for products originating in Cyprus. However, Ugur (2003) stresses that the development gap had already widened well before 1994. A poor development strategy, thus, was also deemed a major contributory factor. From a policy perspective, this latter concern deserves special attention: even with an end to isolation it will require strong policies to trigger sustained convergence.

Key policy concerns have been that, while market-based, the economy relied substantially on the role of the public sector as producer and employer; was dependent on Turkish aid; and, through trade dependency and a common currency, was linked to the then-troubled Turkish economy. This exposed it to a series of economic crises in Turkey – reflected in unstable growth, high inflation, and sharp exchange rate fluctuations. Annual transfers from Turkey have been estimated at 10-30% of GDP – covering budget deficits averaging 17% of GDP for 2000-2003 as well as the need to compensate depositors in banks that failed during the 1999-2002 banking crisis. Aid dependence went hand-in-hand with the development of an extensive public sector (Ayres, 2003), which now directly provides one-fifth of total employment. Behind the low official unemployment rate (1.3% in 2003) there is, moreover, substantial hidden unemployment. Key structural policy weaknesses are familiar from many other countries: they include widespread public ownership; resort to price controls; low private and public investment (partly related to uncertainty and disputed ownership); a banking sector weakened by crisis; and bouts of instability.

Economic convergence could benefit hugely from both an end to economic isolation – arriving as rapidly as possible at a framework in which trade integration is effectively restored – and a forceful move to strengthen institutions and governance in directions suggested by Ugur and, more generally, Clague (1997), European Commission (2004a) and Rodrik et al. (2002). Given the right external setting and strong policies, the economic potential of the North is substantial. Developments in the past few years illustrate the scope for future progress. Following the economic and banking crisis of 1999-2001 and the recovery and stabilization in Turkey, growth in the economy has been picking up and reached 10-12% in 2003-2004, while inflation came down. The potential for export-oriented services is being developed. Universities in the North have become an important source of foreign earnings, attracting students from Turkey, Asia and the Middle East, generating around 15% of GDP. Tourism increased and accounts for a similar share of GDP but is still a fraction of its potential. The North received in 2003 470 thousand tourists (mainly from Turkey), or 20% of the 2.3 million arrivals in the South.

A strong economic upswing has been under way in the North. In addition to heavy property construction – stimulated in various ways by the discussions on reunification in 2004 – activity is also beginning to benefit from the partial opening of...
the border between North and South (the ‘Green Line’) since April 2003. This allowed some freedom of movement in trade and people – a first and very modest beginning of economic integration. For 2004 this has brought in an estimated €100 million (9% of GDP) through trade and tourism from the South but especially in labour income of North workers employed in the South, mainly in tourism and construction.

**Box: Reunification studies - costs and benefits**

Between 2002 and 2004 there was a proliferation of studies on economic aspects of reunification, based on provisions in the UN Annan Plan. Given the large development differences between the North and the South, the potential impact of reunification as a combined demand and supply shock on growth for the whole island could be very positive. Although all the studies focus primarily on costs, institutional frameworks and policy, they do provide some tentative estimates of growth effects, emphasizing that the results crucially depend on how the costs and complex institutional issues of reunification are managed.

Studies include:

1- Appendix III of the 2003 Pre-accession economic programme and of the convergence programme (Ministry of Finance of the Republic of Cyprus, 2003 and 2004). The reports, here taken together, note that reunification would create conditions for accelerated economic growth and new investment opportunities. GDP growth for a transition period of 5-10 years is estimated to fluctuate around 5.5% for the South and to rise to 7.5% for the North. The investment ratio in the South or G/C constituent state would increase from (only) 18.5% of GDP today up to 25% during that period, while for the North or T/C constituent state the investment ratio would increase from the current 17% of GDP to up to 30%. At the same time, there are risks on macroeconomic stability that include inflation, current account deficits, exchange rate pressures and fiscal discipline by the constituent states and federal government. Total reunification costs over the period are estimated at €27 billion or more than 2 times the combined 2003 GDP of Cyprus, requiring substantial financial (foreign) aid to help cover financing gaps. Reunification-related government expenditure is estimated at 4.5% to 7% of GDP annually for the whole of Cyprus during the transition period, mainly dealing with infrastructure investment and relocation costs, with a consolidated (federal plus North and South constituent states) government deficit jumping to 11% of GDP in the years following reunification, declining to 5.5% after three years.

2- The Economics of the Solution Based on the Annan Plan (Vassiliou, 2003). The study concludes that in the first years after reunification, annual growth rates could accelerate to 6% for the South and 8% for the North. The consolidated government deficit would be 6.1% of GDP in the first year and then fall to 4.1% of GDP after two years. Reconstruction costs are estimated at €6.1 billion or 46% of the total Cyprus GDP for 2004, while it concludes that property compensation operated by the Property Board (suggested by the Annan Plan to deal with property issues) will be largely self-financing. These and other estimated costs and the government deficits in the study (but not GDP growth numbers) have been criticized by the government as over-optimistic and thus much too low.

3- Economic Aspects of the Annan Plan for the Solution of the Cyprus Problem, (Eichengreen et al., 2004). Based on historical growth rates and referring to both upside and downside risks, the study provides a growth estimate for the South of 3.7% annually for a decade, while for the North it estimates an immediate boost in income of 12% upon reunification followed by an average (implied) growth rate of around 6% in later years.
Opportunities and challenges ahead

Against this background of wide differences in income, key challenges for policy-makers are to find practical approaches that stimulate convergence, and to work toward ending the economic isolation of the North, and – more broadly – to foster a shared economic vision that helps pave the way toward a final settlement.

The key economic issue for the South, as identified above, is to press forward with strong fiscal consolidation, laying a sound basis both for euro adoption and for the challenges of reunification. On the structural front, a main priority is to ensure that efficient market mechanisms and evolving skill levels foster a steady shift toward high value added activities. These goals are wholly congruent with convergence.

The gains from convergence, moreover, can be substantial in the South as well as the North. Although the two communities are specialized in similar sectors, there are significant synergies that can be realized – as well as complementarities in the market niches they can exploit. In tourism, the North can draw in new and repeat visitors who will in many cases spend periods in both communities, including in markets such as eco-tourism (which must not be jeopardized). In exporting educational services, the two communities can potentially exploit complementary regional catchments. Convergence in the North will offer a valuable market for the South; and companies based in the South (including overseas investors) would be among those contributing to, and benefiting from, accelerated development in the North. In the labour and other production factor markets, there are significant potential synergies.

Although numerous complex technical, legal and political problems remain both with intra-island trade restrictions and in direct trade with the EU, the current upturn in the North provides a valuable opportunity to address economic challenges and shorten transition periods under reunification. At the same time, a series of EU regulations with an aid package of €259 million for 2004-2006 proposed by the Commission, still in discussion in the Council, aim to integrate the North into the EU and end its economic isolation (European Commission, 2004b). With propitious reforms, this could contribute significantly to sustained economic catch-up.

Of course, experience across the EU confirms that economic catch-up is not automatic. It depends critically on macroeconomic and structural policy frameworks, including the role of institutions (European Commission 2004a). Convergence thus entails important challenges for policy in the North: policy frameworks need to be geared to the requirements for market-driven convergence. In all economies in transformation, the role of the private sector has been critical in accelerating growth, and in the North of Cyprus, with much lower levels of income and productivity, the motor of convergence lies very clearly in a rapid expansion of private sector activity. Returns to investment will potentially be high – and reunification, when the time is ripe, can raise those returns through improved trade and transport links and clarification of property rights. Convergence also entails a jump in private and public investment, which needs to be soundly financed.

The orchestration of macroeconomic and structural policies is thus a central challenge in managing convergence successfully.

- **Macroeconomic policies**: The public sector’s key role in this setting is as a facilitator of growth. The challenge in the North is to reform the public sector in ways that can re-target activities from consumption to investment, and also free resources to make way for the investment and labour force demands of strong private sector expansion. In the near term, the current phase of very rapid growth provides an ideal context in which to press on with public sector restructuring – including taxation and social security reform. With the perspective of reunification, the need for public sector reform is all the clearer. To buttress private sector confidence, as well as to achieve Stability and Growth Pact targets, policy-makers in both North and South will need to draw on experience elsewhere in crafting a solid fiscal framework for the combined economy. This will be a key challenge that must be met co-operatively and in a manner that is credible to markets. If reunification were to precede membership of the euro area, the discipline of the exchange rate peg would provide this. But experience in other euro area...
members illustrates that it is equally important to sustain fiscal consolidation durably once in the monetary union.

- **Key structural challenges:** The experience of German reunification (albeit in an entirely different political and economic setting, see European Commission (2002b) and Jansen (2004)) underscores a key lesson: that the battle for convergence is won or lost in the functioning of the labour market and the conditions for private investment (including property rights). The way in which benefit programmes are designed, how flexible wages prove, how legally secure private and public investments prove, how productively public transfers are used to restructure the economy: these are critical challenges. In the immediate future, the shadow adoption of the *acquis communautaire* in the North could help jump-start reforms and enhance compatibility. Higher levels of trade and labour movement across the Green Line, and an identification of acceptable confidence-building measures, could help carry forward convergence on the ground. Three issues stand out as structural priorities in the North: progress with components of the *acquis* that accelerate product market integration; a forceful programme to enhance the competitive working of markets, cutting back interventions that distort incentives; and further steps to ensure that the financial sector can play a full role in supporting broadly based growth.

Action along these lines could accelerate progress on the ground and help to build the conviction that the political and technical challenges of a final settlement will lead to a prize worth seizing. A decisive property settlement is a complex task, but could trigger profound benefits in terms of direct investment and collateralized bank financing. Securing the financing for adequate infrastructure in a unified island will not be easy, but it could unlock major gains for both communities. Public sector reform will be difficult to implement, but (with appropriate skill-building) it could help redirect labour supplies to sustain an extended private sector expansion; and it could help in targeting social support effectively – key considerations at a time of major population movements and a perhaps sizeable adjustment in relative prices.

These are areas in which concrete short-term progress and strategic preparation for the future could prove mutually reinforcing. In a setting of strong growth it will be easier to find a consensus to ensure that convergence and bi-zonality work hand-in-hand, exploiting economic complementarities; that the social dimension of a property solution is addressed harmoniously; and that priority investment needs are soundly financed. The European Commission has already taken initiatives referred to above which illustrate its potential to help support this process – working to enhance market access, aiding with key aspects of the *acquis communautaire*, and buttressing convergence through both financial support and technical assistance.

**Conclusions**

Economic convergence and reunification in Cyprus hold great promise from an economic as well as a political standpoint. This is a process that should unlock sustained and broadly based gains throughout the economy, benefiting both communities. A constructive way forward, building on the Annan Plan experience, is to focus on policies that will help trigger strong convergence – resulting in a sustained boost to growth, not just a short-lived boom. Putting convergence centre-stage, with its promise of mutual gains in both communities, could help move the dynamics of discussion away from downside risks and a zero-sum psychology. This is a demanding agenda, requiring careful preparation to craft workable solutions and set the stage for strong and sustained growth. If achieved, however, it promises to bridge gaps in understanding and foster a shared economic vision, bringing a final settlement of the Cyprus problem closer.
In passing it should be noted that the official data do not take into account a possibly sizeable unrecorded economy in the North, which in the mid-1990s was estimated at up to 70% of GDP (Biçak, 1996). Also, time series data on national income in the North are not available on an ESA 95 basis; this paper reproduces estimates published in other studies for the purposes of information and to illustrate broad trends.

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**Layout:** Vittorio Gargaro, Karl Gradinger, Johannes Kattevilder

**E-mail:** ECFIN-CountryFocus@cec.eu.int

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