Munich Personal RePEc Archive

An Anatomy of the Economy of the 'Turkish Republic of Nothern Cyprus' ("TRNC")

Theophanous, Andreas and Tirkides, Yiannis and Pelagidis, Theodore

2008

Online at https://mpra.ub.uni-muenchen.de/107005/
MPRA Paper No. 107005, posted 07 Apr 2021 01:29 UTC

Andreas Theophanous* **Yiannis Tirkides****
Theodore Pelagidis***

An Anatomy of the Economy of the 'Turkish Republic of Northern Cyprus' ("TRNC")

Abstract

Despite growth in recent years, the economy of the "TRNC" remains fragile and the sustainability of the convergence process without due reform and restructuring is questionable. For sustained investment and growth, far-reaching reforms are certainly required in the private and public sectors, in banking and finance and in the workings of a market economy. This paper presents an overview of the "TRNC" economy, develops the appropriate policy framework and sets clear strategic objectives for growth and efficiency.[1] An overall assessment is that growth and developmental objectives can be better met within the framework of a unified Cypriot economy, which is part of the European and international economy.

* University of Nicosia, 46 Makedonitissas Ave. P.O. Box 24005, CY-Nicosia, Cyprus. Tel.+357-22841600, E-mail: theophanous.a@unic.ac.cy
** University of Nicosia, 46 Makedonitissas Ave. P.O. Box 24005, CY-Nicosia, Cyprus. Tel.+357-22841600, E-mail: i.tirkides@cytanet.com.cy
*** University of Piraeus, 40 Karaoli and Dimitriou, GR-18532 Piraeus, Attica, Greece. Tel/Fax:+330-210-7216033, E-mail: pelagidi@unipi.gr
* *We would like to thank Alpay Durduran and M. Rasıh Keskiner for their valuable contribution to this paper.*
[1] This paper draws from the book A. Theophanous and Y. Tirkides (Eds), *Accession to the Eurozone and the Reunification of the Cyprus Economy*, Intercollege Press, Nicosia 2006 and especially from chapters I and VI.

1. Introduction

Ever since the Turkish invasion of 1974, the occupied northern part of Cyprus has remained almost totally dependent on Turkey economically as well as politically.[2] However, in the last few years and especially after April 23, 2003 the economy of the 'Turkish Republic of Northern Cyprus' ("TRNC") has been able to have more contacts with the outside world as well as more openings. We should be reminded that on April 23, 2003 the regime of the "TRNC" announced the unilateral partial lifting of obstacles to crossing the green line. This led to further changes. One week later the government of the Republic of Cyprus announced measures for the support of the Turkish Cypriots. One year later, with the results of the referenda, Turkey and the Turkish Cypriot leadership claimed the moral high ground and demanded what they describe as the "the end of the isolation of the Turkish Cypriots".[3]

Since 2004 there has also been an unprecedented usurpation of Greek-Cypriot properties in the northern part of Cyprus. At the same time, the role of Turkey in the "TRNC" continues to be dominant. Turkey controls all governmental and institutional agencies. The Turkish Lira became legal tender since the early years following the invasion effectively establishing a monetary union with Turkey, which meant that Turkey's economic and monetary problems would easily transfer to the "TRNC". As a result the economy of the "TRNC" suffered from problems of currency instability and high inflation during the 2000-2001 economic crisis in Turkey. Concomitantly, high interest rates choked long-term investments, which in turn limited the prospects and potential for economic growth.

---

[2] Ch. P. Ioannides, *In Turkey's Image: The Transformation of Occupied Cyprus into a Turkish Province*, Aristide D. Caratzas, New Rochelle NY 1991.

[3] The Turkish side supports that the Turkish Cypriots are subjected to an isolation by the Greek Cypriots. On the other hand, Greek Cypriots stress that they not only theoretically but also practically have supported the advancement of the standard of living of Turkish Cypriots as well as their reintegration in the Republic of Cyprus. To the extent that there is isolation this is an outcome of the occupation of the northern part of Cyprus by Turkey.

Economic activity in the northern part of Cyprus has accelerated following developments in relation to UN-sponsored efforts for a lasting solution and the failure of the Anan Plan in 2004. Resurgence in tourist and construction activity, post-2003, led to an acceleration of growth and a noticeable improvement in living standards. This was simultaneously associated with a reduction in the existing gap with the economy of the government-controlled area.[4]

However, the sustainability of this process would require well-designed macroeconomic and financial policies, a restructuring of the private and public sectors as well as substantial assistance from outside sources. In the absence of such steps the current economic boom may not be sustainable.

There is no doubt that the northern part of the island holds vast economic potential under the right set of circumstances. A combination of policies toward harmonization with the *European acquis* and further economic integration of the northern part with the government-controlled areas, and by extension with the EU, will open up enormous possibilities. Without political normalization on the island, however, there are limits to the degree of economic expansion that can materialize in the northern part.[5]

In order to embark on a sustained path toward economic convergence in living standards with the government-controlled areas it is necessary to create the right macroeconomic and financial environment that will in turn foster the efficient operation of the market economy.[6] The ability to attract and sustain direct investments both from the government-controlled areas and elsewhere, including

---

[4] According to the President of the Turkish-Cypriot Chamber of Commerce the ratio of income per capita in the northern part in 2006 was 1:2. See Conference Proceedings, F. Mullen (Ed.) "Economic Perspectives in Cyprus: the path towards Reunification", PRIO Cyprus Center, 2007, p. 18 22 November 2006.

[5] Such normalization is hard to imagine, in the near term at least. This is because for a comprehensive settlement the consent of Turkey is required. With EU-Turkish relations not precisely defined, drastic developments on the Cyprus question are not the most probable outcome in the near future.

[6] For an in-depth discussion of the macroeconomic and financial framework for sustained growth in the "TRNC" and issues of policy coordination see M. Watson, and V. Herzberg, Wolfson Cyprus Group Conference, "Sustainable Economic Development in Cyprus: Towards Economic Convergence and Reunification – The Case of the Northern Part of Cyprus (Macroecononomic and Financial Frameworks)", May 2005, pp. 1-21.

the EU, is critical. In this regard, and given the synergies that exist with the economy in the government-controlled areas, it is hard for the Greek Cypriots to envision the development of the northern part to their exclusion through political means.

The improvement in the monetary landscape in Turkey in recent years had spillover effects in the "TRNC". The stabilization of the Turkish Lira and falling interest rates meant that the monetary environment in the northern part of Cyprus had also improved considerably with positive implications for economic activity.

It is important to stress that developments since the partial lifting of obstacles to free movement on April 23, 2003 as well as accession of the Republic of Cyprus to the EU had a major economic impact. Thousands of Greek Cypriots have been visiting the northern part of Cyprus as well as a growing number of tourists. This proved to have provided a major boost to the Turkish Cypriot economy. Moreover, by the end of 2005, more than 10,000 Turkish Cypriots were employed either on a fulltime or part-time basis in the area under the control of the Republic of Cyprus.[7]

2. Economic Overview and Current Position

A narrow economic base, a large "public sector", unstable monetary conditions and widespread corruption were the main causes of poor economic performance in the "TRNC" for a considerable period of time. Whilst structural problems continue to persist -and need to be addressed properly for sustainable development-economic activity after April 2003 has been unprecedented and living conditions have improved considerably as a result. Between 2001 and 2005, for instance, GDP in constant prices increased by more than 50%. At the

[7] See Ministry of Finance of the Republic of Cyprus, *The Economy in the Occupied Part of Cyprus: An Assessment*, Nicosia, June 2006 and W. Noë and M. Watson, "Convergence and Reunification in Cyprus: Scope for a Virtuous Circle", *ECFIN Country Focus*, vol. 2, no. 3, 2005, pp. 1-7.

same time, per capita income in current prices expressed in US dollars, more than doubled, rising by 145%. The unemployment rate, based on official statistics, remained low whilst inflation dropped dramatically from 77% in 2001 to 2.7% in 2005 (Table 1).

Table 1 – Main Economic Indicators

	1980	1990	2000	2001	2003	2005
GNP (1977 Prices Million TL)	4,248.4	6,977.4	9,037.9	8,545.9	10,177.1	13,327.0
% change on previous year	0.9	5.7	-0.6	-5.4	11.4	13.5
Base 1977=100	111.5	183.1	237.2	224.3	267.1	349.7
Base 2001=100	------	------	------	100.0	119.1	155.9
GNP (Million $)	233.6	591.0	1,039.9	908.8	1,283.7	2,327.8
% change on previous year	1.1	38.9	7.9	-12.6	36.4	31.9
Base 1977=100	111.6	282.2	496.6	434.0	613.0	1,111.7
GNP Per Capita ($)	1,561.0	3,447.0	4,978.0	4,303.0	5,949.0	10,567.0
% change on previous year	0.3	37.2	6.7	-13.6	34.9	30.5
Base 1977=100	108.1	238.7	344.7	298.0	412.0	731.8
Base 2001=100	------	------	------	100.0	138.3	245.6
GNP pr capita in constant TL	28,396.5	40,691.9	43,267.1	40,465.3	47,162.1	60,497.8
% change on previous year	0.2	4.3	-1.7	-6.5	10.2	12.4
Base 1977=100	108.1	154.8	164.6	154.0	179.5	230.2
Base 2001=100	------	------	------	100.0	116.5	149.5
Inflation Rate (%)	93.0	69.4	53.2	76.8	12.6	2.7
Budget Deficit (Million $)	20.9	31.9	136.7	146.1	176.9	185.3
as % of GNP (in $)	8.9	5.4	13.1	16.1	13.8	8.0
Net Tourism Revenues (Million $)	24.0	224.8	198.3	93.7	178.8	328.8
as % of GNP (in $)	10.3	38.0	19.1	10.3	13.9	14.1
Base 1977=100	79.5	744.4	656.6	310.3	592.1	1,088.7
Number of Unemployed	1,789.0	849.0	1,166.0	1,500.0	1,375.0	1,090.0
Foreign Trade Balance (Million $)	-49.9	-316.0	-374.5	-237.4	-427.0	-1,187.4
as % of GNP (in $)	-21.4	-53.5	-36.0	-26.1	-33.3	-51.0
Export / Import(%)	47.1	17.2	11.9	12.7	10.6	5.4

Source: State Planning Organization, "TRNC"/own calculations.

Real growth was negative in 2000 and 2001 as a result of sharp declines in tourist activity and revenues. Growth recovered in 2002 and accelerated sharply in 2003-2005 amidst political developments that provided the biggest opportunity for a solution to the Cyprus problem as well as by the post-April 23, 2003 events. Specifically, GNP in constant 1977 prices in TL (Turkish Lira) rose by 11.4% in 2003, by 15.5% in 2004 and by 13.5% in 2005. Similarly, tourist activity recovered in 2002 in dollar revenue terms and accelerated sharply in 2003-2005. Much of the impetus to growth since 2003 came from tourist activity, from

investments in tourist and residential construction and considerable contributions from direct and indirect linkages with the government-controlled area.

Per capita income remained fairly stable for a number of years in nominal dollar terms and rose to about US$5,949 in 2003 compared with about $20,000 in the government controlled area of the Republic of Cyprus. Per capita income in nominal dollars spiked upwards in the subsequent period almost doubling by 2005 to $10,567. In 2005 the respective per capita income in the government controlled area of the Republic of Cyprus was about $23,000. Recent increases notwithstanding, per capita income remains considerably lower compared to that in the government-controlled areas.

Inflation had been high and fluctuating for a considerable period of time but dropped steeply in the period 2002-2005. Specifically, price inflation dropped to 2.7% in 2005 from about 77% in 2001 reflecting largely stabilizing developments in Turkey following the financial crisis in 2000/2001 (Table 1). The implementation of the IMF stabilization programme in Turkey had been successful in reining in inflationary pressures, lowering interest rates and encouraging foreign direct investments. The currency stabilized as a result. These developments were also reflected in relevant variables in the economy of the "TRNC". But whilst inflation had dropped sharply, real interest rates remain high.

The budget deficit remains considerably high as a percentage of GNP, having reached 24% in 2002 before dropping to 14% in 2003 and 8% in 2005. At the same time the trade balance shows high and sustained deficits that usually are in excess of 30% of dollar GNP (Table 1). Invisible receipts, capital movements and foreign aid and loans from Turkey finance the trade shortfall.

Developments post 2003, have been spectacular but volatility remains an issue and it is still early to consider the environment as stable. Institutional weakness, limited trade openness, a large public sector and underdeveloped financial

markets only compound the problem. Below we undertake a more detailed analysis.

3. Sector Developments and the Structure of the Economy

Growth in recent years has been universal with only few exceptions; mainly in the stagnating financial sector. Contribution to growth was particularly strong in construction, trade, and business and professional services. Linkages with the economy of the government-controlled areas provided additional impetus.

From a longer-term perspective economic activity gradually shifted away from agriculture and manufacturing toward services, particularly trade and tourism, transport and communication, and business and personal services. Public services remain an important contributory sector to overall economic activity but their importance has been declining in recent years as the private sector was growing more vigorously. It is also important to note that the tertiary education, which is not separately recorded in GNP statistics, remains an important growth area as we discuss in the balance of payments section further below.[8]

The current output structure of the economy and evolution over time is summarised in Tables 2 – 4 below. We discuss, highlighting the main trends and developments.

[8] W. Noë and M. Watson, "Convergence and Reunification in Cyprus: Scope for a Virtuous Circle", op. cit., p. 3.

Table 2 – Sector Developments Constant prices of 1977 (TL m)

	2000	2001	2002	2003	2004	2005	2006P
Primary sectors	**713.5**	**828.4**	**985.3**	**1,057.5**	**1,147.2**	**1,179.5**	**1,177.9**
Agriculture	**619.7**	**770.7**	**921.3**	**989.7**	**1,069.4**	**1,081.3**	**1,083.0**
Crop Production	336.5	442.4	577.5	601.0	657.4	618.1	596.6
Livestock Production	283.2	328.3	343.8	388.7	412.0	463.2	486.4
Forestry	42.9	12.7	15.7	13.1	26.1	31.1	30.4
Fishing	50.9	45.0	48.3	54.7	51.7	67.1	64.5
Industry	**1,937.4**	**1,694.6**	**1,851.9**	**2,174.0**	**2,351.3**	**2,635.7**	**3,162.8**
Quarrying	31.2	27.0	29.0	36.1	39.2	43.5	52.7
Manufacturing	884.0	822.8	869.6	932.9	1,028.0	1,080.9	1,136.3
Electricity - Water	180.8	175.2	177.3	190.0	215.2	240.3	255.7
Construction	**841.4**	**669.6**	**776.0**	**1,015.0**	**1,068.9**	**1,271.0**	**1,718.1**
Services	**5,762.8**	**5,526.5**	**5,706.1**	**6,076.8**	**6,899.6**	**7,847.9**	**8,341.1**
Trade - Tourism	**1,474.6**	**1,246.4**	**1,420.0**	**1,597.9**	**2,004.8**	**2,420.9**	**2,476.3**
Wholesale and Retail Trade	1,186.4	991.8	1,110.5	1,272.9	1,618.5	2,021.9	2,132.4
Hotels and Restaurants	288.2	254.6	309.5	325.0	386.3	399.0	343.9
Transport and Communication	1,113.6	1,108.2	1,149.4	1,197.9	1,303.3	1,487.8	1,558.5
Financial Institutions	529.6	434.3	390.3	416.3	414.9	432.4	445.0
Ownership and Dwellings	461.7	475.8	485.1	496.8	508.9	526.0	549.4
Business and Personal Services	700.0	800.1	807.0	853.3	1,074.9	1,280.0	1,504.1
Public Services	1,483.3	1,461.7	1,454.3	1,514.6	1,592.8	1,700.8	1,807.8
Total industry output	**8,413.7**	**8,049.5**	**8,543.3**	**9,308.3**	**10,398.1**	**11,663.1**	**12,681.8**
Import Duties	604.5	486.2	519.0	710.5	1,043.2	1,353.1	1,355.6
GDP	**9,018.2**	**8,535.7**	**9,062.3**	**10,018.8**	**11,441.3**	**13,016.2**	**14,037.4**
Net Factor Income from Abroad	19.7	10.2	70.8	158.3	298.3	310.8	326.5
GNP	**9,037.9**	**8,545.9**	**9,133.1**	**10,177.1**	**11,739.6**	**13,327.0**	**14,364.0**

Source: State Planning Organization "TRNC"

Table 3 – Sector Developments in real growth index

	Base: 1977=100		Base: 2000=100				
	2000	2005	2002	2003	2004	2005	2006P
Primary sectors	**115.2**	**190.5**	**138.1**	**148.2**	**160.8**	**165.3**	**165.1**
Agriculture	**104.3**	**182.0**	**148.7**	**159.7**	**172.6**	**174.5**	**174.8**
Crop Production	74.2	136.2	171.6	178.6	195.4	183.7	177.3
Livestock Production	201.9	330.1	121.4	137.3	145.5	163.6	171.8
Forestry	1,021.4	740.5	36.6	30.5	60.8	72.5	70.9
Fishing	242.4	319.5	94.9	107.5	101.6	131.8	126.7
Industry	**373.9**	**508.7**	**95.6**	**112.2**	**121.4**	**136.0**	**163.2**
Quarrying	350.6	488.8	92.9	115.7	125.6	139.4	168.9
Manufacturing	278.7	340.8	98.4	105.5	116.3	122.3	128.5
Electricity - Water	463.6	616.2	98.1	105.1	119.0	132.9	141.4
Construction	**549.9**	**830.7**	**92.2**	**120.6**	**127.0**	**151.1**	**204.2**
Services	**239.1**	**325.7**	**99.0**	**105.4**	**119.7**	**136.2**	**144.7**
Trade - Tourism	184.1	302.2	96.3	108.4	136.0	164.2	167.9
Wholesale and Retail Trade	169.2	288.3	93.6	107.3	136.4	170.4	179.7
Hotels and Restaurants	289.1	400.2	107.4	112.8	134.0	138.4	119.3
Transport and Communication	432.6	578.0	103.2	107.6	117.0	133.6	140.0
Financial Institutions	458.9	374.7	73.7	78.6	78.3	81.6	84.0
Ownership and Dwellings	129.9	148.0	105.1	107.6	110.2	113.9	119.0
Business and Personal Services	546.4	999.2	115.3	121.9	153.6	182.9	214.9
Public Services	197.1	226.0	98.0	102.1	107.4	114.7	121.9
Total industry output	**237.2**	**328.8**	**101.5**	**110.6**	**123.6**	**138.6**	**150.7**
GDP	**238.9**	**344.8**	**100.5**	**111.1**	**126.9**	**144.3**	**155.7**
GNP	**237.2**	**349.7**	**101.1**	**112.6**	**129.9**	**147.5**	**158.9**

Source: State Planning Organization "TRNC"/own calculations

Table 4 – Distribution of sector output in total (constant prices)

	1980	1990	2000	2003	2004	2005	2006P
Primary sectors	**19.0**	**9.9**	**8.5**	**11.4**	**11.0**	**10.1**	**9.3**
Agriculture	**18.4**	**9.2**	**7.4**	**10.6**	**10.3**	**9.3**	**8.5**
Crop Production	14.5	6.3	4.0	6.5	6.3	5.3	4.7
Livestock Production	4.0	2.9	3.4	4.2	4.0	4.0	3.8
Forestry	0.0	0.1	0.5	0.1	0.3	0.3	0.2
Fishing	0.5	0.7	0.6	0.6	0.5	0.6	0.5
Industry	**18.2**	**22.6**	**23.0**	**23.4**	**22.6**	**22.6**	**24.9**
Quarrying	0.2	0.4	0.4	0.4	0.4	0.4	0.4
Manufacturing	13.4	12.5	10.5	10.0	9.9	9.3	9.0
Electricity - Water	1.3	1.8	2.1	2.0	2.1	2.1	2.0
Construction	**3.3**	**7.9**	**10.0**	**10.9**	**10.3**	**10.9**	**13.5**
Services	**62.8**	**67.5**	**68.5**	**65.3**	**66.4**	**67.3**	**65.8**
Trade - Tourism	18.8	20.7	17.5	17.2	19.3	20.8	19.5
Wholesale and Retail Trade	16.0	18.2	14.1	13.7	15.6	17.3	16.8
Hotels and Restaurants	2.8	2.5	3.4	3.5	3.7	3.4	2.7
Transport and Communication	6.9	12.3	13.2	12.9	12.5	12.8	12.3
Financial Institutions	3.7	4.8	6.3	4.5	4.0	3.7	3.5
Ownership and Dwellings	7.9	5.9	5.5	5.3	4.9	4.5	4.3
Business and Personal Services	3.7	4.0	8.3	9.2	10.3	11.0	11.9
Public Services	21.8	19.8	17.6	16.3	15.3	14.6	14.3
Total industry output	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: State Planning Organization "TRNC"/own calculations

Table 2 records value added statistics by sector of economic activity in Gross National Product in constant prices of 1977. Table 3 constructs real growth indices taking 1977 and 2000 as alternative base years. Table 4 computes distribution ratios of sector output in total industry output in constant prices. These statistics in combination provide useful insights into the current situation.

The share of agriculture in total industry output declined from 18.4% in 1980 to 8.5% in 2006. This was due mostly to a relative decline of crop production, which accounted for 4.7% of industry output in 2006 compared with 14.5% in 1980. Even though growth of agricultural production increased by 75% since 2000, the relative contribution to GDP growth dropped significantly in the period. Evidently this was due to the relative growth of other sectors of the economy.

Likewise, manufacturing also suffered a relative decline in terms of its contribution to growth. Specifically, the share of manufacturing in total industry

output declined from 13.4% in 1980 to 9% in 2006. Manufacturing output increased modestly in the period after 2000.

In total the share of primary and industry output excluding construction, declined from 33.9% in 1980 to 20.7% in 2006. Whilst there has been a steep decline in relative terms, the corresponding contribution to growth remains considerable. In contrast the growth contribution of construction activity and services increased considerably.

Construction value added more than doubled since 2000 and was particularly strong in recent years rising by 35% in 2006 alone. As a result the corresponding share in output rose from 3.3% in 1980 to 13.5% in 2006 constituting the most important source of growth in GDP. Specifically, about half of the growth in the year emanated from construction activity.[9]

Services in total registered a growth of 45% between 2000 and 2006 whilst their respective share in total industry output rose from 62.8% in 1980 to 65.8% in 2006. Growth was particularly strong in trade, business and personal services, and transport and communication.

Value added in wholesale and retail trade rose by 80% between 2000 and 2006 where it had lagged considerably other sectors in the period prior to 2000. The corresponding share in total industry output dropped from 18.2% in 1990 to 13.7% in 2003 and rose to 16.8% in 2006.

Value added in business and personal services, which include education, was an area of considerable growth throughout the period after the invasion. Sector value added more than doubled between 2000 and 2006 after having risen by more than 5 times in real terms between 1977 and 2000. Likewise the

[9] Sector contribution to GDP growth is calculated as sector growth times the previous year's output share of the particular sector, in this case construction activity.

corresponding share in total industry output rose from 3.7% in 1980 to 11.9% in 2006 accounting for about a quarter of GDP growth in the same year (Tables 3 and 4).

Value added in transport and communication rose by 40% between 2000 and 2006 after rising by more than four times between 1977 and 2000. The corresponding share in total industry output rose from 6.9% in 1980 to 12.3% in 2006. However, contribution to growth has been modest in recent years since sector growth was relatively modest in comparison with the major growth sectors (Tables 3 and 4).

Tourism as measured by value added in hotels and restaurants picked up in 2004-2005 as a result of increasing arrivals and related revenues but declined considerably in 2006. In total, sector value added almost tripled between 1977 and 2000 but grew by a modest 20% between 2000 and 2006. Sector value added dropped by more than 13% in 2006 and the respective contribution to growth turned negative following two years of rapid advance. Tourism remains a relatively small and volatile sector in the "TRNC". However, whilst the share of hotels and restaurants in total industry output remains low accounting for 2.7% in 2006, the importance of tourism in general is far greater. Net tourist revenues represented 14% of GNP in 2005 (Table 1).

The financial sector has been mired in considerable problems in the late 1990s and it is only in the more recent years that it has started to stabilize. Whilst the financial sector had risen by almost five times between 1977 and 2000, growth has been negative for a considerable part in the latter half of the 1990s and early part of the 2000s. Value added declined by more than 20% between 2000 and 2004 before rising modestly in 2005 and 2006. The corresponding share in total industry output dropped from 6.3% in 2000 to 3.5% in 2006 (Tables 3 and 4). The Turkish-Cypriot regime, offered incentives to foreign companies to locate in

the "TRNC" on an offshore basis;[10] the offshore company law was passed in 1993 and in the period that followed to 1999, offshore activity was brisk. High interest rates and lack of adequate regulatory supervision culminated in the banking crisis of 1999.

Irrespective of the positive growth pattern in the last few years, economic activity in the northern part of Cyprus will in the long run depend on sustained openness and linkages with the economy of the government-controlled area and the rest of the world.

4. Employment and Population Changes

Population in the "TRNC", has been growing steadily and any emigration that was taking place was more than counterbalanced by immigration from Turkey. Despite considerable emigration of Turkish Cypriots the total population has been increasing since the invasion resulting in a fundamental demographic transformation. It also seems that increasing employment of Turkish Cypriots in the government controlled area leads to further immigration from Turkey.

[10] It should be noted that given the status of the "TRNC", the relevant legal framework was extremely weak. This was one of the reasons for the financial crisis as well as for the money laundering activities that are systematically reported.

Table 5 – Population and the Labor Market

	1980	1990	2000	2002	2003	2004	2005
Employment	52,531.0	71,525.0	89,327.0	93,114.0	98,860.0	104,873.0	109,090.0
% change on previous year	7.4	2.1	2.1	3.0	6.2	6.1	4.0
Base 1977=100	117.3	159.7	199.4	207.9	220.7	234.1	243.5
Base 2000=100	0.0	0.0	100.0	104.2	110.7	117.4	122.1
Number of Unemployed	1,789.0	849.0	1,166.0	1,535.0	1,375.0	1,814.0	1,090.0
Unemployment Rate (%)	3.3	1.2	1.3	1.6	1.4	1.7	1.0
Labor force	54,320.0	72,374.0	90,493.0	94,649.0	100,235.0	106,687.0	110,180.0
% change on previous year	6.6	2.2	2.3	3.0	5.9	6.4	3.3
Base 1977=100	117.7	156.9	196.2	205.2	217.3	231.3	238.8
Base 2000=100	0.0	0.0	100.0	104.6	110.8	117.9	121.8
Unemployment rate	3.3	1.2	1.3	1.6	1.4	1.7	1.0
Population	149,610.0	171,469.0	208,886.0	213,491.0	215,790.0	218,066.0	220,289.0
Annual Population Growth (%)	0.7	1.3	1.1	1.1	1.1	1.1	1.0
Base 1977=100	103.2	118.3	144.1	147.2	148.8	150.4	151.9
Base 2000=100	0.0	0.0	100.0	102.2	103.3	104.4	105.5

Source: State Planning Organization "TRNC"/own calculations

The level of employment and the size of the labor force have grown in tandem throughout the period following the Turkish invasion. Considering the base indices for population, the labor force, and the level of employment in the economy it follows that population growth lagged behind rising by 52% since 1977 compared with 143% and 138% respectively for the employment level and the labor force (Table 5). Whilst population has been growing mainly through net immigration, the labor force has been growing also through increases in the labor participation rate.

There is also a growing body of illegal workers in the "TRNC" as evidenced in a declining number of elementary school pupils. Whereas the number of elementary school pupils was 17,963 in 1987, their numbers declined to 15,635 in 2000 and to 15,482 in 2002.[11] These figures are evidence that the stable part of the population who have families and have settled in the "TRNC" are only a part of the whole population which suggests a growing body of illegal workers. These people remain unaccounted for until the next a census as it happened in fact in 2000 and 2006.[12]

However, the problem is not only with illegal workers. Big businesses from Turkey have also established operations in the "TRNC". Most of the casinos now in operation belong to Turkish mainland interests. Economically, gambling casinos contribute very little because they operate in such a manner that the money involved either never comes to Cyprus from Turkey or any that does is immediately transferred back to Turkey.

Considering employment by sector of economic activity a number of interesting results are noted. Agriculture for instance has been the only declining sector in terms of employment volumes. Whereas agricultural employment comprised 38% of total employment in 1980, the respective employment share declined to 11% by 2006. Employment in agriculture declined in absolute terms falling to an index level of 69.5 in 2005 from 100 in 1977. These changes have been in line with the changing structure of the economy in the same period (Tables 7 and 8).

---

[11] A. Theophanous and Y. Tirkides, "The Cyprus Economy in Perspective: an Analysis of Growth and Structure" in A. Theophanous and Y. Tirkides, *Accession to the Eurozone and the Reunification of the Cyprus Economy*, pp. 70-73.

[12] Ibid. Furthermore, see S. Bahcheli, "Census reveals soaring population in north", *The Cyprus Mail*, 7 May 2006.

Table 6 – Employment by sector of economic activity

	2000	2001	2002	2003	2004	2005	2006P
Agriculture	15,236	14,931	14,632	14,339	13,765	13,077	12,423
Industry	22,819	22,819	24,677	28,667	29,798	31,008	33,179
Quarrying	1,105	1,105	1,146	1,287	1,343	1,417	1,567
Manufacturing	6,234	6,234	6,364	6,534	6,777	6,903	7,031
Electricity – Water	1,376	1,376	1,381	1,413	1,473	1,528	1,559
Construction	14,104	14,104	15,786	19,433	20,205	21,160	23,022
Services	51,272	52,616	53,805	55,854	61,310	65,005	67,797
Trade – Tourism	9,630	9,630	10,520	11,088	12,505	13,474	13,683
Wholesale and Retail Trade	6,000	6,000	6,325	6,742	7,568	8,420	8,629
Hotels and Restaurants	3,630	3,630	4,195	4,346	4,937	5,054	5,054
Transport and Communication	8,104	8,104	8,310	8,550	9,067	9,952	10,280
Financial Institutions	2,397	2,397	2,397	2,509	2,509	2,583	2,635
Business and Personal Services	13,057	14,401	14,494	15,089	17,914	18,735	20,019
Public Services	18,084	18,084	18,084	18,618	19,315	20,261	21,180
Total Employment	89,327	90,366	93,114	98,860	104,873	109,090	113,399

Source: State Planning Organization "TRNC"
P = provisional

Table 7 – Employment by sector of economic activity: index

	Base: 1977=100		Base: 2000=100				
	2000	2005	2002	2003	2004	2005	2006P
Agriculture	**81.0**	**69.5**	**96.0**	**94.1**	**90.3**	**85.8**	**81.5**
Industry	**317.9**	**432.0**	**108.1**	**125.6**	**130.6**	**135.9**	**145.4**
Quarrying	222.3	285.1	103.7	116.5	121.5	128.2	141.8
Manufacturing	174.5	193.3	102.1	104.8	108.7	110.7	112.8
Electricity – Water	183.7	204.0	100.4	102.7	107.0	111.0	113.3
Construction	**597.6**	**896.6**	**111.9**	**137.8**	**143.3**	**150.0**	**163.2**
Services	**272.7**	**345.8**	**104.9**	**108.9**	**119.6**	**126.8**	**132.2**
Trade – Tourism	313.0	437.9	109.2	115.1	129.9	139.9	142.1
Wholesale and Retail Trade	n.a.	n.a.	105.4	112.4	126.1	140.3	143.8
Hotels and Restaurants	n.a.	n.a.	115.6	119.7	136.0	139.2	139.2
Transport and Communication	440.9	541.5	102.5	105.5	111.9	122.8	126.9
Financial Institutions	296.3	319.3	100.0	104.7	104.7	107.8	109.9
Business and Personal Services	n.a.	n.a.	111.0	115.6	137.2	143.5	153.3
Public Services	138.3	154.9	100.0	103.0	106.8	112.0	117.1
Total Employment	**199.4**	**243.5**	**104.2**	**110.7**	**117.4**	**122.1**	**126.9**

Source: State Planning Organization "TRNC"/own calculations

Table 8 – Distribution of Employment by sector of economic activity

	1980	1990	2000	2003	2004	2005	2006P
Agriculture	38.1	26.7	17.1	14.5	13.1	12.0	11.0
Industry	16.6	21.6	25.5	29.0	28.4	28.4	29.3
Quarrying	1.1	1.3	1.2	1.3	1.3	1.3	1.4
Manufacturing	7.6	8.3	7.0	6.6	6.5	6.3	6.2
Electricity – Water	1.7	1.7	1.5	1.4	1.4	1.4	1.4
Construction	6.2	10.4	15.8	19.7	19.3	19.4	20.3
Services	45.2	51.7	57.4	56.5	58.5	59.6	59.8
Trade – Tourism	7.5	9.7	10.8	11.2	11.9	12.4	12.1
Wholesale and Retail Trade	0.0	7.2	6.7	6.8	7.2	7.7	7.6
Hotels and Restaurants	0.0	2.5	4.1	4.4	4.7	4.6	4.5
Transport and Communication	5.4	8.0	9.1	8.6	8.6	9.1	9.1
Financial Institutions	2.3	2.8	2.7	2.5	2.4	2.4	2.3
Business and Personal Services	0.0	8.8	14.6	15.3	17.1	17.2	17.7
Public Services	30.0	22.3	20.2	18.8	18.4	18.6	18.7
Total Employment	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: State Planning Organization "TRNC"/own calculations

As already discussed manufacturing activity has been lagging; this is also reflected in the employment figures. The volume of employment in the manufacturing sector increased by 12.8% between 2000 and 2006 whilst the share in total employment dropped from 7.6% in 1980 to 6.2% in 2006 (Tables 7 and 8).

Labor absorption has been concentrated primarily in the growth sectors of construction, trade and tourism and business and personal services. Specifically, employment in the construction sector increased by 63% between 2000 and 2006 whilst the corresponding share in total employment rose from 6.7% in 1980 to 20.3% in 2006. Trade and Tourism increased their corresponding volume of employment by 42% in the same period whilst their share in total employment rose from 7.5% in 1980 to 12.1% in 2006. Likewise in the business and personal services, the level of employment rose by 53% between 2000 and 2006 with the corresponding share in total employment rising to 17.7% in 2006 from 7.3% in 1980 (Tables 7 and 8).

According to official statistics the "public services" sector stagnated in recent years. The corresponding share in total employment dropped from 22.7% in 1983 to 18.7% in 2006. At the same time the volume of employment increased by 12% between 2000 and 2006 compared with a corresponding increase of 27% for total employment.[13]

Before the recent census of April 2006 the Turkish settlers, according to estimates, numbered in excess of 130,000, and formed the majority of the population in the "TRNC". Accordingly, the settlers have acquired a more fundamental role in shaping the social and cultural character in the occupied areas. Thus, what distinguishes the "TRNC" from the Greek Cypriots living in the government-controlled areas is not only the level of economic development or ethnic differences; social and cultural factors come increasingly in-between.

In parallel with the waves of settlers coming to the island, Turkish Cypriots have been emigrating since 1974. Whereas Turkish Cypriots numbered 120,000 in 1974, today their population is estimated at around 90,000, at best. The mixed population of the "TRNC" was estimated at about 220,000 people excluding some 36,000 Turkish soldiers. However, the latest census of 2006 has shown a steep increase in population to 264,172 from 200,587 in 1996.[14] This increase is largely attributable to large numbers of immigrant workers. Even before the April 2006 census the composition of the population divided roughly 60 to 40 between settlers and Turkish Cypriots respectively. The continuous contraction of the Turkish-Cypriot population and the massive inflow of Turkish settlers, seen in proportion, constitute a massive demographic transformation. It is ironic to conclude that the Turkish Cypriots in whose name Turkey invaded the island in 1974 are now a minority in the northern part of Cyprus.

---

[13] W. Noë and M. Watson, "Convergence and Reunification in Cyprus: Scope for a Virtuous Circle", op. cit., p. 2. On the other hand though, it should be acknowledged that employment in the broader "public sector" is much higher. See relevant section (5.1 Public Finance) below.

[14] See S. Bahceli, "Census reveals soaring population in north", *The Cyprus Mail*, 7 May 2006. This may also explain in part the extraordinary increase in the number of elementary school children noted above.

The "TRNC" faces a problem of corruption which is no surprise taking into account the extent to which corruption is so prevalent in Turkey. The occupied area constitutes an instrument for money laundering by Turkish interests. It is also no coincidence that the "TRNC" is one of the most militarized regions in the world today. The proportion of military to civilian population is at least one to six.

Before April 2003, with the economy of the occupied territory in a state of perpetual crisis, defiance of the regime was increasing. The situation led many Turkish Cypriots to emigrate lessening their presence and role in the affairs of the "TRNC". But the post-April 23, 2003 situation and subsequent developments reversed this negative outlook; nevertheless, this is not enough to overcome fundamental economic problems including issues of legitimacy. There is still a long way to go before full normalization and modernization.

5. The Macroeconomic Balance

The investment rate achievable in the "TRNC" is limited by the rate of domestic savings. Specifically the savings rate in the "TRNC" never exceeded 20% of GDP, and fluctuated considerably over the years even taking into account aid from Turkey. But private saving has been rising over time partly reflecting the long history of volatility and uncertainty. At the same time consumption has been declining, creating a considerable amount of slack in the economy. Private investment on the other hand started to accelerate as from 2002 onwards but continues to be low in relation to GNP. It is noted that private investment rose to 16% of GDP in 2006 which is an all time high for the "TRNC". It should be stressed that in the post-2003 period there has been a major change in almost all economic indicators and variables.

5.1 Public Finance

In the area of public finance the size of the wider public sector remains relatively large and its role in the economy continues to be dominant. This tends to sustain considerable distortions in the economy that ultimately limit the growth potential. The growth of the public sector has come about as a consequence of low investment and limited economic activity by the private sector. The broad "public" sector employs around 40% of the economically active population.[15] However, this has started to change after 2003, as the economy was expanding more rapidly and local budget revenues increased substantially.

Table 9 – Balance of State Revenues and Expenditures: Share in GNP (%)

	1980	1990	2000	2003	2004	2005	2006P
BUDGET REVENUES	23.8	29.2	44.4	54.2	51.3	49.1	44.9
Local Revenues	11.4	25.2	28.0	31.5	37.7	33.2	30.6
Tax Revenues	8.0	21.4	19.4	17.8	20.4	20.2	20.0
Direct Taxes	2.6	10.7	11.4	8.9	9.6	7.7	7.5
Indirect Taxes	5.4	10.7	8.0	8.9	10.9	12.5	12.4
Other Income	3.4	3.8	5.8	6.0	6.1	6.8	4.4
Fund Revenues	n.a.	n.a.	2.8	7.7	11.1	6.1	6.3
Foreign Aid and Credits	12.5	3.9	16.4	22.7	13.7	15.9	14.3
Foreign Aid	3.7	3.3	9.9	8.6	7.1	6.6	7.4
Republic of Turkey	3.5	3.2	9.9	8.5	7.1	6.6	7.4
Other	0.2	0.1	0.0	0.1	0.0	0.0	0.0
Credits	8.8	0.6	6.5	14.1	6.6	9.3	6.9
Republic of Turkey	8.8	0.6	6.5	14.1	6.6	9.3	6.9
EXPENDITURES	24.0	33.9	51.0	53.9	50.7	47.7	45.8
Current Expenditures	13.8	16.0	19.8	17.5	17.5	18.2	18.4
Personnel Expenditures	11.2	13.4	17.4	15.0	15.1	15.4	16.0
Other Current Expenditures	2.6	2.6	2.5	2.6	2.5	2.8	2.4
Transfers	6.1	11.8	21.9	26.6	24.8	22.3	19.2
Social Transfers	3.8	9.4	13.6	11.7	11.6	n.a.	n.a.
Other Transfers	2.2	2.4	8.3	14.9	13.2	n.a.	n.a.
Defence	1.9	1.3	3.7	3.6	3.1	2.5	2.6
Investments	2.3	4.8	5.5	6.1	5.2	4.7	5.6
BALANCE OF BUDGET	-0.2	-4.8	-6.6	0.4	0.6	1.4	-0.9

Source: State Planning Organization "TRNC"/P = provisional

[15] See A. Theophanous and Y. Tirkides, "The Cyprus Economy in Perspective: an Analysis of Growth and Structure" in A. Theophanous and Y. Tirkides, *Accession to the Eurozone and the Reunification of the Cyprus Economy*, op. cit., p. 72.

Table 10 – Balance of State Revenues and Expenditures: % Distribution

	1980	1990	2000	2003	2004	2005	2006P
BUDGET REVENUES	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Local Revenues	47.7	86.5	63.0	58.1	73.4	67.5	68.2
Tax Revenues	33.4	73.5	43.7	32.8	39.8	41.2	44.5
Direct Taxes	10.7	36.8	25.8	16.3	18.6	15.7	16.8
Indirect Taxes	22.7	36.7	17.9	16.5	21.2	25.5	27.7
Other Income	14.2	13.0	13.1	11.0	11.9	13.9	9.8
Fund Revenues	n.a.	n.a.	6.2	14.2	21.7	12.4	13.9
Foreign Aid and Credits	52.3	13.5	37.0	41.9	26.6	32.5	31.8
Foreign Aid	15.5	11.3	22.2	15.8	13.8	13.5	16.6
Republic of Turkey	14.5	10.9	22.2	15.7	13.8	13.4	16.6
Other	0.9	0.4	0.0	0.1	0.0	0.0	0.0
Credits	36.9	2.2	14.7	26.1	12.9	19.0	15.3
Republic of Turkey	36.9	2.2	14.7	26.1	12.9	19.0	15.3
EXPENDITURES	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Current Expenditures	57.5	47.2	38.9	32.6	34.6	38.1	40.1
Personnel Expenditures	46.8	39.4	34.0	27.8	29.7	32.2	34.8
Other Current Expenditures	10.7	7.8	4.8	4.7	4.9	5.9	5.2
Transfers	25.3	34.8	43.0	49.4	48.9	46.7	41.9
Social Transfers	16.0	27.6	26.7	21.7	22.9	n.a	n.a.
Other Transfers	9.2	7.2	16.2	27.6	26.0	n.a.	n.a.
Defence	7.7	3.8	7.3	6.7	6.2	5.3	5.7
Investments	9.5	14.2	10.9	11.4	10.3	9.9	12.3

Source: State Planning Organization "TRNC"/P = provisional

An examination of the public accounts reveals certain disquieting facts. Whilst the income tax base is narrow rendering revenues volatile and unstable, expenditure needs are relatively large and remain skewed toward transfers and public wages. The result is a large imbalance sustaining considerable distortions in the economy which is only mitigated by substantial flows from Turkey in the form of foreign aid and credits.

On the revenue side foreign aid and credits from Turkey accounted for 31.8% of total revenues in 2006 or 14.3% of GNP. Foreign aid and credits has been fluctuating over time but remains the single most significant source of revenue for the state (Tables 9 and 10).

Tax revenue accounted for 44.5% of total revenues in 2006 or 20% of GNP whereas the importance of indirect taxes has been increasing. Specifically, the share of indirect taxes in total revenue increased from 17.9% in 2000 to 27.7% in 2006. At the same time the share of direct taxes declined from 25.8% to 16.8% in the same period. Interestingly, the share of fund revenue in total revenue rose from 6.2% in 2000 to 13.9% in 2006 (Tables 9 and 10).

Expenditures on the other hand are heavily skewed toward public sector wages (personnel expenditures) and public transfers. Specifically, public sector wages accounted for 34.8% of total expenditures or 16% of GNP in 2006. Likewise public transfers accounted for 42% of total expenditures or 19.2% of GNP in 2006. Transfers have increased sharply in recent years. Public sector wages are high in relation to the private sector. Given the size of the public sector this divergence in terms of pay narrows the tax base considerably.

With the revenue side inherently limited and the expenditure side relatively high the deficit when foreign aid and credits are excluded, is too steep. The fiscal deficit is currently financed entirely by foreign aid and credits from Turkey.

Despite the fact that the "public" sector has been responsible for the construction of the infrastructure the sheer size of the sector, and especially growing transfers, suggest considerable distortions sustained in the product and labor markets. It is thus imperative to reform and modernize the "public" sector. Sustained and rising economic activity would provide a good opportunity to achieve this desirable reform.

Fiscal reform requires the restructuring of the budget in order to remove the inherent consumption bias in favor of private sector investment and growth. Reform will necessarily have to include the tax system, transfers and current spending, public investments and the "state-owned" enterprise sector. Current expenditures will necessarily have to be reduced to allow resources to be

channeled into public infrastructure investments. The extensive subsidy and support system will have to be eliminated in order to foster a more competitive market structure. The importance of the "state-owned" enterprise sector will have to be revisited in a context of a 'more regulation and control' role for the public sector.

Reform in the "public" sector is necessary in order to increase the private sector, to foster competitiveness and ultimately to raise productivity in the entire economy. Without these changes the private economy will be trapped in a 'slow growth and low productivity' vicious circle.

5. 2 The Financial Sector

The importance of the financial sector in supporting private investment and growth cannot be overstated. Banks and financial institutions perform the critical function of channeling private savings to the corporate sector for investment and growth. The financial sector would depend on price signals to be able to perform its role, which in turn requires a liberalized market in which the government itself, state owned enterprises and the private company sector compete for scarce funds on equal terms.

Unresolved property issues currently hinder the process of credit growth, by the absence of loan skills and by the presence of a large "state-owned" enterprise sector. Unresolved property issues emanating from the stalemate surrounding the Cyprus problem hinder the process of credit growth because property cannot be used for collateral purposes, thus reducing the supply of funds to the private sector.

Credit risk management is essential especially where credit expansion is rapid and asset prices are rising. This would certainly require the upgrade of credit risk analysis skills and the strengthening of prudential supervision. Banking reform

will also be needed in the area of loans to the "publicly" owned enterprises and with regard to capital-adequacy requirements.

5.3 External Balance

An examination of the balance of payments of the economy of the "TRNC", is quite revealing. The economy is import dependent with the ratio of exports to imports of goods at 5.4% in 2005 (Table 1). As a result, the trade balance traditionally shows a large-deficit position which reached 51% of GNP in 2005 (Table 11).

At the same time the surplus in the invisibles balance is quite substantial amounting to 39% of GNP in 2005 which allows for the financing of the larger part of the trade deficit. Net tourist receipts have risen considerably in recent years to 16.3% and 14.1% of GNP in 2004 and 2005 respectively. Net tourist receipts show considerable fluctuation over time, which has also been the result of corresponding fluctuation in GNP and the dollar exchange rates (Table 11).

Other services, mainly tertiary education services also contribute significantly towards the surplus in the invisibles account. Specifically other services were 25% of GNP in 2005 and show a relatively more stable pattern in relation to net tourist revenues. The contribution of tertiary education is substantial in value added terms. It should be noted that initially a major objective of promoting the education sector was political.[16] At the same time, however, important socioeconomic benefits have accrued.[17] An additional source contributing to the invisibles surplus is income from foreign investments reflecting mainly high yields in Turkey. Lastly, remittances from abroad and commuting workers employed in

[16] The tertiary education sector supported by Turkey (basically for political reasons) since the late seventies, presents an impressive pattern of growth so much so that today it accounts for about 15% of GNP. The academic institutions in the northern part of Cyprus attract a sizeable population of students, the vast majority from Turkey. At the same time these academic institutions try to build their connections with international academic institutions and, as such, are in a position to also propagate political positions.

[17] Ibid. See also W. Noë and M. Watson, "Convergence and Reunification in Cyprus: Scope for a Virtuous Circle", op. cit., p. 3.

the government-controlled areas of the Republic also constitute an important contributor to the invisibles surplus.

Table 11 – Balance of Payments ($US m)

	1980	1990	2000	2003	2004	2005
Current Account Balance	**-21.7**	**-16.4**	**-32.8**	**19.4**	**-14.1**	**-276.3**
Foreign Trade Balance	**-47.4**	**-316.0**	**-374.5**	**-427.0**	**-791.1**	**-1.187.4**
Exports	47.6	65.5	50.4	50.8	62.0	68.1
Imports	95.0	381.5	424.9	477.8	853.1	1.255.5
Invisibles Balance	**25.7**	**299.6**	**341.7**	**446.4**	**777.0**	**911.1**
Tourism (Net)	24.0	224.8	198.3	178.8	288.3	328.8
Other Invisibles (Net)	1.7	74.8	143.4	267.6	488.7	582.3
Capital Movements Balance	**25.1**	**25.2**	**46.7**	**225.5**	**254.7**	**283.2**
Foreign Aid and Loans by Turkey	25.6	22.5	105.5	178.7	175.3	217.2
Other Foreign Aid	3.2	2.1	---	---	---	---
Imports By Waiver[1]	38.1	169.9	---	---	---	---
Other Short Term Capital Movements (Net)	-41.8	-169.3	-58.8	46.8	79.4	66.0
General Balance	**3.4**	**8.8**	**13.9**	**244.9**	**240.6**	**6.9**
Change In Reserves (- Increase, + Decrease)	**-1.1**	**-6.5**	**22.5**	**-281.0**	**-322.0**	**-53.0**
Net Errors and Omissions	-2.3	-2.3	-36.4	36.1	81.4	46.1
In % of GNP						
Current Account Balance	**-9.3**	**-2.8**	**-3.2**	**1.5**	**-0.8**	**-11.9**
Foreign Trade Balance	**-20.3**	**-53.5**	**-36.0**	**-33.3**	**-44.8**	**-51.0**
Exports	20.4	11.1	4.8	4.0	3.5	2.9
Imports	40.7	64.6	40.9	37.2	48.3	53.9
Invisibles Balance	**11.0**	**50.7**	**32.9**	**34.8**	**44.0**	**39.1**
Tourism (Net)	10.3	38.0	19.1	13.9	16.3	14.1
Other Invisibles (Net)	0.7	12.7	13.8	20.8	27.7	25.0
Capital Movements Balance	**10.7**	**4.3**	**4.5**	**17.6**	**14.4**	**12.2**
Foreign Aid and Loans by Turkey	11.0	3.8	10.1	13.9	9.9	9.3
Other Foreign Aid	1.4	0.4	---	---	---	---
Imports By Waiver*	16.3	28.7	---	---	---	---
Other Short Term Capital Movements (Net)	-17.9	-28.6	-5.7	3.6	4.5	2.8
General Balance	**1.5**	**1.5**	**1.3**	**19.1**	**13.6**	**0.3**
Change In Reserves (- Increase, + Decrease)	**-0.5**	**-1.1**	**2.2**	**-21.9**	**-18.2**	**-2.3**
Net Errors and Omissions	-1.0	-0.4	-3.5	2.8	4.6	2.0
Memorandum Items						
GNP (Million $)	233,6	591,0	1,039.9	1,283.7	1,765.2	2,327.8

Source: State Planning Organization "TRNC"/P = provisional

* Due to new Money and Foreign Exchange Law of 1997 imports waiver account is not considered after 1997

Employment of Turkish Cypriots in the government-controlled areas is considerable and to the extent that it is sustainable (no reason why it should not be) it will tend to constitute a stable source of income. As such it will tend to have a more sustained impact on spending patterns.

Based on the available data, the balance in the current account fluctuated from a small deficit of 1.9% of GNP in 2001, to a surplus of 1.5% of GNP in 2003 but reverted to a substantial deficit of 11.9% of GNP in 2005 as a result of a steep increase in imports of goods.

According to the same data sources, sizeable aid from Turkey in the form of grants and credits more than offsets any shortfall in the current account to thus generate a substantial surplus in the balance of payments. Specifically, grants and credits from Turkey amounted to US$217 million in 2005 or 9.3% of GNP.

Obviously the economy in the "TRNC" displays a high degree of dependence on foreign aid and loans, which can pose problems of incentives and accountability in the public sector. It is also a fact that foreign aid flows remain erratic, which does not tend to favor long-term planning and investment.

6. The Economy of the "TRNC" in Perspective

In sharp contrast to developments in the government-controlled areas, the economy of the occupied territories lags considerably behind. Per capita income was almost four times higher in the government controlled areas in the first quarter of 2003. Developments in the period 2003-2005 however, have led to a considerable change. Per capita income is now approaching 50% of the corresponding income in the areas under the control of the Republic of Cyprus. However, it is important to understand that continued growth will not be sustainable without due reform and modernization.

The economic well being of the island for both the Greek Cypriots and the Turkish Cypriots cannot be seen in isolation of their common future in a united Cyprus. The economy of the "TRNC" picked up considerably following the contraction of 2001-02. However, in order to raise living standards in the north sustainably, to bridge the gap with the economy in the government-controlled areas, and ultimately with the EU, would require well-designed macroeconomic and financial policies, a restructuring of the private and public sectors as well as substantial assistance from outside sources. Moreover, it will require the economic integration of Cyprus as a whole.

It is important to realize however that effective coordination of the reform programme is critical. Measures and policies addressing the problems inherent in the public sector, banking and finance and the balance of payments must take place simultaneously and in proper sequencing to be reinforcing for one another and not to impede the process of reform.

Reform cannot and must not be designed without taking into account the possibility for a final settlement of the Cyprus problem. The requirements of the *acquis communautaire* must likewise influence the reform process. The economic prospects of the northern part of Cyprus must not be seen in isolation from the parameters imposed by the requirements of a solution and by the European *acquis*.

7. Conclusions

The ultimate reunification of Cyprus and the integration of its economy will be a long and arduous process that can be facilitated if cooperation and interaction can take place on a continuous basis. It will also be of extreme importance if economic policy and restructuring in the northern part be guided by the *acquis communautaire* in which case the Republic of Cyprus can provide valuable assistance.

Ever since the Turkish invasion of 1974 and until April 2003, the northern part of Cyprus remained almost totally dependent on Turkey economically as well as politically. A monetary and customs union with Turkey effectively exists whereby the Turkish Lira constitutes legal tender. The result of this has been that Turkey's economic and monetary problems easily transfer to the "TRNC", as in the 1999 crisis.

Economic growth accelerated sharply from 2003 onwards following the partial lifting of obstacles to free movement on April 23, 2003 as well as political and socioeconomic developments following the April 24, 2004 referenda and the accession of the Republic of Cyprus to the EU on May 1, 2004. Growth emanated from construction[18] and tourist activity with important contributions from the multidimensional linkages with the government-controlled areas. Agriculture and transport services made important contributions. Employment of Turkish Cypriots in government-controlled areas is considerable, estimated at around 10.000 (including part-timers) in 2006. To the extent that this is sustainable it will tend to constitute a stable source of income. It will also have a more sustained impact on spending patterns and by extension on general economic activity.

In this context per capita income rose sharply, and the gap with the government-controlled area, although still substantial, has been steadily declining. However, the economy remains fragile and the sustainability of the convergence process, without due reform and restructuring, is questionable.

Economic activity tends to exhibit a high degree of volatility, which is not conducive to encouraging investment activity and constitutes a fundamental reason for poor economic performance. A narrow economic base, institutional weakness, limited trade openness, a large "public" sector and underdeveloped financial markets curtail economic activity.

[18] Greek Cypriots have raised the issue that the bulk of construction activity takes place in Greek-Cypriot properties unlawfully.

At the same time, the budget deficit remains exceptionally high as a percentage of GNP, when foreign aid and credits from Turkey are excluded. A narrow income tax base renders the revenue side highly unstable. Expenditures are large, and skewed toward transfers and public consumption. The result is a large imbalance sustaining considerable distortions in the economy. The fiscal deficit is currently financed entirely by foreign aid and loans, mainly from Turkey. It is thus imperative to reform and modernize the "public" sector.

An examination of the balance of payments is quite revealing. The economy is lightly import-dependent and the ratio of exports to imports of goods is extremely low. As a result, the trade balance features an exceptionally large and chronic deficit relative to GNP.

The surplus in the invisibles balance on the other hand is substantial and allows for the financing of the larger part of the trade deficit. Net tourist receipts vary and income, mainly from tertiary education services, contributes significantly towards the surplus in the invisibles account. An additional source contributing to the invisibles surplus is income from foreign investments reflecting mainly high yields in Turkey. Lastly, remittances from abroad and commuting workers employed in the government-controlled areas of the Republic of Cyprus also constitute an important contributor to the invisibles surplus. Accordingly, sizeable aid from Turkey in the form of grants and credits more than offset any shortfall in the current account and generate a substantial surplus in the balance of payments.

The (mixed) population of the "TRNC" is estimated at about 220,000 people excluding the 36,000 or so Turkish soldiers. The composition of the population divides roughly 60% to 40% between settlers and Turkish Cypriots respectively. However, according to Turkish-Cypriot sources the last census, which took place on April 30, 2006, indicated that the population had reached 264,172. The contraction of the Turkish-Cypriot population and the massive inflow of Turkish

settlers, seen in proportion, constitute a massive demographic transformation. Increasing employment of Turkish Cypriots in the government controlled areas also leads to further immigration from Turkey.

Accordingly, the settlers have acquired a (more) fundamental role in shaping the social and cultural character of the northern part of the island. Thus, what divides the "TRNC" with the Greek Cypriots living in the government-controlled areas is not only the level of economic development or ethnic differences: social and cultural factors come increasingly in-between.

Considering the employment situation it becomes clear that the services sectors have been absorbing considerable resources in recent years. The previously dominating agricultural sector declined in importance and its share of employment declined accordingly. Productivity in the agricultural sector is very low and the contribution of agriculture to GDP remains relatively low. At the same time the "government" sector remains an important employer in the economy. The "central government" accounted for 19% of total employment in 2006. However, it is estimated that employment in the broad "public sector" is considerably higher.

There is no doubt that the northern part of the island entails great economic potential and there are important synergies with the economy in the government-controlled areas. However, without normalizing the prevailing political situation, further economic advancement will be difficult to achieve. Far-reaching reform is certainly needed in the private and public sectors, in banking and finance and in the workings of a market economy.

Fiscal reform requires the reduction of the deficit and the restructuring of the budget in order to remove the inherent consumption bias in favor of private sector investment and growth. Reform will necessarily have to include the tax system, transfers and current spending, public investments and the state-owned

enterprise sector. The extensive subsidy and support system will have to be gradually eliminated in order to foster a more competitive market structure. The importance of the "state" owned enterprise sector will have to be revisited in a context of a more regulation-and-control role for the "public" sector.

A large "state" owned enterprise sector, an undeveloped financial system and unresolved property issues currently hinder the process of credit growth. Liberalization of the financial system is a necessary precondition for the efficient allocation of scarce resources. Unresolved property issues emanating from the stalemate surrounding the Cyprus problem hinder the process of credit growth because property cannot be used for collateral purposes. This reduces the supply of funds to the private sector. Moreover, the issue of legitimacy creates multidimensional problems and issues.

It is important to realize that effective coordination of the reform program is critical. Measures and policies addressing the problems inherent in the public sector, banking and finance and the balance of payments must take place simultaneously and in proper sequencing. However, reform cannot and must not be designed without taking into account the possibility of a final settlement of the Cyprus problem. The requirements of the *acquis communautaire* must likewise influence the reform process. The economic prospects in the northern part of Cyprus must not be seen in isolation from the parameters entailed in the requirements of a solution and the European *acquis*.