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**CYPRUS ACCESSION TO THE EUROZONE AND THE REUNIFICATION OF THE
ISLAND'S ECONOMY***

This paper addresses issues pertaining to the accession of Cyprus to the Eurozone and the reunification of the economy of this island-state. Within this framework the performance of the economy of Cyprus, both in the government-controlled areas and in the occupied northern part,¹ are examined. We also examine the conditions for successful participation in the Eurozone following the introduction of the euro in January 2008, and evaluate the progress toward real convergence. Particular attention is given to the German experience of reunification, with a view to drawing relevant and useful lessons for Cyprus, as well as to issues of political economy pertaining to accession to the Eurozone and the challenge of reunification. The last section summarizes the main points, makes policy recommendations and suggestions for further research.

The Economy of the Republic of Cyprus in Perspective²

The Government-controlled Areas³

Following a long period of growth under conditions of macroeconomic stability in the post-invasion period,⁴ Cyprus went through a period of structural adjustment in the 1990s and the early years of the new century. Output growth fluctuated considerably with sustained periods of restrictive performance. Following accession to the EU (May 1, 2004) and entry into the Exchange Rate Mechanism 2 (ERM 2) (May 2, 2005), there was a marked improvement in economic performance and the macroeconomic framework. As Cyprus prepares to introduce the euro in January 2008, longer-term challenges emanate from the process, including the challenge of real convergence. To a great extent these entail the further restructuring of the output mix between the public and private sectors on the one hand and among the productive sectors of the private economy on the other. In this context Cyprus is currently undergoing two kinds of transitions: toward a more diverse and higher value added model of tourist development, and, toward a services model with a more diversified base.

The eventual reunification of the island and the economic integration of its northern part with the areas under the control of the government present a different set of challenges that need

* 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.

¹ Turkey occupies the northern part of Cyprus since 1974. On November 15, 1983 the (then) Turkish-Cypriot leader Rauf Denktash declared the independence of the so-called "Turkish-Republic of Northern Cyprus" ("TRNC"). The unilateral move was condemned by the Security Council of the UN (Resolution no. 541, November 18, 1983). The "TRNC" is recognised only by Turkey.

² See A. Theophanous and Y. Tirkides "The Cyprus Economy in Perspective: an Analysis of Growth and Structure" in A. Theophanous and Y. Tirkides (Eds), *Accession to the Eurozone and the Reunification of the Cyprus Economy*, op. cit., pp. 19-81.

³ Ibid, pp. 19-63.

⁴ For an excellent reading in relation to the post-invasion period and especially what came to be known as the economic miracle of Cyprus see D. Christodoulou, *Inside the Cyprus Miracle*, Modern Greek Studies, University of Minnesota, Minneapolis, 1992 and A. Theophanous, "The Anatomy of the Economic 'Miracle' 1974-1994" (in Greek), in N. Peristianis and G. Tsangaras (Eds) *Anatomy of a Metamorphosis* (in Greek), Intercollege Press, Nicosia 1995, pp. 13-33.

to be addressed in a timely and orderly fashion. In the meantime Cyprus remains *de facto* divided and the natural forces of economic integration on both sides of the green line are not allowed to operate freely. This creates a framework of effectively two economic structures coexisting side by side with only limited interaction between them.⁵

Several important transformational changes have been taking place in the Cyprus economy since 1980⁶:

- Cyprus witnessed a significant shift in its productive base that transformed the economy into one that is today distinctly services-based whereby the share of the services sectors in total industry output rose from 55% in 1980 to about 77% in 2005.
- Regarding the tourist sector in particular the product mix continues to reflect two primary characteristics that have been shaping sector developments all along: the importance of the UK market which accounts for more than 50% of all arrivals, and the high concentration of arrivals in the summer months reflecting the fact that the tourist product has a strong 'sun and sea' flavour.
- Productivity gains in terms of the growth of real value added per unit labour employed reflect the patterns of growth and employment conditional upon the labour intensity of particular sectors. High value added sectors are limited to 'public utilities', and select tertiary growth sectors like 'financial services', 'trade', and 'real estate and business services'.
- Declining investment ratios have been associated with rising consumption ratios and declining savings ratios. Whilst these trends are characteristic of a maturing economy they also underlie the financial imbalance that has appeared in recent years.
- Inflation moderated to levels below 3% in 2005 and thereafter.⁷
- In the public domain, the government sector remains a significant producer of goods and services where the ratio of total public expenditures has risen considerably to 40% of GDP in recent years. The budget imbalance is sizeable and is only mitigated mainly by a surplus in the social security funds.
- Cyprus has a chronic trade deficit, which is offset by a large surplus in the services balance.⁸
- Cyprus has been participating in the ERM 2 since May 2005. Naturally issues of nominal and real convergence, continued economic restructuring, and early adoption of the Euro have been the focus of policy making in recent years.

Efforts to rein in the fiscal excesses have been successful in reducing the deficit within the Maastricht requirements. However, this has been achieved mainly through the revenue side.

⁵ The partial lifting of restrictions to the movement of people since April 2003, is not a sufficient condition in order to set forth the process of economic integration proper. Neither is this possible under the prevailing political conditions.

⁶ For more details and statistical information see National Accounts of Cyprus (various issues). Ministry of Finance, Republic of Cyprus

www.mof.gov.cy/mof/mof.nsf (link: statistical data).

⁷ The approximate alignment of prices in Cyprus with consumer prices in industrial countries reflects two main facts. First, imports largely from the industrial countries represent over half the total available resources each year. Second, the nominal exchange rate of the Cyprus pound has been stable against the currencies of the main industrial countries whilst the real effective exchange rate had appreciated in the period.

⁸ The strong performance of the tourist sector up until the mid 1990s largely kept the current account in check and deficits thereof were low and easy to finance with modest capital inflows. From about the mid 1990s onwards however, the trends underlying the current account position reversed themselves with declining tourist activity, deteriorating fiscal imbalances and falling savings ratios.

Even though the expenditure/revenue ratio actually declined, further reductions are necessary for a sustainable deficit of 3% of GDP or less. Efforts must necessarily focus on both the revenue and the expenditure sides of public finances.⁹

Cyprus has a large foreign sector with imports of goods constituting 35% of GDP in 2005. Consequently, excess demand quickly translates into imports and pressures on the balance of payments. The magnitude of the current account imbalance in relation to GDP and its persistence over time raises concerns in terms of the eventual economic adjustment. To rectify the problem the fiscal imbalance should be reined in whilst on the productive side of the economy efforts should continue in the direction of further diversification into the more export-oriented services sectors.

Real convergence requires sustained efforts at raising productivity levels, improving competitiveness and further diversifying the productive base. The tourist upgrade and the deepening of professional and financial services will play pivotal roles in the underlying restructuring effort along with foreign direct investment. Other services sectors, primarily education and medical services entail considerable potential.

The need to focus the growth and development effort toward export-oriented services sectors is imperative. The early adoption of the Euro, in January 2008, by removing exchange-related obstacles, should help to foster a higher level of economic activity and attract added flows of foreign direct investment. The 10 July decision of the ECOFIN Council whereby the conversion rate of the Cyprus pound has been fixed at the long-standing parity rate of 1.7086 euro, removed remaining fears of devaluation.¹⁰

The direction of economic policy must necessarily be based on strengthening internal stability, restoring a sustainable external position and a fiscal balance conducive to the targets of internal and external stability and the convergence process. In the meantime the challenge of reunification and integration of the northern part of the island remains formidable.

The Economy of the "Turkish Republic of Northern Cyprus" (TRNC)¹¹

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 effectively exists with Turkey whereby the Turkish Lira constitutes legal tender.

⁹ The tax reform of 2002 created a low tax environment for specific developmental objectives. It should be noted, however, that the other side of the fiscal equation, the expenditures, must be streamlined accordingly. This calls for revisiting some of the practices of the past. In relation to this, see also Ministry of Finance, Cyprus, Convergence Programme of the Republic of Cyprus 2004-2008, Nicosia, December 2004. It must be noted that this programme was essential in the pursuit of meeting the objective for accession to the EMU. Nevertheless, much more work will be required to address the fiscal challenge comprehensively and conclusively.

¹⁰ Council of the European Union, Brussels, 10 July 2007 (11608/07, Presse 164).

¹¹ For an interesting reading see A. Theophanous and Y. Tirkides "The Cyprus Economy in Perspective: an Analysis of Growth and Structure" in A. Theophanous and Y. Tirkides (Eds), *Accession to the Eurozone and the Reunification of the Cyprus Economy*, op. cit., pp. 63-81. See also Ministry of Finance, Republic of Cyprus, "The Economy in the Occupied Part of Cyprus: An Assessment", Nicosia, June 2006; 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; 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 (Macroeconomic and Financial Frameworks)", May 2005, pp. 1-21.

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 2004 referenda and the accession of the Republic of Cyprus to the EU on May 1, 2004. Growth emanated mainly from the multidimensional linkages with the government-controlled areas, construction¹² and tourist activity. Agriculture and transport services made important contributions. Employment of Turkish Cypriots in government-controlled areas is considerable, estimated at almost 10.000, including part-timers, in the spring of 2007. 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 in question.

The budget deficit remains exceptionally high as a percentage of GNP and is covered by substantial aid from Turkey. A narrow income tax base renders the revenue side highly unstable. Expenditures are relatively large and remain 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.

An examination of the balance of payments is quite revealing. The economy is already import-dependent whilst the ratio of exports to imports of goods is extremely low (about 5% in 2005). As a result, the trade balance features a large and chronic deficit that fluctuates around 28% of GNP.¹³ This increased after 2003.

The population of the "TRNC" including the settlers is estimated at about 220.000 people excluding the 40.000 or so Turkish soldiers. The composition of the population divides roughly 60% to 40% between settlers and Turkish Cypriots respectively. However, according to the Turkish-Cypriot regime the last census that took place on April 30, 2006 indicated that the population had reached 264.172.¹⁴ The contraction of the Turkish-Cypriot population and the massive inflow of Turkish settlers, seen in proportion, constitute a massive demographic transformation.¹⁵

Considering the employment situation it becomes clear that agriculture and the government sector continue to be important employers in the economy. According to "official" statistics, total employment in agriculture was 11% in 2005 and in the public sector close to 20% of the labour force. However it is not very clear what the corresponding figures represent. Indeed, it is estimated that employment in the broad "public sector" alone is well above 40%. Productivity in the agricultural sector is very low and the contribution of agriculture to GDP remains relatively low. In the area of public finance, in particular, the size of the public sector remains large and its role in the economy continues to be dominant. It should be noted,

¹² Ever since the referenda of April 24, 2004 the usurpation of Greek-Cypriot properties assumed unrepresented proportions. For example, see (Cyprus) Press and Information Office, Statements by the Government Spokesman – usurpation of Greek-Cypriot properties, April 26, 2005.

¹³ See A. Theophanous and Y. Tirkides "The Cyprus Economy in Perspective: an Analysis of Growth and Structure" in A. Theophanous and Y. Tirkides (Eds), *Accession to the Eurozone and the Reunification of the Cyprus Economy*, op. cit., pp. 75-76.

¹⁴ See S. Bahceli, "Census reveals soaring population in north", *The Cyprus Mail*, 7 May 2006.

¹⁵ Accordingly, the settlers have acquired a 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.

however, that the tertiary education sector has grown considerably in recent years to about 15% of GNP.¹⁶

Fiscal reform requires the reduction of the deficit and the restructuring of the budget in order to remove the inherent consumption bias in favour 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. Furthermore, 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.

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. However, reform should be designed 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.¹⁷

Accession to the Eurozone and Real Convergence¹⁸

Following the 10 July decision of the ECOFIN Council, the euro will be introduced in Cyprus (and Malta) in January 2008.¹⁹ The adoption of the single currency is widely expected to generate positive effects for the new members.²⁰

Successful participation in the Eurozone also requires real convergence. In this regard indicators of real convergence – growth of constant GDP, labour productivity and comparative price levels – have been converging towards the Eurozone averages. However, considerable differences in the pace of convergence across the New Member States (NMS) remain. Regarding Cyprus we highlight the following:

- In 2005 labour productivity per person in Cyprus was 75,7% of the EU-25 average, which is equivalent to about 69% of the Eurozone average. The corresponding figures in 1998 were 78,2% of the EU-25 average or 71% of the Eurozone average.

¹⁶ See A. Theophanous and Y. Tirkides "The Cyprus Economy in Perspective: an Analysis of Growth and Structure" in A. Theophanous and Y. Tirkides (Eds), *Accession to the Eurozone and the Reunification of the Cyprus Economy*, op. cit., p. 67. Also see W. Noë and M. Watson, "Convergence and Reunification in Cyprus: Scope for a Virtuous Circle", op. cit., p.3.

¹⁷ 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 government of the Republic of Cyprus can provide valuable assistance.

¹⁸ In relation to this section see Y. Tirkides "The Challenges of Accession to the Eurozone and the Reunification of the Cyprus Economy" and "Conditions and Prerequisites for the Accession of the Cyprus Economy to the Eurozone and its Reunification", in A. Theophanous and Y. Tirkides (Eds), *Accession to the Eurozone and the Reunification of the Cyprus Economy*, op. cit., pp. 83-107 and pp. 181-214 respectively.

¹⁹ Council of the European Union, Brussels, 10 July 2007, op. cit.

²⁰ Most importantly a single currency promotes trade by reducing uncertainty over interest rates and exchange rates and by eliminating transaction costs. Better access to markets and increased transparency tend to benefit enterprises and consumers respectively.

- Prices in Cyprus have been drifting roughly in line with prices in the Eurozone countries on average during recent years. Cyprus' comparative price level was 91% of the Eurozone average in 2003, as against 88% in 1998.
- Cyprus has had relatively stable bilateral exchange rates and the Cyprus pound has fluctuated largely above its central parity rate and within the narrow band of $\pm 2,25\%$.
- The current account balance of Cyprus exhibits quite high and volatile deficits, which reflect the structure of the economy and its vulnerabilities. In comparison with the NMS as a group, Cyprus exhibits a higher degree of volatility although considerable differences exist at the country level.

Examining structural convergence in the NMS in terms of the composition of output and employment, as measuring nominal and real magnitudes respectively, and by the relative ratio between them, as a relative productivity indicator, is particularly revealing. There are marked differences in the composition of output between Cyprus and the group of the NMS and between the NMS and the Eurozone countries.²¹ Cyprus features one of the highest services shares compared with the Eurozone countries. Also Cyprus features a smaller manufacturing sector and a larger construction sector than either the other NMS or the average in the Eurozone countries.

Whilst there are no dramatic shifts in output composition in the period there is a clear trend of convergence of the NMS toward the Eurozone countries. The share of 'agriculture' decreases and that of 'services' increases. Considering similar shares in terms of employment rather than output composition and also in terms of the relative productivity indicator,²² the differences between the NMS and the Eurozone countries are much greater. There are also considerable differences between Cyprus and the Eurozone countries as well as between Cyprus and the NMS. This means that sector productivity characteristics amongst the EU-25 are diverse and variable.

Within the NMS, Cyprus displays lower relative productivity in 'manufacturing', 'construction', 'trade', 'transport storage and communication' as well as in 'financial intermediation', and higher relative productivity in the 'utilities' sectors, in 'hotels and restaurants', in 'education' and in 'healthcare'. Cyprus' relative productivity ratios are comparable to those of the Eurozone countries in the 'utilities' sectors and in 'hotels and restaurants'. There are wide discrepancies in some of the remaining sectors particularly in 'financial intermediation'.

Trade integration ratios are, on average, higher in the NMS than in the Eurozone countries as regards goods. The same ratios are higher in the Eurozone countries as regards services. However, when volumes of trade in goods and services are added together, the NMS have higher ratios as a group than the Eurozone countries. This indicates that the NMS have a high and rising degree of trade openness. It also reflects, in part, the higher share of primary and secondary sectors in the NMS countries.

²¹ For a detailed presentation see Y. Tirkides "The Challenges of Accession to the Eurozone and the Reunification of the Cyprus Economy" in A. Theophanous and Y. Tirkides (Eds), *Accession to the Eurozone and the Reunification of the Cyprus Economy*, op. cit., pp. 83-107. The analysis of structural convergence follows the approach established by I. Angeloni, M. Flad and F.P. Mongelli, "Economic and Monetary Integration of the New Member States: Helping to Chart the Route", Occasional Paper Series No. 36, Frankfurt, European Central Bank, September 2005.

²² For an interesting discussion on this issues see Y. Tirkides "Conditions and Prerequisites for the Accession of the Cyprus Economy to the Eurozone and its Reunification", in A. Theophanous and Y. Tirkides (Eds), *Accession to the Eurozone and the Reunification of the Cyprus Economy*, op. cit., especially pp. 203-204.

Cyprus has the lowest integration ratio in the trade of goods amongst the NMS. Specifically Cyprus integration ratio for trade in goods was 21% in 2004 down from 27% in 1996. Only Greece, Spain, Italy and France from the group of Eurozone countries match this. In terms of trade integration for services, Cyprus has the highest ratio amongst the NMS and a higher ratio than the majority of the Eurozone countries.

In sum, Cyprus displays considerable differences in terms of output composition, relative productivity, as well as employment composition in relation to both the NMS and the Eurozone countries. In terms of trade integration, the NMS display a higher degree of openness regarding the trade of goods but not so as regards the trade in services. These differences between the NMS and the Eurozone countries are largely reflective of their differing output structure.

The German Experience of Reunification and Lessons for Cyprus²³

The process of German reunification and reconstruction of the East (*Aufbau Ost*) generated considerable apprehension inside the German society at large as a result of two reinforcing factors: a critical *ex post* evaluation of the policy of reconstruction per se coupled with the high cost of funding reunification. For instance, the total of transfers from West to East in the period 1989-2004 exceeded the sum of one trillion Euros, which, on an annual basis, amounts to about 4% of GDP of the former Western Germany.²⁴ Whilst rising living standards in the East, a substantially improved infrastructure and the emergence of competitive economic locations were positive developments, conditions of prolonged economic stagnation in the East, high and rising unemployment and the emigration of predominantly young people, were negative considerations. The population of the eastern regions declined considerably between 1990 and 2001.

Transforming the East German economy post reunification was an unparalleled task in history. In this context the East German economy was confronted with two enormous challenges: to transform from central planning to free market and to integrate with West Germany. This amounted to a massive task and the transformation was labelled the '*Blitz transition*'.

The starting conditions in the east were extremely negative: the economy was skewed toward manufacturing and agriculture; trade flows were geared to the Comecon; productivity was extremely low by comparison and the infrastructure was utterly deficient. Fifteen years later the results of the policies of reconstruction are not seen as satisfactory. The eastern part of Germany is still lacking a self-sufficient industrial base. Some of the policy measures have been inadequate. For instance, labour costs are still the most important locational advantage that eastern Germany enjoys.²⁵

²³ See H. Brey "The German Experience of Reunification and Useful Lessons for Cyprus" in A. Theophanous and Y. Tirkides (Eds), *Accession to the Eurozone and the Reunification of the Cyprus Economy*, op. cit., pp. 143-179.

²⁴ Ibid, p.144.

²⁵ Yet, the Donhanyi-Most Commission Report attributes most of the mismatch between huge transfers and the limited success of reconstruction to the fast and undifferentiated rises in wages. This was a strong disincentive for small and medium sized enterprises. von K. Donhanyi, and E. Most, "Für eine Kurskorrektur des Aufbau-Ost" in *Der Spiegel*, 10 February 2004.

[www.spiegel.de/media/0,4906,4026,00.pdf]

The Donhanyi-Most Commission Report stressed the need and the importance of building awareness regarding two fundamental issues: that reconstruction must be seen as a task for the whole of Germany and that differences in incomes and in hours of work between east and west are unavoidable.

It will be extremely useful if Cyprus learns from the experiences of the German reunification despite the differences between the two cases. We note in this regard:

- Besides obvious differences of ethnic background, language and religion in Cyprus, there is another important dimension that must be noted. The German reunification took place following the break-up of the former Soviet Union. The only viable option at hand was the incorporation of eastern Germany into western Germany. Whilst reunification in Cyprus will necessarily involve the transfer and implementation of the European *acquis* to the northern part of the island, there are important issues of political power sharing, territorial arrangements and taxation that will have to be worked out first within the framework of a comprehensive settlement.²⁶
- Any solution of the Cyprus problem will have to address the present economic disparities between the government-controlled area of the Republic of Cyprus and the northern part. This is an area where there are clear parallels with the German case, and from which important lessons can be derived.
- Any attempt to integrate the northern part of the island into a unified economy would require a transfer and due implementation of the European *acquis*. Improving living standards, establishing a viable economic base, improving administrative capabilities and upgrading and modernising the existing infrastructure should be part of a reconstruction effort that will absorb considerable resources.
- The economy in the northern part of Cyprus is inflicted with many structural problems but restructuring is unlikely to involve the social problems of the scale of Germany's '*Blitz transition*' with massive layoffs and dislocations.
- Trade in northern Cyprus is presently directed toward Turkey in much the same way as trade in eastern Germany was directed toward COMECON. But the process of redirecting trade flows, in the case of a solution, is not expected to disrupt trade in any important way.
- The northern part of Cyprus has a number of obvious comparative advantages that can sustain the development and growth of economic activity – most notably the abundance of tourist space.
- The northern part of Cyprus has been suffering from brain drain already since 1974. An improvement of living conditions is likely to encourage former emigrants to be repatriated. The infrastructure in the northern part of the island will have to be improved and upgraded.

The initiative of private investors accepting the challenge and opportunities to develop the economic potential in the north is of paramount importance for the success of a policy of reconstruction. To the extent that business opportunities in the northern part of Cyprus are made available to Greek-Cypriot entrepreneurs, the additional burdens imposed by reconstruction should not prove too dramatic for the Cyprus economy.

²⁶ In turn, the actual solution will carry implications for the process of reunification of the island and the integration of the northern part into the government-controlled area of the Republic of Cyprus.

The German experience of the reconstruction of the east and the discussion regarding its due reorientation provides a number of useful recommendations for the Cyprus case.

- It will take a long time before northern Cyprus catches up with the economy in the government-controlled area. It is thus important to keep expectations in perspective and prepare the population for possible hardships.
- The German experience reveals that people are prepared to give and share in the costs provided they perceive that their contributions are not wasted.
- It is also important to establish a master plan for reconstruction that analyses potentials and needs, and develops viable strategies.
- It is absolutely necessary to provide incentives to private investments. Programmes and incentive schemes should be targeted on sustainable and competitive sectors and regions and should be transparent.
- Incentives in infrastructure should be directed to the needs of the business sectors as a matter of priority. Investments in vocational training, research and higher education should be tailored to the needs of the economy and be consistent with the overall strategy.
- Restitution and compensation of lost properties is a vital and sensitive issue. In Germany there was adherence to the principle of restitution before compensation. In some cases this created complications.
- The German experience is a constant reminder of the need for timely reforms. If necessary reforms are postponed, the economic and political costs increase tremendously.

The Political Economy of Accession to the Eurozone and Reunification: Policy Implications²⁷

Certainly the structure of the paper would have been different if, in trying to enter the Eurozone, the starting point was a “unified” economy, in the aftermath of a solution based on the Annan Plan.²⁸ Under such circumstances it would have been very difficult to enter the Eurozone in January 2008. The unsatisfactory property arrangements and the financing of compensation would have created discontent and economic problems. The new economic structure would have entailed higher public spending by the three levels of government. An extremely strict form of bizonality would have seriously reduced the fundamental freedoms of Cypriot citizens and the dynamism of the Cypriot economy. This would have had, among other, negative economic repercussions. Last but not least, the decision-making processes would have been hampered given the provisions for dual majorities and the absence of hierarchy between the laws of the constituent states and those of the central government.²⁹

²⁷ This section draws from Andreas Theophanous and Yiannis Tirkides “Summary, Conclusions and Recommendations” in A. Theophanous and Y. Tirkides (Eds), *Accession to the Eurozone and the Reunification of the Cyprus Economy*, op. cit., pp. 215-253 and especially from the relevant section pp. 239-247.

²⁸ Cyprus remains a divided island having acceded to the EU in May 2004 with its long-standing problem unresolved. Intensive efforts prior to accession, culminating in what came to be known as the Annan Plan, failed to come to fruition. Annan Plan V, which was the last version of a series of proposed drafts, was put to a referendum to both communities, Greek Cypriots and Turkish Cypriots on 24 April 2004. The Greek Cypriots voted ‘No’ by an overwhelming majority of 76%. The Turkish Cypriots (and many settlers), voted ‘Yes’ by a majority of 65%. The participation of settlers in the voting process in the occupied areas casts doubt as to the true vote of the Turkish Cypriots themselves. It is noted in this regard that the settlers constitute a majority in the population of the occupied areas.

²⁹ On the other hand it could be seriously argued that there would have also been positive forces and developments. For example, the return of some land to the Greek Cypriots as well as the reconstruction that would have taken place would have pushed the economy forward. The developmental and the reconstruction effort would also have been further advanced by aid from the EU and other international players. Furthermore, foreign investment would also have played its own role.

Cypriots celebrated accession to the Union but at the same time they understand that much work remains to be done in order to address socioeconomic problems and also achieve reunification. Although there is a huge gap in the positions of the leaderships of the two sides, there has been considerably more interaction between the two communities at all other levels. If the external constraints in relation to the Cyprus question are altered then it may be possible to achieve reunification.

It is of fundamental importance to acknowledge that the form of a solution to the Cyprus problem will have a tremendous impact on socioeconomic factors. Over time politicians as well as ordinary citizens made the simplifying assumption that reunification would be associated with positive economic effects. Nevertheless, it is essential to comprehend that each form of constitutional arrangement is associated with a particular economic structure. In its turn the latter will greatly influence economic outcomes.³⁰

Following the accession of Cyprus to the Eurozone, economic reunification can only take the form of reintegration of the economy of the northern part of the island into that of the government-controlled areas of the Republic of Cyprus, even if there is a strong adherence to bicommunality. This in its turn has far-reaching political implications. Participation in the Eurozone greatly influences national economic policy as well as the decision-making processes. With accession to the Eurozone a much more integrated economic structure is required in relation to whatever was discussed previously as part of the solution of the Cyprus problem. Moreover, the risk of currency devaluation because of an increase in public spending and other developments due to a federal solution of the Cyprus problem, ceases to exist.³¹ Furthermore, accession to the Eurozone, will secure incomes but, moreover, it will boost the morale and further enhance the dynamism and the confidence of the Cypriot economy. These characteristics are essential for the convergence of the standard of living between Greek Cypriots and Turkish Cypriots and eventual reunification.

Perhaps what will be of greatest importance is the process of legitimization of the new state of affairs as a result of a solution. This will have to address, among other, property issues and power sharing. One of the great stumbling blocks in the process of resolving the problem was the insistence of the Turkish-Cypriot leadership on clauses of strict bizonality. By definition, strict bizonality clauses not only create more difficulties for the property arrangements but, moreover, they consolidate the *de facto* existence of two economies. This makes the objective of economic integration difficult, if not impossible.

It is essential to arrive at such arrangements that on the one hand protect Turkish-Cypriots from being marginalized and on the other hand do not obstruct the dynamism of an integrated economy. From an economic perspective such a task is not impossible within the framework of a federal arrangement, with loose bizonality clauses that allow mobility of people and capital.

³⁰ See A. Theophanous, *European Cyprus: Constitutional Structure Economy and Society. Accession and the Solution Scenarios* (in Greek), I. Sideris, Athens 2002. One of the major conclusions of this study is that the divergence between the outcomes of the different scenarios is substantial.

³¹ In addition, with accession to the Eurozone the issue of a possible speculative attack against the Cyprus pound will also cease to exist. Likewise the risk of exchange rate destabilization due to negative political developments again is also conclusively dealt with.

Membership of the EU and the need to comply with the Maastricht criteria so as to successfully join the Eurozone by January 1, 2008 have provided a strong incentive for the government to take the necessary measures to address pressing issues of economic policy. In this respect it has been easier for the government to pursue a consistent policy of reducing the deficit and the public debt.³²

Cyprus is located in the Eastern Mediterranean, an area with great geostrategic and geoeconomic influence. It is possible, under certain conditions, for policymakers to take measures so that Cyprus is transformed into an international business centre. Tourism has been an engine of growth and if restructured it can lead to even better results. Furthermore, Cyprus has the potential to serve as a regional academic, medical and financial centre and as a true hub which provides for the needs of the broader area. In this regard, if Cyprus is successful it will turn itself into an important asset of the Union.

Summary, Policy Recommendations, and Suggestions for Further Research³³

Cyprus is a small open economy with limited natural resources and its prosperity and growth prospects are inextricably intertwined with its ability to compete effectively in the regional and international markets. The ability of the economy to attract foreign investment and to integrate fully with the European economic space, will largely determine the success or failure of its growth model and effort at real convergence. The potential reunification and integration of the northern part of the island constitute additional challenges that will require a productive and vibrant economy.

Regarding the economy in the areas under the control of the government, there is an obvious need for continued and multilevel rebalancing and restructuring. The relative importance of the tourist sector has been declining in recent years partly as a result of the sector's inherent problems and partly because of the prominence of other services sectors in the national accounts, primarily 'finance' and 'business services'.³⁴ Such trends constitute a rebalancing of the national product in the direction of a more diversified productive base. Policy efforts in this direction should be duly supported and enhanced, focusing also on additional high-value-added services sectors such as education and medical treatment.

A low tax environment coupled with EU membership and the introduction of the Euro in January 1, 2008 can enable the international business sector to grow to a major source of economic stimulus. In addition to the restructuring of the productive base, macroeconomic streamlining constitutes another area of policy focus. If a low-tax environment has been chosen as a core element of Cyprus' growth model, this would correspondingly require a smaller public sector. Efforts in the area of public finances should thus focus on reducing the expenditure/revenue ratio mainly through further rationalization of the expenditure side.

³² In relation to this see Ministry of Finance, Cyprus, Convergence Programme of the Republic of Cyprus 2004-2008, op. cit.

³³ This last section mostly draws from A. Theophanous and Y. Tirkides "Summary, Conclusions and Recommendations" in A. Theophanous and Y. Tirkides (Eds), *Accession to the Eurozone and the Reunification of the Cyprus Economy*, op. cit., pp. 215-253.

³⁴ In relation to tourism it is noted that further upgrading toward a more diversified and higher value added sector is required. The dominant 'sun and sea' model renders the entire sector more susceptible to exogenous developments and vulnerable to intensifying competition.

Imbalances in the current account sustained in recent years must be comprehensively addressed. This can be achieved by a combination of two reinforcing measures – fiscal consolidation, and, structural reforms that foster further deepening and diversification of those services sectors with an outward orientation.

Real convergence also requires sustained efforts at raising productivity levels and re-invigorating the growth model; this presupposes a more efficient use of financial and human resources. Enhancing the competitive framework and streamlining the macroeconomic balance are necessary conditions for raising the efficiency and productive capacity of the economy.

Despite the fact that the northern part of the island entails great economic potential and that since 2003 there has been a substantial improvement, it will be difficult to achieve a sustained economic advancement in the absence of a political solution that would normalize the situation. At the same time far-reaching reforms will be needed at various levels in order to streamline the economic structure and institutional framework with the European *Acquis*. Reform must necessarily focus on fiscal consolidation, the tax system, the “state enterprise sector” and financial liberalization.

The introduction of the Euro in the government-controlled area of Cyprus in January 2008 will have far-reaching economic, political and social implications. Economically as well as politically, following the introduction of the single currency, issues and challenges for the northern part of Cyprus will involve its own (re-)integration into the Republic of Cyprus and the Eurozone.

The German experience of reunification offers valuable lessons for Cyprus looking forward to its own reunification project. Despite differences between the two cases, there are significant parallels from which some firm conclusions can be drawn. It is important to realise that the task involved is formidable and it will take time and considerable resources in order to implement the *acquis* in the northern part, streamline its economy and integrate it into the economy of the Republic of Cyprus. There will be benefits to accrue if a master plan for the reconstruction of the northern part is carefully put in place in considerable detail regarding the various measures and their sequencing. Mitigating regional disparities will be a slow and arduous process and the population on both sides should be prepared accordingly. Raising undue expectations for short-term political objectives will only lead to frustration in the long run.

More often than not, in the discussion of the Cyprus problem and its potential solution, economic issues and considerations in the broadest sense of the term have not been given priority. However, any solution, which does not seriously take into consideration these economic issues and considerations may prove to be problematic.

In the aftermath of a solution, economic convergence of the two sides would be of great importance. Convergence cannot take place in the absence of effective integration. It should also be noted that convergence in the standards of living cannot happen overnight. Instead, it will be the outcome of a steady and sustained process.

The issue of economic convergence of the two sides must be dealt with comprehensively. It should be understood that the stricter the bizonality clauses the greater the obstacles toward

economic integration and convergence. The implications are clear: Greek Cypriots and Turkish Cypriots must find ways to address Turkish-Cypriot concerns and at the same time achieve economic integration. Toward this end the government of Cyprus must play a significant role. Likewise EU funds could make a sizeable contribution. Assuming that there is a choice to be made by Turkish Cypriots in relation to their future, the options are between a European future within the Republic of Cyprus or the continuation of the current status, which entails the full protectorization of the northern part of Cyprus by Turkey.

In the aftermath of a solution, particular attention must be paid to promoting an effective decision-making process. It is understood that bi-communalism will be an essential characteristic of any solution reunifying Cyprus. Nevertheless, the two communities must learn to also work beyond bi-communalism: in other words, economic issues can be addressed successfully through common unified efforts.

Failure to reach an agreement within the framework of the Annan Plan is not the end of the road. It is possible under particular circumstances³⁵ for the two communities to work in a way so that an agreement will be reached. In this regard it should also be mentioned that the EU institutions and norms play a constructive role. A solution of the Cyprus problem would naturally aim to address the major concerns of the two communities. Such a solution could be based on three fundamental pillars: The high-level agreements; the relevant United Nations (UN) resolutions; and the EU *acquis communautaire* and European political culture. Such a solution would be in the interest of all Cypriots and at the same time serve broader interests in the region, the EU and the international community.

³⁵ Most Cypriots believe that the key to a solution to the Cyprus problem is in Ankara. This implies that if Turkey eventually respects the independence, territorial integrity and the sovereignty of the Republic of Cyprus, the other aspects of the problem will be resolved soon.