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# **Growing Together? – Prospects for Economic Convergence and Reunification in Cyprus**

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# Growing Together? – Prospects for Economic Convergence and Reunification in Cyprus

Max Watson #

## ABSTRACT

Policy-makers have increasingly come to focus on the role of economic factors in fuelling or dampening regional and border conflicts. This issue can be highly relevant in the case of non-recognized entities where some economic interests may benefit from the resulting distortions while others would gain if the political situation were regularised. The experience in Cyprus is interesting in this regard, as it seems that economic factors probably played a significant role in the referenda results of April 2004. Against this backdrop, this paper explores the prospects and priorities in Cyprus by addressing a number of relevant theoretical and policy questions, including: the potential influence of economic factors on conflict resolution; the role played by economics in the failure of the Spring 2004 discussions; the question of the income disparity between north and south; and the synergies that could be unlocked in a converging intra-Cyprus economy.

Keywords: Cyprus reunification, economic convergence, conflict resolution

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# Growing Together? – Prospects for Economic Convergence and Reunification in Cyprus

## 1. Introduction

Policy-makers have increasingly come to focus on the role of economic factors in fuelling or dampening regional and border conflicts. This issue can be highly relevant in the case of non-recognized entities, such as those that exist in the Caucasus and in northern Cyprus. Where a "would-be" state is not recognized by some of its neighbours or potential trading partners, a range of economic factors is brought into play. For example, some economic interests may benefit from the resulting distortions in external trade and in the economic system more generally. Other interests, by contrast, would gain if the political situation were regularised and such distortions ended. Yet others might face conflicting incentives as they fear the upfront costs of change yet see potential longer-run gains for themselves or for younger generations.

The experience in Cyprus is interesting in this regard for several reasons. It seems that economic factors probably played a significant role in the referenda results of April 2004, although perceptions of these factors may not always have been accurate at the time. Moreover, concrete efforts have been made since the referenda to start addressing distortions in the absence of a political settlement. For example, a legal channel has been created for trade between north and south in an attempt to reduce trade distortions and build constructive economic relations; and some attempts have also been made to find property solutions in the north that would be internationally accepted. Finally, and importantly, the economic context in Cyprus is not stationary: developments on

the ground, as they interact with political currents, may contribute to shaping constituencies for or against a settlement in the future.

Since April 2004, informal discussions have continued among economists on the two sides concerning, more specifically, the scope for “economic convergence” between north and south to interact with political convergence in making progress towards reunification. (One forum for such exchanges has been the Wolfson Cyprus Group, founded by the author of this Discussion Paper). The issue of economic convergence initially received particular attention in Cyprus because of income disparities between north and south. But it has a wider resonance also. The term is used to refer to three processes which are distinct, but which have the potential to be mutually reinforcing – and which are used in this paper as a unifying framework in which to think about the interaction between economics and politics in Cyprus: the convergence of incomes in Cyprus towards the EU average; the convergence of incomes in the north towards those in the south; and the convergence of institutional and market structures between north and south. Convergence in each of these respects is important in its own right and also because it may lay a basis for political dynamics, by changing the opportunities and incentives facing citizens.

In this perspective, the April 2006 ECPR workshop in Nicosia on “Cyprus – A Conflict at the Crossroads,” which formed the basis for the present paper, and the book in which it will appear in 2008, was truly timely. The agreement in February 2006 on EU financial aid for northern Cyprus of €139 million had just provided one reason to think carefully about channels to promote growth and convergence. The almost simultaneous Annan-Papadopoulos communiqué opened the question of what economic issues would be valuable to consider in technical discussions between north and south in a perspective of convergence and reunification.

From an economic standpoint, indeed, it can be argued that Cyprus is still standing at a crossroads. In this situation, convergent or divergent economic incentives – and their interaction with key political factors – may have the potential to significantly influence future outcomes in the island. Against this backdrop, seven questions are highlighted in this paper, to help shed light on prospects and priorities in Cyprus, and potentially lessons for other cases:

- The potential influence of economic factors on conflict resolution, including assessments in the recently emerging literature on this topic.
- The role played by economics in the failure of the Spring 2004 discussions.
- The question of the income disparity between north and south.
- The synergies that could be unlocked in a converging intra-Cyprus economy.
- The scope for economic reforms to contribute to convergence.
- The risk that, if opportunities are missed now, divergent forces may dominate.
- Possible wider lessons of this analysis for Cyprus and other conflict situations.

## **2. The potential role of economic influences on conflict resolution**

Recent literature has highlighted the potential importance of economic influences in unrecognized entities and in other cases of unresolved civil or military tensions. The central message in this literature is that economic exchanges can play a positive or a negative role in promoting normalization, depending in part on the balance of incentives. On the one hand, rent-seekers can benefit from distortions created by the unresolved *status quo*, and have a vested interest in its continuation. On the other hand many parties stand to benefit from a restoration of open and legal exchanges.

Champlain (2004) notes, for example, that informal economic relations in unrecognized entities in the South Caucasus can be seen as a coping mechanism, but may also provide space for rent-seeking and the emergence of ‘gate-keepers’ protecting huge profits, thus amplifying tensions and reducing interest in political solutions. Banfield et al. (2006) review the impact of private business in some twenty conflict and post-conflict cases. They, too, see examples of “conflict opportunism,” and note that this may directly sustain military operations or the suppression of civil freedoms. But they highlight the scope for private businesses (especially SMEs) to dampen conflicts by creating pockets of mutual understanding and shared interest. They identify cases where business personalities have played a valuable role – as insiders in negotiations, or as outsiders building trust and providing logistical support for a settlement.

More generally, Smith (2004), discussing unrecognized entities in the South Caucasus, notes that sustainable peace in the region will require economic opportunity, and thus ultimately a thriving business sector operating in internationally recognized legal and institutional frameworks. The relevance of trade incentives to this is confirmed by recent literature on economic institutions. For example, research on economic openness indicates that good institutions are favoured by an environment that is not conducive to rent-seeking, and that here external factors play an important role. Specifically, trade openness is strongly associated with better economic institutions, and hence improved chances of strong and sustained growth (IMF 2005). Openness and undistorted trade can be seen as factors favouring sustainable growth and thus helping to buttress peace.

The relevance of these considerations in the case of Cyprus is clear. Some interest groups on the island (or in Turkey) may flourish on rents derived from distorted trade patterns, and become defenders of the status quo. Others, including consumers, may see major gains if trade is regularized. Property rights in the north are contested, and this adversely affects foreign investment and banking. Some new possessors of housing or commercial real estate, after

population movements, may have developed a vested interest in avoiding regularization, unless their new holdings are in some way acknowledged and protected; and parties throughout the island are concerned to achieve compensation for property losses experienced during those periods of population movement.

More broadly, a regularization of political relations in Cyprus could lead to significant economic disruption as the structure of production (and the role of the state in supporting production) change in the north – a possibility illustrated in a more systemic fashion during the economic transition from in eastern Europe. Such disruption may be a concern for the population; but, nonetheless, they may see it as a price worth paying to secure improved medium-term prospects. Changes in trading patterns can also affect neighbours: economic actors in a regularised northern economy might emerge either as strong competitors or as valuable partners in markets (such as tourism and education) that are important to neighbours, including in the south. Economic interests located in these neighbours may thus be drawn into play.

In all these fields, finally, perceptions may or may not be well-founded. In conflict situations, information flows can be as distorted as trade flows. It is plausible that political opinions may at times be influenced by incorrect perceptions of the economic realities, and in such circumstances the role of credible analysts – perhaps from international organizations or from academia – could be valuable in correcting misperceptions. At all events, there can be little doubt that economic factors, and the perception of such factors, are a potentially important influence on conflict resolution.

### **3. Economics and the Spring 2004 Reunification Talks**

In the Cyprus discussions three years ago, during which the author of this paper was an economic adviser to the UN team, there was only limited time to analyse in depth the economic challenges of reunification. Partly as a result, some key issues were never fully analysed from an economic standpoint, and this added to the inherent difficulty of reaching political agreement on them. In particular, three important questions were not effectively resolved during discussions:

- What was the income gap between north and south? A major concern on both sides, cross-cutting many key issues, lay in the potential costs and forms of support for income convergence within the island. But both sides over-estimated this gap during the discussions, and were probably too pessimistic on convergence prospects (see section 4 below).
- What would reunification cost, and who would pay? Even at a late stage in the talks some key costs were unquantified, including steps needed to regularize public and private sector balance sheets in the north. Moreover the strategy for resettlement in the north was still at a formative stage, with a range of possible costs and risks.
- How could a credible fiscal federalism be created, which would work well in the EU framework? The exchanges did not achieve a shared vision of the challenge, which needed to be addressed in the context of an island with a relatively heavily indebted south; an unquantifiably indebted north; an ex-reunification fiscal deficit peaking at perhaps 10 percent of GDP; an exchange rate peg; and plans for early euro adoption.

These questions were recognized to be important, and were debated, but were not resolved with a deep consensus. A fourth question is no less important, but received even less attention:

- How might the dynamics of the two economies – north and south – evolve in the aftermath of reunification? What would be the convergence mechanisms and requirements? What challenges would have to be faced in the labour market? Would firms in the south face opportunities or threats, and in which sectors? Would labour in the south stand to win or lose in terms of income growth over the medium term, and under what conditions? Could the north be assured that there would be mechanisms – public and private – to finance the infrastructure needed to benefit from intra-Cyprus convergence and access to new markets?

These are not necessarily elements that could be “planned” in advance, in the old-fashioned sense of state planning. But some shared analytical framework and sense of common policy priorities seem essential for a successful economic outcome.

Addressing such questions upfront would help ensure that there is greater clarity among voters about the future – and this could have complex effects on their assessments and preferences compared with the situation in April 2004. At that time, voters may have been guided by economic perceptions that, in some cases, left important considerations out of account.

Specifically, *in the north*, for example, there was in April 2004 a convincing intuition that EU membership offered a source of income convergence and new job opportunities. But convergence is highly policy-dependent: voters may have underestimated the adjustments needed to achieve sustained convergence. Economic liberalization and reform of the public sector are agendas that clearly need to be pursued in the north under all circumstances, but they will bring some painful adjustments as they affect different interest groups in the economy.

Such adjustments are easier if undertaken at a time of buoyant growth. Thus, in principle, reform and conflict resolution may work in a mutually-reinforcing manner. Nonetheless, the share of the capital stock that could prove unviable, and the number of jobs that may be lost, during such a reorientation should not be underestimated.

These factors can be important, or course, in any environment where the economy has been distorted, as in the case of the transition economies. The additional consideration in a conflict situation is that they may influence not only the willingness to *support reform* but the readiness to *support and act in favour of conflict resolution* and, where relevant, legalization of an entity's status. In Cyprus, they represent a potentially negative factor that inevitably will need to be addressed.

In the case of northern Cyprus, a bridge in this direction (discussed further below) would be the staged shadowing of the *acquis communautaire* (which is formally suspended in the north), thus moving to harmonize with the EU before a settlement. However, constraints on the trade of the north reduce the scope to benefit from a reorientation of the economy. The economic incentives and opportunities to gain from a full shadowing of the *acquis communautaire* are not present. Moreover, hard budget constraints have not been fully applied by Turkey, the principal aid donor, to set the stage for more fundamental public sector reforms.

By contrast, *in the south*, as noted in the retrospective report of former UN Secretary-General Annan, voters may have perceived mainly the risks of reunification, including the economic and financial risks: uncertainties or costs that could hamper growth after 30 years of progress. This may have left important factors out of account: there is substantial scope for synergies in economic development that would also benefit the south. As acknowledged in the authorities' submissions for the EU's Lisbon dialogue on reforms that can foster growth and jobs, the economy in the south needs continuing structural

changes to enhance competitiveness. reunification – on the right terms – can be a source of stimulus, synergy and opportunity.

One should note also, from the standpoint of people in the south, that the economics of the property settlement were complex, finalized at a late stage, and perhaps not widely understood: people were not convinced it was in their true interest. A recent study by Stelios Platis and others sheds some interesting light on the dynamics of the proposed Property Board, which can be interpreted rather favourably (Platis et al, 2005).

These considerations could lead to a schematic representation of the interests that might win or lose from reunification in Cyprus – though in some cases the scope for gain or loss may be misperceived, and in some cases also policy actions or developments on the ground could change the relevant perceptions in the future (for a discussion, see Section 5 below). Further work to clarify this issue, to find ways of addressing concerns, and to correct mistaken perceptions, would be a valuable preamble to resumed negotiations.

To be clear, during the UN-sponsored discussions in 2002-04, there was very limited time to explore these issues. But, if economics is indeed an important driver in political affairs, then the negotiators were labouring under a significant disadvantage. One conclusion would be that, if we do not learn from this history, we may repeat it – at some point re-entering discussions with a sense of urgency, but on the economic front being still rather ill-prepared. Informal bodies, such as the Wolfson Cyprus Group, have organized bi-communal discussions on key economic issues, but these have taken place against a political backdrop that has been unpromising for a re-start of formal technical talks.

#### 4. The income disparity between north and south

During the past three years, growth has accelerated in both north and south. This narrowed the intra-island income gap, and boosted convergence towards average EU income levels. In the south, growth averaged two percent during the run-up to EU membership, but then accelerated to nearly four percent in 2004-5, and is set to remain at this level over the next two years. In 2004 per capita GDP stood at 84 percent of the EU average. In the north, growth averaged 6 percent in 2001-2, in the wake of economic volatility in Turkey and a banking crisis. It accelerated in 2003, and GDP rose by 42 percent over the three years to 2005. With the acceleration of growth in the north, the income gap across the island has been shrinking, although the recent pace and pattern of growth in the north does not appear fully sustainable.

**Table 1. Real GDP growth rates in the north and the south (in percent)**

	2001	2002	2003	2004	2005
South	4.1	2.1	1.9	3.8	3.9
North	5.4	6.9	11.4	15.4	10.6

In addition, work in the World Bank has pointed to an income gap between north and south that is much narrower than assumed at the time of the Annan Plan talks. This is an important issue, since the perception of a massive inequality of living standards may have been an important element underlying the concerns on both sides in the negotiations, and also influencing the referenda outcomes.

The conventional wisdom was that living standards in the north lag very far behind standards in the south, and were not catching up with them. Ayres (2003), while warning of measurement hazards, cited EU per capita income data for 2000 that contrast a level of US\$ 6000 in the north with US\$ 13000 in the south. The convergence projections of Mehmet (2004) start from a disparity of 60 percent between income levels. The 2004 report on the Annan plan by

Eichengreen et al. bases its convergence projections on a 60 percent wage gap. In sum, published estimates at that time were based on market exchange rates, and broadly suggested that incomes in the north were around *two-fifths* the level in the south. The authors of some studies thus foresaw very long catch-up periods. For example, Eichengreen et al. warn that, even on a benign scenario, incomes in the north might still be only 62 percent of levels in the south by 2020. However, data available to the authors at that time did not allow comparisons to be made on a purchasing power parity (PPP) basis.

The World Bank has sought to adjust data roughly to a PPP basis, as shown below. The World Bank estimates suggest that the level of living standards in the north could be as much as *three-quarters* of that prevailing in the south. These estimates could perhaps be biased upwards, to the extent that the PPP adjusters used in these calculations are based on price levels in Turkey, since data are not available for the north. Moreover, in assessing living standards, it should be borne in mind that the economy of the north benefits from very sizable external assistance, mainly from Turkey – and in the event of reunification there would be a major adjustment to more open economic conditions. On the other hand, it seems clear that earlier estimates seriously overestimated the living standards gap, and this sheds new light on the context of a reunification settlement.

**Table 2. Per capita income in north and south in 2004 (current US \$, 000s)**

	Nominal	World Bank Atlas	PPP-corrected
North	8.1	7.2	14.8
North – revised base	9.2	8.2	16.9
South	19.4	17.6	22.3
<i>Ratio(north: south)</i>	42	41	66
<i>Ratio - revised base</i>	48	47	76

*Source: IBRD Mimeo.* Statistical Note: The World Bank Atlas method for correcting GNI takes account of nominal exchange rate fluctuations; PPP estimates correct for differences in purchasing power. The revised data base takes account of the input-output matrix developed to assess the adequacy of GDP data in the north by extending coverage of the formal private sector (but not the informal sector, which would add a further 20-35 percent to estimates of economic activity).

## **5. Synergies in a Converging Intra-Cyprus Economy**

When we look for gains from economic integration, one of our first thoughts as economists is to exploit sectoral complementarities and benefit from comparative advantage. In Cyprus, by contrast, the two economies are sectorally quite similar in structure and in comparative advantage. So sectoral synergies, rather than sectoral complementarity, are likely to be an important source of gains. These could be important in several areas.

There seem, first, to be major synergies available in tourism. Exploiting these now is rather difficult in terms of property rights. But it is easy to see how one-time visitors to the south could be tempted back by unexplored sites and the important (though fragile) environmentally appealing areas in the north. Moreover, this is not a win-lose proposition. A night gained in the north may bring one in the south along with it. In fact, convergence in tourism could help restyle the tourist-market image of the south by adding new cultural destinations and beaches.

Education is another growth sector. Northern academics rightly stress continuing quality challenges, but they have shed light on the way ahead. Cyprus has exceptional positioning to deliver higher education products to an East Mediterranean market, and indeed further afield in the Middle East, the Caucasus and Central Asia. An island-wide education network – in an atmosphere of ethnic, linguistic and religious tolerance – is potentially a trump card in service sector development.

Business services represent a regional market of huge promise, and one where new and potential competitors are poised to expand market share. The years of early EU membership offer an unprecedented opportunity to build on existing success in the south. For the north this is also a field in which important

opportunities exist – but are handicapped in a number of ways by the political status quo.

**Table 3. Selected Economic Factors that may have affected Perceptions**

	Possible perceptions in April 2004		Scope for Perceptions to Evolve	
	<i>north</i>	<i>south</i>	<i>north</i>	<i>South</i>
<b>Perceived impact on living standards</b>	Strong hopes of higher living standards	Some concern success of south could erode	More awareness of transition to prepare change	Analysis may help highlight real synergies
<b>Perceived effect on monetary stability</b>	Would bring greater stability	Might weaken sound monetary regime	Euro adoption in south in 2008 to confirm this	Euro adoption removes this major concern
<b>Perceived effect on fiscal management</b>	"Pain" of fiscal reform probably under-estimated	Strong concern about fiscal viability	Progress now would allow a transition period	Ex ante talks on fiscal federalism could reassure
<b>Perceived effect on business interests</b>	Great hopes from direct trade and tourism	Concern about competition in, e.g., tourism	Must recognize extent of likely restructuring	Sectoral studies could reveal positive scope
<b>Perceived effect on regional role</b>	Scope to broaden regional trade links	(Settlement with Turkey positive potential)	Must internalize need to upgrade competitiveness	Studies could role as enhanced regional hub
<b>Perceived impact of property settlement</b>	Some disruption feared from movements	Negative on credibility of proposed deal	Situation harder, though attempts at local process	This remains a major (and now tougher) hurdle

Manufacturing industry is not a sector of the future in terms of GDP share, but it remains important. Moreover it seems to be underdeveloped in the north, where there is nonetheless a skilled labour force. Convergence could be seen as part of a broader philosophy of changing not just market access but also economic incentives in the north – which have not prevented economic development but which are public sector-oriented and very aid-dependent. To the extent there is an anti-export bias in the north this could be corrected. Nonetheless, it may be that full liberalization and opening of the economy of the north triggers a major adjustment in the traded good sector, and it will be important to respond via actions that enhance flexibility and skills in the labour market – not via a step-up in subsidies. These points may seem obvious. But they may not be the economics that the man and woman in the street, three years ago, had at the back of their minds.

Over time, convergence through liberalized markets will tend to foster viable and outward-looking economic opportunities – although this will involve adjustment stresses. Divergence that routes the trade of the north through distorted channels will embed the special interests which benefit from those channels; and such interests will suffer, inevitably, when those distortions are removed. It may be helpful at this stage to summarise schematically some of the actual and perceived economic influences that may be relevant to forward movement on reunification (Table 3) Clearly the points of view in this table should be viewed as stylized: in reality there were many varying interests and no doubt wide spectrums of opinion on each side.

## **6. Economic reforms and the convergence challenge**

The macroeconomic and structural reforms in discussion or underway in both the north and the south are conceived in terms of accelerating sustainable growth and thus income convergence toward the EU average. In the case of the south this implies an upgrading of the growth rate registered over the past few years. In the north, by contrast, growth has recently risen to unsustainable levels, and a slowdown is already underway. With sound policies, the two economies should settle on a path of stable “internal” and “external” convergence. The design and process of economic reform can help accelerate income convergence in both respects, and can also foster greater structural convergence within Cyprus.

First, in the north the *acquis communautaire* represents a network of institutional and policy reforms that can accelerate economic integration with the south and the rest of the EU. Presently, of course, the *acquis* is suspended in the north; but the scope exists to shadow it, and in a number of areas progress has already been achieved. Priority areas include those essential for a single market in goods and services – such as phyto-sanitary requirements,

certification of origin of products, competition policy, etc. Obviously there is rich experience in the south with adopting the *acquis* in an economy similar in structure to that of the north. It would be perverse if problems with EU financing slowed the shadowing of the *acquis* in the north. Still more so if problems concerning *recognition* that complicate the use of “official” offices or communications involving “official” job-titles – or indeed just a negative psychology on either side – left the north without intra-Cyprus assistance as regards experience in adopting the *acquis*. The agreement on the EU aid package can, *inter alia*, help catalyze progress on the *acquis*.

Second, public finance reforms in the north can help address very positively a number of concerns that surfaced in the 2004 discussions on economic issues. It should shift resources from current to investment expenditure; cut the fiscal deficit; and deal with the issue of outstanding loans to publicly-owned enterprises, which is important for incentives in the banking system. Placing the public finances in the north on a viable basis, *inter alia* by clarifying public and external debt levels, represents both a key to improving the investment climate and a major contribution to the reunification agenda.

It may be considered also that euro adoption (preceding reunification) will reduce fiscal and financial concerns in the south, to the extent that any risks to the exchange rate peg no longer apply, and the costs of reunification do not risk creating problems in observance of the Maastricht fiscal deficit reference value. In some ways, however, adoption of the euro will change rather than eliminate such concerns; and the absence of exchange market discipline is not an unmitigated gain. The advent of the euro also removes the exchange rate as a source of flexibility and adjustment. In the south, of course, the long-standing nature of the Cyprus pound peg has not cast it in the role of an adjustment instrument. The north, however, has “benefited” periodically from a safety valve (depreciation of the Turkish Lira) when its competitiveness had become weak.

It is true that the membership of monetary union would resolve some central banking issues. It also brings strong fiscal commitments under the Stability and Growth Pact. Moreover, in both north and south the real sector will need to display flexibility in order to sustain growth, as relative resources are reallocated under reunification – particularly if neither side has the exchange rate available as an a safety valve. It is important also to have some sense in advance where there will be winners and losers, so as to identify skill needs and strengthen mechanisms to support adjustment.

Third, for the north and also the south, there is scope more generally for synergy in pursuing economic reforms. Several examples spring to mind. For example, both north and south need to embark on social security reform to address the challenge of population ageing. It would make great sense for the reforms to be designed in ways that have broad compatibility. More generally, the labour market is a key area in which convergence is taking place. It would be desirable to put in place a framework assuring the compatibility or portability of different types of benefits and regulations between north and south. At a still more general level, the Lisbon agenda is clearly relevant to both parts of the island, where there will be a continuing need to move up-market to meet competition from lower wage economies. This process is crucial in unlocking more rapid growth, which in turn will ease concerns (in both north and south) about shocks and adjustments involved in economic convergence and reunification.

So there is scope to meet various economic reform challenges in Cyprus through a process of coordination between north and south – however informal – in the broad framework of the *acquis communautaire*. Or one might embark on the economic future with scant regard to this, but that is a strategy that will not facilitate the working of convergence mechanisms in the labour market or elsewhere. The past three years, despite some progress on the Green Line, seem to have seen the gradual embedding of an uncoordinated approach to reform.

## **7. The Risks That Economic Gravity May Foster Divergence**

An economic reform agenda is not only important in its own right for both economies: it can also enhance economic constituencies for reunification – indeed it might serve as a form of high-level *confidence building* approach. The alternative may be that opportunities to foster convergence begin to slip away. To make these opportunities and risks more concrete, it may help to think of them in terms of the different markets through which intra-Cyprus convergence could be a mechanism of growth.

Economic links between north and south are developing through limited channels. Labour market and tourist sector integration, through movement of persons across the Green Line, are the main elements. Trade volumes between north and south have been rising, but remain low, and there is little or no portfolio or direct investment across the Green Line. Overall, the partial opening of the divide since 2003 has added some EUR 100 million (9 percent) to the GDP of the north, mainly from labour income of workers from the north employed in tourism and construction in the south.

First, the labour market has begun to function substantially. We know relatively little about how it is affecting prices and wages, but a recent survey by Professor Ozay Mehmet and others begins to explore the structural shifts going on in the labour market. This suggests that there is not necessarily a net drain of skills underway from the economy of the north; but it also draws attention to a set of integrated changes that include flows of migrants from Turkey – and the need to think carefully how to handle this situation going forward. One aspect of the changes underway, at all events, must be to raise wage rates in the north (including as migrant and other informal labour is registered). This makes more urgent the pursuit of reforms to enhance productivity in the north. Moreover, the social security framework for commuting across the Green Line appears in need of attention.

Second, in services there is some synergy developing in tourism, but in a very informal manner. Both economies are probably gaining, but there is no synergy on the provider side. Some efforts have been made to explore joint projects, but barriers have surfaced – including property rights. And the dependency of the north on package tourism is troubling, since it encourages a pattern of development that is not particularly environmentally friendly. In the healthcare sector, people in the north are now benefiting from facilities in the south.

Third, it is clear that the goods market is not working effectively. The volume of goods that crosses the Green Line has been rising, but very slowly in terms of the potential that is there. Trade with the south is equivalent to some 4 percent of total exports of goods and services from the north. Flows of goods were some CYP 275,000 in the last four months of 2004; CYP 981,000 in 2005; and CYP 142,000 in the first six weeks of 2006. Little trade passes from south to north. The main exports from the north have recently been agricultural products, followed by electrical goods and wood and stone products. Other workshop sessions will be devoted to that topic, but it is clear that a quantum change is needed for this channel to be truly substantive in terms of impact on the pattern of economic growth. The problems are quite complex though – ranging from taxation to standards and certification, to marketing and design, and to consumer psychology as regards the acceptance of goods from across the Line.

Finally, an intra-island capital market is not there, and the capital market in the north is not yet fully supporting growth. An integrated capital market could, of course, play a key role in supporting economic expansion in the north – in combination with know-how and experience in the south in accessing other markets. Again, property rights are a major issue for capital market development in the north, affecting the scope for SMEs to be a source of dynamism, innovation and employment creation. Capital market segregation and distortion have costs. And, of course, developments in property ownership since 2004 have further complicated issues to be resolved in the future –

whether through bilateral legal or broader settlements. In particular, there has been further construction on disputed land; and some improvement of properties since April 2004 may have been triggered by a clause in the Annan Plan (Version V) that took improvements into account in determining the rights of a current occupant.

Anecdotal evidence suggests that economic links between the north and Turkey are also deepening. These links include sizable financial flows to the north, technical assistance in approximating to the *acquis communautaire*, and help in designing and implementing public finance reforms. Available data suggest that airline flights between Turkey and the north have been rising at a pace exceeding 20 percent per annum.

This is a mixed picture. It underscores, in several key respects, the costs to the economy of the north in the present status quo. Even in narrow economic terms, a major drawback of the now-traditional pattern of growth in the north is that it involves significant distortions. Those affecting trade are obvious, and include sizable informal costs. Moreover, property rights are a major distortion, and their impact, as already noted, is rather pervasive – affecting the scope for bizonal tourist development and also the form and pace of financial development. In other words, economic incentives for the north strongly favour reunification. But in the absence of progress on the economic front, the short-run incentive for firms and service institutions in the north can be to look to alternative strategies, in the long-standing setting of monetary union with Turkey.

For the south, too, there are opportunity costs in continuing separation, as the economy adjusts to meet the evolving challenges of an increasingly globalized service economy.

## **8. Conclusion: Are there Lessons for the Future in Cyprus other Cases?**

Looking at the Cyprus issue from an economic perspective may seem a narrow focus, but it does highlight a major risk facing all parties. The passage of time could result in incentives and pressures working to make any breakthrough progressively less likely. Economic interests can embed separation. Uncoordinated reforms can inhibit convergence. Unless other incentives are put in place – such as the EU aid package, initiatives that could flow from the Annan-Papadoulouos communiqué, and evolution on the trade issue – one could face a process of creeping divergence.

In other words, if economic incentives were indeed to work perversely, they could jeopardize the path toward reunification. People would grow apart, not together. Reunification initiatives, as they affect the economic domain, could be like Gulliver: tied down and immobilized by the Lilliputian threads of daily economic life.

This perspective also suggests a valuable way forward, which could contribute to catalyzing a dialogue. Apparently foreshadowed in the 2006 Annan-Papadopoulos communiqué, this is to establish technical meetings between north and south that would provide a forum to study and report back, on a bi-communal basis, on key issues of mutual concern. While this may in part begin with modest and operational issues, it could also come to embrace some of the economic questions explored above. It could serve as a channel of communication on reform progress and compatibility. It could also call for submissions and contributions from other bodies. It could, for example, ask for an evaluation of EU experience with fiscal federalism and decentralization in the context of the Stability and Growth Pact. Finally, it could explore areas in which economic elements of the reunification agenda could be put into place bilaterally on a confidence-building basis.

This approach could help lead toward a path of convergence and reunification, which should be attractive to both sides, under the right conditions. No question, the role of a unified, multicultural Cyprus – an EU hub in the East Mediterranean, and a global exporter of high quality business, tourism, and education services – is an *image de marque* that could steeply enhance its citizens' prosperity and well-being. It could serve also as a pole of attraction, stability and security in the entire region. Good business and good politics, this seems a deeply attractive future – and one which, while perishable, is still open to Cyprus today.

The experience so far in Cyprus also suggests some wider lessons.

First, it illustrates concretely the potential role of certain economic influences that can influence progress with conflict resolution in such cases – for example, property rights and the impact of a potential settlement on economic growth and stability.

Second, it is an unusual case in terms of progress in legalising trade. The Green Line regulation, in effect, gets around a fundamental recognition conflict to allow legal bilateral trade to take place between the parties in dispute. As such, it has rightly attracted the attention of experts working on problems in the Caucasus: informal discussions on this have taken place during the past two years – involving experts in Cyprus and the author of this paper.

In this latter respect, Cyprus may offer a model to exploit in other cases, though one that is dependent on three factors: an external actor (e.g., the EU) able to press through an agreement; a legal instrument that can be adopted externally (e.g., the "Green Line Regulation"); and the identification of local agencies such as NGOs – in this case the Turkish Cypriot Chamber of Commerce – which can act as a formal agent acceptable to both sides for the purposes of certification and other legal issues. From the point of view of some actors in northern Cyprus, the green Line Regulation has not lived up to some hopes; but

for those who have no such legal trading regime it may be a promising avenue for progress.

Third, in the view of some commentators, there are lessons in this case about the way in which the EU's capacity to promote solutions evolves once it becomes itself a direct party (e.g., one side is the legal representative of a member state), compared with possible leverage during the Accession process. It can be argued that the EU's influence is then no longer on a level playing field, with one party having voting rights in the Council after Accession. Alternatively, it could perhaps be argued that EU membership might actually facilitate resolving issues within the broad framework of the *acquis communautaire*, and help foster "deals" and informal pressures that make a favourable outcome more likely. At all events, this issue deserves further study, since lessons here may be relevant in parts of southeastern Europe, and the merits of this issue deserve further exploration.

Finally, informal organizations such as the Wolfson Cyprus Group have played a role in bringing together actors on both sides to debate macro-and microeconomic issues of mutual concern. Nonetheless, it has been difficult to secure substantive progress without the engagement of the two sides in direct talks. This underscores that, while economic analysis and perceptions can be important, they are at most co-drivers in what is, at heart, a deeply political process.

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