

# WILTON PARK CONFERENCE

## CYPRUS: THE WAY FORWARD

**How can the economic gap between the two communities be reduced and mutual development best achieved?**

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### **Introduction**

The need to develop a shared economic vision of convergence and reunification as a positive sum process emerges powerfully from the UN Secretary-General's report of 28<sup>th</sup> May, 2004. He wrote in these terms of both the South and the North:<sup>2</sup> *"Many see in the settlement little gain, and quite a lot of inconvenience and risk."*

One could not ask for a more succinct summary of the underlying economic issue to be addressed in moving forward. Convergence in the economies, and in economic vision, can help importantly to pave the way toward a comprehensive solution.

The months ahead offer a precious opportunity to advance on five fronts:

- through technical and informal discussions, to foster a **shared vision** of how economic convergence can bring benefits to both sides;
- to monitor and analyze **changes taking place on the ground**, assessing the potential to foster a "win-win" experience that builds support for a settlement;
- to map out economic and social changes in the North, and put in place **policy frameworks** that help foster convergence and pave the way to a settlement;
- exploit fully the **potential of the *acquis communautaire*** as a potential basis for harmonization and convergence, extending to "best practice" in selected policy areas where progress is needed; and
- to show imagination in extending **the present process of staged progress** to build confidence, embed mutual benefits, and bring closer a settlement.

The time pressure of the 2004 discussions precluded a full exploration of many economic issues, and by force of circumstance left little time to foster a shared vision of a future that would bring gains to both sides. Filling this gap would help to pave the way forward. One useful step could be, in some practical format, to build on the technical economic work that was underway during the discussions in spring 2004.

### **Developing a shared vision**

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<sup>1</sup> This paper reflects the author's presentation as a Discussant, adjusted in light of exchanges during the Conference. It is his sole responsibility, and is written on a personal basis. The author is a member of Wolfson College, Oxford; a Visiting Fellow at the University of Reading; and an Economic Adviser to DG ECFIN, European Commission. The paper does not seek to represent the views of these institutions.

<sup>2</sup> The terms "South" and "North" are used throughout for ease of reference, not in terms of recognition.

Productivity and income levels in the North of Cyprus are substantially lower than in the South. Against this background, enhanced access to markets, and the right macroeconomic and structural policies, have the potential to trigger strong and sustained convergence, bridging the economic gap between the two communities.

This process can be of major benefit to the South as well as the North. Important synergies exist between the two economies – and valuable complementarities in production factors and market niches: the scope is present for a virtuous circle in which sustained convergence and reunification bring strong benefits to both (Box 1).

### **Box 1 – The Scope for Mutual Economic Gains**

The two communities are specialized in similar sectors: future growth in both lies to a high degree in market-oriented exports of services. But convergence between them is not a zero-sum game. There are important synergies to realize between the two – as well as complementarities in the market niches they can exploit. In tourism, the North has the opportunity (which must not be lost) to develop key markets such as eco-tourism, drawing in new and repeat visitors who will in many cases spend periods also in the South. In exporting educational services, the communities can potentially exploit complementary regional catchments. More broadly, rising incomes in the North will offer valuable markets for goods and services from the South. Companies based in the South (including through joint ventures, and with many investors from other countries) would naturally be among those contributing to, and benefiting from, accelerated development in the North. In the labour market and other factors of production, there are important synergies to realize.

Such synergies will not achieve their full potential without the right setting – including effective market access; measures to ensure that growth is sustainable and soundly financed; and action to address distortions or social tensions that emerge in the course of convergence. A further critical requirement is that sustained growth and convergence take place in a manner that helps strengthen constituencies for reunification, easing the challenges en route to a final settlement.

In other words, convergence needs to be managed. That is true over the medium term, including under a final settlement. But it is true also of the economic changes taking place on the ground at the present time.

### **The evolving situation on the ground**

In economic terms, the situation on the ground has been changing in ways that are potentially important. This is clear in the labour market, with the staged opening of the Green Line to commuting workers. It is also occurring in the goods market, on a scale that should progressively expand. As data on developments in incomes, wage rates and relative prices (for both traded and non-traded goods) emerge, these will provide valuable insights into the benefits and challenges of convergence. In these markets, apart from the growing level of transactions, a key aspect is that exchanges between the two communities have been moving into a transparent and legal mode. More complex developments are evident in the property market, with a boom recently underway in the North that reflects both sustainable and unsustainable elements.

In broader political economic terms, these changes should also shed light on ways in which bi-communality and convergence play out in practical terms. It will be important that the process on the ground clearly results in benefits for both sides – and is seen

and understood to do so in the short as well as the long run. The potential for a positive or negative impact on this front is key.

Experience in other areas of the world – where non-recognition or limited recognition of states is an issue – underscores that changes on the ground can have quite far-reaching implications. They can help to build constituencies for a settlement, or the reverse. Transparent exchanges, which divert resources from rent-seeking channels to the legal market place, are core examples of benign change: they build wide support for the gains that final settlement can unlock.

For all these reasons, it is valuable to monitor and assess the convergence process underway on the ground in Cyprus, and help shape and manage it constructively.

### **Information, Analysis and Policy Frameworks**

Convergence is not an automatic process. This is clear from the diverse experience within the EU – both across both countries and across time periods in any one country (Box 2). Convergence depends on policies, some of which act with long lags, and on the role of institutions. Structural issues are important, but macroeconomic stability also is needed to trigger take-off. In this connection, policy frameworks in the North will need to cater for a strong private and public investment boom, particularly as prospects for reunification improve, and ensure that this is soundly financed. One element underlying the recent economic in the North will, over time, come to have much wider and positive repercussions: the impact on the economy of financial stabilization in the Turkish economy, and the resulting decline in real interest rates.

In the immediate, several priorities can set the stage for sustainable growth and convergence – and contribute to a shared vision in the context of a final settlement:

- **The value of information gathering and analysis in the North should not be underestimated.** An understanding how price and wage dynamics are likely to evolve in the North (including public versus private wages) is important so as to ensure that wage decisions are well informed and that price shocks are cushioned, where needed, for vulnerable groups. Ongoing price and wage developments, moreover, will signal skill needs and potential social pressures that may need to be addressed in a process of continuing economic change. Reunification, in turn, will potentially entail the movement of many thousands of individuals: a social and skills assessment in the North is needed to prepare for this – laying the basis for a viable housing strategy in the future, blending market incentives with warranted social support.
- **With regard to macroeconomic policies, the public sector's key role in a convergence setting is as a facilitator of growth.** In the North, there is a far-reaching challenge to reform the public sector in ways that can retarget activities from consumption to investment, and also free resources to make way for the investment and labour force demands of strong private sector expansion. In the near term, the current phase of strong growth provides an ideal context to press on with public sector restructuring – including taxation and social security reform. Turning to reunification perspectives, the case

#### **Box 2. Economic Convergence in the Enlarged European Union**

Experience with convergence in the enlarged EU was the subject of a study in the 2004 Annual Economic Report of the European Commission. Several features that emerge from this analysis appear closely relevant to the way ahead in Cyprus:

- In recent decades, average annual rates of ( $\beta$ ) convergence in the EU were some 2-3 percent. but varied sharply. Even Ireland's much more rapid growth

for public sector reform is even clearer. To buttress private confidence, as well as to achieve Stability and Growth Pact targets, policy-makers in both North and South will need to draw on experience elsewhere in crafting a solid fiscal framework for the combined economy, in a manner credible to markets. Last but not least, the development of a sound medium-term macroeconomic framework, by setting a baseline for reunification plans, can help define the specific needs for external financing in catalyzing a soundly financed solution.

- **Structural policies, including the role of institutions, play a critical role in fostering strong convergence.** As regards structural priorities in the North, three challenges stand out: progress with components of the *acquis* that accelerate product market integration (discussed further below); a forceful programme to enhance the competitive working of markets, paring back interventions that distort incentives; and further steps to ensure that the financial sector can play a full role in supporting broadly-based growth. Experience with German reunification (albeit in an entirely different political and economic setting) has underscored that the stakes of convergence are high in the functioning of the labour market and the conditions for private investment, including property rights. The way in which benefit programmes are designed; how flexible wages prove; how legally secure investments prove; how productively public transfers are used: these are key challenges.
- One valuable feature of pre-Accession in eastern Europe was **benchmarking and external support for reforms**. Some informal benchmarking along the lines of the EBRD's Transition Report surveys could be valuable in assessing progress, and in identifying priorities to enhance the business environment. Moreover, outside bodies – while they cannot substitute for domestic reform momentum – can foster, guide technically, and support key structural reforms: they represent a valuable mechanism for commitment and monitoring.

**Current policy priorities in the South** can also help lay the basis for convergence. The crucial priority is to press through with the forceful fiscal consolidation plans laid out in the current EU Convergence Programme. This is desirable in its own right to safeguard sustainability in the public finances; it is critical for a swift path to euro area membership; and, importantly, it also sets the stage for a strong expansion of investment in the setting of convergence and – when the time is ripe – reunification. In terms of structural policies in the South, the present policy focus on facilitating a

shift of private sector up the value added scale, through stronger R & D in the public and private sector, through enhancement of skills, and through easier entry to markets – is highly congruent with convergence.

This is not to deny the key importance of the demand side for sustainable growth in the North: unimpeded market access for goods and tourist and educational services is fundamental. More broadly, one has to view frameworks for durable growth in the North, as well as the South, as favourable elements for both communities and for a settlement. Durable growth roots even more deeply convictions that reunification is essential. And progress with sound policy frameworks is itself a valuable component in paving the way toward understandings that can lead to a final settlement.

### **The Acquis Communautaire and the EU Dimension**

In the immediate, harmonization with the *acquis communautaire* in the North, in areas ranging from product markets to financial standards and public accounting norms, can help anchor reforms and enhance compatibility. Much more efficient access to markets for the North, and an identification of acceptable confidence-building measures, can help carry forward convergence.

But experience across the EU with policies and institutions offers also a broader resource to draw on imaginatively (Box 3). Experience can be tapped in a range of areas – including, but not limited to, policies to accelerate economic convergence, complex but viable fiscal structures, durable financial reforms, the underpinning of monetary anchors, and measures to address product and labour market challenges. In this respect, the scope for the *acquis* to act as a catalyst in achieving consensus solutions is broad indeed.

#### **Box 3. The Acquis Communautaire as a Catalyst**

From a layman's standpoint, the relevance of the *acquis* to Northern Cyprus may seem to lie primarily in the harmonization of regulations relating mechanically to **goods and services in the context of a single market**. And indeed, in this narrow sense, harmonization with the *acquis* certainly is a key factor that can help level the playing field for exchanges across the two communities. Priority areas for harmonization of this kind include obvious candidates such as agriculture, customs, public sector procurement, statistics, or taxation.

However, the impact of the *acquis* also lies in **frameworks that relate more broadly to private and public sector engagement in the economy** in areas crucial for investment and growth. Examples are the *acquis* relating to financial sector regulation; to the energy, transport, and telecommunications sectors; the environment; judicial systems; and aspects of public sector management relating to public accounting, health, and social security systems.

The experience of discussions in the Spring of 2004 points, in addition, to a third and much broader relevance of EU processes. This often goes beyond the *acquis* in a technical sense to embrace an **emerging collective experience concerning best practices** in organizing economic activity. An example would be the public finances, where Member States have had to wrestle with institutional ways in which national complexities can be accommodated creatively to deliver results compatible with EU goals such as the Maastricht criteria or the Stability and Growth Pact. As it harmonizes increasingly with EU practice, the North can tap this common experience – with a strong chance that solutions crafted in this way may in due course help pave the way a final settlement embracing such issues within Cyprus itself.

which illustrate its potential to support this process directly – working to enhance

market access, aiding with key aspects of the *acquis communautaire*, and buttressing convergence through both financial support and technical assistance.

### **Progress through a Staged Process**

The debate whether to make progress through a staged process – as opposed to the immediate reopening of discussions on a comprehensive package – has thus been settled in the immediate by events on the ground. A staged process is underway already, even if gradual and with inevitable setbacks. The opening of the Green Line has occurred, and is being widened. Importantly also, the process of harmonization with the *acquis communautaire* across the economy of the North is fully accepted, and technical assistance is being put in place to jump-start this. In other ways, too, the context has moved on – prime examples being the stabilization of the Turkish economy, and the fact that Cyprus is now a Member State of the EU.

The challenge is to monitor, understand, and keep ahead of events – reinforcing trends that hold potential. Imagination may be needed in identifying expanding areas of staged agreement: putting pieces in place which reassure both sides that implementation of committed measures will truly prove viable. Among these elements, market access for the North remains a central concern.

A staged process can thus help build conviction that the challenge of a settlement is worth the candle. This is not to downplay the difficult political issues that lie at the heart of a final settlement – or the crucial need, on any growth scenario, for generous external assistance to help bring these elements together. But even with the most difficult issues there are key areas where careful preparation and staged progress can smooth the path to settlement. When the time is ripe, there is scope to exploit and build on the technical work done on economic issues by sub-committees during the discussions of Spring 2004, which held important promise for the future.

### **Conclusion**

Sustained convergence in Cyprus holds great potential from a political as well as an economic standpoint. This is a process that can unlock sustained and broadly-based gains throughout the economy, benefiting both communities. Putting convergence centre-stage, with its promise of mutual gains in both communities, can help move the dynamics of discussion away from downside risks and toward a positive-sum psychology. Soundly managed, convergence can pave the way toward a final settlement.

Such a promise underscores the importance of achieving practical progress on the ground now, through a staged process of advance; of analyzing developments closely; and of drawing on the *acquis* to put policy frameworks in place that will foster sustainable growth.

This is a demanding agenda, including in terms of the economic preparation needed to craft workable solutions and set the stage for strong and durable convergence. Such a focus, though, can help bridge gaps in understanding and foster a shared economic vision – bringing a final settlement of the Cyprus problem closer.