

Cyprus in Search of a New Economic Paradigm

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Introduction

The objective of this paper is to assess the current state of the Cyprus' economy and to put forward some major guidelines for a new paradigm.² This discussion takes place almost six years after the collapse of March 2013 and its ongoing repercussions. We also briefly review the causes of the crisis and attempt to evaluate to what extent it has been effectively dealt with. Within this framework the current structural problems and challenges are assessed.

In the first section, we overview the background and the context of this discussion. The political and historical dimensions are briefly assessed. We also focus on the economic crisis which led to the advent of the Troika. Furthermore, the socioeconomic cost of the Memorandum of Understanding is outlined. This is followed by a brief presentation of the stabilization and the recovery that eventually took place as well as the shortcomings of this process.

The second section addresses the record of the pursued economic policies focusing on the gap between the rhetoric and the actual results. Furthermore, a brief overview of developments that took place is put forward with an emphasis on specific sectoral dimensions. This section also underlines the fundamental structural problems that still exist. In addition, a brief reference is made to the socioeconomic and political situation in the northern occupied part of Cyprus.

In the next section, we describe the existing challenges and opportunities. Initially we assess the position of Cyprus in the regional and international context. Subsequently, the problems of the financial sector are examined. Within this framework special emphasis is given to the non-performing loans (NPLs). The importance of attracting foreign investment is also stressed. The socioeconomic and political implications of a solution to the Cyprus Problem are also assessed.

Then we briefly summarize the structural problems that have to be addressed.

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2 This paper was initially presented in Luxembourg within the framework of a conference entitled 'Competitiveness Strategies for the EU Small States' that took place in Luxembourg in 18-19 April 2018. This conference was organized by the Observatoire de la Compétitivité of the Ministry of the Economy of Luxembourg in collaboration with the Islands and Small States Institute of the University of Malta and the National Statistics Institute of Luxembourg (STATEC).

It is also stressed that almost six years after the collapse of March 2013 Cyprus has no comprehensive economic paradigm yet. We also underline the importance of enhancing the effectiveness of public administration as well as of the optimal utilization of human capital. A comprehensive economic paradigm should also include new engines of growth. Last but not least we also briefly refer to the unresolved Cyprus Problem and to the relevant implications.

Finally, a short epilogue places issues and challenges into perspective.

Background and Context

Political and Historical Context

It is essential to briefly review the economy of Cyprus and the causes of the economic collapse. When Cyprus became an independent state in 1960, it was basically an agrarian country with a very low level of development.³ Following independence there was a remarkable process of economic growth and development. From 1960 to 1973 the real annual average rate of growth was about 7%; furthermore, there were major infrastructural projects while the secondary and tertiary sector of the economy grew gradually both in size and relative importance. Within this framework tourism gradually emerged as a new sector of growth and development.⁴

This process was abruptly interrupted by the Turkish invasion of 1974 and the occupation of almost 38% of the territory of the Republic of Cyprus. The socioeconomic disruption that took place was unprecedented. Nevertheless, Cyprus managed to survive following a severe depression. The recovery after 1976 and the sustained growth rates and the development that followed were impressive. This was described as an economic miracle; its most important aspect was the survival and the continuity of the Republic of Cyprus.⁵

The economic success was a major factor which enabled Cyprus to apply for

3 D. Christodoulou, *Inside the Cyprus Miracle: Labours of an Embattled Mini-Economy*, (Minneapolis: Modern Greek Studies, University of Minnesota, 1992); A. Theophanous, 'Economic Growth and Development in Cyprus 1960-1984', *Modern Greek Studies Yearbook*, Vol. 7 (1991), 105-132; A. Theophanous, 'Cyprus: From an Economic Miracle to a Systemic Collapse and its Aftermath', in *Small States and the European Union: Economic Perspectives*, ed. L. Briguglio (London: Routledge, 2016), 28-49 and *The Economist*, 'Cyprus: Miracle in Half an Island', Vol. 264, No. 6991 (1977), 50-51.

4 Ibid.

5 Christodoulou, *Inside the Cyprus Miracle*. Be that as it may it is also essential to acknowledge that this process had its shortcomings. For example, tourist development and reconstruction took place in a way which did not take into consideration the environment. Moreover, the enhancement of the sophistication of the society and the political system lagged behind the sharp improvement of the material standard of living. For a comprehensive analysis see D. Christodoulou, *Where the Miracle has not Reached* [in Greek] (Nicosia: Intercollege Press, 1995).

membership to the European Union (EU) in 1990. The Republic of Cyprus joined the EU on 1 May 2004, despite the fact that the Cyprus Problem remained unresolved. Had Cyprus been denied accession to the EU because of the Cyprus Problem this would have amounted to rewarding Turkey for its aggression – the 1974 invasion and the ongoing occupation of the northern part of the island.⁶

The Annan Plan⁷ which the Greek Cypriots rejected a few days before accession – on 24 April 2004 – could not have been accepted as it was an imbalanced plan and was in many ways legitimizing the Turkish actions since 1974. Moreover, it was replacing the Republic of Cyprus with a new three headed state structure in which no major decision could have been reached without the consent of the Turkish-Cypriot side. Given the effective control of Turkey on the would be Turkish-Cypriot constituent state, Greek Cypriots were very concerned. Be that as it may the Republic of Cyprus was seriously criticized for rejecting the Annan Plan.⁸

With the accession to the EU, the adoption of the euro on 1 January 2008 and the ongoing globalization, the economic structure of Cyprus continued to undergo a serious transformation. By 2008 the tertiary sector of the economy was around 78% of GDP. The financial sector had emerged by this time as one of the most important sectors of the economy.⁹

It should be also noted that the collapse of the Soviet Union, Yugoslavia and the socialist block as a whole affected Cyprus in many ways. Suffice to say that Cyprus gradually attracted huge amounts of funds from the former Soviet Union and South Eastern Europe. There was an evident underestimation of the risks involved in the huge size of the banking sector: total banking sector assets were 808% of GDP at the

6 For an interesting discussion of all these issues, see A. Theophanous, *The Cyprus Question: The Challenge and the Promise*, (Nicosia: Intercollege Press, 2004).

7 United Nations, Annan Plan, 2002, I, II, 2003, III, 2004, V <http://www.un.org/Depts/dpa/annanplan/annanplan.pdf>.

8 President Papadopoulos was also under serious criticism from the opposition in Cyprus and from various foreign circles. There were serious critical reports in the international press. For example, see C. Deloy, 'Failure of the referendum on the reunification of the Island', Fondation Robert Schuman (2004, April 24), available at <https://www.robert-schuman.eu/en/eem/0291-failure-of-the-referendum-on-the-reunification-of-the-island>; S. Sachs, 'Greek Cypriots Reject a U.N. Peace Plan', *The New York Times* (2004, April 25), available at <https://www.nytimes.com/2004/04/25/world/greek-cypriots-reject-a-un-peace-plan.html>; S. Cagaptay, 'UN Plan Fails in Cyprus: Implications for Turkey, the European Union and the United States', The Washington Institute for Near East Policy (2004, April 29), available at <https://www.washingtoninstitute.org/policy-analysis/view/un-plan-fails-in-cyprus-implications-for-turkey-the-european-union-and-the-> and R. Bryant, 'An Ironic Result in Cyprus', *Middle East Report Online* (2004, May 12), available at <https://merip.org/2004/05/an-ironic-result-in-cyprus/>. Also see International Crisis Group, 'The Cyprus Stalemate: What Next?', Europe Report No. 171 (2006, March 8).

9 Statistical Service of the Republic of Cyprus.

end of 2010.¹⁰ By 2012 total assets dropped to 633% of GDP.¹¹ The problems of the banking sector were very serious. These entailed imprudent practices including reckless lending as well as lack of effective controls and supervision. There was overexposure in highly risky markets like Greece and elsewhere as well as poor corporate governance and risk management.¹² Furthermore, foreign, mostly Russian deposits, constituted a relatively high proportion of the total amount. Cypriot banks were also accused of money laundering practices.¹³ Furthermore, there were also corrupt interlinkages with several pillars of the socioeconomic and the political structure of the country. Inevitably the impact on the economy was negative.

Moreover, there was an inadequate understanding of the architecture of the Eurozone and its implications. When the Euro was created its implications were not fully realized. Leading economists, above all, Professor Martin Feldstein of Harvard University and Former Chairman of the White House Council of Economic Advisers had warned since the '90s of the faulty aspects of the architecture of the Eurozone and pointed to the prerequisites for its success.¹⁴ He also stressed that the Eurozone architecture did not have the tools to deal effectively with a major crisis and with serious asymmetric business cycles. Furthermore, instead of automatic stabilizers the system has embedded automatic destabilizers.¹⁵ There was a hidden assumption in the Eurozone structure that, more or less, the markets would be self-regulating.¹⁶ This was not a valid assumption.

There were countries which fulfilled the criteria for participating in the Eurozone, like Britain, but opted to stay out and countries that did not fully meet the criteria, such as Greece, but were accepted. It is tragic that Greece is in a protracted crisis with a very

10 Stockwatch, 'EY: Cypriot banking sector large' (2015, December 3), available at <https://www.stockwatch.com.cy/en/article/trapezes/ey-cypriot-banking-sector-large>.

11 Ibid.

12 Independent Commission on the Future of the Cyprus Banking Sector, *Final Report and Recommendations*, (2013, October), available at https://www.centralbank.cy/images/media/pdf/LSE_ICFCBS_Final_Report_10_13.pdf.

13 For example see A. Rettman, 'Leaked report damns Cyprus on money laundering', *euobserver.com* (2013, May 20), available at <https://euobserver.com/economic/120167>.

14 See the following articles by M. Feldstein: 'The Case Against the EMU', *The Economist* (1992, June 13), 12-19; 'EMU and International Conflict', *Foreign Affairs*, Vol. 76, No. 6 (1997, November/December), 60-73 and 'The Political Economy of the European Economic and Monetary Union: Political Sources of an Economic Liability', *The Journal of Economic Perspectives*, Vol. 11, No.4 (1997, Fall), 23-42.

15 See J. E. Stiglitz, *The Euro: How a Common Currency Threatens the Future of Europe*, (New York, NY: W.W. Norton, 2016) and A. Theophanous, 'Troika Fixes Fail: How to Fix the Troika', *Friends of Europe* (2014, December 4), available at <http://www.friendsofeurope.org/future-europe/troika-fixes-fail-fix-troika/>.

16 For a comprehensive analysis of the errors on the Eurozone structure see Stiglitz, *The Euro*.

high socioeconomic and demographic cost; some economists have described it as ‘the depression of the century’.¹⁷

Cypriots had very high expectations of the EU especially in relation to the Cyprus Problem. The main hypothesis was that the EU and its value system would contribute in various ways to the resolution of the Cyprus Problem. Cypriot policymakers also thought that the adoption of the Euro would entail economic as well as political implications.

When Cyprus found itself in a deep economic crisis the troika recipe was harsh. Cypriots knew that to a great extent the structural problems were of endogenous nature but it was clear that there was an exogenous dimension of the crisis as well. These included the Greek crisis and expediencies arising from the German elections of September 2013 which influenced the way Cyprus was handled.¹⁸ In March 2013 Cypriots felt that the package they received was extremely harsh in comparison to their sins. Cypriots have been also convinced that what was enforced upon them would never have been imposed on, for example, Italy or Luxembourg. The prescriptions given to Cyprus deepened the crisis. In addition, prudent Greek Cypriot institutions and citizens not responsible for the crisis were penalized.

The Economic Crisis and the Troika

The adoption of the Euro on 1 January 2008 was an important development. When Cyprus acceded to the Eurozone on 1 January 2008 the economic indicators were satisfactory. There was a fiscal surplus 0.9% of GDP; the public debt was 45% of GDP, inflation 4.7% and unemployment 3.2%.¹⁹ Cyprus’ successful record was a major factor which led to complacency and to the underestimation of developments that could lead to an abrupt end of this successful record.

After 2008 there were sustained deficits which also led to a dramatic increase of the public debt from 45% in 2008 to 79.7% of GDP by the end of 2012. It is important to stress that in the fall of 2014 the way GDP was calculated by the European Statistical Service changed.²⁰ Before this change the public debt was, in 2012, higher than 85% of

17 See Th. Pelagidis, *Greece: From Exit to Recovery?* (Washington, D.C.: Brookings Institution Press, 2014, June) (see in particular Chapter II).

18 This has been the conclusion of several discussions I had with foreign diplomats and experts. See also A. Apostolides, ‘Beware of German Gifts Near Their Elections: How Cyprus Got Here and Why it is Currently More Out than in the Eurozone’, *SSRN.com* (2013, May 3), DOI.org/10.2139/ssrn.2260222, and A. Orphanides, ‘What happened in Cyprus’, *SAFE Policy Letter*, No. 6, Goethe University (2013), available at <http://nbn-resolving.de/urn:nbn:de:hebis:30:3-294834>.

19 Statistical Service of the Republic of Cyprus.

20 *The Economist*, ‘Calculating European GDP Changing the scales’, (2014, August 23), available at <https://www.economist.com/finance-and-economics/2014/08/23/changing-the-scales>.

GDP. It is also essential to understand that the dynamics of the growth of the public debt was creating great concerns. Indeed, from 2008 to 2012 the public debt increased by 77%.

It was obvious that the economic model of Cyprus required urgent restructuring. Cyprus' membership of the Eurozone made this change imperative. Unfortunately though, no major actions was taken. This had very negative repercussions.

There was lack of adequate leadership at almost all levels of public life. The government of President Christofias (2008-2013) did not have a full understanding of the shortcomings of the Cypriot economic model and the way the Eurozone functioned. Thus, the structural problems of the economy were underestimated. What is even worse bankers at almost all levels underestimated the implications of participation in the Eurozone. This included the Central Bank of Cyprus. A long period of relatively high rates of economic growth and full employment led to complacency and a misleading perception of invincibility. In addition, both the state and the society spent beyond their means. Indeed, the public and in particular private debt were extremely high (see Table 1). There were voices of warning from prudent institutions and a few opinion leaders but these constituted an exception, not the norm. Any suggestions for restraint were faced with opposition by populist politicians and trade union leaders, especially those of the broad public sector and of the banking system.²¹

Table 1: Public, Private and Total Debt in the government controlled areas of the Republic of Cyprus

Year	Public debt (% of GDP) ¹	Private debt (% of GDP) ²	Total debt (% of GDP)
2008	45.1	285.0	330.1
2009	53.8	306.0	359.8
2010	56.3	315.6	371.9
2011	65.7	321.6	387.3
2012	79.7	328.1	407.8
2013	102.6	340.1	442.7
2014	108.0	352.4	460.4
2015	108.0	353.5	461.5
2016	105.5	337.8	443.3
2017	96.1	316.3*	412.4*

Source: ¹Central Bank of Cyprus, ²Eurostat, *provisional

21 An overview of the Greek Cypriot press during that period and, moreover, statements of leading politicians and trade unionists point out to this unfortunate reality.

The Mari explosion, which destroyed the major electricity plant of the country on 11 July 2011 and led to the death of thirteen persons, was a turning point as it was symbolic of an imminent collapse.²² This incident also entailed adverse economic repercussions; the overall cost was estimated about €2.5 billions.

Cyprus joined the Eurozone at a time when a financial crisis was starting in the US that soon spread to the EU and internationally. Cypriot policymakers naively thought and stated that ‘Cyprus will not be touched’.²³ If Cyprus had its own currency the impact of the crisis would have been of a lower magnitude due to the automatic stabilizers. A depreciation of about 15%-20% of the national currency would have acted in a corrective way at least for a period of time. But participation in the Eurozone led to higher real salaries and more borrowing at a lower interest rate. Furthermore, given the faulty architecture of the Eurozone and the lack of its comprehensive understanding by Cypriot policymakers at various levels matters became worse.

Furthermore, the exposure of Cypriot banks to Greece had a very serious negative impact on the banking system balance sheet. The restructuring and ‘haircut’ of the Greek debt in October 2011 led to a loss of about €4.5 billion in the Cypriot banking system; this amounted to about 25% of Cyprus GDP.²⁴ The Cypriot leadership gravely misunderstood the serious impact of the Greek PSI on the two major banks (Bank of Cyprus and Laiki/Popular Bank) and did not request European support before accepting this deal. Had Cyprus applied for EU support in late 2011/early 2012 the package of the Memorandum of Understanding would have been substantially different from the one in March 2013. Most likely, troika would have insisted on salary reductions, but not on bail-in. This did not take place as a result of the ideological positions of President Christofias and the lack of statesmanship. In March 2013 Cyprus was to pay a huge price. In addition to the major multidimensional crisis facing Cyprus the exaggerated negative European and international narrative around the Cyprus banking sector as well as the expediciencies of the German national elections

22 P. Polyviou, *Report of Single Member Commission of Investigation on the explosion that occurred at the Naval Base ‘Evangelos Florakis’ in Mari on July 11, 2011*, (Nicosia, 2011, September 30).

23 Statements by President Christofias and the Minister of Finance Charilaos Stavarakis in the Press. See ‘A Historical Overview of the Economic Crisis: October 2008 – February 2013’ [in Greek], Part 1, available at <https://stockwatch.com.cy/search.?gq=χρoνoσ%20εξελικωσ%20oικoμικησ%20κρiσησ>; *Kathimerini*, ‘A. Neofytou: C. Stavarakis should apologize to the citizens’ [in Greek] (2010, February 15), available at <http://www.kathimerini.com.cy/gr/14525/?ctype=ar>. Furthermore see C. Ioannou and A. Emilianides, ‘How and Why Cyprus was shaken by the Crisis: The Real Causes’ [in Greek], *Foreign Affairs: The Hellenic Edition*, Vol. 12 (2013), 41-51.

24 S. Clerides, ‘The Collapse of the Cypriot Banking System: A Bird’s Eye View’, *Cyprus Economic Policy Review*, Vol. 8, No. 2 (2014), 3-35.

which were scheduled to take place in September 2013 should not be discounted.²⁵

Undoubtedly, the newly elected President Anastasiades in February 2013 had inherited an extremely difficult situation that could be described as ‘scorched earth’. But this was no excuse for the lack of adequate preparation for the negotiations with the Eurogroup in March 2013. Cyprus could have secured a less painful deal.

The Socioeconomic Cost of the Memorandum of Understanding

There is no doubt that the EU-IMF imposed bail-in program and its effects remain highly controversial. Those supporting the troika-imposed program indicate that this was inevitable. Moreover, today Cyprus has a promising future.²⁶

Nevertheless, this is only one way to assess the situation. The bail-in/ haircut of deposits (and bank debt) was not the most effective way to address these problems, without touching the issues of fairness and equitable treatment. We should also take into consideration the total massive loss of wealth of about €9.4 billions excluding the shareholders of the Laiki/Popular Bank which was resolved and of the Bank of Cyprus which was restructured. The following table shows that the total sum bailed-in by bank.

Table 2: Cyprus Banks Bail-in, € billion, March 2013

	Bank of Cyprus	Laiki/Popular Bank	Total
Uninsured deposits	3.9	4.0	7.8
Senior debt	0.0	0.1	0.2
Subordinated debt	0.6	0.8	1.3
Total	4.5	4.9	9.4

Source: IMF

It is also important to comprehensively assess the broader implications of these developments. The bail-in had severe social and economic repercussions. First, it caused an enormous redistribution of wealth with inevitable adverse impact on inequality, on the saving and consumption rate and of course the potential growth rate of the economy. Second, the bail-in contributed significantly to the rise of the non-performing loans since it hampered the households’ ability to repay loans. Third, the bail-in seriously undermined trust in the banking sector and the political system.

The banking system of Cyprus suffered a huge loss and bank ownership changed hands. With the collapse of the Cooperative Central Bank in the latter part of 2018 the cost for the tax-payers will be even higher. In 2013 the method of bail-in was

25 Apostolides, *Beware of German Gifts Near Their Elections*; A. Orphanides, ‘What happened in Cyprus’, and Rettman, ‘Leaked report damns Cyprus on money laundering?’.

26 *Phileleftheros* (Financial section), Interview with Jeroen Dijsselbloem (2018, November 18), 6.

chosen; in 2018 for the Cooperative Central Bank the bail-out option was chosen by the government. In effect today there is no Cypriot Bank with Greek Cypriot majority ownership.

The Cyprus economy entered into a deep recession in 2013 following the bailout agreement signed with the troika in March 2013 based on the bail-in pre-condition. Real GDP fell by 2.9% in 2012, 5.8% in 2013 and 1.3% in 2014 (see Table 3). The austerity measures led to a sizeable shrinking of the economy. Cyprus GDP at constant prices shrank from €18.8 billion in 2012 to €17.7 billion in 2013 and €17.5 billion in 2014.²⁷ GDP fell by almost 11% in nominal terms and almost 10% in real terms in 2014 compared to 2011; it is now struggling to catch up to pre-crisis levels.

Table 3: Real and Nominal GDP in the government-controlled area of the Republic of Cyprus

Year	Real GDP (Bil. €)	% change	Nominal GDP (Bil. €)	% change
2008	19.437	3.6	19.006	8.5
2009	19.045	-2.0	18.674	-1.8
2011	19.377	0.4	19.731	2.2
2012	18.820	-2.9	19.490	-1.2
2013	17.728	-5.8	18.140	-6.9
2014	17.496	-1.3	17.610	-2.9
2015	17.839	2.0	17.746	0.8
2016	18.698	4.8	18.490	4.2
2017	19.489	4.2	19.571	5.8

Source: Statistical Service of the Republic of Cyprus

As it was noted earlier in November 2014, the Statistical Service of the European Commission changed the way of estimating GDP for all EU countries. Given the increase of GDP as a result of this methodological change, it appeared that there was an improvement of the fiscal deficit and public debt indicators. For example, it was reported that the public debt of Cyprus was 107.5% of GDP in 2014 under the revised system; while under the previous methodology of calculation, the public debt would have been around 120% of GDP. If this change had taken place at the end of 2012 the troika requirements for Cyprus would have been much less.

²⁷ Statistical Service of the Republic of Cyprus.

Table 4: Demographic indicators in the government-controlled area of the Republic of Cyprus 1975 - 2016

Year	Fertility rate	Net migration	Marriage rate	Divorce rate	Percentage of old to young people
1975	2.01	-23.0	11.2	0.24	--
1982	2.50	-0.1	10.8	0.41	43
1992	2.49	16.4	8.1	0.71	43
2001	1.57	6.6	15.1	1.71	54
2010	1.44	19.2	7.3	2.33	75
2011	1.35	21.4	7.3	2.28	78
2012	1.39	-0.7	6.7	2.36	81
2013	1.30	-14.0	6.4	2.15	85
2014	1.31	-17.4	6.3	2.21	89
2015	1.32	-2.4	7.2	2.14	92
2016	1.37	2.9	7.5	2.29	96

Source: Statistical Service of the Republic of Cyprus

The drastic decrease of economic activity led to high unemployment and underemployment. Furthermore, the country witnessed serious demographic outflow.²⁸ It is also essential to note that inequality increased. In addition, not surprisingly there was greater uncertainty. Furthermore, the gap in the terms of employment between the public and the private sector widened sharply. Indeed Cyprus had become a different country.

Stabilization and Recovery

The economy showed positive growth for the first time in 2015 with a growth rate of 2%. Real GDP grew by 4.8% in 2016 and by 4.2% in 2017. It is important though to note that stabilization and recovery took place at a lower level of GDP in comparison to the beginning of the crisis.

28 See the relevant figures in Tables 4 and 7. Furthermore, see A. Theophanous and A. Sakadaki, *The Economic Crisis and the Demographic Challenges* [in Greek], Policy Paper 6/2015, (Nicosia: Center for European and International Affairs, 2015, October).

Table 5: Selective macro-economic indicators in the government controlled areas of the Republic of Cyprus 2010-2017

Year	GDP (Real growth %)	Unemployment*	Deficit (% of GDP)	Public debt (% of GDP)	Total Public debt** (% of GDP)
2010	1.3	6.3	-4.7	56.3	95.0
2011	0.4	7.9	-5.7	65.7	105.2
2012	-2.9	11.8	-5.6	79.7	120.8
2013	-5.8	15.9	-5.1	102.6	146.7
2014	-1.3	16.1	-9.0	108.0	152.7
2015	2.0	14.9	-1.3	108.0	152.4
2016	4.8	12.9	0.3	105.5	148.1
2017	4.2	11.1	1.8	96.1	137.7

Source: Central Bank of Cyprus

*This data comes from the Statistical Service of the Republic of Cyprus

**including intragovernmental debt and short-term

Liabilities of the Central Bank to the IMF

Unemployment gradually decreased: 16.1% in 2014, 14.9% in 2015, 12.9% in 2016 and 11.1% in 2017. Nevertheless, this was not only as the outcome of the creation of new jobs; many Cypriots and others left the country while more and more Cypriots who study abroad do not return. We also note that there is a great degree of underemployment which is not captured by conventional statistics based on the labour force survey. Public debt was 96.1% of GDP in 2017; it remains to be seen to what extent the resolution of the Cooperative Central Bank will affect the public debt. In this regard we should be reminded that the deal with the Hellenic Bank also essentially involved a bail-out.

The recovery was not made possible because of the troika’s prescriptions alone but mostly because of the resilience of the Greek Cypriot people. I would even argue that the economy recovered despite the troika’s prescriptions.²⁹ In view of the large adverse shock to the Cyprus economy from the bail-in and the austerity measures the recovery started from a statistically low base. It came at a huge economic, social and individual cost, lower living standards and great sacrifices primarily from the bailed-in victims and secondarily from the taxpayers, which included the former. Be that as it

29 I made this statement in my opening address on 12 November 2018 in a special event for the 25 years of the Cyprus Center for European and International Affairs. See A. Theophanous, *The Eurozone Crisis and the Future of the EU*, Eastern Mediterranean Policy Notes, No. 32 (Nicosia: Cyprus Center for European and International Affairs, November 2018).

may and despite some degree of Euroscepticism, Cyprus remains committed to the European Project.

The Cyprus Economy Today

The Rhetoric Versus the Results

The record of the Cypriot economy following the troika imposed program has been debated both in Cyprus and abroad. The government as well as the troika tried to convey the message that it was a success story.³⁰ Certainly, this was an exaggeration. In actual fact there was stabilization at a rather low level of economic activity. It is worthwhile noting that Jeroen Dijsselbloem in an interview with *Phileletheros* stated that taking all relevant factors into consideration and given the high social cost it cannot be considered a success story.³¹ He, nevertheless, stressed that Cyprus has a promising future. In relation to this debate I repeatedly expressed the view that Cyprus is a ‘success story only when compared with Greece.’

The reality though is that to the present day Cyprus lacks a comprehensive vision for the future, despite the fact that the country needs a new paradigm following the economic collapse of 2013. It is essential to assess the factors which led to stabilization as well as the shortcomings.

An Overview of Developments: A Sectoral Approach

The banking sector still faces serious challenges. The non-performing loans constitute perhaps the greatest challenge for the economy. With the economic collapse in 2013 the Laiki/Popular Bank was resolved, the Bank of Cyprus was restructured and the entire banking system was recapitalized, including the Cooperative Central Bank. Nevertheless, poor management and the lack of effective leadership led to its collapse. The ‘good’ part of the Cooperative Central Bank was taken over by the Hellenic Bank and the ‘bad’ part was transformed into a State Asset Management Company with the objective to deal with the non-performing loans. It remains to be seen what this deal will eventually mean for the tax payers and the public debt. Some initial estimates point out that a new debt over €5 billions has been transferred to taxpayers.

In 2017 the non-performing loans were around €21 billion or about 110% of GDP. This in itself is indicative of the magnitude of the problem for the banking system and the economy as a whole. Furthermore, it is interesting to note that the non-performing loans were about 44% of the total in 2017, which fell to 32% by

30 For example, see G. Psyllides, ‘Cyprus a success story, EIB president says’, *Cyprus Mail* (2016, April 8), available at <https://cyprus-mail.com/2016/04/08/cyprus-a-success-story-eib-president-says/>.

31 Interview with Dijsselbloem.

September 2018; in 2013 the respective indicator was about 25%.³² The 44% figure in 2017 is the second highest in the EU.³³

In order to effectively address this thorny problem, in addition to sustained growth ‘thinking outside the box’ is required. This may include various schemes of long-run leasing by the existing house owners.

Tourism has been a strong pillar of growth and recovery. Tourist arrivals in the government controlled area of the Republic of Cyprus grew from 2,464,908 in 2012 to 3,652,073 million in 2017, an increase of 48.16%. By the same token revenues grew from €1,927.2 million in 2012 to €2,639.1 million in 2017, an increase of 36.93%.

Table 6: Tourist arrivals and revenues in the period 2012-2017 in the government controlled areas of the Republic of Cyprus

	Tourist Arrivals (Mil.)	Change (%)	Revenue (Mil. €)	Change (%)
2012	2,464,908	3.0	1,927.2	10.2
2013	2,405,390	-2.4	2,081.4	8.0
2014	2,441,239	1.5	2,023.1	-2.8
2015	2,659,405	8.9	2,112.1	4.4
2016	3,186,531	19.8	2,363.4	11.9
2017	3,652,073	14.6	2,639.1	11.7

Source: Central Bank of Cyprus

Following a fall in the bail-in year of 2013 the accommodation and food service activities sector kept growing in both real and nominal terms at solid rates especially in 2016 and 2017 when the sector grew at 11.2% and 6.5% respectively at constant prices.³⁴ The downward pressure on prices and wages due to the internal devaluation triggered by the Memorandum of Understanding in conjunction with the offer of better-priced packages and higher foreign disposable incomes have been contributing factors.

Following the economic collapse in 2013, the property market as well as the construction sector suffered a serious blow; by 2016 a gradual recovery in both sectors began. The construction sector grew at a phenomenal average rate of 10.8% in real terms during the 7-year-period between 2001 and 2007 leading to a property market bubble. The sector began its expectable unwinding when the world economic crisis hit in 2008 since the sector was largely dependent on foreign demand. Over the 8-year period 2008-2015 the sector decreased at an average real negative rate of 12.2% per

32 Central Bank of Cyprus.

33 Ibid.

34 Statistical Service of the Republic of Cyprus.

year.³⁵ The construction sector rebounded in 2016 and 2017 with constant-price growth rates of 16.6% and 26.8% respectively³⁶ due to the Limassol casino resort project and in particular the government policy of ‘passport for investment’, leading to the erection of sky scrapers.

There have been great expectations from the energy sector given the prospect for discovery of huge amounts of hydrocarbons in the Cyprus Exclusive Economic Zone. Nevertheless, the hydrocarbons exploitation and development phase seems to be a difficult and complicated issue given the hegemonic aspirations of Turkey and its puppet state in the occupied northern part Cyprus. While the prospect of the exploitation of hydrocarbons remains open Cyprus should simultaneously seek alternative energy sources including solar energy.³⁷ Recent experiences may indicate that Cyprus could become more energy self sufficient potentially meeting its growing electricity needs.³⁸

Cyprus has developed into an international shipping centre combining a sovereign flag and a resident shipping industry, as well as one of the world’s largest third-party ship management centres. Cyprus is certainly very competitive in this sector offering tremendous services and advantages to shipping companies registering their vessels under the Cypriot flag. Shipping has proved to be one of Cyprus’ most resilient industries and most promising sectors giving the island substantial political and financial strength. The shipping sector attracts foreign direct investment and contributes more than €1 billion a year to the economy. This accounts for almost 7% of GDP.³⁹ The industry directly employs thousands of shore-based personnel with more than half of them being Cypriot graduates. The sector survived the 1974 Turkish invasion as well as the devastation inflicted on the global shipping industry by the collapse of Lehman Brothers in 2008. It emerged from Cyprus’ bail-in in 2013 unscathed in terms of taxation and operational framework. The Cyprus shipping sector is already benefiting from Brexit with the registration of companies moving out of London due to the island’s recognized comparative advantages.

35 Statistical Service of the Republic of Cyprus.

36 Ibid.

37 International Renewable Energy Agency (IRENA) *Renewable Energy Roadmap for the Republic of Cyprus Summary for Policy Makers* (2015, January), available at [http://www.mcit.gov.cy/mcit/energyse.nsf/C1028A7B5996CA7DC22580E2002621E3/\\$file/IRENA_Cyprus_Roadmap_Booklet_2015.pdf](http://www.mcit.gov.cy/mcit/energyse.nsf/C1028A7B5996CA7DC22580E2002621E3/$file/IRENA_Cyprus_Roadmap_Booklet_2015.pdf).

38 European Commission, ‘Making sun-blessed Cyprus a solar energy leader’, November 2017 http://ec.europa.eu/research/infocentre/article_en.cfm?id=/research/headlines/news/article_17_11_21-7_en.html?infocentre&item=Infocentre&artid=46502.

39 Statement of the Minister of Transport, Communications and Works for the approval of the bill for the establishment of a Deputy Ministry for Shipping, Deputy Ministry of Shipping, (2017, July 14), available at <http://www.dms.gov.cy/dms/dms.nsf/All/D8CEAE7A43A1CBE6C225816B003FD335?OpenDocument>.

During the crisis years, there was a significant deterioration of labour market conditions. Real wages dropped on average by 22% while purchasing power receded to the levels of the mid-1990s. The troika austerity measures in association with the bail-in pushed the Cyprus economy into deep recession, with the negative growth rates adversely affecting the creation of new jobs and the rate of unemployment. Unemployment hit particularly the construction, the banking sector, the young and the newcomers into the labour market. Rising unemployment exerted pressure on wages and widespread job insecurity for people previously employed on a regular basis. Consequently, irregular employment, undeclared work and underemployment rose as the only available options for the unemployed. Certainly, the introduction of flexibility in the labour market was part of the troika desired neoliberal package. Inevitably, labour retreated both as a force organized in trade unions with substantial negotiating power through collective agreements as well as in terms of its share in national income as a factor of production. In addition, the crisis converted Cyprus from a country of immigration to a country of emigration, and population decline accompanied with labour force contraction. The younger and especially the more highly educated persons consider the overall economic environment difficult and not as promising. One of the outcomes is that Cyprus also faces the problem of brain drain.

Table 7: Selective socio-economic indicators in the government controlled areas of the Republic of Cyprus

	2012	2013	2014	2015	2016	2017
Total Population	831,156	827,582	818,497	814,630	820,036	832,619
Change (%)		-0.4	-1.1	-0.5	0.7%	1.5
Unemployment (% ₁₅₊)	11.8	15.9	16.1	14.9	12.9	11.1
Change (%)		34.7	1.3	-7.5	-13.4	-14.0
Labor Force	436,742	433,949	432,288	420,961	417,069	426,789
Change (%)		-0.6	-0.4	-2.6	-0.9	2.3
Gini Coefficient	0.31	0,324	0,348	0,336	0,321	0,308
Change (%)		4,5	7,4	-3,4	-4,5	-4,0
Risk Of Poverty Rate	14.7	15.3	14.4	16.2	16.1	15.7
Change (%)		4.1	-5.9	12.5	-0.6	-2.5

Source: Statistical Service of the Republic of Cyprus

In sum, due to demographic outflows the labour supply was adversely affected. With the recovery unemployment dropped from over 20% to about 11%; this indicator may be misleading given that there are many underemployed persons. Moreover, to some extent the improvement of figures was also associated with emigration of many Cypriots who have been searching for opportunities in other countries. At the same

time income inequality grew. The middle class shrank dangerously while over one quarter of the population (25.2% in 2017) are at risk of poverty.

Even though the shrinkage of the middle class is not exclusive to Cyprus but is a wider phenomenon associated with economic and financial crises,⁴⁰ the bail-in particularly harmed the Cypriot middle class as a social group. Furthermore, middle class earnings and disposable income were hit both by the salary cuts included in the austerity measures and by the increase in taxation.

Fundamental Structural Problems Still Persisting

As already noted the non-performing loans still constitute perhaps the most pressing problem not only of the banking system but of the economy as a whole. Furthermore, it is essential to address the newly-introduced bureaucratic procedures by the banks and facilitate borrowing.

In relation to fiscal issues while it is acknowledged that much progress has been made much more remains to be done. It is not only the magnitude of spending that matters; equally important it is how it is spent. By the same token it is essential to pay attention not only to the level of tax revenues but also to how these are collected; the objective is to minimize the negative side effects such as the impact on economic activity.

It is also essential to push aside the patron–client relations and to promote meritocracy. Lack of public sector reforms and growing inefficiency is reflected in Cyprus’ falling standing in international rankings:⁴¹

- Competitiveness rank: # 83 (2017) vs # 34 (2010)
- Corruption perception rank: # 42 (2017) vs # 27 (2009)
- Ease of Doing Business: # 53 (2017) vs # 36 (2008)

It is indeed unfortunate that the competitiveness rank and the corruption perception rank worsened despite the collapse of March 2013 and the advent of the troika. Unfortunately, the ease of doing business deteriorated in the last decade as well.

One of the great challenges is also the implementation of the General Healthcare System (national health system). Although its implementation is expected to start in mid 2019 it seems that there are several bottlenecks that create serious difficulties. It is essential to avoid a situation in which citizens end up paying more without any improvement in the health system. Be that as it may it is important that at last Cyprus will have an efficient health system with high quality.

40 Furthermore, it seems that this is not a phenomenon exclusive to Cyprus. For a comprehensive analysis see: D. Vaughan-Whitehead (Ed.), *Europe’s Disappearing Middle Class? Evidence from the World of Work* (Edward Elgar Publishing, 2016), available at <https://EconPapers.repec.org/RePEc:elg:eebook:17301>, and M. J. Casey, *The Unfair Trade: How Our Broken Global Financial System Destroys the Middle Class* (New York, NY: Crown Publishing, 2012).

41 Trading Economics, available at tradingeconomics.com.

It is also important to improve the quality of education at all levels. Although considerable resources are allocated to this domain much can be done to obtain better results. Above all rationalization of public expenses in tertiary education is imperative. With the current allocation of resources in higher education it is impossible for Cyprus to maximize its potential and turn itself into a regional academic centre. More specifically the existing policy and practice discriminate in favour of state institutions. For example, the state pays the tuition fees of all students at the state universities (irrespective of income criteria). In addition, the state supports very generously the public universities while private universities have to rely almost exclusively on student fees. It is also worthwhile noting that there is a notable gap in the terms of employment between public and private universities.⁴² Furthermore, in relation to research and development it is unfortunate that Cyprus allocates only 0.54% of GDP for research and development or just €99 million in absolute terms in 2016 according to the latest available data.⁴³

In 2016 public debt was 105.5% and in 2017 96.1% of GDP. Private debt was 337.8% and 316.3% in 2016 and 2017 of GDP respectively (see Table 1). Reducing the public and the private debt are vital objectives which must be addressed decisively and effectively. Higher growth rates and good planning are essential. Prudent as well as intelligent debt management practices are also very important. In this regards, public debt management has been acknowledged by troika and its post program surveillance missions to have been well-organized and methodical. The application of a medium-term public debt management strategy and the implementation of an Action Plan approved by the Council of Ministers has further strengthened the efficiency and competence of Cyprus public debt management.

The Occupied Northern Part of Cyprus

Developments in the occupied northern part of Cyprus must be analysed taking into consideration the broader objectives of Turkey in the island and the Eastern Mediterranean. The population in the occupied part of Cyprus, excluding the 40,000 occupation troops, is about 351,000. It is estimated that only about 35% are Turkish Cypriots. The vast majority of the population in the occupied area are settlers.⁴⁴

42 A. Theophanous, 'The importance of turning Cyprus into a regional academic and research centre after the economic crisis', Policy Paper 4/2017 (Nicosia: Cyprus Center for European and International Affairs, 2017, October).

43 Statistical Service of the Republic of Cyprus.

44 A. Theophanous, *Governance and the Political Economy of a Federal Cyprus* [in Greek] (Athens: I. Sideris Press, 2016), 90-98, and A. Djavit An, *The Turkish Cypriot Community in Historical Perspective and the Changes in its Structure and Identity*, Policy Paper 2/2018, (Nicosia: Center for European and International Affairs, 2018, October).

Gradually and inevitably the composition of the Turkish Cypriot community is changing.

Table 8: Total Population in Cyprus (Government-controlled area and occupied area, 2011, 2014 and 2017)

	Greek Cypriots	Citizens of other countries	Republic of Cyprus controlled areas	Occupied area Turkish Cypriots,* Settlers and others	Total
2011	684.000	178.000	862.000	286.257	1.148.257
	59,6%	15,5%	75,1%	24,9%	100%
2014	694.700	152.300	847.000	313.626	1.160.626
	59,9%	13,1%	73,0%	27,0%	100%
2017	713.500	150.700	864.200	351.000	1.215.200
	58,7%	12,4%	71,1%	28,9%	100%

Sources: Statistical Service of the Republic of Cyprus; ‘TRNC- State Planning Organization’, Economic and Social Indicators 2013, 2014, April 2015.⁴⁵ *It is estimated that the Turkish Cypriots constitute around 35% of the population in the occupied northern part of Cyprus. The vast majority are settlers.

Essentially the self proclaimed ‘TRNC’ is de facto part of Turkey’s economy. The use of the Turkish lira as the ‘official’ currency since the summer of 1974 is indicative. It is estimated that Turkey subsidizes by about 25% the annual budget of the ‘TRNC’; this amount is estimated to be about €350 million annually. Furthermore, Turkey also subsidizes infrastructural projects.

Before the partial lifting of restrictions of people’s free movement in April 2003 the ratio of the per capita GDP in relation to the government controlled areas was estimated at 1:4. This has improved to about 1:2 but following the depreciation of the Turkish lira it is now estimated to be 2:5. Despite the support of Turkey the interlinkages with the government controlled areas of the Republic of Cyprus are of critical importance for the economy of the ‘TRNC’.

There has been much discussion in relation to the prospect of reunification and the economic ramifications. Within this context when EU and IMF officials expressed their will to examine the banking sector in the ‘TRNC’ for some fundamental assessment this proved impossible. Most likely this is related to corrupt practices and interlinkages with Turkey which certainly include money laundering and other illegal activities.

45 See J. Christou, ‘North’s population tops 350 thousand’, *Cyprus Mail Online*, 18 November 2017 <https://cyprus-mail.com/2017/11/28/norths-population-tops-350-thousand/?hilite=%27population%27%2C%27north%27%2C%27has%27%2C%27reached%27%2C%27351%27%2C%27000%27>.

Despite the fact that the ‘TRNC’ is essentially integrated with the Turkish economy, Turkish Cypriots have always preferred the Cyprus national currency, i.e. the Cyprus pound and since 2008 the euro. With the Turkish economic crisis and the depreciation of the Turkish lira, the idea was put forward by some circles in the Turkish Cypriot business community for the adoption of the euro. Such an idea is not realistic. There is no doubt that the requirements for participation in the Eurozone as well as its architecture are not understood in the ‘TRNC’.

In this regard it is essential to understand that the ‘TRNC’, which is an integral part of the Turkish economy, is characterized with a high degree of statism. Given Turkey’s economic support in various ways one can also understand Ankara’s full control of the ‘TRNC’.

Tourism and higher education constitute two of the most important sectors of the economy of the ‘TRNC’. Yet these are characterized by a high proportion of shadow economy, including gambling, money laundering and prostitution.⁴⁶ Moreover, in the last few years, there have been intensified efforts to enhance the islamization in the ‘TRNC’.⁴⁷ There is no doubt that the ‘TRNC’ has been created in Turkey’s image.⁴⁸

Last but not least it should be stressed that there is no ‘tax culture’ in the ‘TRNC’.⁴⁹ This is important especially in view of the debate for a solution of the Cyprus Problem. Given the high deficit of the ‘TRNC’ and the lack of tax culture, much has to change. This is essential within the framework of a solution to the Cyprus Problem in a way in which the northern part of Cyprus should be part of the Eurozone.

Challenges and Opportunities

Cyprus in the New Regional and International Context

While addressing challenges and opportunities for Cyprus it is essential to understand the broader context within which developments take place. Developments in the Eastern Mediterranean, the broader region and the international environment will exert an impact on the Cypriot economy. Consequently, policymakers must be proactive.

While some of the problems of the Eurozone architecture have been addressed much more remains to be done. In this regard Cyprus despite its size has to make its own contribution to issues of European integration. In this context it could advance the objective of more flexibility and discretion while at the same time responsibility

46 Djavit An, *The Turkish Cypriot Community in Historical Perspective*.

47 Ibid.

48 This has been intelligently observed much earlier. In this regard see Ch. Ioannides, *In Turkey’s Image: The Transformation of Occupied Cyprus into a Turkish Province* (New Rochelle, NY: Caratzas, 1991).

49 This has been the conclusion of discussions with Turkish Cypriots as well as with Greek Cypriots and foreign officials.

should be an integral part of the architecture.

Brexit cannot be ignored as it will influence both the United Kingdom and the EU. Cyprus as a member-state of the EU and of the Commonwealth must have a strategy which safeguards the best interests of the country.

Developments in the Eastern Mediterranean, the broader region and the international environment will also have their own impact on the Cypriot economy. Furthermore, developments in Turkey as well as Ankara's policies will also be influencing Cyprus in multiple ways. Cypriot policymakers must be proactive.

Cyprus must devise a low-tensions strategy while at the same time it must involve itself in a network of regional cooperation and security agreements and arrangements. Developments in the broader Middle East cannot be ignored. Cyprus will have to cooperate with other EU member states to advance an EU level policy in relation to the ongoing migration crisis. It is also understood that Cyprus has to pursue policies to deter increasing waves of illegal immigration.

There is no doubt that the ongoing technological revolution taking place will have far reaching implications in almost all aspects of life and economic activity. Cyprus cannot be an exception; consequently, it has to prepare accordingly.

We must also acknowledge the socioeconomic and political fallout of demographic changes and developments taking place. Obviously these have an impact on taxes, pensions as well as the need for increased allocation of resources to health care and related activities for retired people.

It is also important to follow developments in relation to changing paradigms in the region, in the EU and internationally and adjust proactively in due time. Cyprus must also assess the trends and implications of regional geopolitics and plan accordingly. Within this framework it must also fully analyse the multidimensional challenges and threats from Turkey, including the demographic changes in the occupied northern part the island.

Addressing the Challenge of the Financial Sector and of the Non-Performing Loans

Following the collapse of 2013 the ownership of the banking system changed dramatically. With the resolution of the Laiki/Popular Bank and the restructuring of the Bank of Cyprus as well as the recapitalization of the Hellenic Bank the controlling participation of the Greek Cypriots was not dominant anymore. The last vestiges of Greek Cypriot control of the country's banking system disappeared, with the resolution of the Cooperative Central Bank in August 2018.

At the same time it should be noted that the banking system passed from a situation of no controls and checks before 2013 to a new state of affairs with excessive controls and bureaucracy, obstructing its financial intermediation role. In relation to the

pressing problem of non-performing loans, which constitutes the greatest challenge of the financial sector and perhaps of the economy, new ideas and thinking ‘outside the box’ will be required to address it effectively over time.

Table 9: NPLs of the General government, Corporations, Household and Total as % of GDP

	General government € thousands		Corporations € thousands		Households € thousands		Total € thousands	
	Amount	% of GDP	Amount	% of GDP	Amount	% of GDP	Amount	% of GDP
2014	62,304	0.35	14,686.569	83.42	12,579.419	71.45	27,328.292	155.22
2015	47,907	0.27	13,933.116	78.53	12,688.051	71.51	26,669.074	150.32
2016	39,426	0.22	11,733.566	64.40	12,037.053	66.07	23,810.045	130.69
2017	35,679	0.19	9,925.096	51.66	11,179.671	58.19	21,140.446	110.03

Source: Central Bank of Cyprus

Table 10: Percentage of Non-Performing Loans to total gross loans ratio 2009-2017

Year	Non-Performing loans ratio (%)
2009	4.51
2010	5.82
2011	9.99
2012	18.30
2013	28.56
2014	44.97
2015	47.75
2016	48.68
2017	40.16

Source: Statista-The Statistics Portal, 2019

In order to address this major problem it is necessary to utilize some new ideas such as long-run leasing. Furthermore, more borrowing should be encouraged. This may lead to a decrease of the percentage of the non-performing loans while at the same time economic activity will be stimulated. To this end the big difference between deposits and loan interest rates should be reduced to a minimum.

It is also important to strike a new balance between effective controls and monitoring vis à vis flexibility and discretion. Overall, it is necessary to assess creatively the fundamental problems of the financial sector and generate a road map for addressing them. Within the framework of such an approach it is possible that the

credibility of the financial sector will be gradually re-established.

Attracting Foreign Investment

Attracting foreign investment is an important chapter for the economy of all countries. Cyprus after the collapse of 2013 and the deep recession required qualitative foreign investment. It is essential to assess the record so far and also raise the question of what kind of investments the economy requires. Given the imperativeness of new engines of growth, it is important to explore the capabilities and prospects of each type of investment. For example, the policy of incentives for the purchase of real estate and the acquisition of passports has its disadvantages. More specifically, this has been affecting the price of land and of rents in ways which do not help the middle class and the lower income groups.⁵⁰ Investment in real estate construction should be re-evaluated given the fact that this sector is still seriously affected by the price bubble of the period 2001-2007. It is also underlined that the sale of passports benefits mostly specific interests in the financial and legal sectors without sufficient financial benefit across society. It would make much more sense to have a comprehensive policy (with specific incentives, including passports) encouraging qualitative foreign investment which creates new high value-added jobs.

The Socioeconomic and Political Implications of a Solution to the Cyprus Problem

Although much attention has been given to the solution of the Cyprus Problem, not much attention has been given to the day after. It is surprising how frivolously this issue is dealt with. Indeed, repeatedly there have been statements and reports which have been suggesting that following a solution there will be an economic boom. This seems to be the outcome of inflated expectations rather than the outcome of sound economic analysis.⁵¹

The reality, however, is that there will be diverse forces pushing toward opposing sides. A solution within the framework of what is being discussed will create a new state of affairs with a very complex decision making process.

It is essential to take into consideration problems and bottlenecks in the decision making process that will be the outcome of a very complex constitutional arrangement. Furthermore, it is doubtful whether a bizonal bicomunal federal state with three governments, three parliaments and a senate, as well as a complex public administration, can survive the very strict rules of the Eurozone. It is also misleading

50 See *Phileleftheros*, 'Stable salaries, rising rents' (2019, January 21), 8, which was based on information from several studies and data of the government, trade unions and some business enterprises.

51 For example, see F. Mullen, O. Oğuz and P. Kyriacou, *The Day After: Commercial Opportunities Following a Solution to the Cyprus Problem* (Nicosia: PRIO Cyprus Centre, 2008).

to assume that irrespective of the content of the solution of the Cyprus Problem the outcome will be the same. Indeed, each scenario for the solution of the Cyprus Problem entails a specific outcome.⁵²

Economics aside, from a political perspective a solution within the framework of a bizonal bicomunal federation would render Cyprus a protectorate of Turkey. Indeed, several academics and analysts have pointed out that such a solution will satisfy the objectives of Turkey as defined after 1950.⁵³

Toward a New Paradigm

No New Paradigm Yet

Cyprus has not yet advanced a new comprehensive paradigm despite the turning point of the 2013 major crisis including the bail-in. It is acknowledged that inadequate planning and the lack of a comprehensive paradigm entail a high cost. There is no doubt that the country requires a new vision. Cyprus has to address gradually but effectively the serious structural problems it is facing. These include the non-performing loans. Furthermore, it is essential to fully re-establish the credibility of the banking system and the financial sector as a whole. Given that the financial sector has been shrinking, new sectors and niches will be required to generate more employment opportunities. It is also imperative that both the public and the private debt are reduced gradually but steadily.

The Importance of Leadership

Cyprus requires better leadership in all aspects and levels of public life. This includes the political system which needs much improvement as well as sophistication. The necessity of a new economic paradigm for Cyprus is stressed. Cyprus has to address effectively the pressing challenges and also take advantage of opportunities that arise. An effective leadership with vision should be in a position to understand and act up on a changing regional and international environment. This includes the new technological revolution as well as the demographic changes.

52 See A. Theophanous, *The Political Economy of a Cyprus Settlement: The Examination of Four Scenarios*, PRIO Report 1/2008 and A. Theophanous, *Governance and the Political Economy of a Federal Cyprus* [in Greek], (Athens: I. Sideris Press, 2016).

53 For example, see the excellent book by S. Sakellariopoulos, *Cyprus Social Formation 1191-2004: From construction to partition* [in Greek] (Athens: Topos Press, 2017), especially.784.

The Huge Credibility Deficit and the Need to Overcome It

Despite the great socioeconomic and political cost of the collapse of March 2013 it seems that many of the practices and mistakes of the past continue to the present day. The vast majority of Cypriots also believe that corruption has not yet been tackled. On the contrary it continues to be a characteristic of socioeconomic and political life.

Six years after the collapse of March 2013, it is unfortunate that the country is still facing a huge credibility deficit at various levels. The level of trust in institutions is at low levels. Furthermore, despite major steps in the right direction, Cyprus has to overcome bad publicity in the EU and the US.⁵⁴ Indeed, great efforts will be required to reestablish credibility for the major institutions of the country internally and externally.

Rationalization of Public Expenses

A major problem that has not been addressed comprehensively despite the economic crisis and the Memorandum of Understanding is the lack of rationalization of public expenses. It is essential that the pension system is revisited and reformed accordingly. Furthermore, within this framework it is important to revisit public spending on higher education.⁵⁵ Indeed, the political system must proceed with the necessary changes without any fear for the possible political cost. In this respect, populism should not be allowed to have a serious impact on the budgetary process.

Importance of Enhancing the Effectiveness of Public Administration

The pillar of public administration is of the highest importance in any country. It is thus imperative to address the serious problems of bureaucracy, nepotism and corruption. The importance of meritocracy and of pushing aside the patron-client relationships as well as mediocrity is particularly important. Indeed, a meritocratic system of appointments and selection procedures should be a priority. Furthermore, it is essential to increase productivity and also take advantage of technological advances.

Effective Utilization of Human Capital

We must also reassess the composition of the labour supply and examine ways for its full utilization. Obviously this requires adequate planning as well as enhancement of economic activity in all sectors. It is unfortunate that despite the fact that most young Cypriots acquire higher education, Cyprus has one of the highest youth unemployment

54 For example, see *The Economist*, 'Malta and Cyprus face growing pressure over money-laundering', (2019, January 26), available at <https://www.economist.com/europe/2019/01/26/malta-and-cyprus-face-growing-pressure-over-money-laundering>.

55 See International Monetary Fund (IMF), 'Options for Short-Term Expenditure Rationalization' (2013, March), 22-28, available at <https://info.publicintellgence.net/IMF-CyprusExpenditureRationalization.pdf>.

rates in the EU. This is a clear indication that a new paradigm is required. It is also essential to understand the causes and the nature of structural unemployment in the EU and Cyprus.

The Need for New Engines of Growth

Recovery and growth in Cyprus have not been the outcome of new engines of growth which can sustain development over time. New engines of growth are required so that the economy will generate multiple jobs in order to absorb the idle labour force. Cyprus must reassess its expectations in relation to quick energy exploitation, without abandoning its energy program and vision; there are serious political complications which may create additional delays and security risks.

The potential of Cyprus as a higher education and medical centre can and must be enhanced. In this context, enhanced cooperation between public and private sector is necessary. Moreover, the state should adopt a strategic role in this domain and remove obstacles which treat private higher institutions as second to public institutions. Within this framework it is essential that Cyprus offers higher quality education with relatively lower fees. This may be achieved with the reallocation of the state budget for higher education. At the same time it is important not to ignore the potential contribution of vocational training.⁵⁶

The role of Cyprus as a centre for humanitarian, relief and disaster management operations across the Middle East and North Africa must be developed as a new engine of growth. For this purpose Cyprus must utilize its geographical location and establish strong synergies with other EU member-states.

Revisiting the Cyprus Problem

Last but not least, Cypriot policymakers should seriously study the socioeconomic and political implications of a solution to the Cyprus Problem. It is misleading to assume that:

- (a) more or less the impact is the same from any solution; and**
- (b) that any solution will generate positive socioeconomic and political outcomes**

It may be more realistic to consider the possibility of an evolutionary process for the solution of the Cyprus Problem.⁵⁷ Such an approach will also engage Turkey and also include energy issues in the overall discussion. Although there is no guarantee for a fruitful outcome out of this process it is more promising that what has been pursued for so many years.

⁵⁶ Theophanous, *The importance of turning Cyprus into a regional academic and research centre*.

⁵⁷ A. Theophanous, 'Revisiting the Cyprus Question and the Way Forward', *Turkish Policy Quarterly*, Vol. 15, No. 4 (2017 Winter), available at <http://turkishpolicy.com/article/841/revisiting-the-cyprus-question-and-the-way-forward>.

Epilogue

Having lived through turbulent decades in the 1960s and the 1970s, having survived the Turkish invasion of 1974 and despite the *de facto* partition, the Republic of Cyprus managed to build a prosperous economy and enjoyed over thirty years of economic growth, peace and political stability. Indeed, it reached such a level of development that earned its membership in the EU. This has been a remarkable success.

Unfortunately, by 2013 Cyprus had fallen victim to its own success. Many years of uninterrupted economic growth bred complacency, irresponsibility and a culture of invincibility at most levels of society. Without downplaying external factors, it is vital to assess the internal responsibilities for the failure, which left the Cypriot economy with high private and public debts and other serious problems.

These are difficult times as there are profound changes, unrest and widespread security challenges in the broader Middle East and across the planet. Undoubtedly, we are witnessing a transition to a new paradigm whose shape and nature have not yet been fully formed and understood. A major threat of historical transition periods, like the one we have entered, is that more often than not they may seriously affect those nation-states which fail to stand the test of time. They may also revive old bitter memories and uncover old wounds. The current crisis that we are witnessing in Cyprus and beyond is multidimensional: economic, political and social. It also revolves around the lack of a credible value system. Indeed, we have entered a new period where everything, from individual life to social norms and institutions, undergo serious changes.

In this new reality the Republic of Cyprus finds itself at the crossroads of potentially cascading crises. Cyprus is located in the Eastern Mediterranean and near the broader Middle East. It has a predominantly hellenic identity and special relations with Greece. About 37% of its territory is occupied by Turkey, one of the most powerful states in the region. In addition to the British bases on the island, Cyprus shares deep social and economic ties with the United Kingdom despite a bitter historical past. At the same time, it has a strong economic, political and cultural relationship with Russia. Furthermore, in the last few years the Republic of Cyprus advanced tripartite agreements with Israel, Greece and Egypt. In addition, Cyprus has been trying to enhance and advance its regional policy and presence.

Such a precarious geopolitical position coupled with the need to adopt a new economic model requires high-caliber strategic thinking and policy implementation. Furthermore, the policy which has been followed in relation to the Cyprus Problem in the last years will have to be revisited. New realities demand new approaches. Cyprus should encourage initiatives to create a new open environment for a societal dialogue on the most pressing matters and risks it faces as a state. Moreover, Cyprus should

aspire to make a modest contribution to broader pressing issues in the region and the EU. It must also work and position itself in ways that will enable Cyprus to be an asset for the EU and the international community.

Finally, it is imperative that Cyprus will have at last a comprehensive narrative. A major part of it should address the Cyprus Problem. In addition, it is essential that any negative allegations about Cyprus as a business centre are addressed accordingly. Moreover, the narrative would explain the multidimensional role of Cyprus in the EU, the Eastern Mediterranean and beyond.

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