TURKISH CYPRIOT ECONOMY: LOOKING AHEAD TO STEER THE ECONOMY TOWARD A HIGHER GROWTH PATH

A Macroeconomic Monitoring Note

SPECIAL ISSUE: REDUCING THE TURKISH CYPRIOT ECONOMY’S VULNERABILITY TO SHOCKS

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ABBREVIATIONS

ASPIRE: The Atlas of Social Protection Indicators of Resilience and Equity
CAB: Current Account Balance
CPI: Consumer Price Index
EC: European Commission
ECA: Europe and Central Asia
EMU: Economic Monetary Union
EU: European Union
FLFP: Female Labor Force Participation
GC: Greek Cypriot
GDP: Gross Domestic Product
GNI: Gross National Income
HBS: Household Budget Survey
HC: Human Capital
I/Y: Investment-to-GDP Ratio
ICT: Information and Communication Technology
‘MOF’: ‘Ministry of Finance’
OECD: Organisation of Economic Cooperation and Development
PIM: Public Investment Management
SA: Social Assistance
‘SPO’: ‘State Planning Organization’
TC: Turkish Cypriot
TCC: Turkish Cypriot community
TFP: Total Factor Productivity
TL: Turkish Lira
TVET: Technical and Vocational Education and Training
US$: US Dollar
WDI: World Development Indicators
WBG: World Bank Group
YoY: Year-on-Year
LOOKING AHEAD TO STEER THE ECONOMY TOWARD A HIGHER GROWTH PATH THAT IS MORE RESILIENT TO SHOCKS
Following an unprecedented exchange-rate depreciation in 2018 that hammered both the Turkish and the Turkish Cypriot (TC) economies, the previous economic recovery in the TC economy collapsed. After reaching 5.4 percent in 2017, TC GDP growth slowed to just 1.3 percent in 2018, and is estimated to have further decelerated to 0.5 percent in 2019. Meanwhile, the Greek Cypriot (GC) economy maintained its growth momentum that had started in 2015 after the 2012–14 crisis, further delaying any convergence of TC income per capita with EU and GC levels. Despite a non-growing economy in Turkey\(^1\) in 2019, TC growth is estimated to be positive in 2019 thanks to: the services sector, especially higher education ‘exports’, the retail trade, and restaurant services supported by a surge in visitors crossing the Green Line, despite a contraction in manufacturing. Accounting for about 9 percent of the economy, manufacturing, which shrank by 16 percent in 2018 and reduced GDP growth by 1.4 percentage points, is expected to further decline in 2019.

The contraction in manufacturing was the result of the Turkish lira depreciation shock, structural issues in the livestock sector, and declining financial support from Turkey. Manufacturing produces predominantly dairy products and therefore relies heavily on milk production. The lira depreciation affected prices of imported animal feed and energy tariffs (energy is produced with imported fuel), causing the cost of milk conservation to increase and milk production to decline by about 20 percent. In addition, financial support to the real sector from Turkey fell short of expectations, from an average of 1.1 percent of GDP over the past six years to about 0.6 percent in 2018–19.

High inflation driven by food and energy prices disproportionately impacts low-income households, as these basic items consume a greater share of poor households’ incomes, while unfavorable labor market conditions pose a serious challenge to poverty reduction. The fiscal deficit continued to shrink as the TC administration reduced expenditure due to declining budget support from Turkey. Meanwhile, high inflation has helped to reduce the debt-to-GDP ratio, though it remains sizable.

GDP growth is expected to pick up at 1.8 and 2.5 percent in 2020 and 2021, respectively. While services (tourism and higher education ‘exports’, ICT, the retail trade and restaurants)\(^2\) will continue to drive GDP growth, manufacturing is expected to pick up in 2020 and construction of infrastructures to rebound. But these developments will be subject to the signing of a new financial protocol (2020), currently in negotiation between the TC administration and Turkey, and greater funding flowing in to support ‘public’ investment in infrastructure and the private sector, including manufacturing. Manufacturing should also benefit from a recovery in livestock and milk production for the production of dairy products.

Agriculture is also expected to contribute positively to growth, thanks largely to a good rainy season and a return to previous levels of livestock production. Meanwhile, inflation is expected to decelerate, albeit remaining high, while the fiscal deficit is expected to remain below 1.0 percent of GDP and the debt-to-GDP ratio to stabilize.

However, risks to this outlook are tilted to the downside, explained by a combination of several factors, including tensions in the Eastern Mediterranean, a further exchange-rate depreciation, or a delay in the signing of the new financial protocol with Turkey due to the upcoming election of a new TC leader.

Triggered by several structural factors, the economy has been growing on average by 0.42 of a percentage point below population growth since 2012. The slowdown in GDP growth in 2018–19 has therefore worsened the decline of TC income per capita and widened the income gap with the rest of the EU.

Looking ahead and doing things differently will help break this downward trend in income per capita

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2 Tourism is projected to rebound in 2020 as growth in Turkey is expected to pick up in 2020. Retail trade and restaurant activities are also expected to keep up as crossing over the Green Line will continue to increase. Meanwhile, the ICT sector is likely to further expand thanks to the implementation of the mobile phone interoperability confidence building measure started in July 2019.
and avoid widening the gap between TC income per capita and the EU. This will require investing more in higher-quality physical assets by changing the business model both in the ‘public’ and private sectors; improving the quality of human assets by addressing both the technical and socio-emotional skills gaps, and inefficiencies in the education system; improving labor force participation by facilitating access to work opportunities for youth and women; and enhancing firms’ productivity by upgrading the business environment and reducing inefficient use of resources. Using the World Bank Long-Term Growth Model, our simulations show that the real income per capita of Turkish Cypriots could double from between now and 2035 if investment in high-quality physical assets increases from 16.5 to 33.5 percent of GDP, female labor participation (FLFP) for women aged between 15 and 64 rises from 40 to 70 percent, human capital growth increases from 1.2 to 1.8 percent, and TFP growth improves from 0.3 to 1.5 percent.3 Pursuing this goal will help the TC economy prepare to become an effective and prosperous part of a united Cyprus in the event of a settlement. Commitment, coordination and cooperation will be central in achieving this outcome.

While looking ahead to steer the economy toward a higher growth path, strengthening the resilience of the economy to shocks will help not only in achieving the objective of doubling income per capita in a shorter timeframe, but also in ensuring that the most vulnerable and deprived are not left behind.

The TC economy is particularly vulnerable to economic shocks, causing it to lose the ground gained during periods of high growth. As a result of structural factors and vulnerability to shocks, Turkish Cypriots are now on average €2,000 poorer than in 2011 in nominal terms. This greater vulnerability to shocks than the more resilient European economies is explained by the lower quality of institutions that shape the response to shocks. The TC labor market has rigidities that limit the extent to which wages and employment can respond to a shock to help production remain competitive. Lack of competition, including anti-competitive product and services market regulations, limits the private sector’s crisis response and its ability to rebound. Regulations that should allow firms to quickly adjust production and new firms to enter (and failing firms to exit) are outdated. Active labor market policies that should help those who lose a job to find a new job are ineffective. Social protection has low coverage of the poor and is unable to support those at risk of falling into poverty when shocks occur. There is also a low level of trust among Turkish Cypriots in the fairness and efficiency of institutions, which undermines the administration’s capacity to implement difficult policies at times of shocks so the economy can readjust, regain its competitiveness and recover. Boosting resilience in the TC community should focus on creating greater flexibility in labor markets and private sector conditions, as well as protecting the poor, with improved trust in institutions reinforcing resilience.

Setting the TC economy on a high growth path and boosting its resilience to shocks will require reducing the economy’s dependence on imported fuel and diversifying toward renewable energy (RE). Relying on imported fuel has two critical implications for the TC economy. The first is having electricity tariffs that are among the highest in Europe and affect the competitiveness of the economy and household budgets. It also creates greater vulnerability to exchange-rate shocks and oil-price fluctuations. Diversifying energy supply toward RE and reducing dependence on fuel will reduce energy production costs with a potential to lower energy tariffs. Lower energy tariffs will improve households’ purchasing power, bring down production costs, and make the economy more competitive, productive and resilient. More RE will also help to lower the emission of greenhouse gases.

This macroeconomic monitoring note is structured in two chapters. Chapter 1 discusses recent economic developments and the short-term outlook, lays out the challenges to long-term growth that hold back income per-capita growth and proposes policy recommendations to break the trend so that the TC economy can double its income per capita in the coming 15 years. Chapter 2, the special issue, discusses how the TC economy can strengthen its resilience to help shield the economy from shocks, protect the most vulnerable, and ensure that incomes can rebound quickly.

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3 This means that over the period, investment-to-GDP ratio will reach an average of 25 percent, FLFP an average of 55 percent, human capital growth and TFP growth an average of 1.5 percent and 0.9 percent respectively.
Chapter 1: Steering the Economy toward Higher Growth

1.1 Recent Economic Developments and the Short-term Outlook

1.1.1 Economic growth is estimated to have further decelerated in 2019 following the sharp 2018 slowdown.

After reaching 5.4 percent in 2017, TC GDP growth slowed significantly to just 1.3 percent in 2018, far lower than forecast, and is estimated to further decelerate to 0.5 percent in 2019. In the second half of 2018,

Figure 1: The TC economy was hit by an unprecedented exchange rate depreciation shock in 2018

Figure 2: TC growth slowed remarkably to below EU averages


both the Turkish Cypriot (TC) and Turkish economies were hit by an unprecedented exchange-rate depreciation shock (Figure 1). As a result, GDP growth declined by 4.1 and 4.7 percentage points in the TC and Turkish economies, respectively (Figure 2). While GDP growth in Turkey is expected to fall to zero in 2019,⁵ TC GDP growth is estimated to have further slowed to 0.5 percent. With the Greek Cypriot (GC) economy maintaining its growth momentum (Figure 2) that had started in 2015 after the 2012–14 crisis, the sharp slowdown in TC growth below the EU27 average (Figure 2) is likely to further delay any convergence of TC income per capita with EU and GC levels.

Despite zero GDP growth in Turkey in 2019, TC growth is estimated to be positive in 2019 thanks to the services sector, notwithstanding a strong contraction in manufacturing.⁶ The manufacturing sector, which accounts for almost 80 percent of the industry sector, contracted by 16 percent in 2018. As a result, the industry sector reduced GDP growth by 1.4 percentage points (Figure 3) and now accounts for only 9.5 percent of GDP, down from 11.0 percent in 2017. As the manufacturing sector is expected to decline in 2019, the overall industry sector will further contract (Table 1). Growing at 8.0 percent in 2018, construction continues to contribute positively to growth but is expected to slow in 2019. Agriculture

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⁴ The EU-funded World Bank Macroeconomic report of November 2018 forecast a slowdown of GDP growth of 2.5 percent for 2018. Lower-than-forecast GDP growth is due to a stronger contraction of the manufacturing sector and a slower-than-expected expansion of the tourism sector.


⁶ The analysis focuses on the supply side because of lack of complete data from the demand side for 2018.

⁷ For the first time in nine years.
added 0.3 of a percentage point to GDP growth in 2018, thanks to a strong increase of 12 percent in crop production. The sector is expected to contribute positively to growth in 2019 thanks to a good rainy season. Despite a sharp slowdown of the trade and tourism industry in 2018, thanks to higher education ‘exports’ services and ICT, the services sector remained the primary driver of TC growth and contributed 1.3 percentage points to growth. In 2019, the services sector is estimated to remain the major contributor to the meager 0.5 percent GDP growth.

While tourism, especially from Turkey, is expected to stagnate in 2019, higher education ‘export’ services and increasing crossings across the Green Line are estimated to support the services sector. Higher education services keep growing thanks to a continued increase in the number of foreign students enrolled in higher education institutions (3.2 and 1.2 percent in the 2018/19 and 2019/20 academic years, respectively).\(^8\) Tourism activity is estimated to have slowed further, especially from Turkey, given Turkey’s GDP growth stagnation in 2019. Indeed, the bed occupancy rate over the first three-quarters of 2019 somewhat stalled compared with the same period in 2018. Meanwhile, thanks to the opening of new crossing points in November 2018 and the lira depreciation, crossings across the Green Line in January-September 2019 almost reached the 2018 total.\(^9\) This surge in crossings is expected to help retail trade and restaurant services in 2019, as reflected in increasing payments made by non-Turkish Cypriots visitors on the TC side.\(^10\)

The contraction of the manufacturing sector is the result of the lira depreciation shock, structural issues in the livestock sector, and declining financial support from Turkey. The manufacturing sector produces predominantly dairy products and therefore relies on milk production. Livestock production declined by 2.3 percent in 2018 as a result of several factors. According to the qualitative interview with the head of the Animal and Livestock Breeders Union, the lira depreciation affected prices of imported animal feed and energy tariffs (energy is produced with imported fuel), causing the cost of milk conservation to increase. Milk production therefore declined by about 20 percent\(^12\) as producers of raw milk could not increase administration-controlled prices to the extent needed to cover input costs. In addition, as a consequence of animal disease, producers had to slaughter affected animals, reducing the sheep and goat population from 320,000 to 270,000 in the period of 2017–18, and the bovine population from 77,000 to 68,458. Manufacturing then

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\(^8\) While higher education services support growth, entry requirements in higher education institutions need to be strengthened to increase the quality of education.


\(^10\) See the TC Chamber of Commerce Note: Facilitating Crossings across the Green Line.

\(^11\) The graph does not show estimated contributions for 2019 because data for 2019 are not available yet. Our estimates are based on a forecast model that does not break down services in private and public. In addition, construction sector is included in services.

\(^12\) The head of the Turkish Cypriot Livestock Breeders Union explained that daily production used to be 500 tons and has declined now to 350 tons starting end of 2017. With the lira depreciation, price of inputs increased, and the sector had to decrease production because it could not increase the price of raw milk to cover the increase of input prices, so exports of raw milk have also declined.
faced a decline in milk production, together with higher borrowing costs and electricity tariffs, and an increase in the price of raw milk. In addition, as the financial support to the real sector from Turkey fell short of expectations, from an average of 1.1 percent of GDP over the past six years to about 0.6 percent in 2018–19, manufacturing is estimated to contract further in 2019.

Construction appeared to be somewhat more resilient thanks to a diverse profile of external buyers, but the sector is nonetheless still struggling to sell existing new construction units and is expected to slow in 2019. According to the qualitative interview with the Chairperson of the Building Contractors Association, the lira depreciation lowered domestic demand as higher inflation reduced domestic purchasing power. But the various profiles of foreign buyers (the Gulf countries, China, Finland, Norway, the Russian Federation, Switzerland) helped cushion declining domestic demand. However, supply of new construction units has exceeded demand, especially in cities such as Trikomo/Iskele and Kyrenia, where there is a surplus of unsold dwellings. According to the head of Construction and Building Contractors Association, the sale of these dwellings is expected to decline in 2019.

1.1.2 Labor market conditions and high inflation pose a challenge to poverty reduction

Labor market conditions pose a serious challenge to poverty reduction. Labor force participation for the population aged 15+, at 51 percent in 2018, remains low compared with the EU27 average and GC level, and is among the lowest in the EU. The unemployment rate increased from 5.8 percent in 2017 to 6.9 percent in 2018, and is expected to have increased in 2019, with a substantial gap between males and females. The male unemployment rate in 2018 stood at 5.7 percent versus 9 percent for females. The employment rate fell from 48.2 percent from 2017 to 47.3 percent in 2018. Meanwhile, the services sector continued to provide most jobs, as it accounted for more than 80 percent of total employment, albeit of low quality. Relative poverty, at 22.2 percent in 2015, is likely to have worsened in 2018–19. Indeed, some authors have found that changes in labor market opportunities, especially the unemployment rate and labor income, are the major determinants of changes in poverty.

High inflation driven by food and energy prices disproportionately impacts low-income households, as these basic items consume a greater share of poor households’ incomes. With the lira depreciation, inflation accelerated in 2018, reaching 38 percent in October 2018 YoY and 23 percent on an annual basis, which

13 With the lira depreciation, the increase of nominal interest rates of the Central Bank of Turkey translated into an increase of TC nominal rates preventing firms from borrowing more. In addition, with an annual inflation of 23 percent in 2018 compared with 15 percent in 2017, real credit to the private sector contracted by 3 percent compared with an increase of 7 percent in 2017 restraining firms’ ability to produce more because of higher inputs (mainly electricity and raw milk) prices.

14 Companies contracted by the administration faced further challenges due to the less than-expected cash-flow for investment grants from Turkey.

15 EU 27 average LFPR of the population aged 15+ is about 58 percent and the GC level 61 percent, and is among the lowest in the EU. The unemployment rate increased from 5.8 percent in 2017 to 6.9 percent in 2018, and is expected to have increased in 2019, with a substantial gap between males and females. The male unemployment rate in 2018 stood at 5.7 percent versus 9 percent for females. The employment rate fell from 48.2 percent from 2017 to 47.3 percent in 2018. Meanwhile, the services sector continued to provide most jobs, as it accounted for more than 80 percent of total employment, albeit of low quality. Relative poverty, at 22.2 percent in 2015, is likely to have worsened in 2018–19. Indeed, some authors have found that changes in labor market opportunities, especially the unemployment rate and labor income, are the major determinants of changes in poverty.

16 The gap for active population remains also significant between males and females: while 60 percent of working age males are economically active, only 40 percent of working age females are active.

17 The EU-funded World Bank Macroeconomic report of November 2018 found that the recent decline in total labor productivity resulted from slumping labor productivity in services both public and private.

18 Relative poverty, defined as per EUROSTAT’s methodology as the proportion of people with an equalized disposable income below 60 percent of the median equalized disposable income, results from the EU-funded World Bank Poverty and Social Assistance Report of February 2019 using the latest available HBS 2015.

19 For instance, using US data over the period 1967–2003, Hilary Hoynes, Marianne Page, and Ann Stevens in their 2005 NBER working paper (https://www.nber.org/papers/w11681.pdf), Poverty in America: trends and explanations found that increasing the unemployment rate by 1 percentage point increases the poverty rate by 0.4 to 0.7 of a percentage point. Meanwhile, median wage increase by 10 percent decreases the poverty rate by about 2 percentage points.
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reduces purchasing power from both labor income and loans. Indeed, while nominal credit growth to private sector (households and businesses) reached about 20 percent in 2018, real credit to the private sector declined by 3 percent. Prices increased even faster for food and non-alcoholic beverages, transport and housing (Figure 4). Poor households spend about 65 percent of their budgets on these consumption categories, which is much higher than the 53 percent budget allocation of non-poor households.\(^20\) Increasing prices in these goods and services therefore have a far more adverse impact on the poor than the non-poor.

excluding grants from Turkey, the CAB surplus declined from 2.5 percent of GDP to 1.0 percent. As an import-dependent economy, import of goods increased from 44.6 percent of GDP to about 48 percent despite the currency depreciation. The net ‘export’ of goods and services improved from a deficit of 1.1 percent in 2017 of GDP to a deficit of about 0.4 percent in 2018, thanks to services ‘exports’ (higher education and tourism). However, net factor income and other foreign inflows decreased from 3.5 to 1.5 percent of GDP. In 2019, the CAB surplus is estimated to have increased thanks to a further improvement of the net ‘exports’ of good and services (Table 1).

Figure 4: High inflation driven by food and energy prices disproportionately impacts low-income households

The fiscal deficit continued to shrink as the TC administration adjusted its expenditure downward due to declining budget support from Turkey. Budget support from Turkey has been dramatically declining in recent years (Figure 5), from 6.5 percent of GDP in 2013 to 1.5 percent in 2017, and only 0.22 percent \(^21\) in 2018. As a result, the TC administration has embarked on a dramatic fiscal consolidation program, cutting total expenditure from about 43 percent of GDP in 2013 to 34.5 percent in 2017, and to about 30 percent in 2018. Between 2017 and 2018, total revenues fell

\(^{20}\) These findings are from the EU-funded World Bank Poverty and Social Assistance Report of February 2019 using the latest available HBS 2015.

\(^{21}\) Financial assistance from Turkey is comprised of grants (investment, defense and support to the private sector) and budget support to the Central administration for deficit financing.
from 33 percent of GDP to 29 percent as both foreign aid and domestic revenues declined by 2.5 percent of GDP and 1.5 percent, respectively. But a more sizable expenditure consolidation than revenue reduction helped reduce the deficit from 1.5 percent of GDP to 0.7 percent of GDP. The primary deficit is almost equal to the overall deficit, as the TC administration barely pays interest on its domestic debt. Excluding grants, the deficit remains significant at 3 percent of GDP. As the budget support in 2019 is estimated to have remained as in 2018, the fiscal situation in 2019 is expected to remain unchanged compared with 2018 (Table 1).

Fiscal consolidation and high inflation have helped to reduce both total public and publicly guaranteed (PPG) debt and domestic public debt-to-GDP ratios, but the levels remain high. With the high inflation experienced in 2018 and 2019, nominal GDP increased by 26 percent in 2018 and is estimated to have increased by 21 percent in 2019. This increase in nominal GDP, combined with the lessening of the fiscal deficit, resulted in a reduction of total ‘public’ debt from 148 percent in 2016 to 111 percent of GDP in 2018, and to about 104 percent of GDP in 2019. Meanwhile, ‘public’ domestic debt declined from 48.5 percent of GDP in 2016 to 33.4 and 28.2 percent of GDP in 2018 and 2019, respectively (Table 1).

1.1.4 The short-term outlook is somewhat positive

Growth is expected to pick up in 2020 and 2021, as manufacturing and construction are projected to rebound. Real GDP is expected to grow at 1.8 and 2.5 percent in 2020 and 2021, respectively (Table 1). While services (tourism and higher education ‘exports’, ICT, the retail trade and restaurants) will continue to drive GDP growth, manufacturing is expected to pick up in 2020 and construction of infrastructure to rebound. These developments are, to some extent, subject to the signing of a new financial protocol (2020) currently in negotiation between the TC administration and Turkey, and greater funding flowing in to support ‘public’ investment in infrastructure and the private sector, including the manufacturing sector. Manufacturing should also benefit from a recovery of livestock and milk production for the production of dairy products.

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22 Public finance tables from the ‘Ministry of Finance’ show a fiscal surplus for 2018 as foreign borrowing and other non-revenues items are classified as revenue.

23 As consumption and investment data have not been published for 2018, the outlook for the real economy focuses on the supply side.

24 Tourism is projected to rebound in 2020 as growth in Turkey is expected to pick up in 2020. Retail trade and restaurant activities are also expected to keep up as crossing over the Green Line will continue to increase. Meanwhile, ICT sector is likely to further expand thanks to the implementation of the mobile phone interoperability confidence building measure started in July 2019.
Looking ahead to steer the economy toward a higher growth path that is more resilient to shocks

Agriculture is also expected to support growth in the short and medium term, as a result of several factors. The 2019 good rainy season helped to produce significant amounts of animal feed to cover the 2019–20 period, contributing to a partial reduction in the need for imported animal feed and supporting a return to previous levels of livestock production. In addition, a substantial share of the animal population was treated for disease, and the Animal and Livestock Breeders Union is in discussions with the agriculture administration on importing 30,000 to 40,000 appropriate breeds of sheep as replacements. These developments will further support livestock production and overall agriculture production (Table 1).

Inflation is expected to decelerate but will remain high, while the fiscal deficit is expected to remain below 1 percent of GDP and the debt-to-GDP ratio to stabilize. In the event of a relatively stable exchange rate, the inflation rate is projected to remain high but to decline to 17.5 percent in 2020 and then to 15 percent in 2021. The fiscal deficit is expected to remain below 1 percent of GDP. Assuming the new financial protocol is signed, revenue and expenditures are expected to increase from 2020 thanks to increased grants ('public' investment and private sector)

Table 1: Short-term prospects are somewhat positive

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
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<td>-7.0</td>
<td>4.0</td>
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<td>Services, percent volume change</td>
<td>3.7</td>
<td>6.5</td>
<td>3.2</td>
<td>1.3</td>
<td>1.5</td>
<td>2.1</td>
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<td>CPI (pa), percent change</td>
<td>8.3</td>
<td>15.1</td>
<td>23.1</td>
<td>19.5</td>
<td>17.5</td>
<td>15.0</td>
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<td>Fiscal accounts</td>
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<td>Revenues, percent GDP</td>
<td>34.1</td>
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<td>29.1</td>
<td>29.2</td>
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<td>Expenditures, percent GDP</td>
<td>35.9</td>
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<td>29.9</td>
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<td>Capital, percent GDP</td>
<td>2.9</td>
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<tr>
<td>Fiscal Balance, percent GDP</td>
<td>-1.7</td>
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<td>-0.7</td>
<td>-0.9</td>
<td>-0.8</td>
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<td>Excluding foreign aid, percent GDP</td>
<td>-6.1</td>
<td>-6.4</td>
<td>-3.1</td>
<td>-3.4</td>
<td>-5.0</td>
<td>-5.1</td>
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<tr>
<td>Financing, percent GDP</td>
<td>1.7</td>
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<td>0.7</td>
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<tr>
<td>External, percent GDP</td>
<td>1.9</td>
<td>1.5</td>
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<td>Internal, percent GDP</td>
<td>-0.2</td>
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<td>0.4</td>
<td>0.5</td>
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<td>Public and public guarantees debt, percent GDP</td>
<td>147.9</td>
<td>138.7</td>
<td>110.8</td>
<td>104.2</td>
<td>92.1</td>
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<tr>
<td>Internal, percent GDP</td>
<td>48.5</td>
<td>41.5</td>
<td>33.4</td>
<td>28.2</td>
<td>24.4</td>
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<td>Balance of Payments</td>
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<tr>
<td>Current Account Balance, percent GDP</td>
<td>7.5</td>
<td>7.4</td>
<td>3.5</td>
<td>5.3</td>
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<tr>
<td>Excl. foreign grants, percent GDP</td>
<td>3.1</td>
<td>2.5</td>
<td>1.0</td>
<td>2.7</td>
<td>0.9</td>
<td>1.3</td>
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<tr>
<td>Net merchandise exports, percent GDP</td>
<td>-37.8</td>
<td>-42.0</td>
<td>-45.3</td>
<td>-44.0</td>
<td>-45.4</td>
<td>-45.7</td>
</tr>
<tr>
<td>Net services exports and other transfers, percent GDP</td>
<td>45.3</td>
<td>49.4</td>
<td>48.7</td>
<td>49.4</td>
<td>50.5</td>
<td>51.2</td>
</tr>
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Source: SPO, ‘Statistic Office’ and World Bank staff.
Note: e=estimate; f=forecast
from Turkey and a corresponding increase in capital expenditures. The debt-to-GDP ratio is projected to decline owing to high inflation (Table 1).

The CAB is projected to remain positive and stable around 5 percent of GDP, carried by ‘exports’ of services and an expected increase in foreign grants. As the economy picks up, increased imports will somewhat worsen the trade of goods deficit. But the expected rebound in tourism and an increase in grants from Turkey will help counterbalance the deterioration of the trade of goods deficit (Table 1).

1.1.5 But risks to the outlook are tilted to the downside

Risks to the outlook are tilted to the downside, explained by a combination of external factors. These include, among others, tensions in the Eastern Mediterranean and a further exchange-rate depreciation. Ongoing tensions in the Eastern Mediterranean, if exacerbated, could affect investor sentiment, delaying investment in new construction and decisions to buy existing dwellings by foreigners. Ongoing tensions may also affect higher education and tourism activities — the main drivers of short-term growth — as tourists and foreign students look to other destinations. Meanwhile, a further exchange-rate depreciation would affect consumption through higher inflation, and production through imported input prices.

Internal factors could also hinder growth prospects. The signing of the new financial protocol with Turkey could either not materialize or the negotiations could be delayed due to the upcoming election of a new TC leader. If signed, the cash flow could be delayed if the TC administration fails to meet the conditionalities needed to trigger the disbursement. Without the protocol and the TC administration’s failure to allocate domestic resources to capital expenditure, private and ‘public’ investments are likely to be further jeopardized.

Both external and domestic factors previously discussed are likely to further affect already fragile TC economic sentiment. Turkish Cypriots compared with Greek Cypriots are systematically more pessimistic about economic conditions. The EU-financed World Bank quarterly “Pulse” has found that over the past year, less than 20 percent of Turkish Cypriots were optimistic about near-term economic conditions. While the optimism gap seemed to close over the third quarter of 2019, it surged again in the last quarter of 2019, with only 6 percent of TCs versus 38 percent of GCs being optimistic about short-term economic conditions.

Figure 6: Turkish Cypriots are more pessimistic than Greek Cypriots about near-term economic conditions

1.2 Structural Factors behind the Decline in Income Per Capita

1.2.1 The slowdown in GDP growth has led to worsening income per capita triggered by several structural factors, primarily low-level and inefficient investment

The slowdown in GDP growth has worsened the recent fall in income per capita, further widening the gap with the EU average. Since 2011, TC income per capita (using the GNI Atlas method) fell from US$13,810, to US$11,340 in 2018 (Figure 7), a loss of about an equivalent €2,000 in nominal terms. As a result, the TC economy fell in the global ranking from 53 in 2011 to 68 in 2018 out of 200 economies. While the recent exchange-rate depreciation may have affected the GNI per capita using the Atlas method, in real terms since 2011, the economy has been growing on average at a slower pace than population growth, causing a fall in real income per capita.\(^{25}\) As the EU real income per capita has fully recovered from the global financial crisis, with the 2018 TC slowdown in growth, the gap between TC real income per capita and the EU average, at 60 percent in 2011, has now widened to 63.5 percent.

The decline in income per capita since 2011 is not a random event, but caused by structural factors, in particular the deficit and inefficiencies in investment. Capital accumulation is the TC economy’s driver of long-term growth, explaining more than 60 percent of GDP growth,\(^{26}\) but the total investment-to-GDP ratio (both public and private) has substantially declined in recent years. Between 2004 and 2011, total investment as a share of GDP averaged 20.3 percent of GDP and decreased to 15.5 percent between 2012 and 2017 (Figure 8). Over the same period, TC investment was almost half the investment level of other upper middle-income economies, 4.5 percentage points of GDP below the EU average and below other regional economies’ investments levels (Figure 9).

Figure 7: The income of Turkish Cypriots has fallen every year since 2011. As a result, the TC economy has no longer been a high-income economy since 2015

Source: ‘State Planning Organization’, World Development Indicators, World Bank staff.

Note: TC per capita income is calculated using the World Bank’s Atlas method to smooth the impact of fluctuations in exchange rates. GNI for an economy in US dollars for year t is calculated based on a conversion factor (“Atlas conversion factor”) computed for the period that covers years t-2, t-1, and t. Each year, the three-year base period moves forward, including the target year for which GNI is computed and the two preceding years.

\(^{25}\) TC GDP explains most of the fluctuation of the GNI. Indeed, net factor income is negligible and has a very limited contribution to the fluctuations in GNI.

\(^{26}\) According to World Bank staff estimates in previous work.
While capital formation has decreased in recent years, the allocation of this investment appears to have shifted toward lower-return sectors of the economy. Infrastructure (non-residential construction) and machinery and equipment investment are found to generate more growth than investment in buildings, and economies with high levels of equipment investment experience higher growth. However, the share of residential construction and services investment appears to have disproportionately increased at the expense of investment in manufacturing and non-residential construction. At the same time, public investment in education and health—at the core of human capital formation—has declined to the benefit of other public services with lower returns (Figure 10).

Fiscal policy does not support growth, as ‘public’ investment is a low share of ‘public’ expenditure and less efficient per quality of infrastructure. TC ‘public’ expenditures are biased toward current expenditures, accounting for more than 80 percent of the budget. The share of the budget allocated to capital expenditures, which backs growth, fell gradually from about 15 percent in 2006 to about 6 percent in 2011, and has remained broadly unchanged since then (Figure 11). In addition to the low level of public investment, the quality of infrastructure remains deficient compared with international quality. The ranking of TC infrastructure quality is only 101 globally out of 140 economies (Figure 12).

![Figure 8: TC investment has substantially declined](image)

![Figure 9: Turkish Cypriots invest less than in peer economies](image)

Source: ‘State Planning Organization’, WDI.

Source: ‘State Planning Organization’

Figure 10: Investment has shifted toward sectors with lower returns


28 These current expenditures appear to be inefficient especially subsidies to agriculture as discussed in the 2017 EU-funded WBG Assessment of ‘Public’ Spending on Agriculture.
LOOKING AHEAD TO STEER THE ECONOMY TOWARD A HIGHER GROWTH PATH THAT IS MORE RESILIENT TO SHOCKS

Public investment management (PIM) is also weak, leading to low absorption of the financial support from Turkey for investment projects. Disbursement rates—how much of the annual funds committed to ‘public’ investments are spent—as per the 2015 EU-funded World Bank report, averaged only 39 percent, low by international comparison. Such a low disbursement rate indicates that projects are insufficiently prepared, and therefore fail at the approval stage, or encounter delays in implementation. Delayed projects may also block public funds that could be used for other more productive purposes.

The financial sector remains shallow and credit to the private sector has stagnated as the economy expand, with firms unable to absorb increased savings because of the high cost of borrowing. The TC financial sector essentially comprises just the banking system, which prevents firms from using other financial instruments (stocks, bonds, etc.) to finance their investments. In addition, borrowing costs have substantially increased in recent years—to which the non-servicing of ‘public’ debt contributes—rising to about 2 percentage points higher than in Turkey in 2018, for instance. As a result, credit to the private sector has stagnated at around 76 percent of GDP since 2013 (Figure 13). The savings rate, which is still low by international standards, has substantially increased over

Figure 11: Budget allocation is biased toward current expenditures

![Figure 11](image1.png)

Figure 12: Quality of infrastructure is low

![Figure 12](image2.png)

Figure 13: Credit to the economy as share of GDP has stagnated

![Figure 13](image3.png)

Figure 14: High borrowing costs prevent the private sector absorb domestic savings

![Figure 14](image4.png)


29 Strengthening TC public investment management.

30 The TC administration does not service its domestic debt (principal and interest payment) contracted mostly from domestic banks. Especially, there is an old loan contracted from a ‘public’ bank that has never been serviced. See the EU-funded World Bank Macroeconomic report of November 2018 for the implication of that loan on non-performing loan. The administration announced a plan to start servicing that loan, but the implementation is yet to be seen.
the past three years, reaching an average of 19 percent of GDP between 2012 and 2016, from below 15 percent on average between 2006 and 2011. But the investment rate has remained on average 5 percentage points of GDP lower (Figure 14).

1.2.2 Challenges to improving human capital and total factor productivity growth are other factors holding back income per capita growth

In addition to low labor force participation, which results in low availability of labor, other deficiencies diminish the quality of the current workforce from being more productive. According to anecdotal evidence, employers often complain about an oversupply of higher education graduates and a scarcity of TVET graduates. Employers point to a perceived generalized lack of technical, but also interpersonal and socio-emotional skills among TC youth and students, which reduces their productivity at work. This anecdotal evidence is backed by the findings of the 2018–19 TC Competitiveness Report. Globally, the rankings of the TC economy are 139 in the ease of finding skilled employed (scored 2.56/7), 105 in digital skills among population (scored 3.68/7), 84 in skilled sets of graduates (scored 3.9/7) and 138 in quality of vocational training (scored 2.91/7). Employers do not also provide enough training for their staff. As the report found, the TC economy’s global ranking in the extent of staff training is 129 (scored 3.21/7). Across all these indicators, the TC economy is underperforming compared with the GC economy, and with more than half of the Europe and Central Asia (ECA) economies (Figure 15).

Constraints to the education system also impede the quality of the future workforce and therefore future labor productivity. While the pupil-to-teacher ratio in primary education is among the lowest globally, with the TC community ranking 16 globally, the TC economy is among the laggards in the “critical thinking in teaching” indicator with a ranking of 132 globally (according the 2018–19 TC Competitiveness Report). Entry requirements for tertiary education suggest significant limitations. While barriers to entry are low, making the admission system highly inclusive, the system’s effectiveness is low as reflected in a poor matching between the fields of student studies and labor market demand. The system’s efficiency is also low, as students lack proper guidance to improve the matching between their profiles and interests, and the study programs that they end up taking.

Figure 15: TC economy lags in providing skills needed to enhance employee productivity


31 This is true for TVET students as well. The transition from secondary TVET institutes to universities are easy, with many TVET graduates continuing onto or switching over to universities with no barrier and guidance, undertaking academic and career paths that have often little to do with their secondary TVET education or skillset.

32 See the World Bank EC-financed “Review of entry requirements and the admission system for Turkish Cypriot students applying to local higher education institutions, 2019” report.
The poor business environment is another factor that affects firms’ productivity. The EU-funded World Bank Macroeconomic report of November 2018 found that labor productivity, which depends on TFP, has been declining on average since 2011. Among the determinant of firms’ productivity is the business environment that makes it easier or harder for firms to do business. However, the EU-funded World Bank Group (WBG) report (2019a) “Doing Business in the TC Economy” reveals that the TC economy has one of the most difficult business environments globally (181 out of 190 economies), as measured by “Doing Business”, which is at odds with the TC economy’s upper middle-income economy status (its income per capita ranking 68 in 2018 out of 200 economies). The report ranks the TC economy at 185 (out of 191 economies) globally in terms of protecting minority investors; 179 in terms of the administrative burden of paying taxes; 175 on the ease of starting a business; 173 on the ease of enforcing commercial disputes; 164 on the ease of dealing with construction permits; 161 on resolving insolvency; 144 on getting electricity connections; and 144 on the ease of getting credit. The TC business environment lags the average performance of economies in ECA, OECD high-income economies, and globally (Figure 16). In addition, the regulations do not allow low productivity firms to exit.

Inefficient use of resources, another determinant of firms’ productivity can be exacerbated by the high level of corruption as reported by businesses. According to the “Corruption Perceptions in the Turkish Cypriot Economy 2017” report, with a score of 40/100 the ranking of the TC economy...
is 81 among the least corrupt of over 180 economies. Meanwhile, results of the survey suggest that: 89 percent of business people surveyed think that “bribing and corruption exist in the TC economy”; 48 percent said that “diversion of public funds to companies, individuals or groups” due to corruption was very common or common; and 43 percent said that “a tradition of payment of bribes to secure contracts and gain favors” was also very common or common. When asked in which areas bribing was most common, it happened always or most of the time in the: “allocation of land and similar incentives” for 63 percent of respondents; “taking a loan” for 56 percent; “obtaining a favorable judicial decision” for 45 percent; “awarding of public contract and licenses” for 44 percent; and “annual tax payments” for 41 percent (Figure 17).

1.3 Looking ahead and Doing Things Differently Will Help Break the Downward Trend

1.3.1 The TC economy can double its income per capita in 15 years

If Turkish Cypriots continue doing business as usual, the gap in income per capita with the EU will continue widening. Assuming TC real income per capita\(^{34}\) over the next 15 years continues to grow on average at about 1 percent per year, the equivalent of the average real income per capita growth over the past five years—corresponding to an average GDP growth of 2.5 percent—then the gap in real income per capita at 63.5 percent in 2018 will widen to 66.2 percent by 2035.\(^{35}\)

By investing more and better in physical and human assets, bringing more women into the labor market and improving TFP growth, TC income per capita can double in 15 years and approach the EU average.\(^{36}\) Actioning just one input would not be enough for TC income per capita to grow enough to approach the EU level, but a combination of actions on all input factors would do so, based on the experience of other economies. Using the World Bank Long-Term Growth Model, our simulations show that the real income per capita of Turkish Cypriots (Figure 18) could double from between now and 2035 (US$13,553 now to about US$27,250 in 2035 in constant 2010 US dollars) if investment in high-quality physical assets increases from 16.5 to 33.5 percent of GDP, FLFP for women aged between 15 and 64 rises from 40 to 70 percent, human capital growth increases from 1.2 to 1.8 percent, and

Figure 18: By implementing right policies, Turkish Cypriots can double their income per capita in a generation

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\(^{34}\) The World Bank income per capita is based on the Atlas method which smooths the exchange rate fluctuation to convert local currency income to US dollars. Given the high volatility of the exchange rate, therefore challenging to forecast over 15 years, the projected growth in income per capita is based on real income (constant US$ 2010=1).

\(^{35}\) The assumption is that EU28 average real income per capita will continue to grow by 1 percent per year, the average growth of the past five years.

\(^{36}\) The team used the World Bank’s Long-Term Growth Model to simulate different income per capta paths.
TFP growth improves from 0.3 to 1.5 percent. This means that over the period, investment-to-GDP ratio will reach an average of 25 percent, FLFP an average of 55 percent, human capital growth and TFP growth an average of 1.5 percent and 0.9 percent respectively. As such, TC real income per capita could increase from about 36.5 percent of the EU level today to about 60 percent by 2035, with the gap declining to 40 percent.

In other words, this could result in an average annual increase in real GDP of 5.8 percent (or 4.3 percent annual GDP per capita growth). This is an additional 3.3-percentage-point increase in GDP growth compared with the baseline (2.5 percent GDP growth or 1 percent GDP per capita growth), of which there is a 1.4-percentage-point contribution from investment, a 1.0-percentage-point contribution from female labor force participation, a 0.2-of-a-percentage point contribution from human capital growth, and a 0.7-of-a-percentage-point contribution from TFP growth (Figure 18).

1.3.2 How to invest more and better on physical and human assets, improve labor force participation and TFP growth?

Investing more and better on physical assets would require changing the business model both in the ‘public’ and private sectors.

- Rebalancing public expenditures for greater public investment, while preserving public services, will increase the productive capacity in the long run through building higher-quality infrastructures, while improving PIM\(^{37}\) will increase its efficiency.

- Mobilizing more revenue by modernizing and automating the tax administration, broadening the tax base, simplifying the tax system, and streamlining tax benefits, subsidies and exemptions, will help finance public investment domestically.

- Paying public debt to banks will help lower interest rates, while developing a capital market will help to improve access to credit for greater private sector investment.

- Rebalancing private investment between real estate construction, and machinery and equipment for more manufacturing, will yield higher returns for the economy in the long run.

Improving the quality of human assets will require addressing both the technical and socio-emotional skills gaps, and inefficiencies in the education system.

- Investing efficiently in TVET schools will help reduce the technical skills gaps, while counseling and working with students to develop their socio-emotional skills will help them to increase their confidence and achieve their aspirations.

- Making public funding to higher education institutions performance-based and innovation-oriented; strengthening entry requirements for tertiary education; restricting the establishment of new higher education institutions and ensuring that existing, together with any new, institutions also address labor market needs to help increase the quality and responsiveness of the education system.\(^{38}\)

Improving labor force participation will require facilitating access to work opportunities for youth and women.\(^{39}\)

- Implementing active labor market measures, for instance by training and counseling unemployed youth and inactive people, will help them become more active in the labor market.

- Promoting female employment through support for childcare, flexible work

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\(^{37}\) For further details on improving PIM, see the 2017 EU-financed World Bank policy note: Getting More Mileage from ‘Public’ Investments.

\(^{38}\) See the 2018 EU-financed World Bank report “Review of entry requirements and the admission system for Turkish Cypriot students applying to local higher education institutions” for more details.

\(^{39}\) For more details, see the 2016 EU-financed World Bank report “Towards Quality Employment: Inputs to the Employment Strategy of the Turkish Cypriot community, 2017–2020”
arrangements, and investing in reliable public transportation will increase female labor force participation.

Improving firms’ productivity growth will entail upgrading the business environment, while reducing inefficient use of resources.

- Continuing with the simplification of the trade regime across the Green Line, cutting red-tape and administrative burdens, and implementing doing business recommendations provided by the EU-funded WBG report (2019c) “Doing Business Reform Memorandum for the Turkish Cypriot Economy” will make it easier for firms to do business and become more productive.

- Decoupling agriculture subsidies from production, addressing reported corrupt practices, and allowing the exit of non-competitive firms will help reduce the inefficient use of resources.

1.3.3 Commitment, coordination and cooperation (the 3Cs) will be central in ensuring that policies yield their desired outcomes

As the TC administration is in the process of designing a long-term growth strategy that may encompass previously discussed policy recommendations and beyond, commitment, coordination and cooperation (the 3Cs) will be key for success. According to the World Bank’s World Development Report 2017, “Governance and the Law”, the capacity of actors to commit, and their willingness to cooperate and coordinate to achieve socially desirable goals, are what matter most for policy effectiveness.

- Commitment. Commitment enables actors to rely on the credibility of policies so they can calibrate their behavior accordingly. While consistency over time in policymaking is not easy to achieve, agreed policy reforms by all stakeholders would help to ensure policy continuity. An inclusive approach in the design of the long-term growth strategy will set the stage for policymakers to commit in implementing these policies, even in the event of a change in the administration. Adopting a legal text that keeps unchanged the main objectives of the long-term growth strategy could enhance policymakers’ commitment.

- Coordination. As commitment alone is not sufficient, coordination of actions between the public and private sectors will help resolve market failures for better investment decisions. Also, the economies that have undertaken successful business environment reforms share certain features, including strong high-level leadership, an extensive consultation with the private sector, and an institutional mechanism that measures and communicates successes.

- Cooperation. To achieve equitable development, policies need cooperation, particularly citizens’ willingness to contribute to public goods and avoid free-riding by paying taxes. Such cooperation can happen only if citizens trust that institutions are fair and efficient. Such trust is at present at a low level (Figure 19). Fighting against corruption and providing better public services for all will increase trust among citizens and their adhesion to the administration’s policies.

**Figure 19:** Trust in institutions in the TC economy is low

1.4 Conclusions

TC GDP growth significantly slowed from 5.4 percent in 2017 to just 1.3 percent in 2018 and is estimated to have further declined to 0.5 percent in 2019. TC GDP growth significantly slowed from 5.4 percent in 2017 to just 1.3 percent in 2018, and then to 0.5 percent in 2019, due to a strong contraction in the manufacturing sector. The short-term outlook is somewhat positive, with growth expected to pick up slightly in 2020. But risks to the outlook are tilted to the downside due to increasing tensions in the Eastern Mediterranean and the possibility of delays in the signing of the new financial protocol with Turkey. The slowdown in GDP growth in 2018 has led to a worsening of the recent decline in income per capita, triggered by several structural factors. As a result, the income gap with the rest of the EU has widened.

Looking ahead and doing things differently will help to break the downward growth trend. By investing more in higher-quality infrastructure, with greater and efficient public investment; rebalancing private investment between real estate construction and long run high-return investments on machinery and equipment; addressing both technical and socio-emotional skills gaps and inefficiencies of the education system; facilitating access to work opportunities for youth and women; and improving the business environment, while reducing inefficient use of resources, TC income per capita can double in 15 years and approach the EU average. Pursuing such an objective will help the TC economy better prepare to be an effective and prosperous part of a united Cyprus in the event of a settlement. Commitment, coordination and cooperation will be central in achieving this outcome.

**Strengthening the resilience of the economy to shocks will help in achieving the objective of doubling income per capita in a shorter timeframe.** While looking ahead to steer the economy toward a higher growth path, the TC administration would be well advised to strengthen the resilience of the economy to shocks so that not only the objective of doubling income per capita is not delayed, but also to ensure that the most vulnerable and deprived are not left behind. Built upon the recent World Bank (2019a) report entitled “EU Regular Economic Report: Inclusive Institutions”, Chapter 2 argues that there is significant ground to catch up with respect to Europe in terms of creating flexibility in labor markets, ensuring private sector competition and protecting low incomes. Such improvements will help to shield the economy from future shocks, protect the most vulnerable and ensure incomes can rebound quickly.
Chapter 2: Reducing the TC Economy’s Vulnerability to Shocks: Lessons from Resilient European Economies

2.1 Introduction

The TC economy is vulnerable to economic shocks. The TC economy has experienced a series of shocks over the past decade that have contributed, together with the structural weaknesses highlighted in Chapter 1, to the income per capita falling every year since 2011, with an economic recovery still not in sight (see Figure 7 in Chapter 1). As a result, Turkish Cypriots are on average €2,000 poorer now than in 2011. In contrast, most Northern, Western and Central Eastern European economies have seen the incomes of their citizens already surpass their 2011 levels and continue to increase. Southern European economies, which have taken longer to recover, are now on a recovery path. The TC economy’s vulnerability to shocks has meant that it has lost significant ground gained during previous periods of high growth.

The TC economy can draw lessons from the more resilient European economies that are not as impacted by shocks and recover faster from them. This chapter summarizes the main findings of a recent World Bank (2019a) report entitled “EU Regular Economic Report: Inclusive Institutions”, which identifies the institutional differences that explain why some European economies have not been as impacted by the 2008 global financial crisis and the 2012 eurozone crisis, and have recovered faster than other, mostly southern, European economies. This special issue ends by laying out recommendations for the TC economy.

2.2 Differences That Explain Why Some European Economies Are More Resilient than Others

The World Bank (2019a) report finds that the degree of resilience of European economies to shocks (i.e., how shielded an economy is from the impact of a shock and the speed of recovery) is associated with the quality of institutions that shape the absorption and response to these shocks. Since eurozone members (and economies that fix their currencies to the euro) have no control over their nominal exchange rate, they cannot use short-term monetary and nominal exchange rate policies to absorb the shock, as is also the case in the TC economy. They are therefore reliant on measures taken by the Economic Monetary Union (EMU) or by themselves, both measures being significantly constrained. On the one hand, the EMU’s capacity to respond is constrained by the incomplete development of the European Monetary Union’s “architecture”. On the other hand, the measures these economies can take are constrained by the Stability and Growth Pact, which limits how much deficit an economy can accumulate. As a result of these constraints, individual eurozone members have had to rely largely on adjustments of their real exchange rates—the relative price of domestic versus international goods and services, which depend among other things on relative wages and changes in employment. These adjustments are an outcome of the quality of the institutions that govern markets. And because the quality of these institutions differs across economies, resilience also differs.

41 Resilience is measured in World Bank (2019a) with an index that aggregates trends in convergence, output, unemployment and household income.
42 The Stability and Growth Pact is an agreement among the 28 member states of the EU to facilitate and maintain the stability of the EMU. The purpose of the pact was to ensure that fiscal discipline would be maintained and enforced in the EMU.
The World Bank report shows that resilience and the quality of key institutions is strongest in Western Europe, and weakest in Southern Europe, with Central and Eastern Europe occupying an intermediate position (Figure 20). Resilience is weakest in Latvia, Hungary, Spain and Greece, economies with weaker institutional quality, and resilience is strongest in Belgium, Austria, Sweden, France, the Netherlands, Poland, Denmark, Germany and the United Kingdom, economies with stronger institutional quality.

The report shows that there are clear institutional differences between the most and the least resilient European countries, which help to explain their differing performance. The resilient economies had a mix of policies marked by flexible labor markets paired with active labor market policies and protection for the poorest, together with competition and regulatory policies that allow firms to quickly adjust production and new firms to enter. Of particular importance is the role of poverty-targeted social protection institutions that can quickly absorb those who risk falling into poverty when shocks occur, and also contribute to increasing the countercyclicality of fiscal policy.

Good labor market conditions are a key determinant of resilience. The study finds that stronger resilience is associated with institutions that allow wages to adjust, collective bargaining in a context of high trust in institutions, levels of employment protection that are not excessively high, and active labor market policies. Flexible labor market conditions allow economies to adjust to a shock through changes in employment and wages that help the economy adapt and regain its competitiveness. Collective bargaining in economies where there is high trust can help reach agreements on wages so that sectors can remain competitive and recover quickly from a shock. Two examples are Belgium and the Netherlands, which set a maximal margin for wage increases based on an assessment of the evolution of costs and productivity relative to its main trading partners (in particular, Germany). This ensures that increases in wages—a key component of the real exchange rate—do not undermine competitiveness. In the case of the Netherlands, having learned from the negative experience of automatic indexation of wages to inflation, which contributed to Dutch disease, the 1982 Wassenaar Agreement has kept wage increases continuously below productivity gains and below German wages.

The highly resilient economies of the EU (Belgium, Austria, Sweden, France, the Netherlands, Poland, Denmark, Germany and the United Kingdom) are underpinned by sound labor market conditions. They combine flexibility in their labor markets with active labor market policies, while benefiting from collective bargaining institutions that
yield outcomes that support resilience. For instance, the results suggest that in an economy with a 20-percentage-point higher collective bargaining coverage (the difference between Finland and Spain in 2018), the half-life of an employment recession tends to be four months shorter than in average economies in which it is around 30 months. The exceptions are Poland, which scores low on collective bargaining, part-time work and wage flexibility, and the United Kingdom, which has lower collective bargaining coverage and higher hiring-and-firing costs than its peers.

**Better private sector conditions also support resilience.** Europe’s most resilient economies boast policies and institutions that make it easier to do business, avoid excessive product market regulation, help enforce contracts and come to closure on insolvency efficiently. Sound private sector policies and institutions are positively associated with resilience in Austria, the Netherlands, Denmark, Finland, Germany and the United Kingdom.

**Lack of competition, and product and service market regulations that are anti-competitive and not in the public interest, limit the private sector’s crisis response and rebound.** The higher the level of competition, the faster market prices will adjust to the new economic context. Conversely, lack of competition implies high mark-ups (due to market power), counteracting both price and wage responsiveness. When faced with a negative shock, firms reset their prices more frequently in a more competitive environment. In other words, the more competition, the higher the flexibility of the real exchange rate. This also matters for the economic rebound.

**From a short-term employment perspective, adjustments in prices by firms (resulting in lower profit margins or mark-ups) are a more desirable shock response than adjustments through firm closures.** Firm closures lead to lay-offs, which could make an economic rebound more difficult if the unemployment episode is lengthy—workers may lose their skills or high-skilled workers may move away permanently. Of course, from a medium-term employment perspective, firm closures and lay-offs can also have benefits, facilitating a wider economic restructuring and reducing the buildup of non-performing loans, which is why it is important to have good regulations on insolvency. In this context, open, competitive markets support recovery and restructuring by allowing the speedy entry of new, and the exit of unproductive, firms. All these factors explain the positive association between levels of competition and resilience.

**Policy and institutional reform in these areas can improve resilience significantly.** For instance, if a country improves its labor market conditions to the same extent as was done by recent reformers (as was achieved by Portugal between 2008 and 2012 with respect to the strictness of its labor market regulation) or if a country improves the quality of regulatory environment for business, measured by the WBG’s Ease-of-Doing-Business indicator by 10 points (as was done by Poland between 2010 and 2014), it can expect a reduction in the half-life of a given economic output shock by three months.

**Resilience is also boosted by protecting low incomes.** The report shows that countries with high social protection spending directed toward old age and health, but limited spending devoted to poverty-targeted policies and programs (as is the case in the TC economy), face deeper poverty increases and longer periods of recovery. Social protection programs need to reach the poor, cover enough households, and be responsive to additional enrolment during times of need. They support households vulnerable to shocks, enabling them to continue consuming during such periods, which allows the economy to recover faster. Effective social protection can assist in absorbing shocks and help to ensure a rebound that is inclusive and does not leave sections of society behind.

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43 Mark-up is the difference between the price and the cost of a product. Such difference covers overheads and profit.
Finally, the report underlines the positive impact that a policy environment marked by trust between government, labor unions and the private sector can have on resilience. People’s confidence in the institutions that govern them plays a fundamental role in the economy’s stability. High levels of distrust can put that stability in jeopardy and restrict the administration’s response to an unforeseen crisis. A sound response will lead to a faster rebound after a slowdown. Note that the relationship between resilience and trust works both ways. More trust leads to more resilience and more resilience boosts trust in institutions, while less resilience destroys it.

2.3 Lessons for the TC Economy to Increase Its Resilience to Shocks

Learning from these experiences, the TC administration would be well advised to strengthen its institutions to increase the resilience of the economy to shocks. There is significant ground to catch up with respect to Europe in terms of creating flexibility in labor markets, ensuring private sector competition, and protecting low incomes. Such improvements will help shield the economy from shocks, protect the most vulnerable, and ensure that incomes can rebound quickly.

The TC economy is constrained by rigidities in its labor market. This is reflected in the low share of the population that has a job. In 2014, only 49.6 percent of working-age people had a job, as opposed to 64.8 percent in the EU. This difference is mainly due to not making good use of its young people and women (Figure 21). Only 16.9 percent of the TC youth were employed, in stark contrast to 32.4 percent in the EU. And only 34.9 percent of TC women were employed, against 59.5 percent in the EU. These rigidities in the labor market not only imply lower production, lost human capital, inequality and social tension, but also lower flexibility to adapt to economic shocks. The lower attractiveness of private sector jobs relative to jobs in the administration reduces firms’ capacity to make wage adjustments that would help them remain competitive faced with a shock.

It is therefore important to increase the flexibility of the TC labor market, so it is better able to adapt to shocks. This can be done by increasing incentives to work through improved working conditions in the private sector and a reformed social welfare system, as well as by enhancing youth employability through improvements in the quality of education and training. Specific reform recommendations for the labor market are detailed in the EU-funded World Bank (2019b) policy brief entitled “Putting People First.”

The capacity of the TC economy to respond to an economic shock is also constrained by its poor business environment. As noted earlier in this Macroeconomic report, the EU-funded WBG report (2019a) “Doing Business in the TC Economy” reveals that the TC economy has one of the most difficult business environments globally, as measured by Doing Business. The EU-funded WBG report (2019c) “Doing Business Reform Memorandum for the Turkish Cypriot Economy” identifies concrete short- and medium-term reform recommendations that could significantly improve the ease of doing business and would provide the private sector with the dynamism needed to weather economic shocks.

Figure 21: The low employment rate in the TC community is driven by the small shares of employed youth and females

The weaknesses in the current TC social assistance (SA) program limit the support to the vulnerable and poor at times of shocks, which slows down economic recovery. SA expenditure remains low and below international standards. Though total expenditure on SA has been increasing both in nominal and real terms since 2014, it has not increased fast enough. As a percentage of GDP, SA expenditure dropped from 1.24 percent of GDP in 2014 to 1.05 percent in 2017. In low-income economies, average SA expenditure is 1.47 percent of GDP. In high-income and OECD economies, SA expenditure absorbs 1.91 and 2.83 percent of GDP, respectively. Current SA programs also fail to focus on poverty reduction, and their coverage is low. The main SA programs are the “Poor in Need” program, disability transfers and education scholarships. The “Poor in Need” program is mainly designed for the elderly and has very complex eligibility criteria. Rather than focusing on poverty reduction, however, current SA programs target individuals unable to work, also providing them with free health care. SA tends to benefit smaller households with fewer dependents, suggesting that many poor households with high dependency ratios are being left out. Worryingly, SA covers only 27.1 percent of households in the poorest decile, and 17 percent of households in the poorest quintile (Figure 22).

Two key actions needed to strengthen the SA program in the TC economy are:

- Modify the “Poor in Need” program to become a poverty-targeted program and design an absolute poverty line to better monitor poverty and identify poor households at times of shocks.
- Conduct detailed household surveys on a more frequent basis to monitor the evolution of poverty and vulnerability.

The specific recommendations to implement those two actions can be found in the EU-funded World Bank (2019c) Policy Brief entitled “Poverty and Social Assistance in the TCc”. For the TC administration to implement policy effectively at times of shocks, it is important to build citizens’ trust in the fairness and efficiency of TC institutions. Such trust is at present at a low level (Figure 19 in the first chapter). Improving trust will increase the TC administration’s capacity to implement difficult policies at times of shocks, so that the economy can adapt to the change, regain its competitiveness and recover.

![Figure 22: Share of households receiving social assistance: TC vs selected economies (%) - by quintile](image)

Source: HBS2015 and WBG ASPIRE database (most recent year available).
2.4 Conclusions

Boosting resilience is about reforms that help cushion the economy from shocks and support an economic rebound. Boosting resilience in the TC community should focus on creating flexibility in labor markets and private sector conditions, as well as protecting low incomes, with improved trust in institutions reinforcing resilience in a virtuous circle (trust generating resilience and resilience generating greater trust).

Boosting resilience will give the TC economy the space, the capacity, and trust to effectively implement the structural reforms needed to create sustainable high growth. These reforms are detailed in the first chapter of this macroeconomic monitoring note.

Setting the economy on a high growth path and boosting its resilience to shocks require addressing the TC economy’s high dependence on imported fuel as its source of energy. Such dependence has two important implications. The first is having electricity tariffs that are among the highest in Europe affecting the competitiveness of the economy and households’ budget. The second is the greater vulnerability to exchange-rate shocks and oil-price fluctuations. On the economic side, diversifying energy supply with more renewable energy and reducing the dependence on fuel will help reduce energy production costs with a potential to lower energy tariffs. Lower energy tariffs will improve households’ purchasing power, bring down production costs and make the economy more competitive, productive and resilient. On the climate side, lower energy tariffs will also help to lower the emission of greenhouse gases.