

Regional and Country Experiences

Economic Growth and Development: Lessons from the Experience of Cyprus – a Small Island Economy¹

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Objectives of the paper: *This paper attempts to identify the major factors which explain the successful economic and social development of Cyprus. These will be used to draw conclusions which could be of help to other small economies in their quest for economic growth and development.*

The paper is divided into the following sections:

- ◆ *An outline of the conditions at the time of independence and the extremely adverse circumstances created by the Turkish invasion in 1974;*
- ◆ *The paper gives various indicators of the country's economic performance since independence;*
- ◆ *An extensive analysis of the factors that explain how Cyprus achieved economic development;*
- ◆ *An elaboration of some current problems of stability caused by internal developments and by changing international conditions;*
- ◆ *Relevant conclusions.*

Circumstances in 1960 and after the Turkish invasion

Cyprus is now on the doorstep of the European Union and hopes to achieve full membership in due course. Accession negotiations between Cyprus and the EU began in 1998. The possibility of membership is being considered because Cyprus has made impressive economic and social progress.

But this picture has to be viewed in its historical context; in 1960, Cyprus could only be described as an underdeveloped small island with few prospects.

¹This paper was presented at the Commonwealth Secretariat/World Bank Joint Task Force on Small States conference held in St. Lucia in February 1999.

The circumstances in 1960

A team of UN consultants on a mission to advise on how the country should tackle the problem of underdevelopment wrote in its final report: 'The Government of the Republic took over in 1960 an economy with all the symptoms of underdevelopment'. These are some indicators of 1960:

- ◆ Cyprus was a predominantly agricultural country, with the agricultural sector contributing 18 per cent of GDP and 45 per cent of gainful employment;
- ◆ Exports had the usual pattern of developing countries, with primary sectors contributing 87 per cent to domestic exports, minerals 58 per cent and raw agricultural products another 29 per cent;
- ◆ Manufacturing was very limited, mostly handicraft in nature and concentrated on the processing of agricultural commodities;
- ◆ Domestic savings were very low at 6 per cent of GDP;
- ◆ The country lacked natural resources and the mineral deposits for which the island was famous were nearing exhaustion due to centuries of exploitation, while water was in short supply;
- ◆ Unemployment was very low, but large emigration was taking place. Between 1959 and 1962, 8 per cent of the population left the island;
- ◆ Cyprus, like all other small countries, was vulnerable and subject to many constraints such as:
 - Openness and extensive dependence on imports, and on exports to generate a large proportion of GDP
 - Earthquakes
 - Political instability due to internal ethnic strife and being located in the Middle East
 - Inability to achieve economies of scale and high transport costs
 - Lack of previous experience in self-government.

The situation in 1960 was not promising. Nevertheless, between 1960 and 1973, the country achieved economic and social development, as is shown by the following:

- ◆ An annual rate of growth of 7.2 per cent (see Table 1);
- ◆ Extensive restructuring with agriculture, manufacturing and tourism expanding with very high rates of growth;

- ◆ Export growth – agriculture took over as the leading sector, followed by manufacturing, while the country was becoming a net service exporter, through tourism;
- ◆ Low unemployment, which in some years fell below 2 per cent;
- ◆ An average annual growth rate of real wages of almost 6 per cent.

This was a good performance and was favourably commented upon by foreign observers.

Table 1. Average Annual Rate of Growth (%) 1960–96

1960–73	7.2
1973–75	-18.0
1975–80	11.4
1980–85	6.3
1990–97	3.8
1975–97	6.6
1960–97	5.2

Effects of the Turkish invasion of 1974

All this were shattered in 1974 with the coup and the Turkish invasion, creating a policy-maker's nightmare as the well-integrated economy suffered extensive dislocation. The following were key factors:

- ◆ Thirty-seven per cent of the territory was occupied including
 - some of the most fertile land, with a substantial proportion of farmers becoming landless
 - two-thirds of tourist facilities
 - the only international airport and deep port facility of the country;
- ◆ Thirty-four per cent of people in the areas under the control of the government became refugees. The shortage of housing affected 45,000 households;
- ◆ Between 1973 and 1975 GDP fell by about one-third;
- ◆ Gainful employment was almost halved from 253,000 to 135,000;
- ◆ In the second half of 1974 the unemployment rate jumped to 30 per cent of the economically active population;
- ◆ Between 35,000 and 40,000 people, or about 7 per cent of the total population of the areas under the control of the government, left the country.

The outcome was that a small country became even smaller and more vulnerable. It is evident that the country had to start twice over, with conditions being much more difficult the second time, not only because of the devastation of war, but also because of the 1973 crisis in supplies of oil, on which the country was completely dependent. However, the effort proved successful and economic growth and development took place.

Indicators of economic performance

The World Bank, in its book on the Asian miracle, placed Cyprus in the top 12 countries on a world-wide basis, with high rates of economic growth over the period 1960–1985. The UNDP in its 1998 Human Development Report places Cyprus twenty-third overall and first among developing countries. These references offer recognition of Cyprus's economic performance.

The average annual growth was 6.8 per cent between 1975 and 1996, and 5.2 per cent since independence in 1960 (see Table 1). As a result:

- ◆ Per capita GDP now stands at US\$13,000;
- ◆ Earnings increased during the same period by an annual real rate of 5.1 per cent;
- ◆ Income distribution is satisfactory, with an overall gini coefficient of 37;
- ◆ Growth has been employment intensive, so that between 1975 and 1996 employment more than doubled from 135,000 to 282,000;
- ◆ Unemployment has not exceeded 3.7 per cent of the economically active population since 1978;
- ◆ At the end of 1997 there were 31,000 registered offshore businesses, of which 1,000 were active, contributing to exports and creating employment opportunities.

Profound restructuring has taken place:

- ◆ The primary sector declined radically; in 1996 it contributed less than 5 per cent to GDP, 11 per cent to employment and 4 per cent to total exports of goods and services (see Tables 2 and 3);
- ◆ The dominant economic force became services, particularly tourism. Services made up 71 per cent of GDP, 65 per cent of gainful employment and 73 per cent of foreign exchange earnings from the export of goods and services (see Tables 2 and 3).

Table 2. Structure of GDP 1990–96 (percentage distribution)

	1960 %	1973 %	1980 %	1997 %
Primary	22.3	16.6	11.3	4.6
Secondary	20.8	29.5	33.6	22.5
Tertiary	56.9	53.9	55.1	72.9
Total	100.0	100.0	100.0	100.0

Table 3. Structure of Employment 1960–96 (percentage distribution)

	1960 %	1973 %	1980 %	1997 %
Primary	46.9	38.5	20.51	0.2
Secondary	23.0	25.8	33.7	23.6
Tertiary	30.1	35.7	45.8	66.2
Total	100.0	100.0	100.0	100.0

Changes have also occurred in other spheres:

- ◆ The female labour force participation rate jumped from 29 per cent in 1976 to 47 per cent in 1996;
- ◆ The percentage of women in gainful employment increased from 33 per cent in 1976 to 39 per cent in 1996;
- ◆ The average size of household shrank from 3.94 in 1960 to 3.23 in 1992;
- ◆ The proportion of the population living in urban areas now stands at 69 per cent;
- ◆ The age profile of the population changed, with the proportion of those over 65 increasing to 11 per cent in 1992.

Factors explaining the achievement of economic development

Attempting to explain the processes and factors that account for the achievement of economic and social development is not an easy task. It is complicated because the explanation is an amalgam of policies and other determinants. This analysis cannot hope to do full justice, but only to identify some of the elements that appear to have worked. The overall

result was the outcome of a combination of policies, institutions, manpower characteristics, geographical factors and social attitudes. This paper will attempt to identify these factors.

The overall quality of governance

The first major group of factors that could be considered to have contributed to the success of the country is the quality of government. Cyprus inherited what was believed to be a well-functioning administrative structure, including many local officials. This quality appears to have been maintained.

It is, however, not easy to have objective criteria by which to measure good governance. One piece of evidence is the comments of foreign consultants who visited the country and praised the efficient use of technical and financial assistance through the effective implementation of projects. Another element is the high credit ratings, by the various international-rating firms. Other ways of evaluating governance are:

◆ *Macroeconomic stability and fiscal and monetary policies*

Fiscal Policy. The case of Cyprus confirms the importance of macroeconomic stability. The success of the country was built upon the strong foundation of a stable macroeconomic environment achieved through fiscal and monetary policies. Even at the time of crisis and the obvious need for a strong demand push by the government, this was exercised in a manner that did not endanger the long term stability of the country.

Macroeconomic policies were very cautious in the period immediately after independence, but developmental in content, given the adoption of planning and the existence of a separate budget for investment purposes. Macroeconomic policies provided the overall framework, the confidence and the incentives for the private sector to pursue all those activities that helped to achieve growth and development.

These cautious policies, implemented during the first decade of independence, were based on the recognition that with limited capacity to produce in the domestic market, expansionary fiscal deficits would be likely to fuel inflation and balance of payments disequilibrium. So the overall fiscal position was restraining, and in 10 out of 14 years there was no fiscal deficit. The fiscal deficits of the other four years were small at about 1 per cent of GDP, with the exception of 1973 when the figure was 3 per cent (see Table 4).

While the public sector's overall approach was conservative, the government encouraged the semi-government organisations to take a more

adventurous stance. Through government guarantees, it ensured that they were able to borrow substantial funds from abroad in order to implement investment programmes for the creation of the necessary infrastructure in electricity, telecommunications, etc.

Table 4. Public Revenue, Expenditure and Fiscal Deficits as a percentage of GDP 1960–96

	Revenue	Expenditure	Fiscal Deficit/ Surplus
1960	25.5	19.9	+5.6
1965	18.0	15.9	+2.1
1970	18.3	17.6	+0.7
1973	18.3	22.0	-3.7
1975	26.0	34.0	-8.0
1980	22.9	29.8	-6.9
1985	26.3	30.2	-3.9
1990	27.8	33.1	-5.3
1995	31.9	32.9	-1.0
1996	32.0	35.5	-3.5

In the late 1970s, because of the severity of the conditions, such as high unemployment and the collapse of economic activity, the government adopted expansionary fiscal deficits, resorted to foreign borrowing and assumed a much bigger role in the economy. This was expressed through the size of fiscal deficits, which jumped a few percentage points higher as a ratio of GDP. While between 1960 and 1973 government receipts and expenditures oscillated between 18 per cent and 22 per cent of GDP, in the years immediately after the invasion receipts fluctuated at an average of 23 per cent and expenditures at 29 per cent. Later, these percentages increased even further and today revenue absorbs 32 per cent of GDP and expenditure 38 per cent. As a result, fiscal deficits were high, and in some years reached 12 per cent of GDP. Between 1975 and 1986 the deficit averaged 6 per cent. The real expansionary effect on the economy was much bigger, given that foreign aid represented on average three per cent of GDP in the period 1975–1980.

Since then fiscal deficits have been reduced, but they continue to characterise fiscal policy. Politicians have learned to love deficits and the potential it provides for patronage. The result has been the gradual emergence of a serious public debt problem. Before the invasion public debt was declining. In 1973 total long-term foreign debt was only 7 per cent of

GDP compared to 10 per cent in 1960. Very soon after the invasion it climbed to over 40 per cent of GDP. Foreign debt has since fallen because the government chose to resort to internal borrowing, but total public debt has continued to rise and today stands at about 60 per cent of GDP.

Monetary policy. The same general conclusion can be drawn by examining the shape and effects of monetary policy and the rate of inflation. Indeed monetary expansion was moderate. The rate of growth of total liquidity, 13 per cent on average every year, kept pace with the growth of the economy (5.2 per cent) and allowed only a moderate dose of price inflation at 4.5 per cent (see Table 5). This was a commendable performance, given the limitations imposed on monetary policy by the legal cap on the rate of interest and the inability to exercise indirect methods of monetary intervention, as well as the tight labour market.

It should be noted that the annual rate of inflation was kept low, also because of the policy of relative openness in imports.

Table 5. Average Annual Rate of Inflation 1960–97 (%)

1960–70	1.1
1970–80	7.8
1980–90	4.9
1990–97	4.3
1960–97	4.5

◆ *The use of planning*

A second very important aspect of the overall approach of government, was the adoption of planning. At the time of independence the country faced a general climate of uncertainty. There was a complete absence of any previous experience of self-government which added to the general feeling of unease that prevailed at the time. The country was poor in resources, faced serious structural problems, depended excessively on imports, and lacked adequate infrastructure, while the effectiveness of the market system was in doubt, so there was a natural predisposition towards interventionism. This was reinforced by the advice of UN consultants, who recommended the adoption of a system of economic and social planning as a means to accelerate the process of development. The government adopted planning and the preparation of five-year development plans as the means to achieve development. This was interventionist in orientation, without abandoning the general principle of the free market economy. Hence the system of planning adopted in Cyprus was indicative in nature, in the sense that it did not substitute for the market mechanism,

but attempted to reinforce it through limited guidance. At the same time planners indicated that they did not have complete faith in the price system and advocated limited direct government involvement in production in cases where the private sector proved reluctant or where a large amount of capital was needed.

In general, planning as practiced in Cyprus proved a basic tool for the achievement of development for the following reasons:

- ◆ It helped policy to be focused and strategic, with priority ranking of projects to be implemented. In this sense planning was always targeting sectors for promotion;
- ◆ It distinguished between the medium- and long-term policies needed for development and was comprehensive, covering all matters having to do with development in a consistent way;
- ◆ It ensured the overall co-ordination of departments and other organisations involved in the implementation of policies and projects;
- ◆ It gave emphasis to projects and to implementation through the annual development budget;
- ◆ It gave the private sector a consultative role in the preparation of development plans and a central role in direct production activity, while safeguarding private property and the role of profits;
- ◆ Plans were not legally binding and were flexible, subject to readjustments in the light of changing external circumstances.

Targeting sectors to promote the role of tourism and other services. One of the important tools of planning was the targeting of sectors to promote. This element is isolated because it merits some comments. To start with it should be stated that Cyprus, when faced with the choice of which sectors to promote, opted for manufacturing and agriculture. The former, was the backbone of the Cypriot economy at the time of independence, while the latter was the normally prescribed sector in the economic literature on development. The Cypriot government began to implement protective measures and active promotion.

As a result the 1960s was the decade of agriculture, which became the leading sector for growth and was dominant in domestic exports, with a 60 per cent share. Manufacturing, with an emphasis on infant industries and import substitution, registered high rates of annual expansion in the 1960s, but took off dynamically in the 1970s, when the government turned to export promotion as the only reasonable avenue for growth. This proved successful and the sector became a leader, dominating

domestic exports with a share of over 70 per cent in the 1980s, mostly to the Arab countries of the Middle East.

Since then the two sectors have been in long-term decline, to a large extent because of protection which blunted incentives and meant that entrepreneurs failed to remain competitive. It appears that high protection policies can work only in the medium term. In the long run, they create the wrong type of expectation on the part of entrepreneurs.

The other sector which received the attention of Cypriot policy-makers was tourism, for which a package of measures was introduced. The outcome was rates of annual growth that far exceeded anything that other sectors experienced. However, because the sector started from a very low level of contribution to GDP, its impact in the 1960s and 1970s was very small. It was in the 1980s that the sector became dominant in growth, job creation and foreign exchange earnings. These reached 23 per cent of GDP in the middle 1980s and are now 19 per cent. Indicative of the success in tourism is the number of tourists, which jumped from 24,000 in 1960 and reached 2.2 million in 1997. The number of available hotel beds increased from 4,300 in 1960 to nearly 100,000 today. In the process Cyprus became over-dependent on tourism and could be described as monocultural and vulnerable to fluctuations in tourism which is politically sensitive, as was shown during the Gulf War. Once again a policy succeeded only in the medium term. The longer-term effect was for the sector to lose its competitive edge and undergo a period of recession, partly because of the gradual deterioration of the environment.

The most interesting development, in terms of sectoral approach, was the gradual emergence of tertiary sectors other than tourism. The term refers to banking, insurance, transport, communications, accounting, consultancy, offshore, trade, health, public administration, etc. Looking at the historical structure of the Cypriot economy one cannot fail to observe that service sectors, including tourism, had a relatively large share in the creation of GDP, with 56 per cent at the time of independence. But the share of these sectors in employment was relatively small. However, gradually these tertiary sectors became the dominant force, contributing 62 per cent of GDP and 55 per cent of employment in the 1990s.

This happened without the direct help of the government. Indeed five-year development plans consistently underestimated the growth potential of the tertiary sectors, including tourism, while they over-estimated the potential of the primary and secondary sectors. Realised average annual rates of growth of services greatly exceed the figures projected by planners.

It is clear then that this outcome was the result of market forces which

directed interested entrepreneurs towards those activities where the economy appeared to have relative competitive advantage. This can be considered as a supply response to available resources. It was eventually recognised by planners, who invited specialists from the World Bank to look at the situation, and who strongly recommended that the development effort would have to target tertiary sectors as well.

So even though tertiary sectors did not benefit from government policies, they were able to register impressive rates of growth, because of market forces. This is not to maintain that the other sectors developed because of government action, but that they received special treatment that made their task appear easier, since in the long run the policies of protection for agriculture, manufacturing, and even tourism, have turned sour.

◆ ***Project-oriented approach – building infrastructure and institutions***

As noted above, the other important characteristic of planning was project orientation. This was a basic factor in the achievement of the goal of economic development, and was expressed through:

- ◆ the Development Plans, which provided for programmes of action;
- ◆ the annual Development Budget, the implementing tool of Plans, with the various projects;
- ◆ the projects of semi-government organisations.

This took the form of :

Investments in infrastructure. The project approach found one expression in the building of infrastructure, needed to support the activities of the private sector. Hence, the government implemented its own big programme of investments, which included:

- ◆ The establishment and upgrading of international airports;
- ◆ The expansion, improvement and upgrading of the road network. The number of kilometres of road increased from 5,900 in 1960 to over 10,400 in 1996;
- ◆ The construction of water storage capacity and the expansion and improvement of the water distribution systems. Water storage capacity increased from 6 million cubic metres in 1960 to over 300 million cubic metres in 1997;
- ◆ The establishment of industrial estates, industrial zones and zones for small artisan activities to locate manufacturing activities;
- ◆ The establishment of livestock areas and zones for the relocation of livestock farmers;

- ◆ The construction of hospitals, schools, conference facilities, fishing shelters and marinas.

At the same time the government encouraged the semi-government organisations to invest in basic infrastructure such as:

- ◆ The generation and distribution of electricity;
- ◆ The expansion and upgrading of both the domestic and the international telecommunications infrastructure;
- ◆ The expansion of ports;
- ◆ The creation of an International Fair facility.

It is indicative of the whole approach that the breakdown of investments between the broad public (public and semi-public) and the private sectors has been almost constant over the long term. Government is responsible for about 12 per cent of fixed investments and the semi-public organisations for another 12–15 per cent, leaving 70–75 per cent as the share of private enterprise. There is no doubt that the building of infrastructure was a basic factor that attracted the private sector and persuaded foreign businesses to settle in Cyprus.

Establishing institutions. A connected element in the project approach was the establishment of basic institutions. Hence, the government included in its general programme of action the creation of many institutions, which were deemed essential for the functioning of the economy. Some of the most important institutions that were established included:

- ◆ The Central Bank, the Cyprus Development Bank, the Cyprus Stock Exchange, the Housing Finance Agency and the Land Development Corporation;
- ◆ The Planning Bureau and the mechanism of planning;
- ◆ Training institutions such as the Apprenticeship Scheme, the Industrial Training Authority and the Productivity Center;
- ◆ The Ports Authority;
- ◆ The Agricultural Research Institute, the Agricultural Insurance Organisation, the land consolidation department and various marketing boards (cereals, vine products, potatoes, milk and dairy products and olive oil);
- ◆ The Institute of Technology, the Institute for the Promotion of Research, the Institute of Neurology and Genetics, and the Cyprus University to carry out research;

- ◆ The State Fairs Authority;
- ◆ The Handicraft Centre and the Cyprus Standards Authority;
- ◆ The Cyprus Tourist Organisation.

◆ ***Active but flexible policies***

The above description shows that government implemented active and interventionist policies. In general there was a predisposition to interventionism. What is also important to note is that these same policies were flexible and adaptable to changing circumstances. A broad survey of policies and how they changed over time will show this adaptability.

- ◆ Fiscal and monetary policies became expansionary in the 1970s compared to tight and restrictive policies used in the 1960s.
- ◆ The content of fiscal policy, which included many and varied items, was never static but changed over time. So the type of infrastructure given priority was originally the construction of dams, then the building of airports and ports, followed by road construction. A similar principle applied in the case of expenditures on social sectors, protection of activities, the structure of tariffs, etc. This process included the continuous review of the legislative framework, with a view to adapting and modernising legislation so as to ensure that it did not prove inimical to new entrepreneurial initiatives.
- ◆ Government pursued many and varied policies that encouraged investments, created employment opportunities and promoted exports or substituted imports. The policies also varied depending on the sector concerned.
- ◆ The overall policy framework did not exclude the possibility of direct involvement of government in production, in areas where the private sector was reluctant to undertake the investments because they were risky and large. Hence, the government created a national air carrier, a large fertiliser plant, the Cyprus Development Bank, an oil refinery and Cyprus Forest Industries. Although generally very limited, the overall experience proved that government was a poor entrepreneur as most of these projects did not survive, while others needed extensive subsidies. Nevertheless government was ready to abandon some of these when they failed.
- ◆ The tax regime was changed to accommodate the establishment of the Cyprus Shipping Register and the creation of the general environment for offshore enterprises. These have been very successful projects and as a result Cyprus became the fifth biggest shipping register world-wide and a centre with more than 31,000 offshore companies. The case of

offshore businesses is interesting because Cyprus entered this particular area because of the misfortunes of Lebanon, and it is indicative of how opportunities were taken up by entrepreneurs who then persuaded policy-makers to respond.

- ◆ Government introduced an ambitious housing policy, where none existed before 1974. As a result, between 1977 and 1982 the country was investing on average 12 per cent of its GDP in housing, 70 per cent of which was financed through government budgets. The number of housing units completed per year reached 8,000 a year after 1978, up from less than 5,000 in the period before 1973, in an attempt to meet the needs of the refugees as quickly as possible.
- ◆ An interesting case is the policy of reactivation pursued after the invasion of 1974, when one of the more serious consequences of the collapse of economic activity was the creation of unprecedented unemployment. This was also manifested in a sharp fall of wages. So when the government introduced a legal system guaranteeing people a minimum standard of living, it appeared that this acted as a strong disincentive to employment. Hence, the government proceeded also to introduce an incentive scheme through which it continued to pay assistance allowances at half the previous level for six months, and at a quarter for a further six months, if an unemployed person was able to find gainful employment. This acted as an extremely strong push and within three years full reactivation was achieved and the scheme was abandoned.
- ◆ Finally, policy priorities changed from advocating the promotion of primary and secondary sectors, together with tourism, towards the adoption of proactive policies in favour of other service sectors (banking and finance, insurance, business consultancy, accounting services, communication, transport, health, education, etc.).

◆ ***Emphasis on education and foreign technical assistance***

When Cyprus won independence, the educational achievements of the population, were already quite good (Table 6). There was evidence of universal education at the primary level (Table 7). Despite, this relatively good background, the country put considerable emphasis on education because one of the strong beliefs of Cypriot planners was the importance of investment in human capital through education. It was understood that without the acquisition of specific skills many productive activities would not be able to prosper. The need for foreign consultants to advise on policies and projects also reinforced the urge to create an indigenous knowledge base in order to reduce dependence on foreign expertise.

Table 6. Literacy Levels 1946–92

	1946 ¹	1960 ¹	1976 ²	1992 ³
Men	81	91	96	98
Women	53	73	85	90
Total	67	82	90	94

¹People aged seven years and over

²People aged ten years and over

³People aged fifteen years and over

Table 7. Gross Enrolment Ratios by Level of Education (percentage of age group) 1960–95

	1960	1976	1995
Pre-primary education			
Males	n.a.	27	60
Females	n.a.	27	59
Total	n.a.	27	60
Primary education			
Males	106	111	100
Females	102	111	100
Total	104	111	100
Secondary education			
Males	51	85	96
Females	35	80	99
Total	43	83	97
Tertiary education			
Males	n.a.	32	39
Females	n.a.	21	42
Total	n.a.	27	40

Enrolment ratios are calculated on the following ages: pre-primary 3–6 years old; primary 6–11 years old; secondary 12–17 years old; tertiary 20–24 years old

This policy resembles the one followed by the East Asian countries, as noted by the World Bank in its study of the Asian miracle. The World Bank considers education to be a basic factor in the overall achievements of the Asian countries which expanded and transformed their systems of education and training.

Hence the large number of education measures:

- ◆ The introduction of compulsory six-year elementary education in

1962, even though elementary education was already universal and female participation was high, with gross enrolment ratios of over 100 per cent;

- ◆ The expansion of technical vocational education and the creation of tertiary level training institutions for technicians and hotel specialities;
- ◆ Extension of free public secondary education;
- ◆ The introduction of public pre-primary education on a big scale;
- ◆ The expansion of educational opportunities by the creation of evening secondary schools;
- ◆ The raising of the age of compulsory education from 12 to 15 and its' length from six to nine years;
- ◆ The establishment of the Cyprus University.

The absence of a local university did not prevent Cypriots from acquiring university education. On the contrary large numbers of Cypriots attended universities in Europe and the USA, as can be seen from the high enrolment ratios achieved long before Cyprus had its own university (Table 7). In all these, one should include the extensive use of scholarships and fellowships awarded by international organisations and friendly countries to train people abroad in priority fields. It is appropriate, therefore, to make some observations about the role of foreign technical assistance.

The role of foreign technical assistance. A frequently discussed problem confronting small states is that because of the limited population base and the relative absence of sophistication in the economy, it is impossible to develop all the human skills and specialist knowledge that are required for development. This is an inevitable disadvantage of small countries.

So small countries need to follow a policy that is creative and varied. One answer is the resourceful use of foreign expertise, through multilateral, bilateral or other similar schemes. Indeed this was the type of policy used extensively and in a very determined way by Cypriot policy-makers in their effort to secure the required persons with the specialist skills to provide the missing link in the drive for development and to fill identified gaps. Technical assistance from abroad took various forms:

- ◆ The most widely used form of course was in terms of foreign specialist consultants, either from international organisations or from friendly countries;
- ◆ The second line of approach was the request for scholarships and

fellowships for local people to be trained outside the country. Even though the need was usually for long-term scholarships, emphasis was placed on short-term learning experiences, since it permitted the training of more people;

- ◆ The third approach, which was an important substitute and a very cost-effective way of acquiring specialist skills and knowledge, was to have seminars and workshops organised locally by foreign groups and consultants. Again this enabled the training of more personnel.

However, some comments are called for regarding this approach and the options open to small countries.

The first comment concerns the principle that receiving countries request that donor countries or organisations submit more than one candidate for such jobs, and preferably three. This affords the option to exercise discretion and select the most appropriate candidate. But for this to be effective it is necessary to prepare detailed terms of reference and ask for a description of the formal qualifications and experience in small developing countries of the proposed candidates. It is also essential that a local counterpart is posted to work alongside the consultant and that requests are scrutinised to ensure that only priority areas are put forward.

A second comment is that an affective policy on the part of the receiving country is to provide its own allocations of funds. An allocation in the domestic budget is considered worthwhile, with high rates of return, because if a country feels the need for specialist knowledge and this is not being met by external sources, then it should make an effort to get it, through its own resources. This will also show that the need has been carefully evaluated and conveys the message that the demand is not simply made because training is available on the cheap. The allocation of funds from the country's own budget adds a dimension of choice.

A third comment concerns the possible exploitation of expatriates who emigrated in the past. These emigrants obviously do not want to abandon the prospects of professional advancement and the glamour life in the big cities of the world. But it may be possible to entice them back on short-term missions. This is a ready-made pool of talent, with a high degree of sophistication and the know-how to deal with the very specific issues of a small country.

One final comment on the general issue of the transfer of knowledge is that small countries need to make their own budget allocation for the pursuit of research to solve specific and unique problems that they face. The characteristic approach for small countries is to depend on outside assistance for the transfer of knowledge and technology. This is the right

approach for high technology, where small countries are at a disadvantage. However, without indigenous research capacity, certain issues cannot be resolved by the appeal to international experience, even if this is available from other small countries. There are unique problems which cannot be solved without local effort. Small countries must allocate increasing amounts of funds to research projects which address very specific localised and unique problems, such as specific training, managerial practices, and social and economic issues of particular concern to small societies. This is an issue that is becoming easier to deal with, because of technological progress.

◆ ***Participatory policies – tripartite co-operation***

Before concluding this discussion of the overall role of government it is necessary to touch upon one other important area of policy. This refers to the participatory approach of policies evident in many of the programmes implemented. Indeed, the basic philosophy of government was that the whole development effort was co-operative in nature and anthropocentric. It was viewed as a partnership between social groups and the government and aimed at raising the standard of living of the population. Hence overall development policies were chosen for their impact on the various social groups and the mechanisms for implementation were based on the principle of tripartism.

This principle was implemented through the creation of management bodies on which the social partners (that is government, employers and workers) participated. In general, tripartism is a fact of everyday life in Cyprus.

One example is the composition of consultative committees on the preparation of five-year development plans. These committees are made up of people from the government, representatives of employees and of organised workers, or individuals with expert knowledge who are expected to comment on policies and the feasibility of proposals. This has meant that development plans have had the understanding and the support of the private sector, a fact contributing to their implementation since a large part of the responsibility for action fell on the private sector.

Another example is in the management of many institutions, such as the social insurance scheme and training institutions such as the Higher Technical Institute, the Higher Hotel Institute, the Productivity Centre, and the Industrial Training Authority. The social partners also participate in various other advisory committees. They sit on Management Boards of semi-government organisations, the Labour Advisory Council, etc.

Tripartite co-operation was a basic factor in the maintenance of good

industrial relations, despite the existence of very strong and active trade unions. An example of this was in the 1960s, when in response to a severe economic crisis, due to political events, trade unions accepted a wage freeze and refrained from submitting wage demands for three years. Similarly, when the conditions demanded it, in the period after the invasion, trade unions agreed to take a cut in salaries of 20–25 per cent and to suspend the automatic cost of living allowance, despite quite high inflation.

Participatory policies were also a characteristic of the government's approach to the implementation of social policies. On the one hand, housing policy was a major tool in the reactivation process through its multiplier effects. On the other hand, this policy helped improve the housing conditions of the refugees. The same could be said about health, welfare and education policies.

The figures indicate some good outcomes:

- ◆ In 1992 64 per cent of the population lived in owner occupied housing units, while another 23 per cent of households lived in houses provided free of charge by the government;
- ◆ The population-to-room ratio, which in 1960 was 1.30 persons per room, was 0.64 in 1992;
- ◆ 100 per cent of households now have electricity;
- ◆ 99 per cent have a telephone at home;
- ◆ 95 per cent are connected to the public water network;
- ◆ The ownership of consumer durables is universal (see Table 8);
- ◆ 99 per cent of households own a refrigerator;
- ◆ 97 per cent own a colour television;
- ◆ 91 per cent have a washing machine;
- ◆ 81 per cent own a private motor car;
- ◆ A good indicator of the effectiveness of public policies is the gini coefficient. This showed relative stability in three relevant surveys carried out between 1984 and 1996, revealing a coefficient of 0.37 (Table 9);
- ◆ Another is the improvement of the average earnings of females compared to males, which rose from 83 per cent lower in 1976 to 39 per cent in 1996.

Table 8. Ownership of Consumer Durables 1971–96 (percentage of households owning a particular durable good)

	All Cyprus			Rural		
	1971	1985	1996	1971	1985	1996
Car	33	62	81	18	49	75
Refrigerator	78	96	99	65	92	99
Washing machine	28	67	91	13	53	87
Television	49	90	97	29	82	95

Table 9. Income Distribution – Gini Coefficient 1984–97

		All Cyprus	Urban	Rural
1984/85	Household	37.0	34.2	37.0
	Per capita	n.a.	n.a.	n.a.
1990/91	Household	37.1	36.1	37.8
	Per capita	33.4	33.2	30.4
1996/97	Household	36.8	36.5	34.9
	Per capita	33.1	33.4	28.1

Based on the *Household Income and Expenditure Surveys* 1984/85, 1990/91 and 1996/97

This participatory approach again resembles that pursued by the East Asian countries and is a very effective tool in the hands of government in providing the incentives for people to contribute to the development effort.

Flexibility of human resources – seizing opportunities

One of the most important elements in the success of the effort to achieve economic and social development is the quality of human resources. Human resources in Cyprus have proved dynamic, flexible and adjustable to changing conditions, as well as responsive to new opportunities. This adaptability manifested itself in a number of ways.

One such example is the overall educational achievements, given that many pursued high educational qualification by enrolling abroad with very little government assistance.

The dynamism of entrepreneurs manifested itself in the explosion of small productive units and the continuous restructuring of the economy. Thus the economy underwent profound change and diversification through the development of different sectors, first agriculture, and then manufacturing and tourism, but most importantly the great push that the private

sector gave to other service sectors such as banking, insurance, consultancy, offshore, etc. Between 1976 and 1995 the number of establishments in the non-agricultural sectors increased from 28,000 to over 60,000, showing creativity and innovation on an unprecedented scale.

The flexibility and opportunism of Cypriot entrepreneurs was also evident in the pressure that they exercised on the government to open Cyprus to foreign businesses after the civil war in Lebanon which resulted in the transformation of Cyprus into a major offshore business centre. This opportunistic spirit led many entrepreneurs to look for the available openings in the Middle East region. As the economy expanded, these same entrepreneurs demanded that the government change its policies to allow the import of foreign workers to meet the increasing labour shortage that was driving up wages and raising production costs.

Flexibility and adaptability were the factors that first drove people to emigrate, and then induced them to return when times improved and the business environment became favourable. A closer look at emigration reveals that it took the form of mass flows of people during periods of political instability. This happened in the period 1959–62 and after the 1974 invasion. When conditions improved in the 1960s and the 1980s the flow was reversed. This same spirit guided people to seek opportunities abroad after the invasion through temporary employment. Immediately after the invasion, thousands of Cypriots sought temporary employment in the countries of the Middle East, Greece and other Balkan States. Some went on their own, some followed Cypriot businesses which secured contracts abroad and some responded to official policy initiatives to sign agreements with countries that needed workers. At the peak of emigration in 1977, 14,700 Cypriots were working abroad, representing 7.3 per cent of the economically active population.

The flexibility of response and of policies would soon be evident with the flow of people back into the country. More noteworthy was the reversal of official policy when the very fast growth of the economy and the shortage of labour induced very high increases in wages. The government then changed its approach and put in place a more liberal policy of allowing foreign workers to enter Cyprus. This led to a flood of foreign workers, rising from 3,000 in 1989 to 17,000 in 1996, representing 5 per cent of the economically active population. It is believed that the true number is now much larger because there are many workers, estimated at about 10,000, who have entered the country illegally.

The flexibility of people was also demonstrated in their response to the need to finance the development effort.

Financing needs – willingness to save and invest

One of the factors that made a big contribution to the overall success of the country was the response of the people to the need for financial resources. It is well accepted in the literature that any country aiming for growth needs to raise the level of savings and investments in order to succeed. The case of Cyprus confirms the need for enhanced savings and investment performance. Within a very short period of time after independence, people raised both their propensity to save and their willingness to invest in productive capacity. The ratios of GDP that were saved and invested were at very low levels at the time of independence, but increased significantly in response to policy measures such as tax incentives and other measures that created an appropriate business environment. However, the propensities to save and invest were badly affected by the 1974 events and fell substantially immediately after. Within a very short time, and again responding to the introduction of new policies and the reactivation of the economy, the proportion of GDP that was saved and invested climbed not only to previous levels but even higher.

Gross domestic saving in 1960 was a mere 6 per cent of GDP and rose to 17 per cent in the early 1970s. It tumbled to 1 per cent of GDP in 1975, as a result of the collapse of economic activity. It very soon responded to various policy measures and the improved economic situation and reached 27 per cent of GDP in the mid-1980s. Since then it has fallen back to 22 per cent (Table 10). This was a factor that went some way towards explaining why it was not very painful to rely so extensively on domestic resources for investment.

Table 10. Domestic Savings and Investments – Ratio to GDP (%) 1960–96

	Domestic Savings	Investments
1960	6.4	17.6
1970	14.8	23.5
1975	1.3	19.4
1980	19.5	34.2
1985	22.1	26.7
1990	27.3	24.2
1995	24.9	19.1
1996	21.6	19.4

The same pattern characterises fixed investments. In the early 1960s the ratio of investments to GDP was around 17–18 per cent, and towards the end of the 1960s and in the early 1970s it rose to between 23 and 28 per cent. It fell again in 1975 to 19 per cent but rose immediately, as people

responded to generous incentives, the pull of the foreign markets, the strong housing policy and the need to replace infrastructure and productive capacity. In the years 1977 to 1984, the average level of investment amounted to 30 per cent of GDP, giving a great push to economic activity and helping create many job opportunities. In more recent years this percentage has declined to 19 per cent (Table 10).

The figures for domestic savings and fixed investments reveal a substantial financing gap, which was reflected in large balance of payments deficits. It was partly financed by the inflow of foreign aid, the remittances of Cypriot expatriates and temporary workers abroad, but mostly through substantial borrowing by the state, semi-government organisations and the private sector.

The evidence shows that Cypriots responded to the challenge and raised the proportion of GDP that is both saved and invested, helping achieve high rates of annual growth. Indeed, investments were greater than usual, because of the emergency conditions and the severe shortages, particularly in housing, schools and infrastructure. The one important question related to the issue of financing is the role of foreign direct investment (FDI).

The role of foreign direct investment. The usual model of development emphasises the big role of foreign direct investment. Policy statements also stressed the need for FDI, to provide a bridge in funding, help overcome problems of size, expand potential markets by providing marketing outlets of international companies, and raise productivity through technology and managerial capability. All these needs were clearly identified in development plans and have been factors which slowed down the potential growth of the economy. Despite these expressed wishes, actual policy remained restrictive. Entrepreneurs did not welcome foreign participation and foreign direct investment was not facilitated. Many sectors were labelled as saturated and foreign investment entirely prohibited, while in others foreign participation was permitted only as minority shareholding, obviously another discouraging factor. Indeed the publications of the Central Bank of Cyprus made very discouraging reading for anybody interested in investing in the country. Hence, FDI was very limited, and was confined mostly to the offshore sector in accounting firms, financing activities and, to a lesser extent, in tourism and oil distribution. In manufacturing, agriculture, mining and construction, foreign capital does not participate. A high proportion of foreign capital originated from Cypriot expatriates who invested mostly in property. Therefore it did not contribute to the areas identified as needing foreign participation, such as marketing, technology and modern management.

This restrictive policy towards foreign investment has gradually been relaxed and the situation has changed. But it is indicative that the Central Bank was unable to provide adequate information. Collected data were limited to approved sums, not realised investments. Hence, actual investments may have been smaller. Nevertheless, permits can give some indication of the magnitude of FDI; they show for the past 15 years it averaged less than 3 per cent of total investment.

Development in Cyprus was mostly domestically financed and the needed bridge was provided by foreign borrowing. This is an interesting aspect of development because Cyprus is a relatively open economy, with an overall climate friendly to business and a big centre of offshore activity. However, the absence of foreign investment must, in some sense, be held responsible for the low level of productivity and the relative loss of competitiveness in recent years.

Financing needs and the role of international institutions. As has been shown, Cyprus had substantial financing deficits. Since neither the inflow of capital nor the amount of external aid were adequate to finance this deficit, the country had to resort extensively to foreign borrowing, either through multilateral institutions or through the international commercial banking institutions. This appears to have been the preferred solution. The general direction of policy was, at the beginning, to resort mostly to international financial institutions, particularly for semi-government organisations. But after the invasion, and with extremely large fiscal deficits, the government had to apply to international commercial banking institutions. During these periods, the government had to convince commercial bankers of its overall ability to generate the revenues to repay the loans. This it did, at the beginning with the stamp of approval of the IMF and the World Bank. However, with the amount of public debt gradually increasing and becoming quite large, this was insufficient. As a result, when it was deemed necessary, the government resorted to foreign borrowing.

Even if international organisations do not intend to provide direct financial assistance or lending, they can be invaluable if they are invited to help with the preparation of detailed evaluation of projects for implementation. This is the practice of the Cyprus Government which invited the World Bank and other international institutions to evaluate various projects intended for international financing. Where these received the approval of such organisations, it immediately elevated the potential for securing funds from other international and commercial financiers. It was also important for these projects to have local participation, either by the government or by the private sector. This is an area where the multilateral institutions could be of great help to small countries.

Openness and the role of exports of goods and services

It was observed right from independence in 1960 that the country, being small, exhibited the usual signs of openness and excessive dependence on foreign products. The country could not hope to produce enough food to meet even its basic needs, despite being a heavily agricultural country. It had to import both a large percentage of foodstuffs and many other commodities, such as raw materials, machinery and equipment, durable consumer goods and oil. As a result, the policy on imports had a heavy accent on protection, but at the same time permitted many items to be imported either free or at low duty. The objective was to ensure that consumers were able to find the required goods in adequate quantities and at affordable prices. A liberal import policy was essential in order to keep inflation under control. For a small country, prohibitions on imported essential commodities that could not be produced domestically would have resulted in shortages, speculative actions and exorbitant black market prices. Hence the liberal policy as illustrated by the ratio of imports to GDP, which was 41 per cent in 1960. In the period 1976 to 1979, following the invasion, it climbed to 60 per cent. It settled at around 50 per cent of GDP in the 1980s and has fallen to 44 per cent in 1996. The openness of the Cypriot economy is even more pronounced if one includes the import of services, which were 3 per cent of GDP in the 1960s, but have since climbed to around 8 per cent. In all, imports of both goods and services amount to more than half of GDP (Table 11).

Table 11. Imports of Goods and Services as a Ratio to GDP 1960–96 (%)

	Goods	Services	Total
1960	40.5	2.8	43.3
1965	37.8	2.6	40.4
1970	43.3	4.2	47.5
1975	44.2	12.5	56.7
1980	55.8	7.3	63.1
1985	51.4	7.4	58.8
1990	50.0	7.0	57.0
1995	42.0	8.3	50.3
1996	44.8	8.5	53.3

This liberal approach to imports was essential, in that it provided a safety valve through which inflation was kept under control even in periods of excess demand in the internal market, because imported commodities experienced much lower inflation than locally produced goods and services. Between the years 1979 and 1996, price inflation of imported commodities was significantly lower at 3.7 per cent on average every year,

compared to the inflation of locally produced goods at 5.5 per cent and services at 5.8 per cent.

Openness was not only characteristic of imports, but also of exports. The country, of necessity, followed a policy which was outward in nature. This is another area in which the experience of Cyprus strengthens the evidence about the advantages of openness and its contribution to growth and development. Because of the political situation on the island and the presence of foreign troops, the role of services in exports has always been high. Thus we see that domestic exports of goods were 18 per cent of GD, at the time of independence, dominated by mineral and agricultural products. This was supplemented by a small amount of re-exports, with a share of GDP of about 3 per cent. Domestic exports remained at this level for the next 20 years, first with the growth of agricultural products replacing minerals, and then with the strong showing of light manufacturing items such as clothing, footwear and travelling apparel. The same situation was true of re-exports which remained relatively constant at 2–3 per cent of GDP. The 1980s saw a radical change. With the gradual loss of competitiveness of domestically produced goods, domestic exports fell substantially from 20 per cent of GDP in 1980 to 5 per cent in 1996. Re-exports moved in the opposite direction, experiencing very healthy growth. As a result, re-exports are now almost double the amount of domestic exports, at 9 per cent of GDP (Table 12).

Table 12. Exports of Goods and Services as a Ratio to GDP (%) 1960–96

	Goods			Services			Grand total
	Domestic exports	Re-exports	Total	Tourism	Other services	Total	
1960	18.2	2.7	20.9	2.0	9.7	11.7	32.6
1965	17.0	1.5	18.5	1.6	14.3	15.9	34.4
1970	17.7	2.2	19.9	3.6	14.4	18.0	37.9
1975	19.0	2.5	21.5	2.1	11.9	14.0	35.5
1980	19.5	3.4	22.9	9.4	13.0	22.4	45.3
1985	13.4	3.8	17.2	15.7	15.8	31.5	48.7
1990	10.0	5.2	15.2	22.5	13.8	36.3	51.5
1995	5.8	7.0	12.8	20.4	13.4	33.8	46.6
1996	5.3	9.1	14.4	18.9	13.1	32.0	46.4

However the most spectacular change took place in the export of services, which gradually assumed a dominant role, in the same way that they did in domestic production and employment. They now are more than twice domestic exports and re-exports together, and foreign exchange

earnings from tourism alone exceed those from exports and re-exports combined. In 1960 the value of earnings from tourism amounted to 2 per cent and that of other services, because of the existence of the British bases, to another 10 per cent. The share of tourism rose gradually to 9 per cent of GDP in 1980; in 1990 it stood at 23 per cent and fell more recently to 19 per cent. At the same time the share of other services showed some fluctuation, rising to almost 16 per cent in 1985 and then settling at around 13 per cent. All in all the share of exported services increased from 12 per cent 1960 to 32 per cent in 1996 (Table 12).

The evidence on both imports and exports is an indication of the openness of a small country and the need to rely more heavily on the foreign sector. This increased the degree of vulnerability of the economy, but represents the only viable alternative to expansion of production and development.

Export strategy – Customs Union with the European Union. It is important to also offer some comments on the general strategy of the country with regard to international trade. At first the country opted to remain within the British Commonwealth, an institution which provided access to Cypriot exports. When the UK joined the EU and abandoned the preferential treatment of Commonwealth countries, Cyprus entered into an association agreement with the EU, which leads to a customs union and the free flow of goods between the two. As a result, the country gradually liberalised its trade with the EU with reciprocal terms. The customs union provides that Cyprus must adopt the external tariff structure of the EU, which is much lower than the Cypriot one, and has meant a very substantial reduction of tariffs for third countries. Further liberalisation has taken place with the accession of Cyprus to the World Trade Organisation agreement. The country has accepted the challenges of liberalisation knowing that long-term survival could only be achieved, through trade liberalisation and expansion of exports of both goods and services.

The role of exogenous factors

All the elements analyzed above represent various endogenous factors. But economic progress cannot be attributed solely to them. Cyprus was able to achieve economic development because it was also helped by a combination of several exogenous factors. One could also term this interplay of exogenous factors as a dose of good luck. But good luck on its own cannot deliver, unless reinforced by enabling forces which transform the potential into fact. Good luck was certainly there, but it was also necessary for Cypriot businessmen were seize the opportunities and take advan-

tage of the chances that were presented to them. They were able to wrestle these opportunities from potential competitors. The fact that it was Cypriot entrepreneurs that exploited them must be considered an indication of their flexibility, presence of mind and readiness to take risks. The elements of good luck were the following.

- ◆ The crisis in Lebanon. The unfortunate experience of Lebanon contributed to favourable outcomes in Cyprus in a number of different ways:
 - The first was the fact that many thousands of Lebanese came to Cyprus with large cash balances and many stayed, making Cyprus their permanent centre of business activity when they realised the advantages of the country and found good partners;
 - Lebanon became an important customer for Cypriot products, which were exported to Lebanon through the small ports that remained operational. This trade was for domestically produced goods and also for large quantities of re-exported items. This was one of the factors that gradually made Cypriots turn their attention to re-exports;
 - The elimination of Lebanon as a source of supply for the Middle East markets. This opened the way for Cypriot businessmen who seized the opportunity and developed their business activities in the region, winning contracts and sending their exports;
 - Finally, the crisis in Lebanon opened the way for Cyprus to become a business centre. This was eventually developed through the concept of the offshore business centre, which was to prove an extremely important activity. Again this was an opportunity taken up by Cypriot businessmen who persuaded the government to change its policies and create a favourable framework for offshore activity.
- ◆ Another exogenous factor, which contributed during the first stages of reactivation, was foreign aid in money and kind which met a large part of the needs of the refugees. The assistance helped restrict deficits, both in the current account of the balance of payments and in the public sector. Between 1974–78 foreign aid constituted 12 per cent of total receipts from the exports of goods and services. With reactivation after 1978 the role of foreign assistance diminished. Again, the issue is deeper because foreign aid was put to good use. It is not enough to have access to foreign funding and technical assistance; it is also necessary to be able to make good use of it and turn it into productive and rewarding projects.

One other important external factor was the large Arab market which developed as a result of the increase in oil prices. Despite its adverse impact through the increased cost of energy, the creation of a large market proved to be more important, fully exploited by Cypriot businessmen who won construction contracts and sent exports. During the first post-invasion years the annual rate of growth of exports was more than 30 per cent, an achievement mainly connected with the large market of the Middle Eastern oil-producing countries which became the largest market for Cypriot products and replaced the EU in this role for some years. Again, the existence of the market could only be considered as potential. The fact that this potential became reality was the result of astute business practices and the exploitation of opportunities. It should also be noted that it was mostly in the Middle East markets that Cypriot workers found temporary employment.

Cyprus's strategic location at the crossroads of three continents, with access to the markets of the Middle East, North Africa and the Balkans, also played a role in this overall performance. This proved very important after the invasion, but it also had a negative aspect because of the continuous political upheavals in the area.

These are some of the external factors that contributed to economic growth and development of Cyprus.

Taking advantage of small size

Finally, what about small size? One of the basic text book recommendation for development and growth is the promotion of large organisations in order to achieve economies of scale and enhance of productivity, and therefore maintain competitiveness in the international marketplace.

This model cannot always offer the desired solutions for small countries. The experience of Cyprus is important in showing that small size matters in some instances and that small firms can become competitive if they maintain flexibility and constantly adapt to changing international and local conditions. In Cyprus, smallness has been used to provide flexibility through the proliferation of small productive units, supplemented whenever possible by the formation of strategic alliances which can offer support on the international market. As consumers demand good service and personal attention, small companies have an advantage in this area. Indeed, in Cyprus small companies enabled the country to maintain dynamism, differentiate and restructure. There has been an explosion of small units of production over the years. The situation is becoming even easier now that technological developments, such as the immense increase of the power of small computers and of small machinery which

incorporates this enhanced technology, enable small companies to achieve competitiveness. Strategic alliances and the possibility of outsourcing further enhance the potential of small companies to remain competitive; this is particularly important in service industries, where size is always advantageous and where the technology and investments needed are not large.

The lesson, then, is that smallness need not be a disadvantage. On the contrary, it can be an important advantage and should be used by small countries as a strategic option.

This is an extensive list of factors that contributed to the success of the Cypriot economy. This paper will attempt to select the most relevant for other small countries. But first an evaluation of the present situation is necessary.

Evaluation of existing conditions – the constraining factors

The Cypriot economy was able to grow and expand, differentiate and restructure. But it has reached a crossroads and it is necessary to take a hard look at the situation. The economy faces a fresh set of challenges, including globalisation. What was done in the past, and the way in which it was done, no longer suffices. The future looms uncertain and contains many challenges. Countries face a set of circumstances that is much differentiated, dynamic and competitive. In addition, the technology has greatly changed and will continue to change at an even faster pace in the future.

Given these changed external circumstances, there is a need to carefully address the adequacy of past policies. The fact that a country has succeeded in the past must be helpful for the future. But it is certainly not sufficient. It may even be asserted that in some circumstances, particularly if it creates a sense of inertia and feeling of contentment, it could prove disastrous. Hence the need to search for a more complete picture and to identify the country's weaknesses and the strengths. A tentative list appears below.

◆ ***Gradual loss of competitiveness.*** The most important problem facing the country at this point of time is competitiveness. Since 1985 domestic agricultural and industrial exports have stagnated while import penetration has increased, and the number of tourists has stopped growing. Elements affecting competitiveness are:

- **Costs:** Long-term increase in wage levels has undermined competitiveness through rising costs. As a result labour costs per unit of output have risen in Cyprus at a annual rate 2 per cent percentage points higher than in competitor countries. Given that inflation has been much higher in services in recent years, the long-term competitiveness of services is also being eroded;
 - **Quality of goods and services:** As emphasised by many analysts, competitiveness also depends on quality which in the case of Cypriot products and services leaves a lot to be desired;
 - **Adequacy of infrastructure:** Competitiveness will also be affected by the level and quality of infrastructure. Even though infrastructure has been upgraded over the years, its adequacy is now being questioned, particularly in crucial areas such as telecommunications, ports and airports, because of delays in implementing projects and the consequent rise in costs.
- ◆ **The structure and utilisation of investment.** Although past investment rates have often been high, the overall structure of investment is weak. For instance, 70 per cent of investment is in construction and only 20 per cent is in machinery and equipment. In most industrially advanced economies investment in machinery and equipment represents more than 40 per cent of total gross fixed capital formation. Furthermore, existing capital is only partially used at a time when the world economy operates on a 24-hour basis.
 - ◆ **Low technology and productivity.** The consequence of limited investment in machinery and equipment has been a low level of technology in production, which in turn is reflected in low productivity which has been measured at less than 50 per cent of the European average. More disappointing is the fact that in recent years productivity has been growing at a slower pace than in competitor countries.
 - ◆ **Limited research and development effort.** Data on research and development for 1996 show that expenditure on this activity in Cyprus barely reaches 0.3 per cent of GDP. The most competitive economies are spending 3–4 per cent of GDP on research and development. The acceleration of technological development makes the need for increased allocations urgent.
 - ◆ **Over-dependence on tourism.** Foreign exchange earnings from tourism amount to 19 per cent of GDP, indicating over-dependence on this activity as reflected in the slowdown of the economy when tourism stagnated. In no other country of the EU does this ratio exceed 8 per cent.

- ◆ **The environment.** In the case of tourism competitiveness also depends on the state of the environment, which has suffered from an unregulated and rapid expansion of facilities. But the environment is acquiring significance of its own, given the realisation of its overall role and the pressure on resources from expanding human activity.
- ◆ **Rigidities in the market – liberalisation.** The market mechanism has been deemed adequate in the past, and the implementation of the Customs Union Agreement introduced further liberalisation. But there are constraints and rigidities, such as restrictions to foreign investment, statutory ceilings on interest rates, extensive subsidies, wage indexation, inadequacy of capital markets, price caps etc. More recently protection returned through the backdoor, with export subsidies.
- ◆ **Level of public debt.** Despite relative stability in public finance, there have at times been high fiscal deficits, which have gradually led to an overburdening public debt. The public debt is forecast to exceed 60 per cent of GDP in 1998 compared to less than 10 per cent in 1975. The total public debt, which includes the debt to the Social Insurance Fund, has risen even more alarmingly and was nearing 100 per cent of GDP in 1998.
- ◆ **Inefficiencies of the broad public sector.** Cyprus inherited what was considered to be an efficient public sector. But the performance of the sector has gradually deteriorated, hampered by inefficient procedures and absence of innovativeness and consequently raising the cost of production. There is at the same time increasing meddling of political parties in the functioning of the public sector with perceived adverse repercussions. Moreover, there are a number of high cost, monopolistic semi-government organisations.
- ◆ **Cost of social insurance and health care.** The continuing upward trend of social costs, particularly the rising costs of social insurance and of health care, even though still low, could easily get out of control, given demographic factors.
- ◆ **Quality of education.** Cyprus enjoys high quantitative educational standards but many questions are being raised about the quality of the educational system as Cypriot students achieve low results in international science and mathematics competitions. Low productivity, together with the fact that methods and content of education are known to have changed very little in the past decade, raises further doubts. Overall educational standards do not meet the requirements of the twenty-first century.

- ◆ **Adverse social attitudes.** Finally, a basic flaw appears to be the existence of a number of social attitudes which are inimical to change and reform:
- One of these is the culture of protection, which finds expression in the continuous appeals for state intervention. Protectionism has gradually contributed to the erosion of competitiveness as entrepreneurs have accepted high wage demands, because they were able to pass on the increases in costs to the consumer in the country's protected markets;
 - Other similarly adverse social attitudes are the feeling that since we have done well in the past within the existing framework, things should be left as they are; the short-termist approach to investments, with entrepreneurs failing to give due regard to long-term sustainability; the refusal to engage in a dialogue threatening the long-term viability of tripartite institutions and good industrial relations; and other such attitudes.

This overall evaluation of present day conditions must also take into account that the economy of Cyprus has matured and that, therefore, the high growth rates of the past are unlikely to be repeated in the future.

Concluding remarks and recommendations

The previous analysis has identified the factors that contributed to the achievement of economic growth and development in Cyprus. This is a long list of issues, but does not represent an integrated theory of development. Cyprus has its own unique circumstances and has implemented a mixture of policies, institutions, schemes and projects that suited the specific environment and the cultural endowment of its people. So it is not to be expected that any other country can copy this particular mix of policies and hope that they will work. Even if the complete mixture of elements could be copied, there is no guarantee that they would work in a different environment. But in every case there are some elements, which are easy to copy and promise results. Hence an effort will be made to identify these.

Despite much research, no unified development theory has emerged. However, there seem to be a number of important conclusions that have been widely accepted and these have been confirmed by the experience of Cyprus. These relate to issues such as:

- ◆ macroeconomic stability;
- ◆ high quality of government administration and flexible policies;

- ◆ reliance on the market mechanism;
- ◆ a strong and consistent legal system that safeguards property rights;
- ◆ a modicum of democracy;
- ◆ the relative openness of the economy;
- ◆ a high level of savings and investment;
- ◆ building of infrastructure and institutions;
- ◆ emphasis on education.

What is in no doubt, however, is that implementing these elements into a coherent set of policies is elusive. There does not seem to be an answer to the question of what are the right policies to which people are sure to respond.

Education is generally accepted as an important factor in development since the evidence shows that its expansion and diversification accompanies economic growth and development. There is as yet no conclusive evidence about the causality. Education accompanies growth but does not appear to explain it. However, all countries that have eventually achieved development, also expanded the provision of education. Hence, it is safe to recommend education and the promotion of education is probably one of the easiest policies to implement.

The above list covers general issues that have been accepted in the literature on development. What is more interesting is to try and isolate some other elements that have been identified in the case of Cyprus and could be useful for other countries. These will be divided in two, the positive and the negative.

Positive elements:

The positive conclusions refer to the following:

- ◆ The first recommendation would be that planning and its accompanying mechanism has been a basic factor in development. It proved to be a dynamic force. Indicative planning, which is flexible and relies on the market to do most of the allocation of resources, is very useful. This is planning that relies on strategic thinking, formulates a vision of the future, translates this into targets and eventually become a programme of implementable projects. Planning is a framework for focusing and selecting priorities and includes the construction of infrastructure and the creation of a network of basic institutions. It does not substitute for the market but attempts to strengthen it and limits government direct involvement in production.

- ◆ A second conclusion is that development must be considered a partnership between social groups, particularly between employers, trade unions and the government. This found expression in the principle of tripartism and the composition of various management boards and advisory committees. But a note of caution should be voiced because it appears that sometimes the institutionalisation of contacts between the social partners may be inimical to change.
- ◆ A third recommendation is the need to adopt and implement participatory policies, as happened in the East Asian countries. Participatory policies found expression in social policies which ensured that the people shared in prosperity.
- ◆ A fourth conclusion shows that from the experience of Cyprus small size matters. In cases such as services small firms can become competitive, if they maintain flexibility and constantly adapt to rapidly changing international and local conditions. This should be supplemented by the formation of strategic alliances and outsourcing. Note that technological developments enable small companies to achieve competitiveness.
- ◆ A fifth conclusion is that to be able to resort to foreign borrowing it was important to secure the stamp of approval of international organisations. This is invaluable if they undertake the detailed evaluation of projects for implementation, because it increases the likelihood of securing funds from other international and commercial financiers. So this is an area where the multilateral institutions could be of great help to small countries.
- ◆ A sixth point is that in order to exploit opportunities countries need enterprising businessmen. Cyprus achieved economic development aided by a combination of exogenous factors, but these were reinforced by other forces, such as the willingness of businessmen to seize opportunities, which translated chances into action.
- ◆ Finally, a comment on the role of foreign technical assistance, which is essential for small countries if they are to make up for their deficit in expert know-how and technology. One answer is the resourceful use of foreign expertise through an emphasis on scholarships and fellowships, particularly for short-term learning, which allow the training of more people. There is also a need to prepare well for foreign consultants with detailed terms of reference and the possibility of having an option to choose from more than one prospective candidate. Country allocations of funds may provide power and flexibility by conveying the message that the demand is based on the country's own priorities.

Negative elements

As far as negative conclusions are concerned, the following can be mentioned:

- ◆ One element of planning has been the targeting of sectors to promote. The government used it extensively to promote various activities. But this principle failed, because the basic tool for this was the reliance on protection, which in the long run blunted the incentives and meant that entrepreneurs failed to invest and innovate. Again experience points to the power of the market, since the various tertiary sectors that are now leading the economy were able to prosper without much government help, through the market forces.
- ◆ The experience of Cyprus confirms that government is not a good entrepreneur. Entrepreneurship is better left to the private sector which is more efficient. The government should stick to the things that can do best – public administration, provision of social services and building infrastructure.
- ◆ One interesting conclusion would be that foreign direct investment may not be needed after all since Cyprus was able to achieve development with very little foreign direct investment. However, this may only be a case of the exception proving the rule. Even though this was a commendable performance, it is nowadays looked upon as a weakness, because the absence of foreign capital did not allow the more rapid improvement of productivity, limited the penetration of Cypriot companies in foreign markets and restricted the inflow of appropriate management know-how.

But this paper cannot conclude without mentioning the very different, and potentially extremely difficult, conditions that even successful countries face at this point of time. These conditions cast a big shadow of uncertainty for the future. The Cypriot economy was able to grow and expand, but it has now reached a crossroads. What was done in the past, and the way it was done, no longer suffices. The economy faces a fresh set of challenges much differentiated, dynamic and competitive. In addition, the technology has greatly changed and will continue to change at an even faster pace in the future. So, given the trend towards globalisation and liberalisation, countries need to carefully address the adequacy of past policies. What can be of help under these circumstances is that countries remain flexible and pursue policies that ensure that the market operates and that firms enhance their competitiveness, in a spirit of co-operation with the private sector.

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