

Cyprus' External Competitiveness Assessment†

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Abstract

Cyprus' persistent current account deficits over the last decade point to potential competitiveness problems. This note reviews price and non-price indicators to assess the existence of a competitiveness gap in Cyprus and the factors underlying it. Results show that, while productivity growth has been higher in Cyprus than in the euro area, wages growth outstripped productivity gains. As a result, unit labor costs grew more rapidly than in peer countries, implying a steady loss of competitiveness vis-à-vis Cyprus' trading partners. A solid labor market and a dynamic service sector provide some reassurance, but action to restore a healthy competitive business environment is needed. Structural measures to enhance efficiency and labor market flexibility, and a revision of the current wage indexation system would increase the capacity of the economy to adjust to external shocks and curb unit labor cost growth; while curtailing government consumption expenditure would increase national saving thereby reducing the current account deficit.

Keywords: Current account, competitiveness, monetary union, productivity, exchange rate, trade balance.

1. Introduction

Competitiveness is typically framed as a country's success in placing its goods and services in the international markets. Hence being competitive is important for a small open economy as Cyprus, which relies on export driven growth and direct foreign investment to increase productivity and improve the standards of living. A lack of competitiveness is usually revealed by recurring current account deficits that over the long term need to be corrected through low inflation or structural reforms if nominal depreciation is prevented by fixed exchange rate arrangements. Therefore, although competitiveness is an exchange rate concept it can be framed also

† The views expressed herein are those of the author and should not be attributed to the IMF, its Executive Board, or its management.

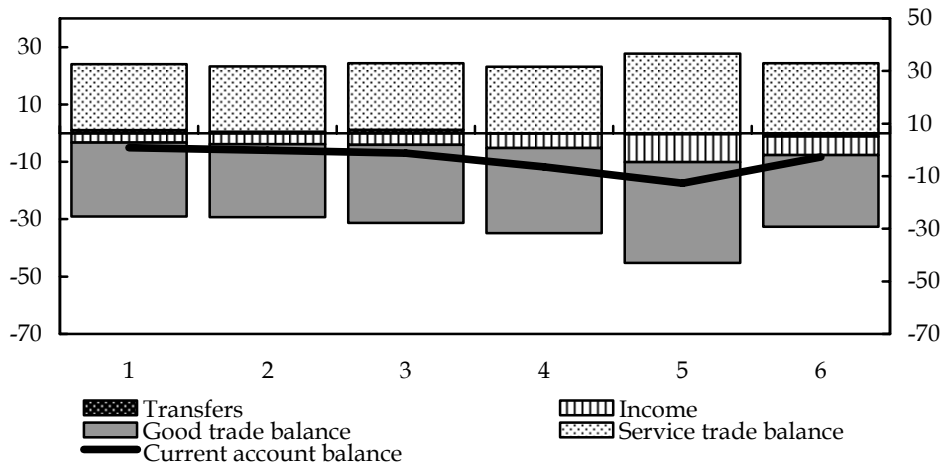
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in terms of structural factors which affect productivity and influence current and long-term growth and the current account, such as the functioning of the labor market, education and skills, R&D and a variety institutional factors conducive to a friendly business environment.

Cyprus experienced persistently negative current account balances since 1995.¹ Although to some extent this reflects Cyprus' high dependence on imported oil and income outflows with a counterpart on the financial account due to the high presence of foreign companies operating in the country, persistent current account deficits might indicate weak competitiveness. Increasingly negative goods trade balance have been only partially offset by surpluses in the services balance, resulting in average current account deficits of 6 percent of GDP since 1995. Moreover, although the potential impact on macroeconomic stability of large current account imbalances has been reduced since Cyprus adopted the euro, the financing of external deficits has taken the form of sustained capital inflows, mostly short-term non-resident deposits with domestic financial institutions. This exposes the country to external vulnerabilities since the volatile nature of these inflows creates uncertainties with regard to Cyprus' balance of payments sustainability.

FIGURE 1

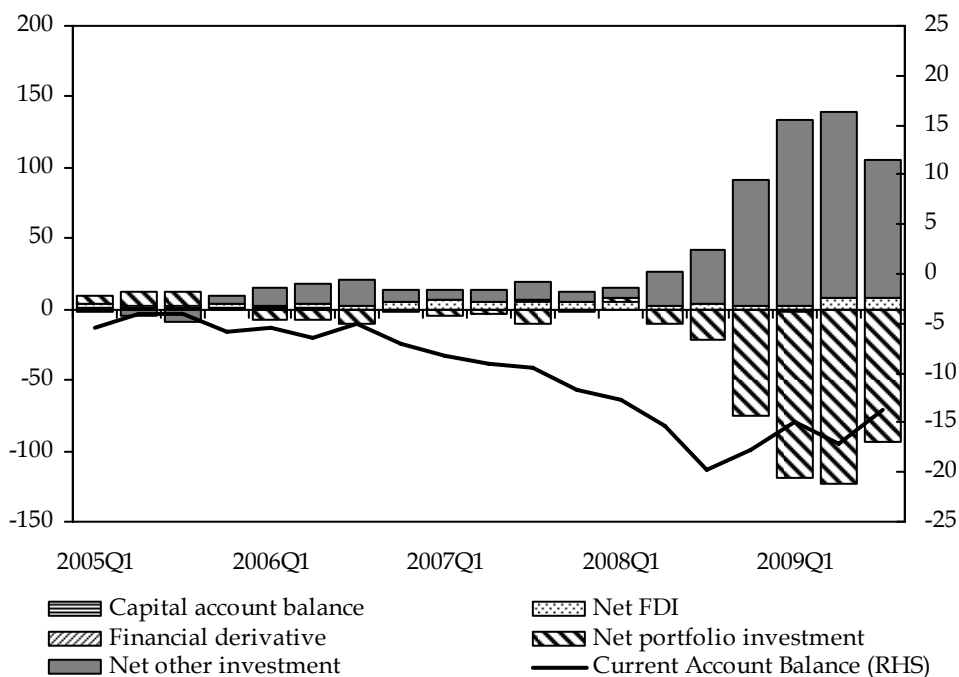
Current account (Percent of GDP)



Source: Eurostat.

¹ The only exception was 1998, when the current account recorded a surplus of 3.1 percent of GDP.

FIGURE 2
Financing of current account
(Percent of GDP, 4-quarter rolling avg.)



Source: Eurostat.

Safeguarding competitiveness is a major challenge within the context of a monetary union in the absence of exchange rate flexibility. The performance and flexibility of its labor market and prices as an adjustment channel has become critical for Cyprus to compete with other industrialized countries as well as low wage emerging economies. A competitive and flexible economy can also facilitate the stabilizing role of fiscal policy which is the primary macroeconomic policy tool that is retained by members of a monetary union.

This note reviews Cyprus' price and non-price competitiveness indicators and draws some tentative conclusions as regards the existence of a competitiveness gap, its underlying factors and the structural reforms needed to restore external competitiveness. The rest of the note is organized as follows. Section 2 reviews Cyprus competitiveness performance by looking at the main price and non-price indicators and a series of comprehensive indicators developed by international institutions. Section 3 looks at labor market developments. Section 4 discusses the wage indexation mechanism and its implications for competitiveness. Section 5

elaborates on the role of the Service sector. Section 6 concludes and discusses policy implications.

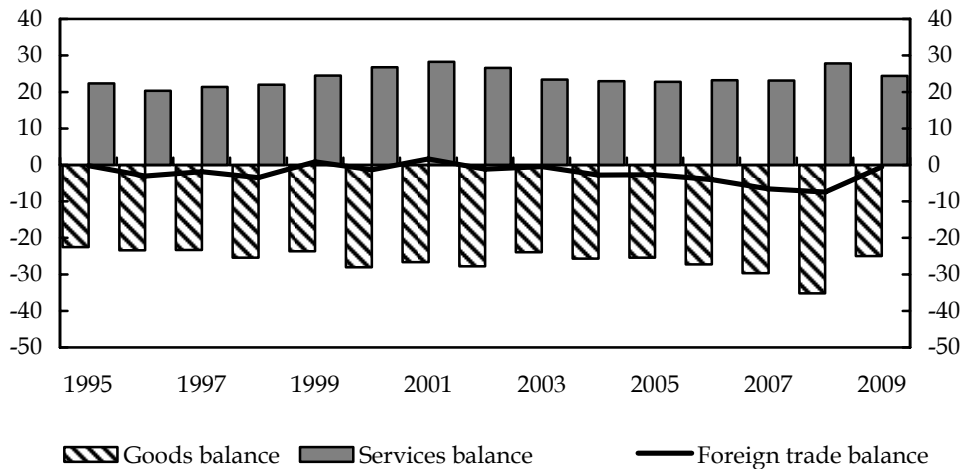
2. Measuring competitiveness

2.1 Export market share indicators

Cyprus' market share in goods has been on a declining trend since the early 1990s with the decline accelerating since the mid 1990s against a backdrop of a rapidly increasing share of service exports on international markets. As the increasingly service oriented economy has caught up with income levels in more advanced economies, rising labor costs in Cyprus have eroded its earlier comparative advantages in some labor intensive manufacturing sectors. More recently, Cyprus' closer integration to the EU economy during the years prior to EU accession has increased Cyprus' exports of services and shifted the economy away from merchandise exports, thus contributing to losses in Cypriot market share of good exports in the EU and global market.

FIGURE 3

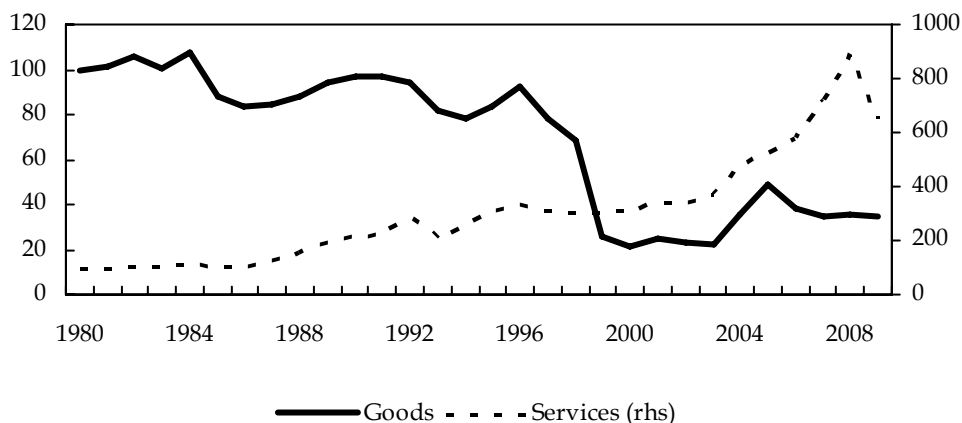
Foreign trade balances (Percent of GDP)



Sources: WEO; Eurostat; Direction of Trade database; and IMF staff calculations.

FIGURE 4

Market share of export (Percent of world exports)



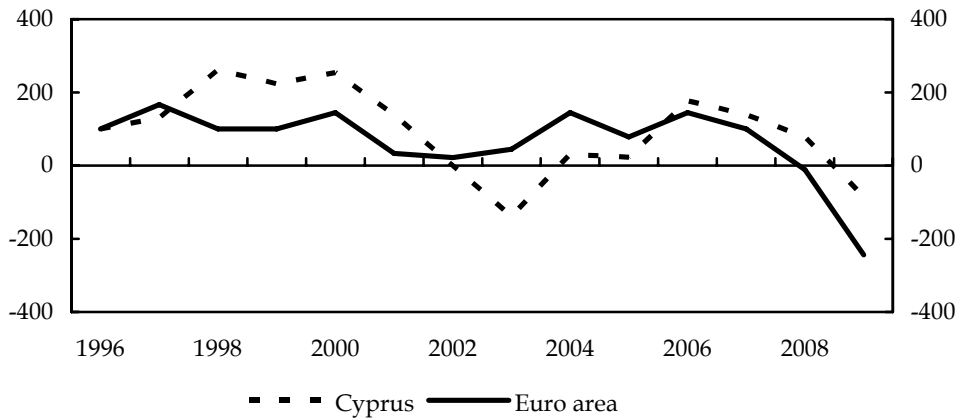
Sources: WEO; Eurostat; Direction of Trade database; and IMF staff calculations.

The rapid increase in several categories of high value service exports has crowded out the market share of good exports and only partially compensated the increase in good imports, resulting in a recurrently negative balance of trade in goods and services. Diversification in ship transportation and construction as well as financial and other business services has more than offset the decline in tourism revenues thus enabling Cyprus to increase its global market share of exports of services.

2.2 Productivity and price indicators

Labor productivity in Cyprus grew slightly faster than in the euro area over the last decade. High productivity rates, sustained by strong labor supply and a friendly business taxation environment have allowed Cyprus to experience robust growth and embark in a successful real convergence with the EU and accession to the euro. Cyprus real GDP has been growing at an annual average rate of almost 4 percent since 1995, compared to 1.7 in the euro area while employment grew by 2.2 percent, sustained by inflows of foreign workers and a historically low unemployment rate.

FIGURE 5

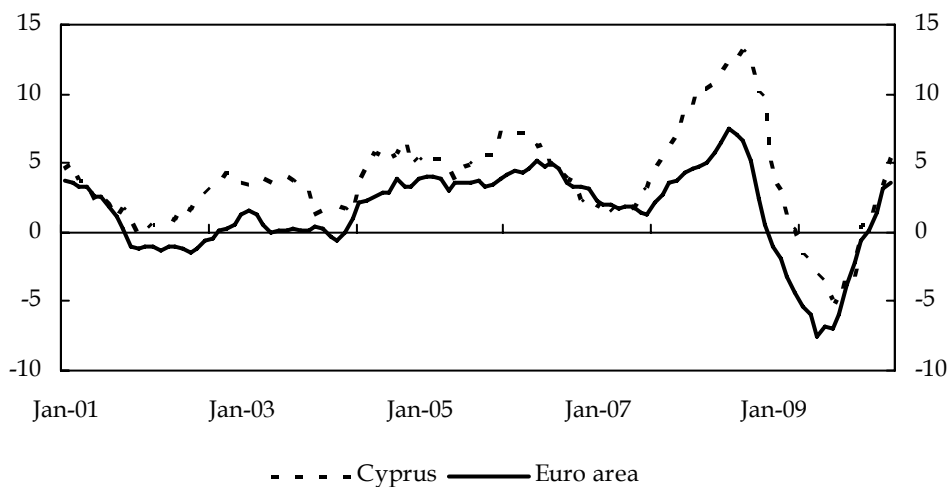
Labor productivity per person (Index, 1996=100)

Sources: Eurostat; and IMF staff calculations.

However, prices and wages grew faster than labor productivity. The consumer price index (CPI) as well as the producer price index (PPI) and labor costs exhibit steadily positive gaps with respect to euro area. While the CPI may result in an inaccurate indicator of external competitiveness since it includes a significant share on non-traded consumption goods, and is subject to distortions owing to taxes and subsidies, PPI and labor costs are better indicators of competitiveness in the tradable sector.² Both these indicators suggest a persistent competitive disadvantage of Cyprus with respect to trade partner countries in the Euro area. However, wage increases reflect to some extent the labor shortages and low unemployment rates that prevailed before the crisis.

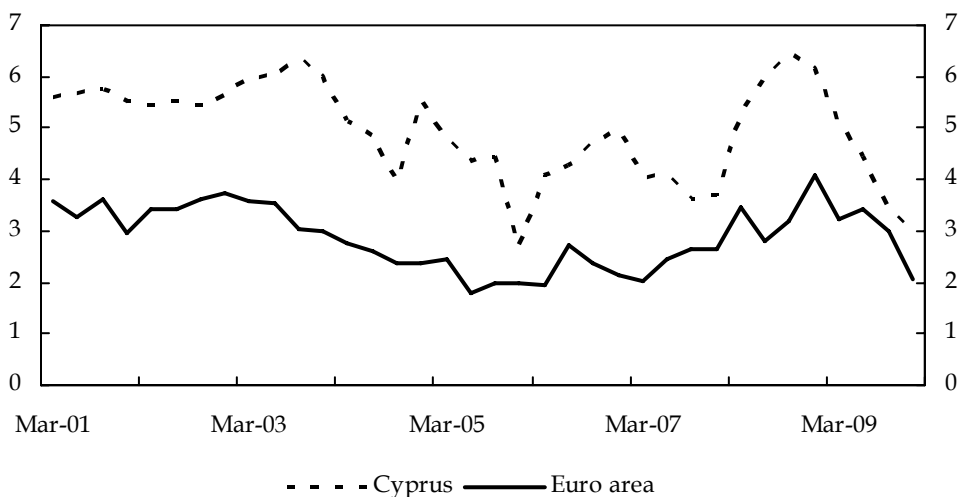
² The underlying basket of PPI includes a wide range of intermediate goods that are subject to international competition, and labor costs capture differences in wages and other related costs.

FIGURE 6
Producer price inflation



Sources: Eurostat; and IMF staff calculations.

FIGURE 7
Labor cost inflation



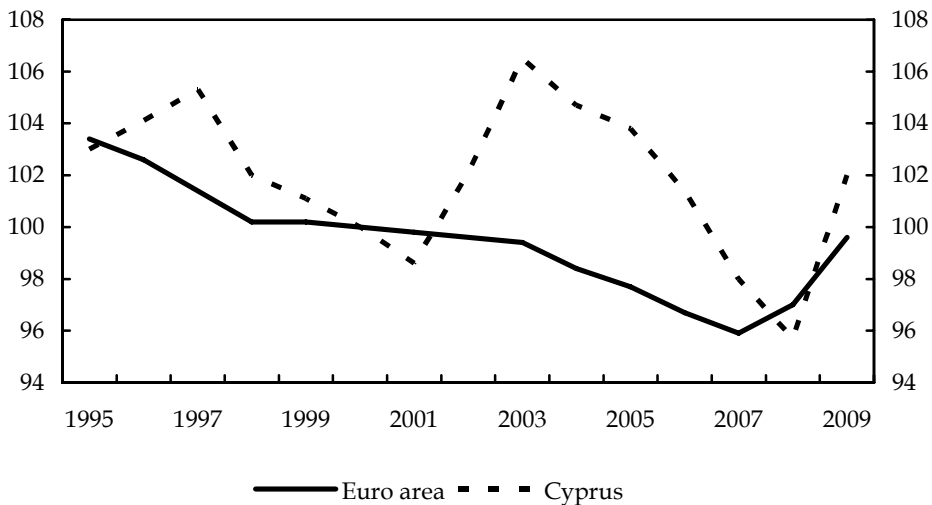
Sources: Eurostat; and IMF staff calculations.

As a result, unit labor costs (ULC) grew more rapidly than in the euro area, implying a loss of competitiveness vis-à-vis Cyprus' trading partners. Real ULC have accelerated since 2001, while they were on a decreasing path in the euro area. After falling lower than the euro area ULC in 2008 as Cyprus

economy was booming, the gap has reopened in 2009 as a consequence of the global economic downturn which hit Cyprus with a lag. However, developments in ULC may not provide an accurate indication of the competitive position of the Cypriot economy as a whole since the economy is strongly service oriented and the manufacturing sector contributes for less than 10 percent of GDP.

FIGURE 8

Real unit labor cost (Index, 2000=100)

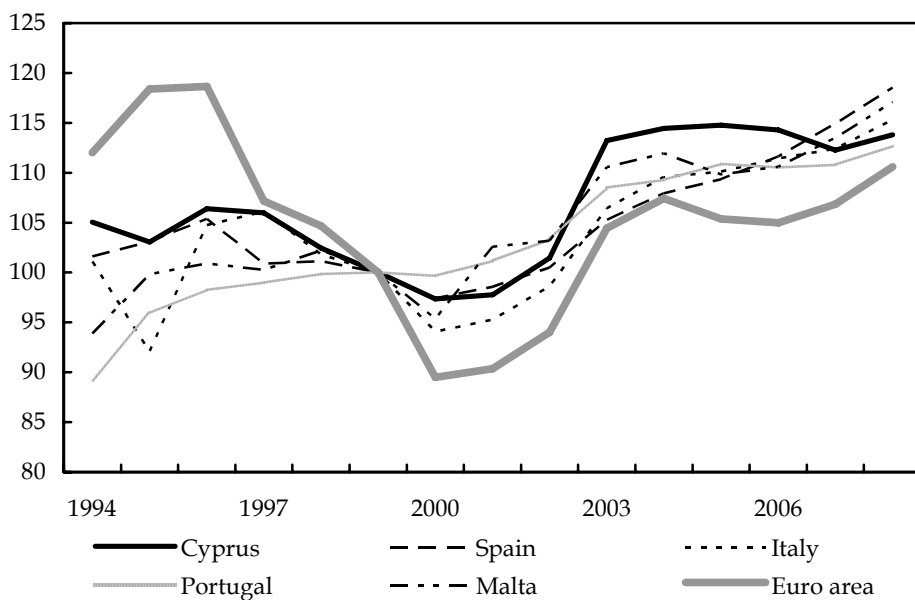


Source: Eurostat.

2.3 Exchange rate based indicators

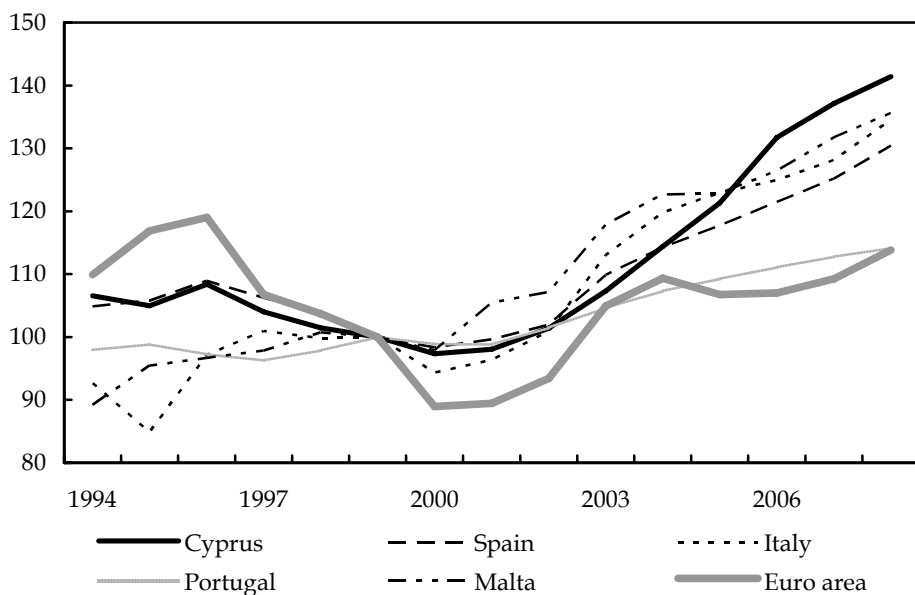
Since 2000 real effective exchange rate (REER) measures have exhibited an appreciation trend broadly in line with the other Southern euro area countries. The real appreciation is mostly hurting the manufacturing sector as high wages in the growing financial and real estate sectors due to high productivity in those sectors put upward pressures on wages in the rest of the economy. When looking at the price deflator of exports of goods and services, however, the real appreciation has been milder in Cyprus than in peer countries, reflecting the high share of high value services exports.

FIGURE 9
REER ULC-based (Index, 1999=100)



Source: European Commission.

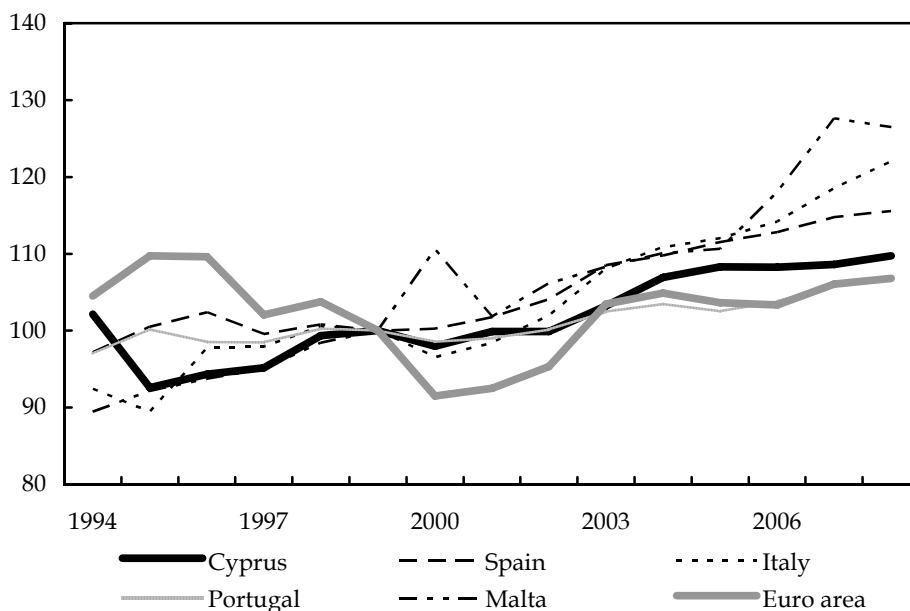
FIGURE 10
REER ULC-based, Manufacturing (Index, 1999=100)



Source: European Commission.

FIGURE 11

REER- based on Price Deflator of Exports of Goods and Services (Index, 1999=100)

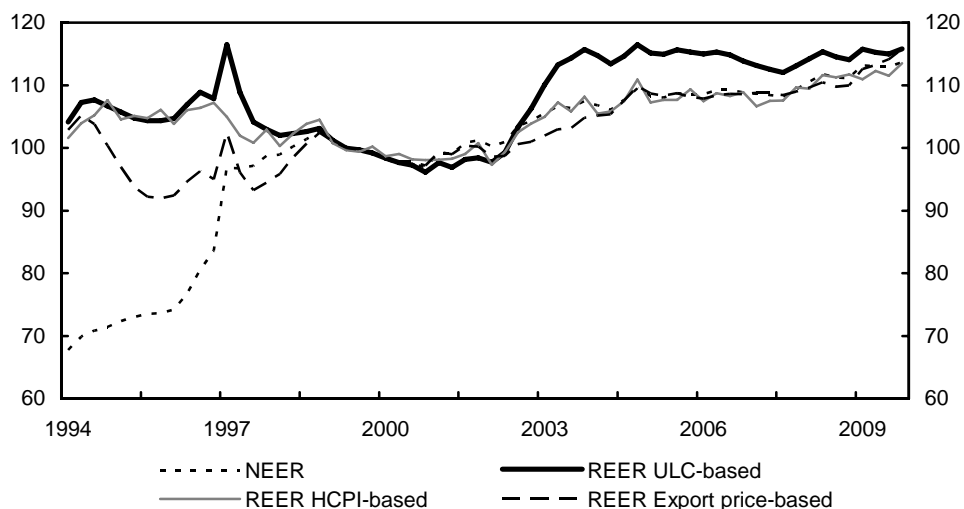


Source: European Commission.

The REER appreciation seems to be in part driven by rapidly growing ULC. A comparison with the nominal effective exchange rate shows that after 2003 the appreciation of the REER based on the HCPI and the export deflator is mainly due to a nominal appreciation, while ULC point at a steeper deterioration on competitiveness. This evidence has to be considered against the backdrop of a period of wage moderation over the past five years, in the context of achieving the macroeconomic convergence criteria for Cyprus's successful integration into the EMU. However, such moderate stance was not enough to preserve Cyprus' competitiveness vis-à-vis its trade partner. On the other hand, in 2008 pay increases at sectoral level were substantially higher compared with the previous years, and in April 2008 the government decided to further increase minimum wages for the five occupational groups covered by the Minimum Wages Law.

FIGURE 12

Nominal and real effective exchange rates (1999 = 100)



Source: European Commission.

CGER-type estimates developed by the IMF³ show that Cyprus is facing a significant competitive disadvantage. All estimates indicate the same directional conclusion, with negative current account gaps and substantial

³ The CGER methodology uses four approaches. First, the Macroeconomic Balance approach calculates equilibrium relationships between the current account balance and a set of fundamentals with panel econometric techniques. For each country equilibrium current accounts are computed from the estimated equilibrium relationships as a function of the level of fundamentals projected in the medium term. The real exchange rate adjustment that would close the gap between the estimated equilibrium current account and the underlying current account is computed based on the degree of the country's openness to trade. Second, the Equilibrium Real Exchange Rate approach is a reduced-form equilibrium model which employs panel regressions techniques to estimate an equilibrium relationship between real exchange rates and a set of fundamentals. Equilibrium real exchange rates are then computed as a function of the medium term level of fundamentals and the magnitude of the exchange rate adjustment is calculated directly as the difference between each country's actual real exchange rate and the identified equilibrium value. Third, the External Sustainability approach focuses on the relationship between the sustainability of a country's external stock position and its flow current account position, trade balance and real exchange rate. This methodology involves determining the ratios of trade or current account balance to GDP that would stabilize the net foreign asset (NFA) position at a given benchmark level. Then, the NFA-stabilizing trade or current account balances are compared with those expected to prevail in the medium term. Finally, the adjustment in the real effective exchange rate that is needed to close the gap between the

exchange rate overvaluation, consistent with recent development in wages and the competitive deterioration in the manufacturing sector. However, the large current account swing in 2009 (from -17.5 to -8.3 percent of GDP) suggests that significant current account adjustments can occur in Cyprus without major changes in the exchange rate (or slower growth relative to trading partners). Moreover, CGER type analysis needs to be interpreted with care for services export-oriented economies, since service exports may be less responsive to exchange rate dynamics.

TABLE 1
CGER-type Estimates

	Macroeconomic balance	External stability	Equilibrium real exchange rate	Purchasing power parity
CAB gap ¹	-4.9	-5.8	n.a.	n.a.
REER gap ²	17.9	21.2	12.1	11.9

Notes: ¹ Difference between actual current account balance (CAB) and the estimated equilibrium CAB in percent of GDP.

² Percentage difference between the actual REER and the estimated equilibrium REER. A positive result suggests overvaluation.

Source: IMF staff estimates.

2.4 Other indicators of competitiveness

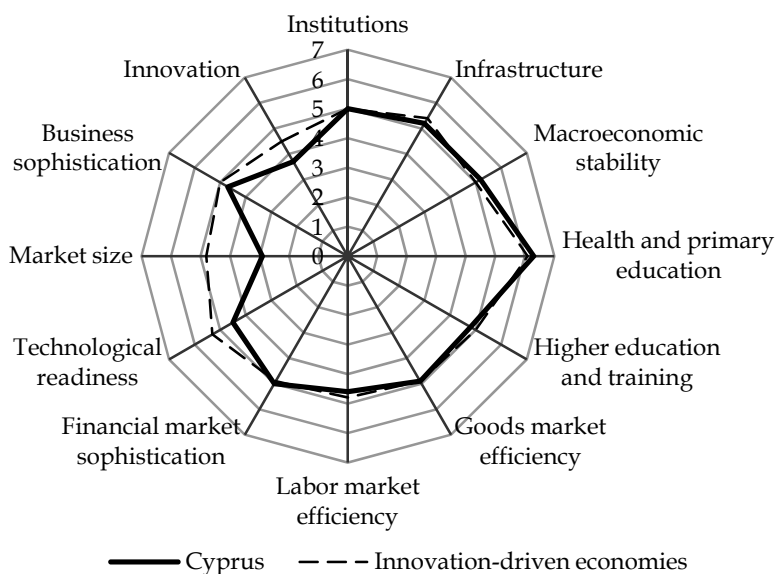
Non price indices and survey data used for global ranking give mixed signals about the competitiveness of the Cypriot economy. Several institutions evaluate competitiveness performance using a comprehensive approach based on hard as well as survey data. Cyprus' position in selected rankings is reported below:

- The *Global Competitiveness Index (GCI)*, published annually by the World Economic Forum (WEF) captures macroeconomic and microeconomic fundamentals of national competitiveness which are conducive to a healthy business environment and sustainable level of productivity. The GCI considers 12 main determinants of competitiveness, including structural factors; it ranks Cyprus 34th out of 133 countries in 2009-10,

actual medium term ratios and the NFA-stabilizing trade and current account balances is assessed. Fourth, the Purchasing Power Parity (PPP) methodology calculates deviation from the long run equilibrium real effective exchange rate under PPP.

with an improvement with respect to the 2008 edition where Cyprus was ranked 40th. Compared to other “innovation driven economies”, Cyprus underperforms in market size, innovation and technological readiness. Survey results point to the following most problematic factors for doing business in Cyprus: (i) inefficient government bureaucracy; (ii) access to financing; (iii) adequate supply of infrastructure; and (iv) restrictive labor regulation.

FIGURE 13
Global competitiveness index



Source: World Economic Forum, The World Competitiveness Report 2009-2010.

- The *Index of Economic Freedom* published annually by The Heritage Foundation and The Wall Street Journal covers 183 countries across 10 specific freedoms—such as trade, business, investment freedom, and property rights—and assigns a grade to each using a scale from 0 to 100, where 100 represents the maximum freedom. The ten component scores are then averaged to give an overall economic freedom score for each country. Cyprus’ economic freedom score is 70.9, making its economy the 24th freest in the 2010 Index. The overall score is almost unchanged from last year, with significant declines in property rights and labor freedom balanced by improvements in business freedom and freedom from corruption. Cyprus is ranked 13th out of 43 countries in the

Europe region, and its overall score is higher than the regional and global averages.

- The *Doing Business Index* published annually by the World Bank investigates the regulations that enhance business activity and those that constrain it. It presents quantitative indicators of business regulations and protection of property rights affecting different stages of the life of a business, from starting a business to enforcing contracts and closing a business. Cyprus is ranked 40th out of 186 countries on the 2010 report, with a deterioration compared to the 2009 report which ranked Cyprus 36th.
- The *Logistic Performance Index (LPI)*, also published by the World Bank is based on a worldwide survey of operators on the ground (global freight forwarders and express carriers), providing feedback on the logistics friendliness of the countries in which they operate and those with which they trade. Feedback from operators is supplemented with quantitative data on the performance of key components of the logistics chain in the country of work. The overall LPI score for Cyprus is 3.13 in a scale from 1 to 5, ranking the Country 46th out of 130, with lower scores on timeliness and logistic competence.

TABLE 2
Cyprus' Logistic Performance Index

Overall LPI	score	3.13
	rank	46
Customs	score	2.92
	rank	42
Infrastructure	score	2.94
	rank	46
International shipments	score	3.13
	rank	45
Logistics competence	score	2.82
	rank	58
Tracking & tracing	score	3.51
	rank	32
Timeliness	score	3.44
	rank	75

Source: World Bank.

- The *Competitive Industrial Performance Index (CIP)* developed by the United Nations Industrial Development Organization (UNIDO) combines four main dimensions of industrial competitiveness: industrial capacity, manufactured export capacity, industrialization intensity and

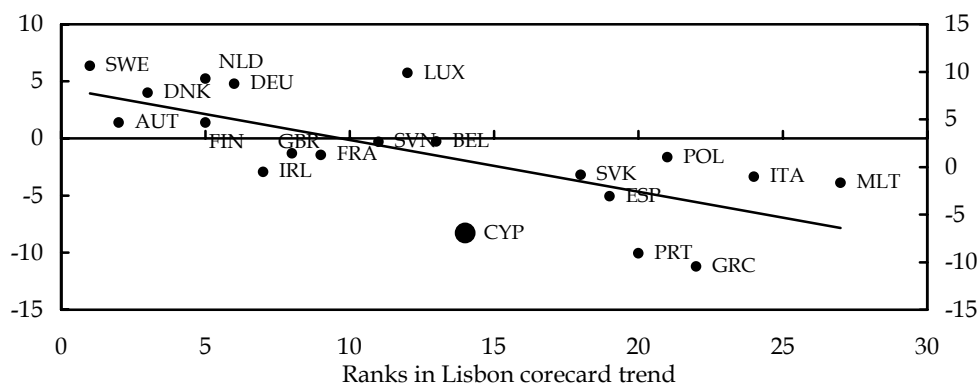
export quality. The CPI ranked Cyprus 41th over 122 countries in 2005, up 18 places compared to 2000, with a significant improvement in export quality and manufactured export capacity mainly driven by a substantial increase of high technology exports as a share of manufactured exports.

- The *Business Environment Outlook* Index developed by the Economist Intelligence Unit, averaged 6.8 out of 10 in 2005-09 ranking Cyprus 34th out of 82 countries. While no significant change is expected in Cyprus's business environment score in 2010-14, improvements in some other countries will result in Cyprus's global ranking falling two places to 36th. According to the Economist Intelligence Unit the country's ranking is negatively affected by the small market size and the distance to the main EU market, no market access to Turkey, a culture of cronyism and the division of the island.

The *Lisbon Reform Scorecard* created by the Center for European Reform assesses individual EU countries' performances relative to their Lisbon targets. The scorecard is based on EU structural indicators which measure performance in economic, social and environmental categories; it provides an overview of EU countries' record on economic reform. In the 2009 scorecard, Cyprus ranks 14th over 27, up one position compared to 2008. Empirical evidence shows that there is a close relationship between the reform scorecard and current account positions across countries. This suggests that Cyprus should speed the implementation of structural reforms to improve non-price competitiveness.

FIGURE 14

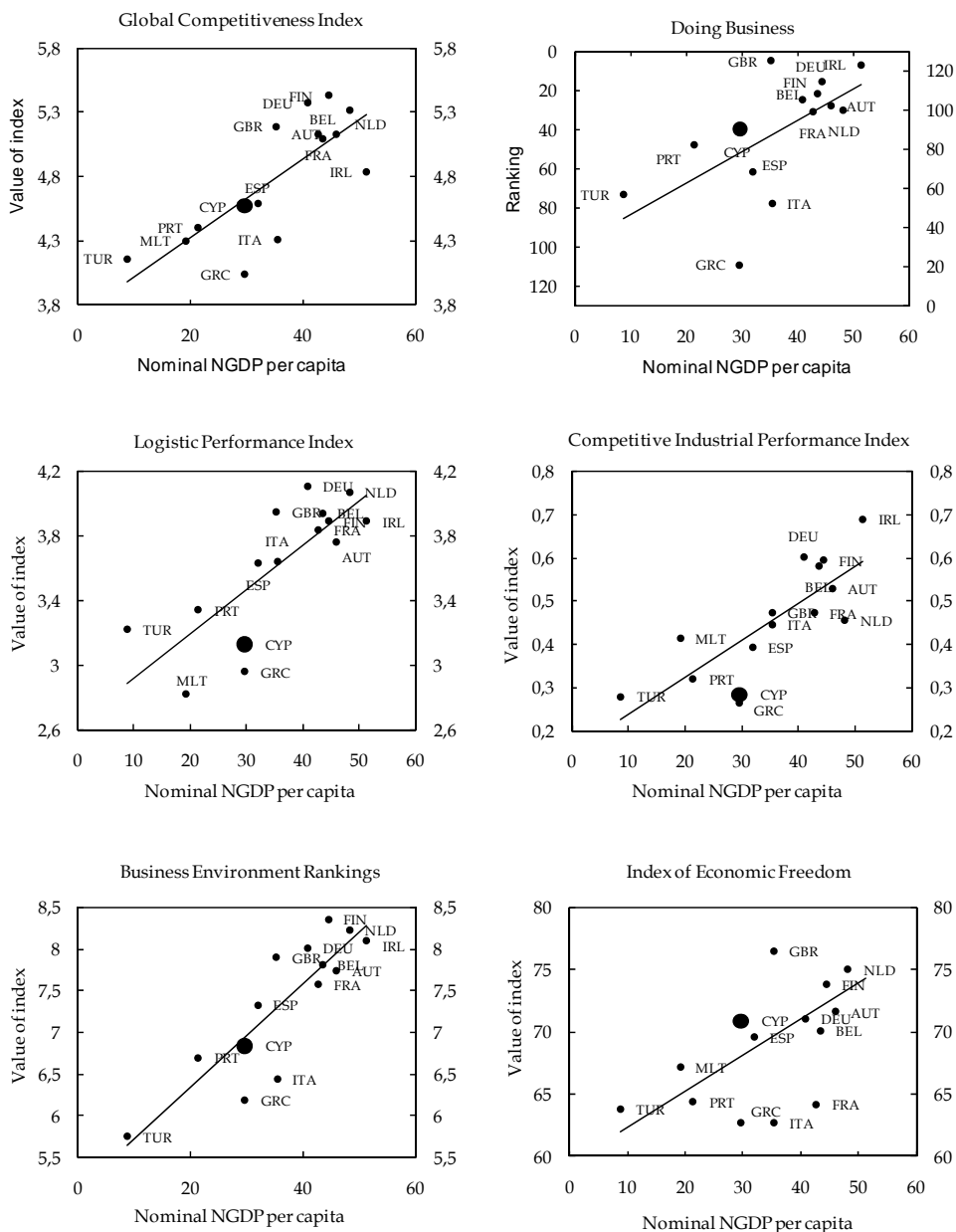
Current account deficit (Percent of GDP)



Sources: International Monetary Fund, World Economic Outlook; and Center for European Reform, The Lisbon Scorecard X. The road to 2020.

FIGURE 15

Competitiveness indicators 2009



Sources: World Economic Forum, Global Competitiveness Index 2009-2010; World Bank, Doing Business 2010; The Heritage Foundation, 2010 Index of Economic Freedom; Industrial Development Report 2009, Competitive Industrial Performance Index; Economic Intelligence Unit, Country Forecats March 2010; and World Bank, Logistic Performance Index.

3. Labor market developments

Assessed vis-à-vis the usual macroeconomic and Lisbon benchmarks the Cypriot labor market performs well and better than the EU average. The labor market has historically been characterized by conditions of almost full employment and high job creation. Unemployment is particularly low partly due to sustained GDP growth, a flexible labor market and an efficient unemployment insurance system, characterized by relatively low benefits of short duration. Over the last ten years, the unemployment rate averaged at 4.3 percent; it fell to 3.6 percent in 2008. Employment has been growing by 2.5 percent, accelerating to 3.3 during 2003-2007, and has been benefiting from sizeable inflows of foreign workers. Long-term unemployment has remained very low, less than 1 percent of the labor force. However, while the employment rates for females and older workers fulfill the relative Lisbon target, the gender pay gap currently stands at 23.1 percent, which is one of the largest gap among the EU Member States.

4. The role of wage indexation

The current system of wage determination in Cyprus provides for the automatic adjustment of wages on the basis of general changes in price levels (the Cost-of-living allowance – COLA system). Specifically, the gross earnings of workers are revised at the end of every six months – that is, on 1 January and 1 July – on the basis of the consumer price index percentage increase of the preceding six-month period. The COLA system has been in operation since 1944. Until recently, it has been considered as a non-negotiable issue during collective bargaining, enjoying the strong support of trade unions and governments as a catalyst to the harmonization of the relationship between labor and management, despite opposition from the employer organizations.

The uniform application of the COLA limits the ability of wages to reflect productivity differences across economic sectors while the second-round inflationary effects could undermine flexibility and erode competitiveness. Although there is no empirical evidence that the COLA has contributed to a self-perpetuating inflationary spiral⁴, it is possible that this might have been due to the low inflationary conditions that have prevailed in Cyprus so far. At times of strong inflationary pressures, the COLA can impede the stabilizing role of fiscal policy, which is a major drawback within the

⁴ Eliofotou (2008).

context of a monetary union and the related absence of exchange rate flexibility.

The shortcomings of the COLA become also more evident in the current low-growth economic environment. By linking wages to CPI rather than productivity, COLA undermines competitiveness and labor flexibility, in addition to exacerbating the level and persistence of price shocks. In addition, downward wages stickiness resulting from the COLA may become an impediment to the economy's ability to respond to the current low-growth environment. In particular, in the presence of long-duration wage contracts the COLA constrains the markets' ability to correct an overshooting of wages that may result from too optimistic an outlook at the time of the contract's inception.

Another issue raised against the COLA is that it is applied irrespective of the level of wages. As a consequence, it increases wage differentials between employees at the lower and higher scales, in particular in the public sector, thus contributing to enhancing inequalities as well as to eroding its labor market peace enhancing benefits. The share of employees in the private sector that benefits from COLA has been on a downward trend, in particular due to an increasing number of foreign workers not covered by the COLA. Recent estimates by the CBC place at approximately 50 percent the overall share of such employees.

5. Developments in the service sector

Sectoral analyses of the labor market reflect a steady transformation of the Cypriot economy characterized by the increasing importance of the services sector. The Services sector, which contributed 73.8 percent to GDP in 2008, exhibits strong dynamism, reflected in high rates of growth, an increase in their share to value added and an expansion of their shares in international markets. Specifically, the sectors of banking and other financial services, international business services, and shipping appear to have successfully exploited Cyprus' comparative advantages in terms of geographic location, infrastructures, and highly educated human capital.

Such sectoral shift is mostly welcome since the services sector is a key element in the adjustment mechanism within a currency union, and developments in services play an important role for the macroeconomic performance of the entire economy. Services are increasingly used as inputs in manufacturing and other non-service sectors and can have a positive impact on the economic performance of other sectors. Moreover, most services are relatively labor intensive implying that a strong growth performance of these sectors will better absorb the unemployed. Finally,

price rigidities in the service markets may hinder the necessary adjustment essential to facilitate adjustment to shocks while efficiency gains in services may contribute to lower inflation rates.⁵

The tourism sector has been underperforming in recent years and its contribution to growth shrank in 2009, while financial and business services have been growing rapidly. Tourism is the single most important sector in Cyprus once the restaurant and hotel sector is combined with the effect of tourism on transport, construction and retail. Comparatively high prices and increased competition from other Mediterranean destinations as well as the heavy dependence on a severely weakened UK market have weighed on the tourism sector performance. On the other hand, low barriers to business establishment, a favorable corporate tax rate and strong telecommunication infrastructures have favored financial and business services, which have been playing an increasingly important role in the economy.

While Cyprus' road, electricity, water and telecommunications networks are of good quality, air transport liberalization has been slow and public transportation is poor. The relative absence of budget airlines as a byproduct of delayed liberalization, and the infrequency of direct flights to some key destinations have hampered Cyprus' aim to become a regional hub for airlines. The currently poor bus service network and reliability contributes to the problem of traffic congestion in towns, especially at the beginning and end of the public sector working day. The government has plans to increase the use of public transport (from the current 2 percent of total transport) by improving the quality of public transportation while there are no plans to develop a railway system.

6. Conclusions

Cyprus competitiveness has suffered from high growth rates in wage and labor costs notwithstanding solid productivity trends and labor market developments and the good performance of the services sector. In light of Cyprus accession to the euro area in 2008 the need to preserve competitiveness in the absence of exchange rate flexibility is paramount. The above analysis suggests that there is room for improving competitiveness with policy measures designed to reduce rigidities, control labor cost increases and raise national saving.

⁵ Leichter et al. (2010).

Action to preserve competitiveness includes structural reforms aimed at increasing efficiency and reducing structural rigidities. Increasing the flexibility of labor and product market, streamlining the regulatory environment, improving transport and communication infrastructure, and encouraging financial and services support for exports would help stimulate economic activity and external competitiveness. Further promotion of the financial support to trade is desirable given the positive performance of this sector in Cyprus and the strong linkages among finance, trade and other macroeconomic sectors highlighted by the current financial crisis. Efforts to reduce the pay gap between men and women are also suitable to buttress a flexible and efficient labor market. In addition, there is room to increase labor participation in view of the challenges of an ageing population by encouraging part-time work and flexible working practices.

In view of the fixed exchange rate after the euro adoption and the higher growth in labor costs compared to Cyprus' trade partners, the automatic wage indexation mechanism should be better targeted to reflect sectoral productivity gains or gradually eliminated. Current efforts to set up a medium-term budgetary framework present an opportunity to revisit and address the issue of wage setting in the public sector, which accounts for most of the employees benefited by the COLA system. The objective would be to adopt a framework which correct the structural rigidities induced by the current system. Allowing wages to reflect sectoral or firm level productivity gains would be conducive to a more efficient allocation of labor. On the other hand, well targeted social measures for those in need of protection could be implemented to counteract any adverse impact that such reform may have on the most vulnerable fraction of the labor force.

Containing government consumption spending is mostly recommended as an action to raise national savings thus reducing the large current account deficit. Reducing government consumption expenditure is also particularly recommended given empirical evidence that increases in government consumption tend to increase the relative price of nontradables and leads to real appreciation of the exchange rate⁶. Moreover, such a policy squares with the need to reduce the current fiscal deficit and restore the sustainability of the government balance.

Overall, there is need to invest in service infrastructure to upgrade the country's overall business environment and attract higher-spending

⁶ Ricci et al. (2008) and Lee et al. (2008).

tourists. Efforts to improve the quality of the tourism product and to diversify into sports and business tourism should help to halt the recent decline in competitiveness and attract higher income tourists. The prioritization of investment in transport infrastructure would also enhance the overall business environment and attract non-Cypriot customers and labor force.

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