

The day after

Commercial opportunities following a solution to the Cyprus problem

Fiona Mullen

Özlem Oğuz

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TURKEY

Ceyhan
oil terminal

CYPRUS

 **PRIO**
CYPRUS CENTRE

PAPER 1/2008

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to the Cyprus problem*

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Finally, we would like to thank the business representatives who shared their views with us on business opportunities after a solution. We sincerely hope that our work will encourage other business people to come forward and discuss more ways to turn the reunification of this island into a profitable enterprise.

Nicosia
January 2008

EXECUTIVE SUMMARY

Rapprochement between Greece and Turkey has led to a boom in commercial relations between the two countries that has transformed Greece into one of the top ten foreign investors in Turkey and has turned Turkey into one of the fastest growing markets for Greece, especially for tourism. Trade in goods and services between these two countries rose at an annual average rate of 25% in 2000-06, while the tourism market increased at an astonishing average rate of 275% per year.

This remarkable increase in business, despite centuries of mutual hostility, indicates that businesses quickly overcome feelings of mistrust as soon as political conditions improve. These developments, combined with Cyprus's small size, suggest that the most lucrative opportunities for Cypriot businesses and the wider public after a solution lie beyond the island, namely in doing business with Turkey.

In order to give Cypriots on the island an idea of the value of these opportunities in money terms, we make projections for key sectors based on both a reunification and a continued division scenario. By subtracting the divided Cyprus from the reunified Cyprus scenario, we can calculate the annual peace dividend for each sector.

For our methodology, we take the growth rates in exports of goods and services between Turkey and Greece as an initial guide, as well as recent macroeconomic and sectoral trends in both parts of Cyprus. We pay particular attention to those sectors which have the most to gain from doing business with Turkey and from likely developments on the island after a solution. These sectors are tourism, shipping, construction and real estate, tertiary education, and accounting and legal services.

Deliberately avoiding the economics of any specific solution, we make one simple assumption: that the solution that would gain the majority support of both communities would be politically and economically sustainable.

According to our calculations, if Cyprus were reunited, the recurring annual benefits to Cypriot businesses in the first seven years after reunification would generate, on average:

- EUR 510 million per year in additional exports of goods and services to Turkey, of which EUR 385 million would be tourism and EUR 22 million would be transport
- EUR 618 million per year in total additional trade in goods and services with Turkey
- EUR 393 million per year in new business for Cypriot construction companies
- EUR 155 million per year in new business for Cypriot real estate companies
- EUR 316 million per year (excl. new business from Turkey above) in new business for Cypriot tourism enterprises

- EUR 162 million per year of additional revenue for the Cypriot university education sector
- EUR 103 million per year in additional income for Cypriot accounting and legal firms
- EUR 184 million in new foreign direct investment (excl. construction and real estate above) into Cyprus
- The annual boost to business—the annual peace dividend—rises from EUR 283 million in Year 1 to EUR 3.9 billion, or 10% of GDP, by Year 7.
- The peace dividend is the equivalent of approximately EUR 1.8 billion per year (over CYP 1 billion or more than YTL 3 billion).
- If this is translated into the annual dividend per family (household) in Cyprus, it comes to an annual peace bonus of approximately EUR 5,500 per household per year. This is around 20% of the current average salary in the southern part of Cyprus and an estimated 40% of the average salary in the northern part of Cyprus.

This calculation is the least that can be expected since it focuses only on the sectors that stand most to gain. Moreover, the peace dividend calculated could be almost doubled if important regional developments, such as new business from the Baku-Ceyhan oil pipeline (EUR 1.3 billion) and the implementation of the Ankara Protocol (EUR 187 million per year) are taken into account.

SUMMARY TABLE A REUNITED CYPRUS: THE RECURRING BONUSES FOR BUSINESS	2008* Year 0 EUR m	2009* Year 1 EUR m	2015* Year 7 EUR m	Annual bonus EUR m**	Bonus per household EUR **
New business with Turkey					
1. New exports of goods to Turkey	0.0	6.4	106.1	46.3	139.2
2. New exports of services to Turkey	0.0	53.4	1,116.9	463.7	1,392.5
3. New business with Turkey bonus (1+2)	0.0	59.8	1,223.0	510.1	1,531.7
Additional construction and real estate business					
4. New construction business	0.0	62.3	746.2	392.6	1,179.1
5. New real estate business	0.0	29.5	290.3	155.3	466.4
6. Additional construction and real estate bonus (4+5)	0.0	91.7	1,036.5	548.0	1,645.5
Other additional business					
7. New tourism revenue (excl. Turkey included in services above)	0.0	67.3	597.7	315.6	947.8
8. New education income (excl Turkey in services above)	0.0	12.5	440.1	161.7	485.5
9. New accounting and legal services	0.0	19.3	206.9	103.3	310.3
11. Additional other business bonus (7+8+9)	0.0	99.2	1,244.7	580.6	1,743.6
Additional foreign direct investment (excl. construction/real estate)					
12. New foreign direct investment	0.0	32.0	379.5	183.9	552.2
13. New foreign direct investment bonus (12)	0.0	32.0	379.5	183.9	552.2
14. Total peace dividend (3+6+11+13)	0.0	283.0	3,884.0	1,823.0	5,474.0
% of reunited GDP	0.0	1.4	10.3	–	–
Memorandum items: Other potential income					
Shipping: implementation of Ankara protocol	0.0	161.1	215.8	187.3	562.6
Transport and storage income from Ceyhan oil pipeline	0.0	250.0	2,000.0	1,321.4	3,968.3
Potential shipping and oil transport bonus	0.0	411.1	2,215.8	1,831.5	5,500.0

* Expected exports/turnover/income. ** New post-solution business per year (average).

Source of main forecast: authors' forecasts based on Greece-Turkey growth and Cyprus' recent macroeconomic performance.

1. APPROACH TO RESEARCH

This study is not intended to promote any specific solution to the Cyprus problem nor any political party or movement on the island. All three researchers in the project are participating in their personal capacities. As the title of our paper suggests, this study is about the day *after* a solution. While the short-term economic impact of one specific solution or another is an important issue, it is a much larger subject that is beyond the scope of this short paper. Our paper focuses, instead, on the long-term, *recurring* business opportunities that would arise after a solution to the Cyprus problem. In order not to get distracted by the specific economics of one solution or another—in order to look at opportunities that arise the *day after* a solution—we make one simple assumption: that the solution that would gain the majority support of both communities, while not necessarily perfect, would be economically and politically sustainable.

Our starting hypothesis is that the major, long-term opportunities of a solution lie beyond the island, namely in commerce (trade in goods and services) with Turkey. Turkey is our largest neighbour, both in terms of population and in terms of economic size. Moreover, because of its large population, it is one of the most promising emerging markets in the world. One can see from other European countries with small populations, such as Iceland, Malta, Estonia and Slovenia, that under normal circumstances a country's largest neighbour is also the smaller country's biggest export market.¹ But only one-third of Cyprus (or one-seventh of Cyprus, if you measure it in terms of the all-island economy) is currently trading with Turkey. The unusual situation in Cyprus is underlined by the fact that the largest export market for the southern part of Cyprus is not even Greece, but the UK, which is more than 3,200 kilometres away.

It is tempting to believe that poor commercial relations between the southern part of Cyprus and Turkey will always be the case: that even after a solution, mistrust would be so deep that no Greek Cypriot would trade with a Turk. In order to test this pessimistic theory, therefore, we first examine in Section 2 the development of commercial and macroeconomic relations between Greece and Turkey from 1996—a low point in relations—and the period after the rapprochement that began between the two countries from 1999. This also gives us a good basis for projecting the potential for a reunited Cyprus and Turkey.

¹ Data on largest export markets of these countries was kindly provided by the Economist Intelligence Unit.

In Section 3, we examine recent commercial relations between the southern part of Cyprus and Greece and between the northern part of Cyprus and Turkey. These developments can give us another indication of the potential for business between a reunited Cyprus and Turkey.

In order to understand the Turkish economy and assess the potential for Cypriot enterprises, we then study in Section 4 the recent macroeconomic performance of Turkey. We also analyse future expectations, focusing on areas that might be of particular interest to Cypriot investors, such as real estate investment, but also other areas of expected growth.

In Section 5, and again in order to assess the potential for a post-solution Cyprus, we analyse the economy in both parts of Cyprus, with particular focus on those sectors which recent macroeconomic performance suggests are the island's five most promising services sectors: tourism, real estate, tertiary education, shipping, and accounting and legal services. We also analyse developments in trade in goods including trade across the Green Line.

Having examined how commercial relations have developed between Greece and Turkey and between Cyprus and Greece/Turkey, having studied the growth potential in Turkey and having identified the key strengths and weaknesses of the main sectors on the island of Cyprus, we then move in Section 6 to quantify, in euros, the annual, recurring "peace dividend" of a reunited Cyprus.

Finally in Section 7, we sketch out some "blue-sky" thoughts: ideas for developments that would help commercial relations really take off between the two countries and in Section 8 we draw our conclusions for the whole paper.

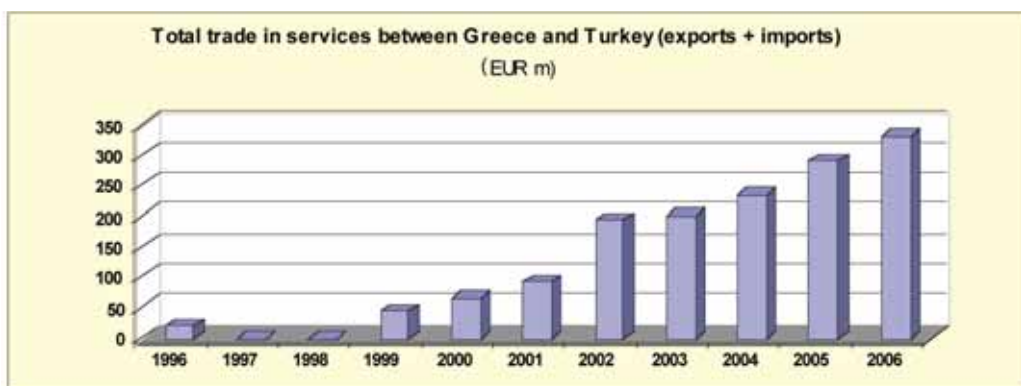
2. GREECE-TURKEY COMMERCIAL RELATIONS SINCE 1999

Rapprochement led to a boom in commercial relations

Both from an historical and from an economic perspective, the year 1999 was clearly a watershed in relations between Greece and Turkey. While the two countries had almost gone to war over the Aegean Islands in 1996, by the end of 1999, a number of events, including the mutual assistance provided after the earthquakes in Izmit and Athens in August and September 1999, had led to an “unprecedented thawing of tensions”.²

This ongoing rapprochement has also led to a boom in commercial relations. Balance-of-payments data for Greece show that exports of services from Greece to Turkey quadrupled between 1999 and 2002 and then nearly doubled again between 2002 and 2006 (see Appendix Table 1). However, the commercial benefit was not only felt by Greece. A similar picture developed with reference to exports of services from Turkey to Greece, with sales of services to Greece more than quadrupling between 1999 and 2002 and then rising by more than one-and-a-half times from 2002 to 2006. As a result, total external transactions of services between Greece and Turkey embarked on a strongly upward trend, rising from a meagre EUR 20.4 million in 1996 and EUR 46.1 million in 1999 to EUR 332.9 million in 2006. Between 1999 and 2006 the annual average increase in services trade between Greece and Turkey was 36.1%. By comparison, total exports of services from these countries to the rest of the world rose by approximately 10% per year in the same period. (See Appendix Table 2.)

Trade in services rose more than sevenfold



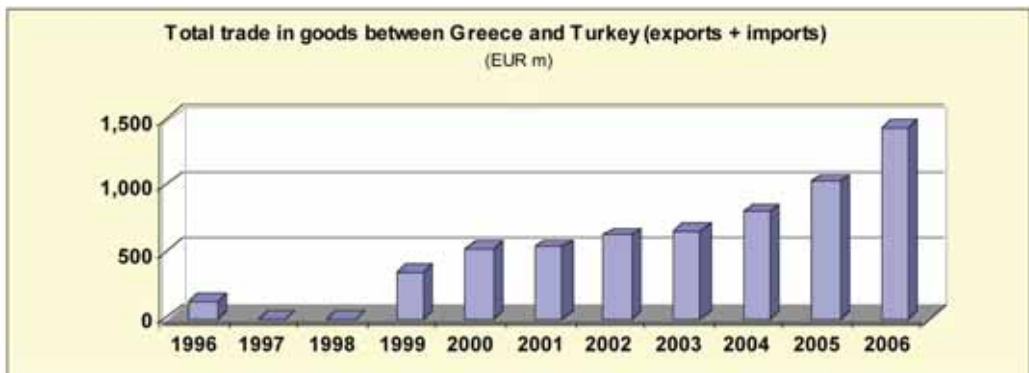
Note: 1997-98 not available.

Sources: Eurostat, Bank of Greece.

² Ker-Lindsay, *Crisis and Conciliation: A Year of Rapprochement between Greece and Turkey*, 2007, page xi.

Trade in goods followed a similar pattern. Exports of goods from Greece to Turkey and exports of goods from Turkey to Greece rose more than fourfold between 1999 and 2006. As a result, total trade in goods between the two countries rose from only EUR 133.8 million in 1996 and EUR 357.0 million in 1999 to EUR 1,446.7 million (EUR 1.4 billion) in 2006—again by four times. The average increase of trade in goods between Greece and Turkey from 1999 to 2006 was 23.2% per year. By comparison, total exports of goods from these countries rose by approximately 15% per year in the same period. In other words, rapprochement appears to have created a strong peace dividend for both countries. (See Appendix Table 3.)

Trade in goods rose more than fourfold



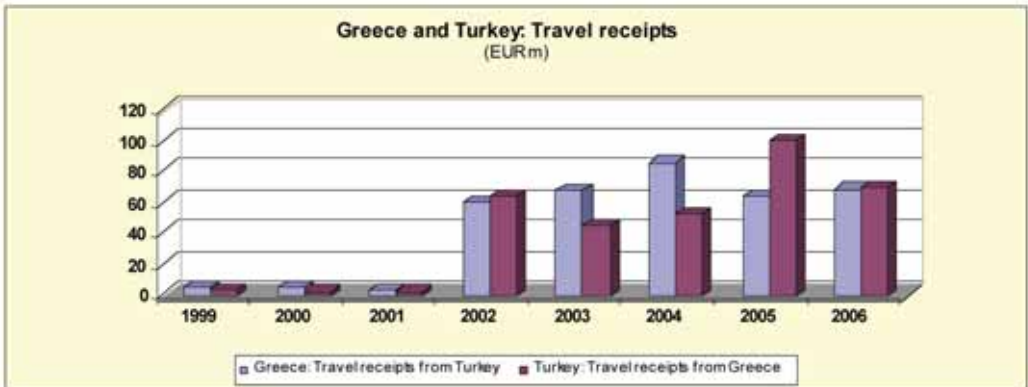
Note: 1997-98 not available.

Sources: Eurostat, Bank of Greece.

The bilateral tourism market is booming

One of the major beneficiaries of the rapprochement between Turkey and Greece has been the tourism sector, a subcategory of services. Greece's travel revenue from Turkey has increased more than 13 times, from EUR 5.1 million in 1999 to EUR 69 million in 2006. Similarly, Turkey's travel revenue from Greece (inferring from Greek data), rose almost 20 times, from EUR 3.6 million in 1999 to EUR 70.2 million in 2006. The total travel market has risen at an astonishing rate of 275.1% per year, from EUR 8.7 million in 1999 to EUR 139.2 million in 2006. (See Appendix Table 4.)

Moreover, data on Greece suggest that business tourism is benefiting as much as leisure tourism from the new relations. Out of a total of EUR 69 million spent by Turks visiting Greece in 2006, EUR 32.3 million was accounted for by business travel and another EUR 35.5 million originated from holiday makers.

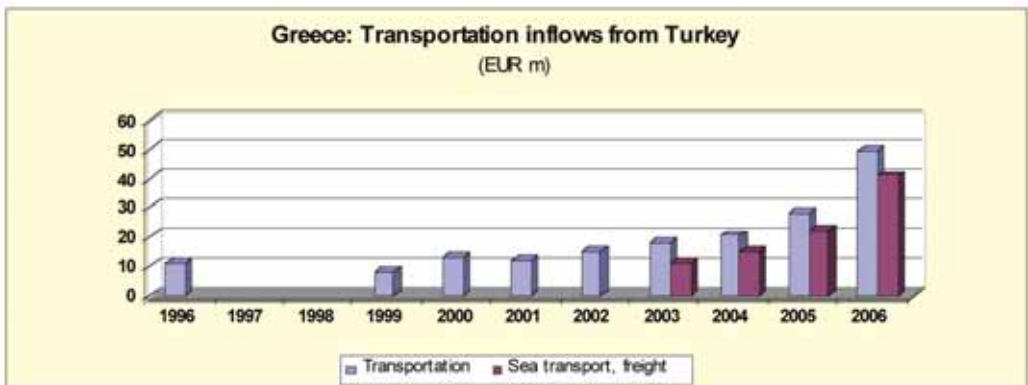


Note: Turkey receipts from Greece derived from Greece debits with Turkey data.

Sources: Eurostat, Bank of Greece.

Greek freight shipping appears to be benefiting

Another services sector which has clearly benefited is transport. Greece's transport revenue from Turkey rose at an annual average rate of 32.2% per year in 1999-2006, while Turkey's transport revenue from Greece rose at an average rate of 35.7% in the same period. Greece's revenue from transportation services increased from EUR 8.2 million in 1999 to EUR 50.2 million in 2006. Data for available years suggest that most of it originated in sea freight transport—EUR 41.4 million in 2006. Greece has the fifth largest shipping fleet in the world.



Sources: Eurostat, Bank of Greece.

GREECE-TURKEY COMMERCIAL RELATIONS SINCE 1999: CONCLUSIONS

The rapid increase in goods and services trade between Greece and Turkey after the rapprochement year of 1999 is strong evidence that as soon as relations between two countries improve at the political level, business follows quickly to profit from the improvement in relations. Moreover, growth in bilateral trade in goods and services far outpaces that of these countries' trade with the rest of the world.

On a net basis, Greece has a current account deficit with Turkey, arising out of significantly higher imports of goods than exports, while trade in services is more or less balanced. However, the benefits to Greece and Turkey are more widely felt than looking at the net balances from a macroeconomic perspective. First, because imports also generate business for shippers, importers, insurers, banks and distributors. Second, and more importantly, because the improvement in political and economic relations with Turkey has opened wider opportunities for investment in Greece and Turkey from the rest of the world as the two countries become hubs for trans-European energy and road networks. The more Greece and Turkey do business with each other, the more investment they appear to attract from the rest of the world. As will be discussed in Section 5, between 1999 and 2006 foreign direct investment into Greece rose by 8 times and into Turkey 19 times, compared with only 1.6 for Cyprus. Our assessment of how Cyprus can benefit in terms of investment and new business from a rapprochement with Turkey will be outlined in Section 6.

3. COMMERCIAL RELATIONS BETWEEN CYPRUS AND GREECE/TURKEY

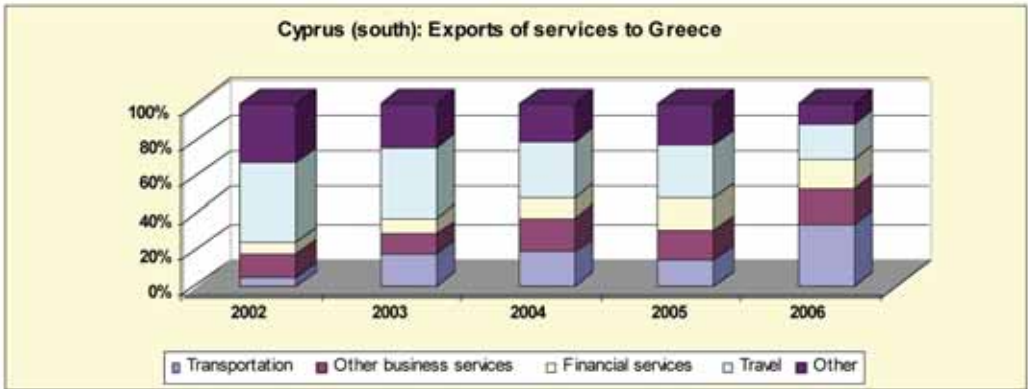
THE SOUTH'S COMMERCIAL RELATIONS WITH GREECE

As well as the development of commercial relations between Greece and Turkey after rapprochement in 1999, commercial relations between the southern part of Cyprus and Greece on the one hand, and the northern part of Cyprus and Turkey on the other can be considered as another proxy of how relations might develop between a reunited Cyprus and Turkey after reunification. Trade between the southern part of Cyprus and Greece has accelerated since 2002 (the earliest available data). Exports of services from Cyprus (south) to Greece have nearly quadrupled in four years, accelerating particularly quickly after entry in the EU. In 2004-06 exports of services rose at an annual average rate of 47.4%.

Cyprus (south): Trade flows with Greece CYP m	2002	2003	2004	2005	2006
Goods, exports	42.5	43.8	65.0	82.0	86.1
% change		3.1	48.4	26.2	5.0
Goods, imports	237.3	275.8	405.6	506.8	559.8
% change		16.2	47.1	25.0	10.5
Services, exports	73.6	84.8	112.8	159.2	271.8
% change		15.2	33.0	41.1	70.7
Services, imports	121.0	187.5	240.8	296.8	321.8
% change		55.0	28.4	23.3	8.4
Total goods & services					
Exports	116.1	128.6	177.8	241.2	357.8
Imports	358.3	463.3	646.4	803.5	881.6
Net	-242.3	-334.7	-468.6	-562.3	-523.8

Sources: Central Bank of Cyprus, Statistical Service.

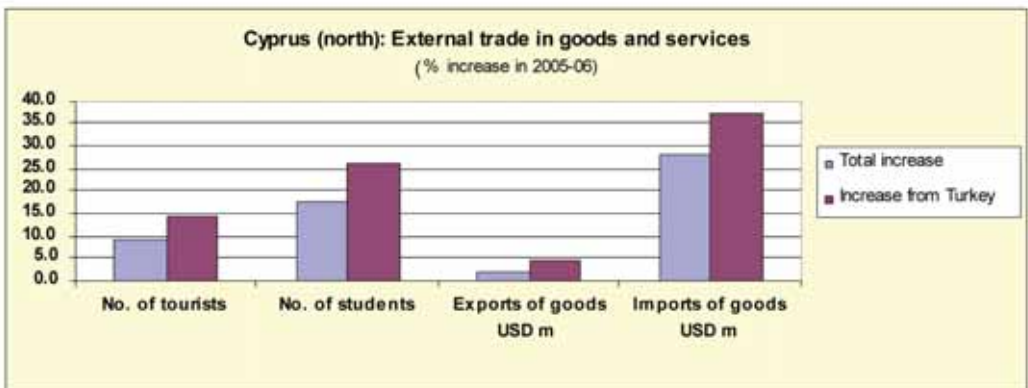
Growth emanates mainly from the rapid increase in transportation, financial and other business services, while travel retains a significant proportion of the total. In 2006 transportation accounted for 34% of exports, travel for 20%, other business services (mainly accounting, legal and merchanting services) for 20% and financial services for 15%. These are also the service sectors that can be expected to gain the most from rapprochement with Turkey.



Sources: Central Bank of Cyprus, Statistical Service.

THE NORTH'S COMMERCIAL RELATIONS WITH TURKEY

As discussed in Section 5, commercial relations between the northern part of Cyprus and Turkey have become much closer since the European Court of Justice ruling in 1994 which effectively cut off alternative export markets. Just over half of all exports of goods go to Turkey. The largest export of northern Cyprus is processed agricultural goods (a total USD 28 million per year), followed by citrus fruits (USD 20 million) and clothing (USD 10 million). Some 80% of all tourists come from Turkey and around two-thirds of foreign students. However, while this is currently a reflection of dependence, it could be a significant advantage in the event of reunification, given the common language and the expansion of export opportunities from the whole island and the faster growth of the Turkish market relative to other markets.



Source: State Planning Organization.

COMMERCIAL RELATIONS BETWEEN CYPRUS AND GREECE/TURKEY: CONCLUSIONS

If one tries to draw conclusions for a reunited Cyprus, it is obvious that while a deficit should certainly be expected on trade in goods with Turkey, the services sector of Cyprus has such growth and export potential that a surplus on the services account (such as is currently enjoyed by the southern part of Cyprus with the rest of the world) with Turkey should be expected. Indeed, in both parts of Cyprus, income generated from services plays an important part in stabilizing the balance of payments.

4. MAIN GROWTH OPPORTUNITIES IN TURKEY

In order to assess how a reunited Cyprus might benefit, as Greece has evidently done, from rapprochement with Turkey, we shall now analyse the prospects for the Turkish economy in the medium term. At present, the Turkish market is all but cut off from the southern part of Cyprus. Yet the Turkish economy, with a population of some 73 million, is a very large market, with GDP amounting to USD 403 billion (EUR 315 billion) in 2006, compared with EUR 14.5 billion for the southern part of Cyprus and only EUR 2 billion for the northern part. According to the World Bank's global rankings for 2006, the Turkish economy is the 8th largest in Europe including Russia and the 17th largest in the world.

Turkey's economy has stabilized

The Turkish economy in the past few years has been an emerging market success story that has inevitably attracted the attention of many investors. The macroeconomy has stabilized remarkably since the crisis of 2001, in which there was a 50% devaluation of the currency, a collapse of the banking sector, a 6.7% contraction of real GDP, an inflation rate of 70% and a net public debt to GNP ratio which exceeded 90%. As a result of the crisis, the government adopted a reform programme for the period 2002-2004 under the auspices of the International Monetary Fund (IMF) and the World Bank. With these reforms, real GDP growth has accelerated, reaching 7.4% in 2005 and 6.1% in 2006.

The main reason behind stronger growth is the strong fiscal performance, with a significant improvement in the public finances. For example, the general government budget deficit was cut from 13.6% of GDP in 2002 to a small surplus of 0.2% of GDP in 2005 (or 0.4% by 2006, according to EU definitions). Another important factor has been the EU's decision in December 2004 to launch accession negotiations which began in October 2005. These have had a positive impact on the Turkish economy as greater business confidence has led to a surge in both domestic and foreign direct investment (FDI)—see below. Moreover, there is consensus that strong growth will continue.

Turkey: Macroeconomic forecasts	2005	2006	2007	2008	2009
Real GDP growth (% change)					
IMF October 2007	7.4	6.1	5.0	5.3	n.a.
European Commission November 2007	7.4	6.1	5.1	5.8	6.5
Economist Intelligence Unit November 2007	7.4	6.1	5.2	5.1	5.4
Turkey State Planning Organization December 2007	7.4	6.1	5.0	5.5	5.7
Consumer price inflation (% change)					
IMF October 2007	8.2	9.6	8.2	4.6	n.a.
European Commission November 2007	8.1	9.3	7.6	5.9	5.0
Economist Intelligence Unit November 2007*	10.1	10.5	8.5	6.1	4.4
Turkey State Planning Organization December 2007	7.7	9.6	6.6	4.1	4.1
Budget balance (% of GDP)					
IMF October 2007	n.a.	n.a.	n.a.	n.a.	n.a.
European Commission November 2007	-0.3	0.4	-0.7	0.2	1.3
Economist Intelligence Unit November 2007	-1.7	-0.7	-2.8	-2.7	-2.6
Turkey State Planning Organization December 2007	0.2	-2.8	-2.2	-1.6	-2.7
Current-account balance (% of GDP)					
IMF October 2007	-6.2	-7.9	-7.5	-7.0	n.a.
European Commission November 2007	-6.7	-7.8	-7.9	-6.8	-9.3
Economist Intelligence Unit November 2007	-6.2	-7.9	-7.3	-7.4	-6.4
Turkey State Planning Organization December 2007	-6.4	-8.2	-7.4	-7.5	-7.2
*Based on 2000=100 index.					
Sources: IMF database; European Commission Autumn Forecast;					
Economist Intelligence Unit Country Forecast November 2007;					
State Planning Organization Pre-Accession Programme 2007.					

According to projections made by the IMF, the European Commission, the Economist Intelligence Unit (EIU) and the Republic of Turkey State Planning Organization (SPO), real GDP growth is expected to be well above 5% in 2008-2009. Inflation is expected to be much lower than in the crisis period of 2001, at between 4% and 6%. This is a very important development, since experience suggests that containing inflation is the key to macroeconomic stability in any economy. Although the ratio of current-account deficit³ to GDP is expected to remain high, at around 7% to 7.5% in 2008-09, the surge of foreign exchange income in the form of FDI (see below) means that this is less of a destabilizing factor than it would have been in the past.

Turkey is a large market for goods and services

During this period Turkey has also seen a strong performance in foreign trade, especially in exports. According to the World Trade Organization⁴, export growth in Turkey was the fifth

³ A current-account balance is net imports of goods and services, net income from interest, profits and dividends and net transfers (for example, emigrants sending money back home).

⁴ World Trade Organization, *Annual Report 2006*.

fastest in 2006. According to data from the Turkish Statistical Institute, exports of goods from Turkey rose from USD 73.5 billion in 2005 to USD 85.5 billion in 2006, or by 16% in dollar terms. The share of the EU in Turkish exports is around 56%. Germany is the primary market, followed by the UK, Italy and the US. (See Appendix Table 6.)

With such a large population, Turkey has also become an increasingly important export market for other countries. According to balance-of-payments data, Turkish imports rose at an annual average rate of 28.7% (in dollar terms) between 2002 and 2006. They rose from USD 116.8 billion in 2005 to USD 139.5 billion in 2006. The EU is the main supplier, with 40% of imports coming from the EU. According to the World Trade Organization's *Trade Profiles*, Turkey was the world's 22nd largest market for goods and the 41st largest market for services in 2006.



Source: Turkish Statistical Institute.

FDI is increasing at a rapid pace

Turkey's implementation of structural reforms, macroeconomic stability and strong economic performance is creating many opportunities for foreign investors, especially after the implementation of new Law on Foreign Direct Investment of 5 June 2003. The main aim of the law has been to encourage foreign investors by improving the investment climate and minimizing bureaucratic procedures. Before the new law, there were a number of bureaucratic restrictions and administrative barriers to foreign direct investment (FDI). Therefore, when the law entered into force, a new era for foreign investment was created. One of its key features is that the new law treats equally both foreign and domestic investors. In addition, the system changed from a screening to monitoring system in the field of FDI. The most important features of the new law are as follows:

- Freedom to invest by dropping all former FDI-related screening, approval, share transfer and minimum capital requirements
- Reassurance of existing guarantees to foreign investors of their rights in one transparent and stable document

- Upgrading to accepted international standards the definitions of “foreign investor” and “foreign direct investment”
- A policy shift from ex-ante control to a promotion and facilitation approach with minimal ex-post monitoring in order continuously to create and improve an investor-friendly climate for growth and development, protecting the acquired rights.⁵

As a result of these and other reforms, and perhaps also because of EU accession negotiations,⁶ inward FDI has increased dramatically, especially since 2004. While cumulative inward FDI between 1996 and 2004 reached just USD 13.2 billion, in 2006 alone FDI reached USD 20.1 billion. Of this total, approximately USD 2.6 billion (just over EUR 2.0 billion) came from Greece, primarily as a result of the purchase of a strategic 46% stake in Turkey’s Finansbank by National Bank of Greece. According to newspaper reports, the value of the deal was USD 2.4 billion. Indeed, among foreign investment stocks by country (cumulative foreign investment), Greece now ranks among the top ten investors in Turkey.



Source: Central Bank of Turkey.

As part of its foreign investment strategy the Turkish government established a “Coordination Committee for the Improvement of the Investment Climate”. The Committee was composed of relevant ministers, representatives of the private sector and related non-governmental organizations. This Committee focused primarily on eliminating red tape and other bureaucratic barriers to foreign investment. Another body, called the Investment Advisory Council, is chaired by the prime minister. The Council is composed of the heads of international companies, four leading business associations in Turkey, the IMF and the World Bank.

⁵ Undersecretariat of the Treasury’s General Directorate of Foreign Investment.

⁶ ‘The impact of EU accession prospects on FDI inflows to central and eastern Europe’, Bevan et al, 2001.

Turkey: Foreign direct investment stocks by country		
USD m	2000	2006
Netherlands	7,500	18,538
United Kingdom	1,949	7,349
France	1,608	7,332
Germany	2,189	7,239
Belgium	223	5,794
Finland	34	5,715
USA	2,245	4,541
Italy	998	4,412
Greece	10	2,832
Luxembourg	239	2,010
Total	19,209	86,818
of which: Europe	15,850	69,482

Source: Turkish Statistical Institute.

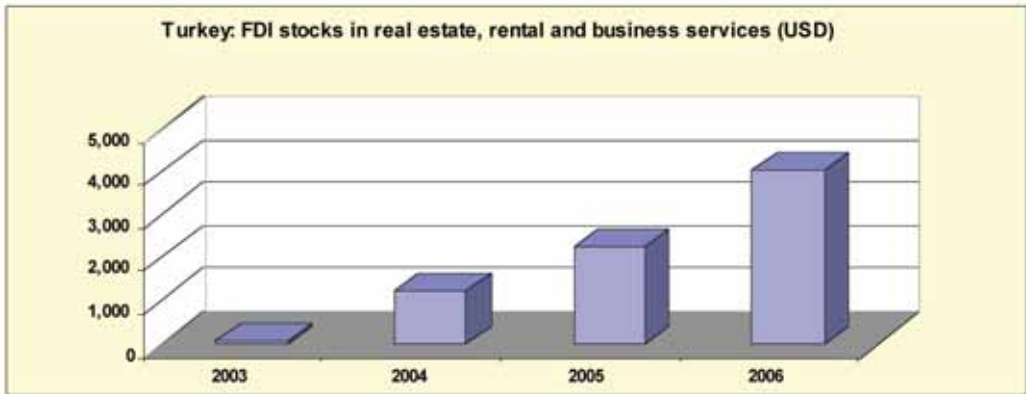
While the Coordination Committee is the internal platform that utilizes its public-private partnership to resolve issues related to the investment climate, the Council is the international platform. The Council meets once a year to overview the progress made on the priorities which it has identified. The main aim of both bodies is to identify the priority issues to be addressed in order to attract investment into the country. Another important development was the creation of the Investment Support and Promotion Agency of Turkey.⁷

Finally, in 2006, the corporate tax rate was reduced from 30% to 20% with the enactment of new Corporate Tax Law on 21 June 2006 in Turkey. According to the A.T. Kearney Foreign Direct Investment Confidence Index for 2005, Turkey jumped to the 13th most attractive market in 2005 from a place below 25 previously. In sum, all levels of government are now highly focused on attracting FDI. For countries like Turkey (and Cyprus) which run large current-account deficits, FDI is the most stable form of financing.

New interest in real estate

As well as interest in banking and telecoms by larger investors, one of the fastest growing sectors of interest for smaller foreign investors has been investment in real estate. According to data from the Central Bank of Turkey, FDI stocks in real estate, rental and business activities more than doubled between 2003 and 2005 from only USD 93 million (EUR 80 million) in 2003 to USD 4.1 billion (EUR 3.2 billion) in 2006. Greek investment in real estate has also been rising at a fast pace, albeit from a low base. Greek investment in Turkish real estate rose from EUR 0.2 million in 2005 to EUR 3.4 million in the first nine months of 2007, according to data from Bank of Greece. Based on the above figures, we estimate that cumulative real estate investment by Greece into Turkey in 2007 accounted for approximately 10% of all foreign real estate investment into Turkey in the same period.

⁷ <http://www.invest.gov.tr/>



Source: Central Bank of Turkey.

Rental yields on the coast are said to be very high

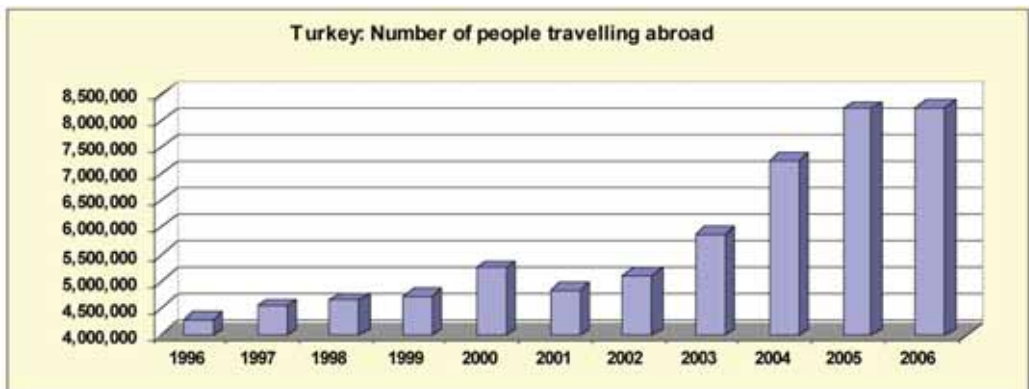
One of the reasons for very high interest in Turkish real estate since the foreign investment regime was liberalized is the high rental returns. According to data from Global Property Guide, rental yields on the Turkish coast range between 12.6% and 16.0%. This is considerably higher than in comparable locations of Cyprus, Greece, Bulgaria and even Romania. This is an opportunity that will reduce in value over time, as prices in Turkey catch up with competitor destinations.

Comparative annual rental yields	range in %
Turkey	
Coastal	12.6 - 16.0
Ankara suburbs	11.5 - 12.0
Ankara central	7.0 - 9.5
Istanbul suburbs	7.5 - 8.8
Istanbul central	6.0 - 7.6
Romania	
Bucharest suburbs	8.2 - 10.6
Bucharest centre	7.8 - 8.4
Houses with grounds	9.8 - 10.3
Bulgaria	
Sofia Central	5.9 - 7.0
Greece	
Main island properties	5.1 - 6.0
Athens suburbs	6.0 - 6.6
Athens	5.5 - 6.9
Cyprus (south)	
Limassol	4.3 - 5.5
Larnaca	3.8 - 4.6
Paphos	4.5 - 5.5

Source: Global Property Guide.

More Turks are travelling

One of the reasons why the travel market between Greece and Turkey has grown so much is because of a growing middle class in Turkey, whose incomes have been supported by macroeconomic stability and strong economic growth. This is reflected in the outgoing tourism statistics, which show that more and more Turkish people go abroad for vacation, especially since 2001. Whereas in the economic crisis year of 2001, there was an 8% decrease in the number of outgoing tourists, this figure increased by 5.6% in 2002 and in 2004 leapt by 23.7%. By 2006, the number of outgoings had reached approximately 8 million people. According to the statistics, EU countries are the most popular destinations for Turkish travellers.



Source: Turkish Statistical Institute.

MAIN GROWTH OPPORTUNITIES IN TURKEY: CONCLUSIONS

Clearly the size of the market in Turkey, the improvement of the foreign investment climate and the increase in personal disposable incomes present a wide range of opportunities for those doing business with Turkey in the medium term. However, as Greek businesses have already realized, the biggest gains in an emerging market are to be made in the early period. For example, while Turkish rental yields appear to be highly profitable at present, they will eventually ease to levels seen elsewhere in Europe. More generally, as the Turkish economy matures, economic growth will slow and the profit growth of businesses trading with, or investing in, Turkey, will also decelerate, although it is unlikely to decline. In sum, the earlier Cypriot businesses can start trading with Turkey, the higher the benefits they can reap.

5. KEY SECTORAL TRENDS IN CYPRUS

A. MACROECONOMY

In order to assess the business potential for a post-solution Cyprus, we shall now analyse the economy in Cyprus. After a discussion of the macroeconomy on both sides of the island, we shall then focus on those sectors which recent macroeconomic performance suggests are the island's five most promising services sectors. These are tourism, real estate, tertiary education, shipping, and accounting and legal services. We shall also discuss developments in trade in goods.

In the south, the macroeconomy is stable

The macroeconomy in the south of the island has been stable, underpinned by the Cyprus pound's peg to the euro (formerly the ecu), which was in force from 1992 until the adoption of the euro in January 2008. The real GDP growth rate averaged 3.2% per year in 2002-06, largely as a result of strong growth in domestic demand, which has been fuelled by fast growth in credit. The Statistical Service estimates that real GDP growth reached 4.4% in 2007. The public-sector deficit has also been declining. After a sharp rise in public-sector spending in 2002-03, the government budget deficit has fallen every year since, and is expected to have recorded a surplus of 1.5% of GDP in 2007. Inflation has been well below 3% in 2004-06 (although it is now on the rise, reaching 3.9% at the end of 2007). These developments allowed Cyprus to receive approval in July 2007 to adopt the euro as its national currency on 1 January 2008.

However, strong demand for imported goods, combined with declining income from tourism (as a proportion of GDP), has pushed up the current-account deficit sharply since 2003. It rose from 2.2% of GDP in 2003 to 5.9% of GDP in 2006 and could have exceeded 7% of GDP in 2007. A current-account deficit needs to be financed by inflows of foreign currency, either in the form of portfolio investment (such as purchases of shares and bonds), foreign direct investment (such as investment in factories or large stakes in companies), or by other inflows such as bank deposits. To date, the current-account deficit in the southern part of the island has been covered by very large net inflows of bank deposits by non-residents (the traditional offshore sector).

Cyprus (south): Main macroeconomic indicators						
	2001	2002	2003	2004	2005	2006
Real GDP growth (%)	4.0	2.0	1.8	4.2	3.9	3.9
Consumer price inflation (%)	2.0	2.8	4.1	2.3	2.6	2.5
Budget deficit (% of GDP)	-2.2	-4.4	-6.3	-4.1	-2.3	-1.5
Current-account balance (% of GDP)	-3.3	-3.7	-2.2	-5.0	-5.6	-5.9

Source: Statistical Service.

But foreign direct investment is underperforming

Therefore, although the economy is currently stable, the rising current-account deficit raises questions about the long-term sustainability of growth in the southern part of the island, especially when this deficit depends for financing on bank deposits, which can be withdrawn easily, rather than foreign direct investment (FDI), which is considered a more stable form of financing. One can see by comparing FDI inflows into Cyprus with those into Turkey and Greece, that Cyprus is under-performing in attracting FDI. While investment into Greece rose more than eightfold in 1999-2006, and investment into Turkey rose by more than 19 times, investment into Cyprus rose by only 1.6 times in the same period.

Certainly the division of the island has a negative impact on investors' perceptions. The Economist Intelligence Unit's Business Environment Rankings, which measure the attractiveness of the business environment to foreign investors, places Cyprus 15th out of 18 European countries. One of the key reasons cited is "no market access to Turkey—the Middle East's nearest, largest and potentially most lucrative market".⁸ Owing to the division of the island, Cyprus is also given the lowest political risk score among all EU member states.

Inward direct investment									
EUR bn	1999	2000	2001	2002	2003	2004	2005	2006	Increase in 7 years
Greece	0.5	1.2	1.8	0.1	1.1	1.7	0.5	4.3	x 8.1
Turkey	0.8	1.0	3.9	1.0	1.4	2.1	8.2	15.2	x 19.1
Cyprus	0.8	0.9	1.0	1.1	0.8	0.9	0.9	1.2	x 1.6

Sources: Bank of Greece; Central Bank of Cyprus; Central Bank of Turkey.

And there are questions about longer-term sustainability

A rising current-account deficit and under-performing FDI raise questions about the long-term sustainability of economic growth. As mentioned above, much of the growth in recent years has depended on consumer spending and property purchases, rather than on tourism or exports. For example, retail sales volumes increased by 8.6% in 2006 and by 7.5% year-on-year in the first nine months of 2007. Building permits rose in value by 8.1% in 2006 and by 17.3% year-on-year in the first eight months of 2007. At the same time, however, some key export-oriented sectors declined. For example, arrivals of tourists fell by 2.8% in 2006 and

⁸ Economist Intelligence Unit, *Cyprus Country Forecast* (main report), May 2007, page 11.

rose by only 0.5% year-on-year in the first 11 months of 2007. Exports of goods fell by 9.5% (in value terms) in 2006 and declined by 2.1% in January-August 2007, although domestically produced exports increased, thanks in large part to a strong pharmaceuticals sector.

Consumer spending has been driven by very high rates of lending growth. Bank credit to the private sector rose by 13.1% in 2006 and by 25.8% year-on-year in the first 11 months of 2007, compared with only 6.2% in 2005. To fund this spending, banks have also borrowed heavily abroad. Thus, much of the growth in the southern part of Cyprus over the past few years can be explained by a rapid increase in credit. Growth of credit will eventually find a limit when borrowers can no longer afford the repayments implied by taking on more debt. In addition, banks' willingness to lend may be negatively affected in the coming months as they feel the global impact of the US subprime mortgage crisis, which has raised the costs of borrowing for commercial banks.

Another long-term concern is that despite its low tax regime, the southern part of Cyprus also scores badly on many competitiveness indicators. It is only 23rd in the EU27 in the World Economic Forum's *Global Competitiveness Report 2007-2008*, and is 55th out of 131 countries. Moreover, it has slipped, from 49th in the previous year. Competitiveness will probably weaken in the next 18 months as exports and tourism may suffer again from the rising value of the euro against both the dollar and sterling. Much Russian investment is dollar-based and more than half of tourists in the south of the island come from the UK.

Finally, although the southern part of Cyprus enjoys a low unemployment rate by European standards, at 4.8% according to the Labour Force Survey in 2006, unemployment among the young is more than double that rate, at 10.1% in 2006. Moreover, it has not fallen as fast as the overall unemployment rate in 2007. The overall unemployment rate was 4.1% in the first half of 2007 but the unemployment rate among 15-24 year-olds was 10%.

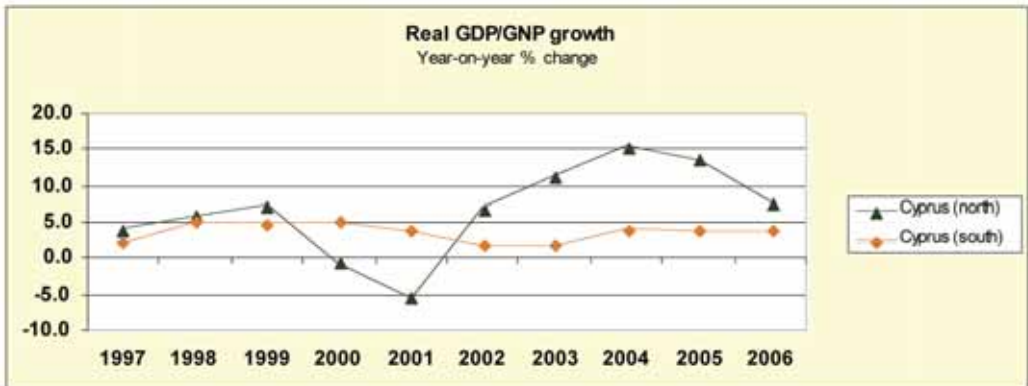
In the north, GDP growth has risen very fast

Economic growth in the northern part of Cyprus has been much faster than the south in recent years. Real GNP growth grew at an annual average rate of 13.0% in 2002-06, compared with just 3.2% (real GDP growth) in the south. This has had a dramatic impact on income convergence between the two parts of the island. In 2002, incomes in the north were less than 30% of those in the south. But by 2006 they were just under 50%. (See Appendix Table 8.)

Growth has been spurred by three key developments. First, it has been driven by the stabilization of the Turkish lira since a large devaluation in early 2001, which has reduced inflationary pressures. The lira is the de facto currency of circulation in the north and it has been on an appreciating trend against the dollar since 2002. The lira has also been fairly stable against the euro compared with previous years. When a currency rises in value, this puts downward pressure on prices because fewer units of local currency are needed for every dollar's worth of imports. A second key reason is the boom in construction that accelerated both before and after the UN reunification plan in April 2004. Properties which were identified

as remaining under Turkish Cypriot control gained in value even before the referendum⁹, while many saw the Greek Cypriot rejection of the plan as a sign that the division of the island was permanent, and this also encouraged the sale and development of Greek Cypriot titled property. A third reason given¹⁰ for the strong growth rate has been continued growth in public spending, while the strong education sector (see below) has also played a part.

More than 50% of GDP is generated by the service sector. Net revenues from tourism and higher education have compensated for the trade and current-account deficits in recent years.



Sources: Statistical Service, State Planning Organization.

But there are many structural problems

Despite very strong growth rates in recent years, the economy in the northern part of the island has some serious handicaps, caused by both restrictions on international commerce and by inherent structural problems, which raises questions about how long such growth rates can be maintained. As far as external transactions are concerned, the cost of trade in goods and services is significantly increased (see below) as a by-product of the fact that Ercan/Tymbou airport and Gazimagusa/Famagusta and Girne/Kyrenia ports do not enjoy international recognition and therefore trade in both goods and services is conducted via Turkey. This has made the economy more and more dependent on Turkey over the years and also has a knock-on effect on price levels. At the same time, the north lacks the kind of strong incentives to reform which Turkey and the southern part of Cyprus have experienced in recent years (such as full membership of the EU or IMF support). The economy therefore remains unreformed, and highly dependent on spending by an inefficient public sector.¹¹ As enforcement of tax-collection is weak, public-sector spending is largely subsidized by transfers from Turkey. One reflection of the economy's structural problems is the large and growing current-account deficit.

⁹ *The Property Regime in a Cyprus Settlement*, Platis, Orphanides and Mullen, PRIO, Oslo, 2006.

¹⁰ "Contemporary issues in the Turkish Cypriot economy", speech by Vargin Varer, published in edited form in *Economic Perspective in Cyprus: The Path Towards Reunification*, PRIO Cyprus Centre, Nicosia, 2007.

¹¹ World Bank, *Sustainability and Sources of Economic Growth in the Northern Part of Cyprus*, June 2006.

Cyprus (north): Main macroeconomic indicators							
	2000	2001	2002	2003	2004	2005	2006
Real GDP growth (%)	-0.6	-5.4	6.9	11.4	15.4	13.5	7.8
Consumer price inflation (%)	53.2	76.8	24.5	12.6	11.6	2.7	19.2
Budget deficit (% of GDP)	-6.6	-2.5	-2.4	0.4	0.6	1.4	-2.5
Current-account balance (% of GDP)	-3.2	-1.9	1.5	1.5	-0.8	-11.9	-10.7

Source: Statistical Service.

And lack of competition keeps prices high

It is a common assumption that because incomes in the northern part of the island are on average lower than in the southern part of the island, prices of goods should also be lower. However, this is not the case. As a result of restrictions on international commerce, businesses in the north face huge challenges in attempting to reach global markets. Business is therefore mainly restricted to a few suppliers of imports and limited export markets, which reduces competition. As a small island economy the north has to import its raw materials, prices of which can also be volatile. Therefore the few suppliers who do trade with the north try to maximize profits in order to compensate for the risks they are taking and, given that competition is limited, they are able to apply a large profit margin. Thus, importing goods into northern Cyprus costs more compared with neighbours. According to recent research by the KOBİ Center, it is estimated that freight prices in the north are 30% higher than the south.¹² The restrictions on external transactions also affect the transportation sector. Limited transportation choices lead to higher costs of local production. As a consequence, consumer prices are also generally higher than prices in the south, especially in the case of goods.

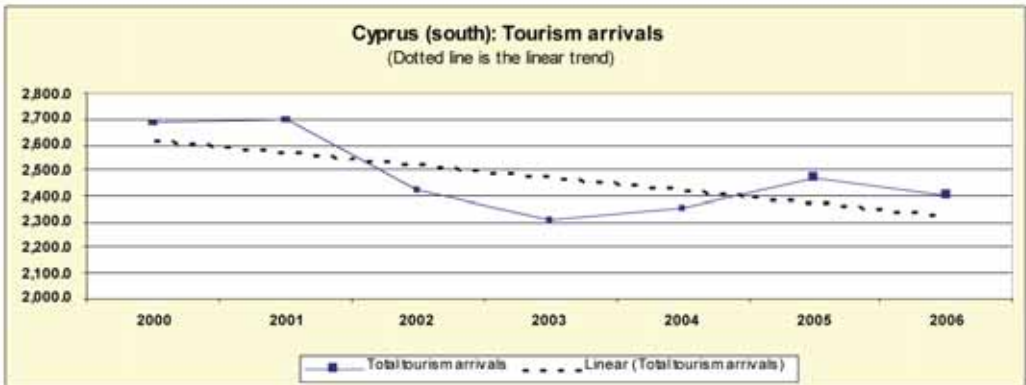
Within the domestic market, there is also lack of competition. In the absence of competition policy and a law to regulate the free market and state aid, private-sector businesses do not enjoy a level playing field. This distorts the market and is another cause of high prices in the economy. With price and other disadvantages that the north economy is facing, consumption has recently shifted towards to the southern part of Cyprus. According to studies on credit-card spending undertaken by the Merkez Bankası (central bank), it is estimated that Turkish Cypriot credit-card spending in the south amounts to an average USD 5 million dollar per month—that is without including cash spending. By contrast, Greek Cypriot credit-card spending in the north amounts to only USD 1 million per month.

¹² Benter, Selcuk, Transportation in Cyprus, KOBİ Center, June 2006.

B. TOURISM

In the south, tourism is struggling

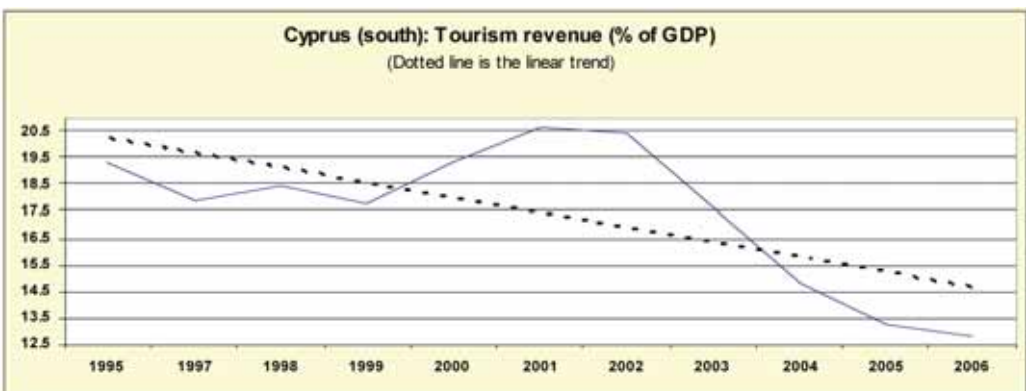
In the southern part of Cyprus, tourism has been struggling since 2002. Arrivals and revenue have been on a downward path overall, having not yet recovered to the levels reached in 2001. Indeed, in 2006, the number of arrivals (2.4 million) was still more than 10% lower than in 2001 (2.7 million), while revenue was more than 19% lower.



Source: Statistical Service.

Revenue is falling as a percentage of GDP

Since revenue has been on a declining trend in nominal terms, it has fallen even more dramatically as a proportion of GDP. Overall, the contribution of the sector to the generation of value added has been declining since 2001-2002. As indicated above, this has also driven the current-account deficit to unsustainably high levels, and is indicative of the decreasing competitiveness of the economy. (See Appendix Table 9).



Source: Central Bank of Cyprus.

Tourism in the south has lacked investment

One of the key reasons for poor performance is the downgrading of a tourism product which is also associated with lacking investment in infrastructure in the last five years. More specifically, there has been no investment in public transport to facilitate the movement of tourists around the island (including from the airports); the delay in introducing airline competition kept air fares rather high; and until very recently the airports themselves were poorly equipped for the expectations of today's tourists.¹³ Plans to attract higher-spending tourists (such as building marinas or golf courses) have been subject to repeated delays. The development of golf courses has in any case been hampered by the fact that Cyprus is a drought-prone island and there has been no investment in the enhancement of the water supply. The island has only two desalination plants (plus a third in the Sovereign Base Areas) but despite repeated pledges, not even one additional desalination plant has been constructed in the past five years. Lack of public transport and little investment in solar energy is also leading to increasing problems of congestion, road accidents and pollution and keeps the economy highly dependent on expensive imports of oil for electricity generation. This, in turn, hurts the competitiveness of the tourism product that is already struggling.

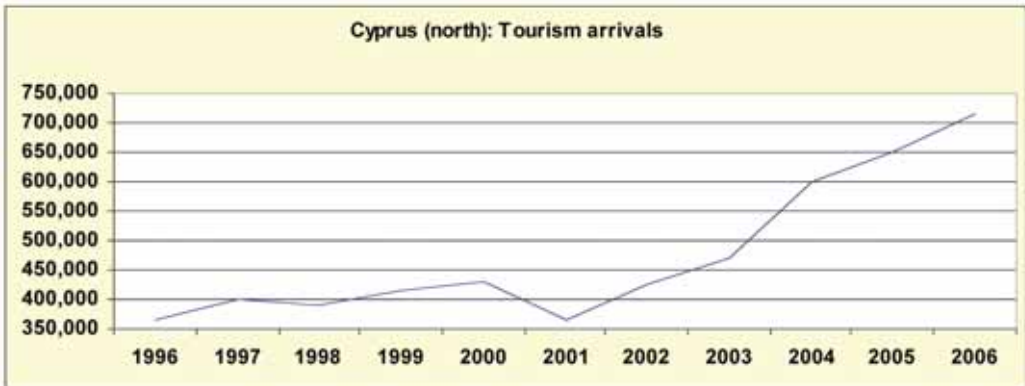
However, even if these issues were addressed by the government, it is also obvious that the current de facto division of the island is severely hurting the performance of the tourist sector. It limits the geographical scope offered to the visitor, which makes the product much less attractive, while the fragmentation and lack of coordination of the two communities over improving infrastructure and with respect to the content of the tourism product undermines its quality and hence its attractiveness.

What is required is a redefinition of the tourism product to widen its scope beyond the traditional sea and sun elements to include the island's historical and cultural heritage, its natural landscape features and activities compatible with different age and income groups. Prospects for the tourism sector under a reunited island scenario will be discussed more fully in Section 6.

In the north, tourism is rising fast

While tourism arrivals in the southern part of the island have been on a downward trend since 2001, the reverse is true for the northern part of the island. Arrivals rose from 435,556 in 2002 to 715,749 in 2006. This is despite the fact that there are no direct flights to the north and tourists must arrive via Turkey, which adds to costs and flying time. The main tourist market is Turkey, the only country which has direct access to the north. This makes the north a more competitive place for the rising number of Turkish travellers.

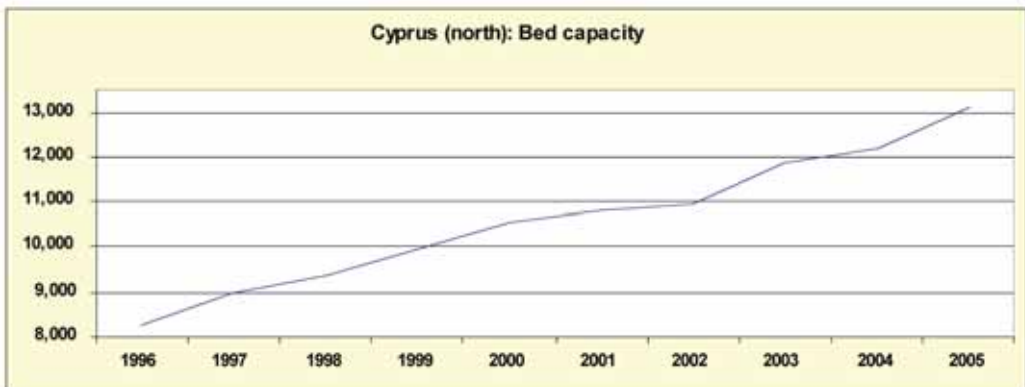
¹³ In 2004, Larnaca airport was voted the "most disappointing airport" in the Telegraph Travel Awards of 2004 conducted by the *Daily Telegraph*.



Source: State Planning Organization.

Bed capacity is increasing

One of the reasons why tourism has been able to expand is that bed capacity has increased from a low base, partly owing to the fact that the authorities in the north took some measures in order to attract and encourage the investment in the tourism sector. As a result of these measures bed capacity has increased, reaching 15,816 as of August 2007, an increase of 46% compared with the 10,798 beds in 2001.



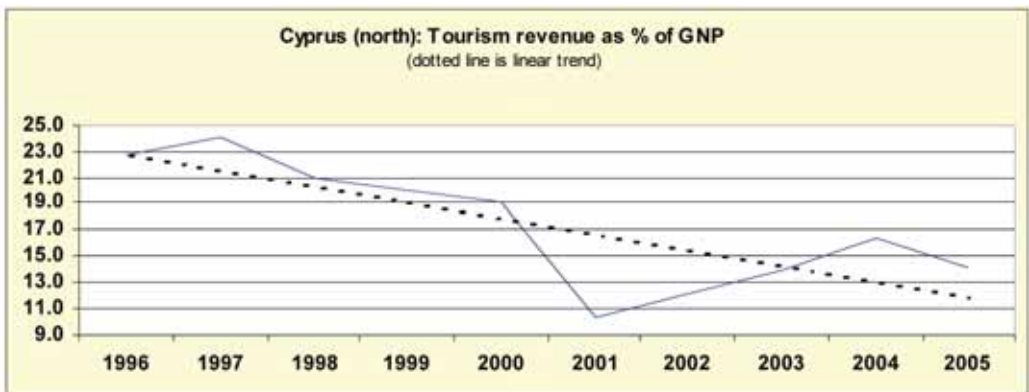
Source: State Planning Organization.

But revenue as % of GDP is also on a declining trend

However, the tourism sector in the north is not without its problems either. While net tourism revenues increased by 61.2% in 2004 to reach USD 288.3 million (EUR 227.5 million), or 16.3% of GDP, net tourism revenue entered a downward trend as a proportion of GDP thereafter. Although in nominal terms, net tourism revenue rose in 2005 to reach USD 328.8 million in 2005, it declined as a proportion of GDP to 14.1%. In 2006 it is expected to be only 11% of GDP. Moreover, the percentage of net tourism revenue covering the trade deficit is also estimated to have decreased from 28% in 2005 to 23% in 2006.

While the tourism remains one of the main foreign income sources of revenue, net revenue from tourism seems to be stagnating as a result of the abovementioned increase in capacity. As more hotels are built, occupancy rates fall. Another reason behind the decrease in revenue relative to arrivals is that the data on the number of arrivals also include students, who come to study at the universities in north.

A third reason for falling official revenue figures is that many visitors from UK, which is the second largest tourism market after Turkey, have bought houses in the north. These are used either as own accommodation or they are marketed as an accommodation unit to other tourists. These unregistered units are not counted in the bed capacity figures and, as in the southern part of the island, it is likely that spending by these kinds of visitors is not fully captured in tourism revenue figures.



Source: State Planning Organization.

C. REAL ESTATE

Real estate has been booming in the south

The real estate sector has been booming in the southern part of the island in the past few years, thanks to a range of developments, including falling official and commercial interest rates, rising per capita incomes, longer mortgage repayment periods, a growing population and strong interest from foreign buyers for holiday homes. Anticipation of VAT on residential land, due in 2008, has also been an important factor. The strong growth of the real estate business is reflected in the growth of the construction sector, which rose in real terms by an average 5.6% in 2002-06.

Cyprus (south): Construction statistics										
Year-on-year % change	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Construction growth in real terms (GVA)	-3.0	-0.1	-1.3	-1.2	4.0	5.5	7.0	5.4	5.3	5.0
Number of building permits authorized	-7.6	-0.8	-2.0	-5.2	6.6	5.5	10.1	9.3	10.3	7.7
Value of building permits authorized	-7.1	3.8	-5.2	7.2	26.1	12.9	17.1	13.3	14.8	8.1

Source: Statistical Service.

Prices are still rising

Strong demand has led to a steadily rising trend in the price of residential property. According to the hedonic BuySell Home Price Index, prepared by MAP S. Platis, the price of a home in the south rose by 21.5% between January and November 2007.



Source: BuySell.

But debate about whether it will last

However, there is now much debate about whether prices can continue to rise so quickly given unfavourable global conditions. Interbank rates—the interest rates used when banks lend to each other—have been on a rising trend. This will have made borrowing more expensive for local banks, which in turn will attempt to pass on the cost to their customers, thus increasing the cost (other things being equal) of a mortgage. At the same time, various indicators of house prices in the UK—Cyprus's biggest foreign market for real estate—show that prices are falling, at least compared with the previous month. This trend will restrict UK buyer's ability to use the value of their first homes to borrow to buy a second home abroad.

These factors will dampen the impact of other positive factors for real estate prices, such as the recent cut in official interest rates from 4.50% to 4.00% and the fact that the Russian market, buoyed by strong oil prices, is likely to remain robust.

Real estate has begun to slow in the north

Growth in the construction sector in the northern part of Cyprus accelerated in 2000-06, growing by 27% per year in real terms. One of the main reasons was reduced expectations of a solution after the referendum in April 2004. This had the effect of reducing the perceived risk of developing Greek Cypriot land. The number of construction companies rose from 65 in 2003 to 1,000 companies in April 2007.¹⁴ The impact on the economy has been broad, since according to the State Planning Organization (SPO), the construction sector affects 27 sub-sectors. Thus, after a 20.4% decrease in the value added of this sector in 2001, construction rose in real terms by 18.9% 2005 and is estimated to have risen by 35.2% in 2006. The share of the construction sector in GNP was 9.8% in 2005 and is estimated to have increased to 12.2% in 2006. The strong growth in the sector up to 2006 is reflected in the number of final approvals for building permits, which increased by 48% in 2006 to reach 2,914.

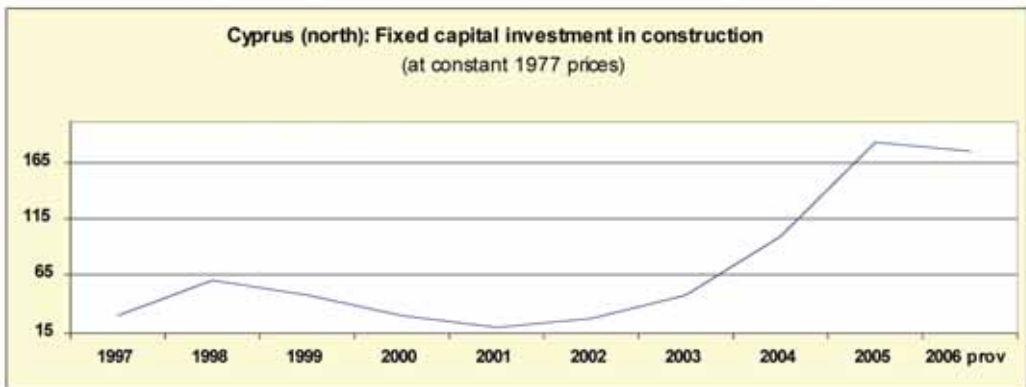
Cyprus (north): Building permits authorized										
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Dwellings	528	514	468	471	367	384	593	675	1,019	1,293
Apartments	796	853	810	686	1,209	694	761	719	945	1,621
Total	1,324	1,367	1,278	1,157	1,576	1,078	1,354	1,394	1,964	2,914

Source: State Planning Organization.

However, there are widespread reports that the construction sector experienced a sharp slowdown in 2007. Fixed capital in construction already began to decrease in 2006 according to provisional data, and it is expected that the pace of growth of the construction sector will slow down in the following years. The main reasons for slowdown can be summarized as follows:

- Decrease in demand (especially foreign demand) as a result of global trends but also factors mentioned below.
- Authorities' declaration of intention to build public housing. This has created expectations among the public (especially low income earners) which has had the effect of decreasing demand.
- Over-supply and liquidity problems among construction companies
- Decreasing construction quality owing to lack of standards and control

¹⁴ Department of Labour.



Source: State Planning Organization.

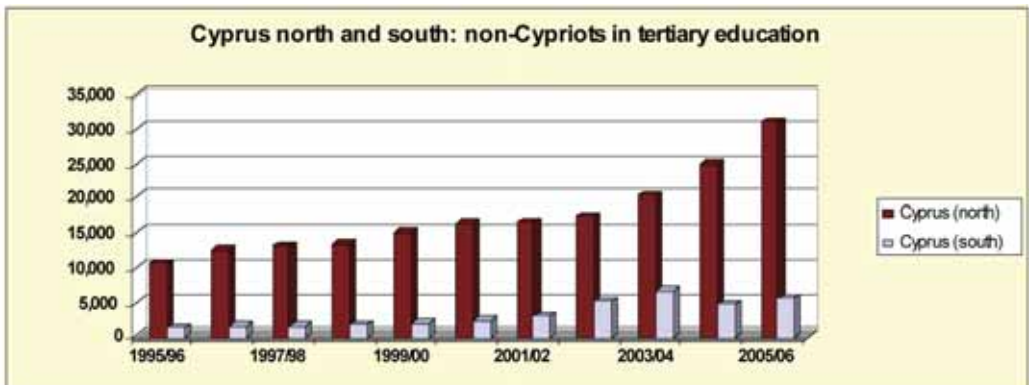
D. EDUCATION

Tertiary education is under-developed in the south

One sector which remains very under-developed in the southern part of the island is tertiary education of foreigners, especially given that English, today's global lingua franca, is widely spoken in Cyprus. The tertiary education sector in the south attracted a mere 5,630 foreign students in 2005/06, lower than the 6,679 in 2003/04. Of the 5,630, only 377 were at the public University of Cyprus. The main reason why the sector has failed to attract foreigners is because of inertia on the part of the government, which did not grant university status to private colleges until 2007 and previously did not allow foreign students to work part-time, as they can elsewhere in Europe. According to balance of payments data, foreign exchange income from education amounted to only CYP 8 million (EUR 13.9 million) in 2006, or 0.1% of GDP. (See Appendix Table 10.)

The north attracts over six times more foreign students

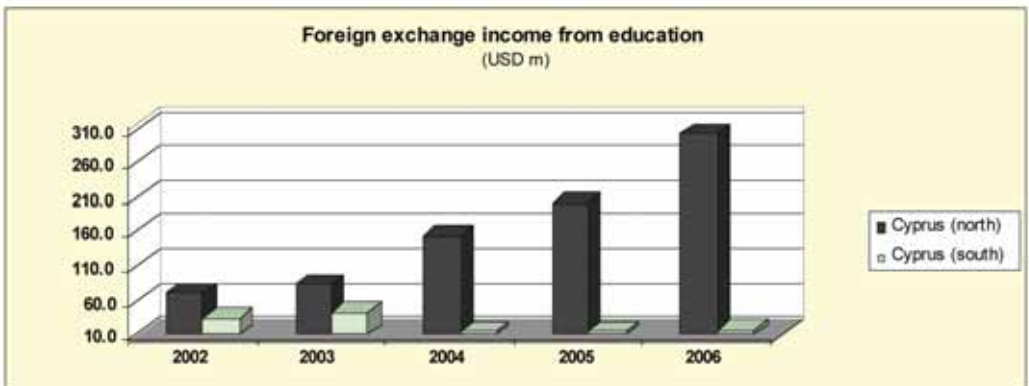
By contrast, higher education plays a vital role in the economy of the north. There are six universities operating in the north and at the start of the 2005/06 academic year, the number of foreign students was 31,279, of whom 90% were from Turkey. Instruction is in English (with only one or two departments teaching in Turkish). The sector is being integrated into some EU programmes and universities are attempting to take part in the Bologna process.



Source: State Planning Organization.

And earns 18 times more than the south from education

Universities are one of the major sources of foreign exchange earnings in the northern part of Cyprus. In 2005 the net revenue from higher education was USD 202.7 million and is estimated at USD 305 million in 2006, or more than 11% of GDP. This means for the year 2006, education revenue surpassed that of tourism income (estimated at USD 303.2 million). Income from tertiary education in the northern part of Cyprus was 18 times higher than in the south. Moreover, the trend is set to continue. The universities estimate that the total enrolment will double over the next ten years. (See Appendix Table 11.)



Source: State Planning Organization.

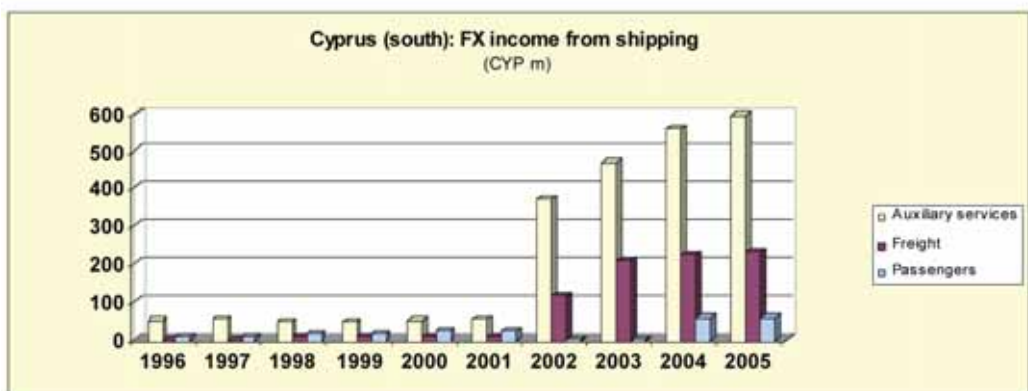
E. SHIPPING

In the south, shipping is losing out

One by-product of the Cyprus problem is that the shipping sector in Cyprus is slowly leaking business to other countries. To date Turkey has not implemented the Ankara Protocol which would extend the EU-Turkey customs union to the Republic of Cyprus. Republic of Cyprus-flagged ships are therefore unable to dock at Turkish ports. This is clearly a disadvantage for shipping companies (many of them non-Cypriot) that use the Republic of Cyprus flag. The Department of Merchant Shipping estimated in 2004 that the annual loss to shipping from the non-implementation of the Protocol was CYP 65 million (EUR 111 million) per year.¹⁵ That is 13% of shipping income in 2004 or 0.9% of GDP.

Freight transport is under-performing

Freight services have been particularly affected. Whereas income from auxiliary shipping services, helped by low taxation, has accelerated in recent years, growth in freight transport appears to have stagnated since 2003.

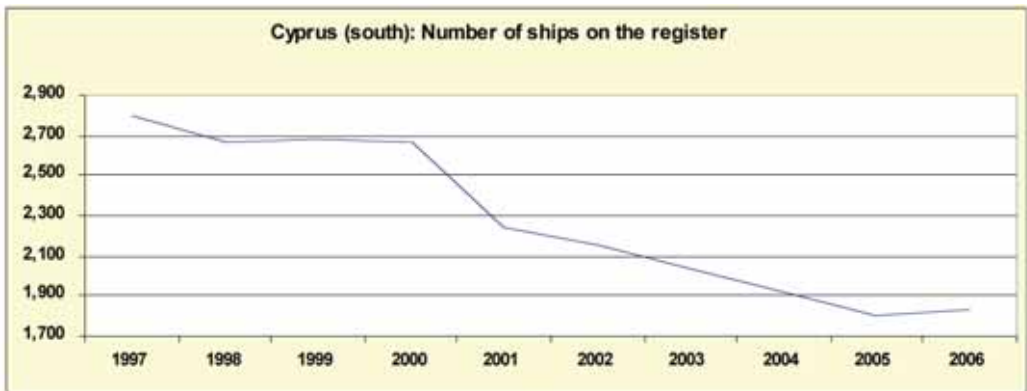


Sources: Central Bank of Cyprus, Eurostat.

Clients are going elsewhere

Thus, the Republic of Cyprus flag has been in steady decline, falling from a peak of 2,798 in 1997 to 1,826 in 2006. Last but not least, the shipping sector in the southern part of the island is missing out on one of the most important developments for the sector in recent years, namely the opening of the Baku-Tbilisi-Ceyhan oil pipeline. The potential for the shipping business of this trade is huge (see below and Section 7).

¹⁵ An internal document figure provided by the Department of Merchant Shipping.



Source: Statistical Service.

In the north, shipping incurs large additional costs

As referred to above, political circumstances and restrictions on trade have affected transportation in the northern part of Cyprus. Transportation costs are high compared with the southern part of Cyprus as importers and exporters have to transship through Turkey. In addition to restrictions on direct trade, the lack of economies of scale, the small size of the domestic market and inefficient services and management at the ports also lead to higher costs.¹⁶

Transfer costs range anywhere from USD 450-USD 800 based on the cargo.¹⁷ For example, the cost of importing goods from China to Mersin and China to Limassol is USD 1,800 (for 20 containers). However, from Mersin in Turkey to Famagusta in northern Cyprus, the cost is an additional USD 600. Thus, the lack of direct trade incurs additional costs of imports. Freight costs to export markets are also considerably higher.

Turkish Cypriot v Greek Cypriot freight costs		
	TC shippers (average)	GC shippers (average)
To UK (regular business hours)	\$3,155	\$2,809
To Europe	\$5,155	\$2,809
To Jeddah	\$5,100	\$3,972

Source: Derived from KOBİ Center, *Transportation in Cyprus*.

Import costs are also affected by difficulties in finding transport and shipping agents willing to deliver goods to northern ports owing to the political situation. To compete with all these negative factors, northern Cyprus has to compensate with high freight and transport prices in order to attract shippers.

¹⁶ World Bank, *Sustainability and Sources of Economic Growth in the Northern Part of Cyprus*, June 2006.

¹⁷ Selcuk Benter, *Transportation in Cyprus*, KOBİ Center, 2006.

But there is big potential from the Ceyhan oil transit trade

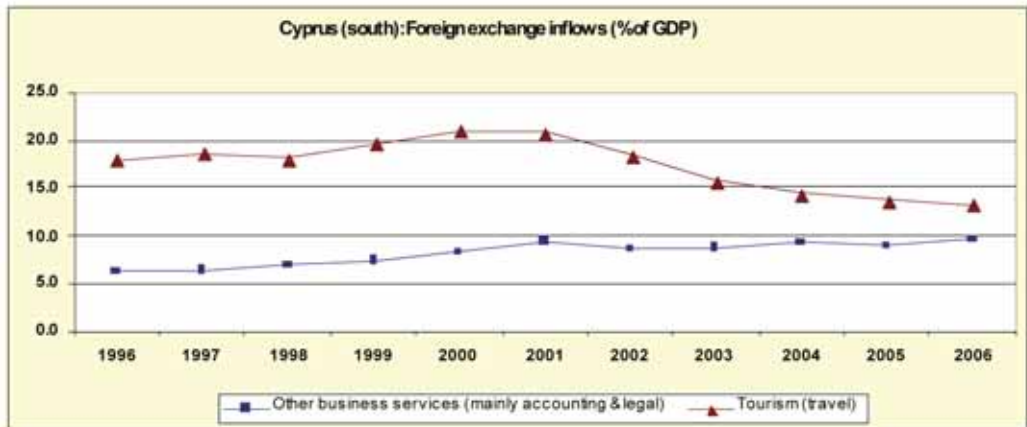
One bright spot for the transportation business in northern Cyprus, however, is the potential from the Baku-Tbilisi-Ceyhan oil pipeline. This was opened at the Ceyhan end in mid-2006 and transports crude oil from Azerbaijan and Kazakhstan to world markets through Ceyhan in south-eastern Turkey. Oil transit through Ceyhan is expected to boost economic opportunities in the region as a whole and Cyprus (currently only the northern part) is expected to benefit from the increase in business activity. At its peak, Ceyhan oil transit trade is expected to carry 40 million tonnes of crude oil per year. While the same oil shipping consortium was loading vessels of 150,000 metric tonnes (MT) to export crude oil from the Black Sea region, they will now be able to export the same product in vessels which are an average 300,000 MT in size. This will push down unit costs and put Ceyhan oil transit trade in a considerably more attractive position compared to its Caspian subsidiaries. These large vessels will also trigger marine service sales in the region, such as transport and marine insurance, agency services and oil storage. The pipeline capacity is 900,000 barrels per day and it is expected to reach 1.6 million barrel per day. Our projections for how much income could accrue to Cyprus from these developments are outlined in Section 7.

One of the most important and promising opportunities for the north would be oil storage. With its low tax rates and long coastline, the northern part of Cyprus can expect to accommodate multinational oil company's storage facilities. This will boost the economy further by triggering development in sub-sectors like shipping agencies, handling agencies, as well as the shipyard industry.

F. BUSINESS SERVICES

Business services are the new growth area for the south

One of the most dynamic services sectors in the southern part of the island in recent years has been "other business services". This is an item in the balance of payments which in Cyprus comprises mainly accounting, legal and merchanting services. While it is not yet as important a source of foreign exchange income as tourism, it is fast catching up. In 1996, income from "other business services" accounted for 6.3% of GDP in 1996, while travel income (mainly tourism) accounted for 18% of GDP. By 2006, however, income from other business services had risen to 9.6% of GDP (EUR 1.4 billion), while income from travel had declined to 13.2% of GDP (EUR 1.9 billion).



Source: Central Bank of Cyprus.

But this is heavily dependent on the US and UK

One potential weakness of this dynamic sector, however, is that it is rather dependent on the US and UK markets. In 2006, more than one quarter of all “other business services” income came from these two countries combined. This concentration of business could be risky given the weakening dollar and sterling relative to the euro.

Cyprus (south): Other business services in 2006(a)			
CYP	Credit	Debt	Net
Total	806,658,456	135,084,704	671,573,752
US	125,929,260	6,325,675	119,603,585
UK	115,615,152	32,346,740	83,268,413
Germany	80,872,553	3,351,681	77,520,872
Greece	54,080,228	18,406,606	35,673,622
Russia	49,310,706	24,273,483	25,037,223
Romania	41,405,429	1,306,922	40,098,507

(a) Mainly, accounting, legal and merchanting.

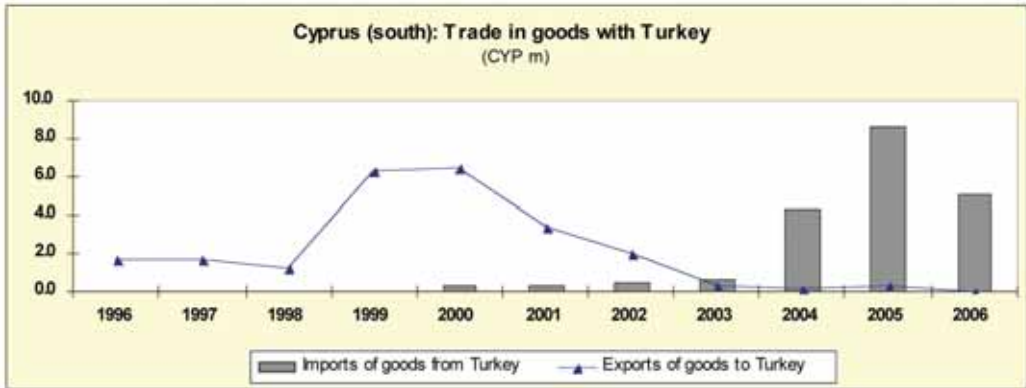
Source: Central Bank of Cyprus.

G. TRADE IN GOODS

Cyprus (south) does sell some goods to Turkey

Despite the fact that Turkey does not recognize the Republic of Cyprus and does not allow Republic of Cyprus ships to enter its ports, there is a small amount of trade in goods between the southern part of Cyprus and Turkey. Indeed, the potential for trade in the future is underlined by the fact that there was a noticeable increase in trade in the early years after the Greek-Turkish rapprochement of 1999. Exports of goods from the southern part of Cyprus to Turkey rose from CYP 1.2 million in 1998 to CYP 6.2 million in 1999 and CYP 6.4

million in 2000. However, there has been a notable deterioration in exports since. By contrast, imports from Turkey have increased, particularly since 2004 when the Republic of Cyprus joined the EU. It is possible that this trend reflects transshipment trade: that is, non-Cypriot companies using ports in the south for warehousing and sending goods onto other destinations. Either way, the balance of trade is clearly in Turkey's favour. (See Appendix Tables 13 and 14.)

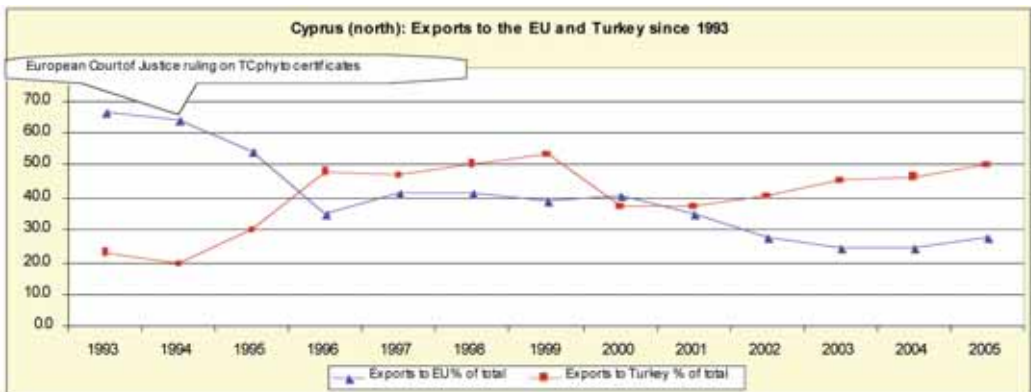


Source: Central Bank of Cyprus.

North's commercial ties with Turkey are very strong

Commercial ties between the northern part of Cyprus and Turkey are naturally very strong, given that the north can trade easily only with Turkey. Turkey is therefore the major trading partner of the north both in goods and services (see Appendix Table 15). However, it was not always the case. Before the decision of the European Court of Justice in 1994, which ruled that goods from the north must have phytosanitary certificates from the internationally recognized authorities, namely those of the Republic of Cyprus, the EU was northern Cyprus's primary trading partner, with a share of 72.8% in total exports. Following the European Court of Justice decision, trade with EU countries declined rapidly whereas the proportion of exports to Turkey rose, so that by 2006, the share of Turkey in exports was approximately 50% of the total. Exporters are therefore increasingly cut off from international markets.

In the case of imports of goods, the share of Turkey in total imports was 65% in 2005 and 69% in 2006. The share of Turkey is also high as regards exports of services (mainly tourism and education). The proportion of all tourists coming from Turkey was 80% in 2006, while the share of Turkish students in total enrolment was 68% in 2005. While the close commercial relationship with Turkey is currently a reflection of the restrictions faced by the economy in the north, it could be a significant advantage for the whole island in the event of a solution. (See Appendix Table 16.)



Source: State Planning Organization.

Green Line trade is low but rising fast

Under the EU Green Line regulation, Turkish Cypriot businesses can technically export a limited range of goods to EU markets by sending goods over the Green Line and from Larnaca or Limassol ports in the southern part of the island. However, so far there has only been one export to another EU market via the Green Line regulation (of scrap aluminium) and the European Commission reported in September 2007 that “there are still many obstacles to the further development of Green Line trade”¹⁸. Sales from Turkish Cypriots to Greek Cypriots reached only EUR 4.8 million in the period May 2006 to April 2007, less than one-tenth of exports from northern Cyprus of USD 64.9 million (EUR 50.8 million) in 2006. Nevertheless, the pace of increase has been rapid. Sales from Turkish Cypriots to Greek Cypriots rose by 92% in 2006 and 28% in 2007. This is another sign that businesses react quickly as soon as the fundamental conditions improve.

KEY SECTORAL TRENDS IN CYPRUS: CONCLUSIONS

Both the northern and the southern parts of Cyprus have witnessed robust growth in recent years by historical standards. However, both economies have long-standing structural problems which raise questions about the sustainability of growth in the medium term. Lack of competitiveness is an issue that faces both economies and, if not tackled, will lead to slower growth rates and rising unemployment in the longer term. The social and pensions systems in both parts are also in need of serious overhaul but there are questions about whether the political will exists to undertake the necessary reforms. In sum, neither economy is in such a healthy state that it can afford to ignore the very positive boost to the economy that would arise from reunification of the island.

¹⁸ European Commission, ‘Annual Report on the implementation of Council Regulation (EC) 866/2004 of 29 April 2004 and the situation resulting from its application’, 20 September 2007, COM(2007)553.

6. THE COMMERCIAL OPPORTUNITIES OF A SOLUTION QUANTIFIED

Having analysed the rapid growth of trade in goods and services between Greece and Turkey after rapprochement, having studied commercial relations between Cyprus and Greece/Turkey, having assessed future growth prospects for Turkey and having studied recent macroeconomic developments on the island, we can now make some empirically based projections for the main business opportunities on the island in the event of reunification.

We split our projections into two parts. First, we forecast, in euros, the new business generated each year through exports and imports of goods and services from a reunited Cyprus to Turkey. Our methodology here takes as its basic hypothesis the assumption that the growth of trade in goods and services between a reunited Cyprus and Turkey from the first year after rapprochement will grow at the same pace as that of growth of goods and services between Greece and Turkey after 1999. While the economies of Greece and Cyprus are, of course, not identical, they are both services-oriented economies with a heavy dependence on tourism. In the case of Greece, Year 1 is 2000 and in the case of Cyprus, Year 1 is assumed to be 2009. In 2007-08, we take each part of Cyprus separately and assume that trade grows at the same pace as it did in 2000-06. We have cross-checked the results against a non-solution scenario and where this produced nonsensical results (for reasons that we explain), we have made adjustments (always downwards).

In the second part of our forecast, we project new business generated in the following sectors: construction and real estate (excluding the rebuilding of Varosha, which we excluded as a one-off event); tourism (excluding tourism from Turkey, which is included in the first part of the forecast); tertiary education (excluding students from Turkey); accounting and legal services; and foreign direct investment (excluding construction and real estate already forecast). Our methodology here is more simple: we assume that the synergies of a reunited Cyprus would generate a little more business each year than the two separate parts, especially in the case of construction and real estate.

For each item we also make a forecast for a non-solution scenario. By subtracting this from the reunification scenario, we can calculate the annual “peace dividend” of a reunited Cyprus for each sector and for the whole island.

A. PROJECTIONS FOR EXPORTS FROM CYPRUS TO TURKEY

A new export market for pharmaceuticals

After a solution, new opportunities for Cypriot exporters would arise from the implementation of the Ankara Protocol, allowing Republic of Cyprus ships to dock in Turkish ports. Turkey could become a primary market for generic pharmaceuticals (the largest merchandise export in the southern part of Cyprus), solar power devices (exports of which are increasing rapidly) and other goods also exported by the north, such as citrus fruits and potatoes. There may also be a market for halloumi/hellim, also one of the largest exports from the south. Exports from the northern part of Cyprus will benefit from the fact that its ports will now enjoy international recognition, which will give it greater access to markets through and beyond Turkey, and imports will no longer carry the large premium discussed in Section 5.

As noted in Section 2, trade in goods and services developed rapidly between Greece and Turkey after 1999. Exports of goods from Greece to Turkey in 2000 (Year 1) amounted to EUR 189.7 million and rose at an annual average rate of 27.1% per year in 2000-06 to reach EUR 544.1 million in 2006 (Year 7).

Exports of goods from Cyprus (north and south) to Turkey amounted to EUR 24.2 million in 2006, primarily from the north. For 2007-08 and for the non-solution scenario in 2009-15, we forecast the two parts of Cyprus separately, and assume that exports from each part of Cyprus rise at the same pace as in 2000-06.

For the solution scenario, we apply from 2009 the same growth rate as that of Greece-Turkey in 2000-06 (27.1%). Although exports of goods from Cyprus will be from a much lower base, and therefore could rise even more strongly than exports from Turkey in the post-rapprochement period, we have decided to be cautious given that Cyprus is a small island and exports of goods are concentrated on a limited range of goods.

Exports of goods to Turkey: annual peace dividend of EUR 46 million

Under the scenario of a 27.1% average increase, exports of goods from a reunited Cyprus to Turkey rise from EUR 31.9 million in 2009 (Year 1) to EUR 134.5 million in 2015 (Year 7). By forecasting a non-solution scenario, we can see that this yields a peace dividend for exports of goods to Turkey that rises from EUR 6.4 million in 2009 to EUR 106.1 million in 2015. It amounts to an average EUR 46.3 million per year. If one adds imports of goods from Turkey, which would also create wealth and jobs in Cyprus, this dividend would rise to EUR 160 million per year.

PEACE DIVIDEND: EXPORTS OF GOODS TO TURKEY, EUR m										
Exports of goods to TR		1999	Year 1 2000	Year 2 2001	Year 3 2002	Year 4 2003	Year 5 2004	Year 6 2005	Year 7 2006	Average 2000-2006
Greece		132.2	189.7	128.6	154.74	170.3	216.2	402.2	544.1	
Year/year % change			43.5%	-32.2%	20.3%	10.1%	27.0%	86.0%	35.3%	27.1%
Exports of goods to TR	2007	2008	Year 1 2009	Year 2 2010	Year 3 2011	Year 4 2012	Year 5 2013	Year 6 2014	Year 7 2015	Average 2009-2015
Reunited Cyprus	24.6	25.1	31.9	40.5	51.5	65.5	83.2	105.8	134.5	
Year/year % change		1.7%	27.1%	27.1%	27.1%	27.1%	27.1%	27.1%	27.1%	27.1%
Divided Cyprus	24.6	25.1	25.5	25.9	26.4	26.9	27.4	27.9	28.4	
Year/year % change		1.7%	1.7%	1.8%	1.8%	1.8%	1.8%	1.9%	1.9%	1.8%
Annual peace dividend	0.0	0.0	6.4	14.6	25.1	38.6	55.8	77.9	106.1	46.3

The potential for services exports is huge

Since both parts of the island are dominated by services, the potential for exports of services from a reunited Cyprus to Turkey (and the rest of the world—see below) are huge. The southern part of Cyprus attracted only 254 tourists from Turkey in 2006, compared with 715,749 for the northern part. Reunification would open up two-thirds of the island and would therefore attract new tourists from Turkey, especially as it will be the closest and largest market.

Reunification would also open up the whole island to the 31,000 foreign students who study in the universities in the north. These students need accommodation, banking services, computer services and so on. The full entry of the northern part of the island into the EU can be expected to attract even more students from Turkey and the Middle East. Educational institutions on both sides of the island would benefit, especially now that there are also private universities in the south. As a country that has already joined the EU, there could also be scope for Cypriot (Greek Cypriot and Turkish Cypriot) businesses selling consulting services to Turkey in its path towards EU membership.

The potential for a reunited Cyprus can be seen from Greece. Exports of services from Greece to Turkey rose at an annual average rate of 49.1% in 2000-2006 from EUR 22.7 million in 2000 to EUR 147.5 million in 2006. In comparing Greco-Turkish economic relations with potential Cyprus-Turkish economic relations, one should bear in mind the difference in proportions. While the economy of Greece is about 65% of the economy of Turkey, the Cypriot economy is only about 4.8% of that of Turkey, in terms of GDP. The benefits to Cyprus could be even higher.

On the other hand, exports from a reunited Cyprus to Turkey would be starting at a rather higher base, since the northern part of Cyprus already exports a substantial amount of tourism and education services to Turkey. Applying a growth rate of 49.1% to a reunited Cyprus would produce services exports of more than EUR 8 billion in 2015, which we consider excessive. For our forecast we have therefore adjusted the growth rate down, and assume that exports of services from a reunited Cyprus to Turkey rise at an annual pace of

25% per year. This is still a cautious forecast since, based on the recent export performance of the north, exports of services from a divided Cyprus would be expected to rise by almost 15% per annum even under a non-solution scenario. It is also cautious if one considers that exports of services from the southern part of Cyprus to Greece rose at an annual rate of 36% in 2003-06, primarily as a result of EU membership.

Exports of services to Turkey: annual peace dividend of EUR 464 million

By applying a growth rate of 25%, exports of services from a reunited Cyprus to Turkey rise from EUR 645.8 million in 2009 to EUR 2,463.4 million (EUR 2.5 billion) in 2015, compared with EUR 1.3 billion for a divided Cyprus. This translates into an annual average peace dividend of exports of services that amounts to EUR 463.7 million. If one adds imports of services, which would create jobs for Cypriot businesses such as travel agents, airlines and insurance agents, this peace dividend rises to EUR 790.2 million.

PEACE DIVIDEND: EXPORTS OF SERVICES TO TURKEY, EUR m										
Exports of serv's to TR			Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Average
		1999	2000	2001	2002	2003	2004	2005	2006	2000-2006
Greece		22.1	22.7	22.0	83.4	99.4	121.4	113.5	147.5	
Year/year % change			2.6%	-3.1%	279.1%	19.2%	22.1%	-6.5%	30.0%	49.1%
Exports of serv's to TR	2007	2008	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Average
			2009	2010	2011	2012	2013	2014	2015	2009-2015
Reunited Cyprus	450.6	516.6	645.8	807.2	1009.0	1261.2	1576.5	1970.7	2463.4	
Year/year % change		14.7%	25.0%	25.0%	25.0%	25.0%	25.0%	25.0%	25.0%	25.0%
Divided Cyprus	450.6	516.6	592.3	679.2	778.8	893.0	1024.0	1174.2	1346.4	
Year/year % change		14.7%	14.7%	14.7%	14.7%	14.7%	14.7%	14.7%	14.7%	14.7%
Annual peace dividend	0.0	0.0	53.4	128.0	230.2	368.3	552.6	796.5	1116.9	463.7

Tourism income from Turkey: annual peace dividend of EUR 385 million

Given the importance of tourism and transport in overall services, we have also forecast these subsectors of services separately. Greece's travel income from Turkey rose from EUR 5.1 million in 2000 to EUR 69.0 million in 2006, rising at an astonishing annual average pace of 237.4% per year. We would not expect the same pace of growth for a reunited Cyprus since it is already starting from a base that is much higher, owing to the tourism market that already exists between the northern part of Cyprus and Turkey. All-Cyprus travel receipts from Turkey were already an estimated EUR 178 million in 2006.¹⁹ We have therefore

¹⁹ For northern Cyprus, travel income from Turkey is estimated at 75% of total tourism income, since just over 75% of tourists came from Turkey in 2000-06.

assumed a more moderate growth rate of 30% per year: a little higher than the growth rate for exports of services as a whole. In our divided Cyprus scenario, travel income from Turkey (mainly flowing to the north) would be expected to grow by around 9.5% per year—about the same pace as in 2000-06. Under our reunification scenario, travel income from Turkey would rise from EUR 277.1 million in Year 1 to EUR 1,337.7 million in Year 7, yielding an annual average peace dividend of EUR 384.8 million. If outflows of travel receipts were included (Cypriots travelling to Turkey), the total peace dividend for the travel market would be EUR 560 million.

PEACE DIVIDEND: TRAVEL RECEIPTS FROM TURKEY, EUR m

		1999	Year 1 2000	Year 2 2001	Year 3 2002	Year 4 2003	Year 5 2004	Year 6 2005	Year 7 2006	Average 2000-2006	
Travel receipts from TR											
Greece		5.1	5.1	3.4	60.2	68.1	86.0	64.3	69.0		
Year/year % change			-0.7%	-33.6%	1674.5%	13.1%	26.3%	-25.2%	7.3%	237.4%	
		2007	2008	Year 1 2009	Year 2 2010	Year 3 2011	Year 4 2012	Year 5 2013	Year 6 2014	Year 7 2015	Average 2009-2015
Travel receipts from TR											
Reunited Cyprus	194.7	213.2	277.1	360.3	468.4	608.9	791.5	1029.0	1337.7		
Year/year % change		9.5%	30.0%	30.0%	30.0%	30.0%	30.0%	30.0%	30.0%	30.0%	
Divided Cyprus	194.7	213.2	233.4	255.5	279.8	306.3	335.4	367.2	402.0		
Year/year % change		9.5%	9.5%	9.5%	9.5%	9.5%	9.5%	9.5%	9.5%	9.5%	
Annual peace dividend	0.0	0.0	43.7	104.7	188.6	302.6	456.2	661.8	935.7	384.8	

Transport income from Turkey: annual peace dividend of EUR 22 million

Greece's transport income from Turkey rose from EUR 13.3 million in 2000 to EUR 50.2 million in 2006, rising at an annual average rate of 32.1%. However, according to our estimate for transport income from Turkey in the northern part of Cyprus, transport income would be starting from a much higher base in Cyprus than it did in Greece. We have therefore revised down the forecast to an annual average increase of 20%. Under this scenario, a reunited Cyprus's transport income from Turkey rises from an estimated²⁰ EUR 62.1 million in Year 1 to EUR 185.3 million in Year 7, yielding an annual average peace dividend of EUR 21.8 million. Under a divided Cyprus scenario, transport income rises to EUR 134.7 million in 2015, rising at a pace of 14.7% per year. If outflows of transport income were included (Cypriot vessels going to Turkey), the total peace dividend for the transport market would be EUR 68 million.

Note that the transport forecast excludes the substantial boost to the transport sector of the implementation of the Ankara Protocol, which would imply the lifting of restrictions on Cyprus-flagged ships at Turkish ports. This has been forecast separately, on the basis of official estimates, below.

²⁰ Transport income for the northern part of Cyprus is estimated based on total services receipts.

PEACE DIVIDEND: TRANSPORT INCOME FROM TURKEY, EUR m										
Transport income from TR			Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Average
		1999	2000	2001	2002	2003	2004	2005	2006	2000-2006
Greece		8.2	13.3	12.5	15.8	18.8	21.1	28.4	50.2	
Year/year % change			61.8%	-6.3%	26.7%	19.0%	12.2%	34.6%	76.8%	32.1%
Transport income from TR			Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Average
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2009-2015
Reunited Cyprus	45.1	51.7	62.1	74.5	89.4	107.2	128.7	154.4	185.3	
Year/year % change		14.6%	20.0%	20.0%	20.0%	20.0%	20.0%	20.0%	20.0%	20.0%
Divided Cyprus	45.1	51.7	59.3	68.0	77.9	89.4	102.5	117.5	134.7	
Year/year % change		14.6%	14.6%	14.7%	14.7%	14.7%	14.7%	14.7%	14.7%	14.7%
Annual peace dividend	0.0	0.0	2.8	6.5	11.4	17.9	26.2	36.9	50.6	21.8

B. PROJECTIONS FOR THE CYPRUS CONSTRUCTION AND REAL ESTATE MARKET

We now move to Cyprus itself, in order to assess the benefits to domestic business that would result from reunification. One of the most obvious sectors to benefit will be construction and real estate. Apart from the rebuilding of Varosha, which we have not included in our forecast since it is a one-off event, the real estate market can be expected to take off over the medium term for several reasons.

Many reasons to expect a construction boom

First, assuming that the settlement involves restitution and/or compensation with respect to property, there will be a considerable wealth effect created for all Cypriots by this process. Cypriots' attachment to property suggests that much of this wealth will be reinvested back into the property market. Moreover, given that claims for restitution and/or compensation will inevitably take time to process, the restitution and/or compensation process can be expected to take place over several years. This will significantly reduce the risk of over-supply when properties that previously could not be traded freely or without risk would enter the market.

Second, the rebuilding of Varosha will create an ongoing, long-term benefit for the whole region of a reunited Famagusta, which will now be able to benefit, as other coastal resorts, from having a main town and an internationally recognized port and airport close by.

Third, and importantly for the short term, the settlement of the property issue would put all properties on an equal footing which would no doubt attract considerably more local and foreign investment, especially in the north, than currently. An idea of how fast the property market in the north might grow once perceived risk is reduced or eliminated can be gleaned from what happened in the aftermath of the referendum, when construction rose in real terms at an annual average rate of 27% in 2005-06. Another indication is the construction boom after the de facto division of the island in 1974. After two years of steep decline, construction rose in the southern part of the island by an average 32.9% per year in real terms in 1976-78.

Finally, since, as stated at the beginning, we have taken as our basic assumption that the settlement will be economically sustainable, we assume that any compensation mechanisms provided for in the settlement will be either affordable by the government or backed by international guarantees. In other words, the conditions for a buoyant real estate market would be favourable.

New construction activity: annual peace dividend of EUR 393 million

Given that construction activity in the northern part of Cyprus is expected to rise particularly quickly in the early years after reunification, we have projected the two parts of Cyprus separately. Construction activity in the northern part of Cyprus is forecast to rise in real terms by 27% per year in the first three years (the same rate as in 2005-06), and then at the same pace as the south in the Years 4 to 7. Construction activity in the southern part of Cyprus is expected to rise in real terms at an annual average rate of 7.4%. This is two percentage points higher than in 2000-06 for the reasons stated above. For all parts of the forecasts, in order to calculate the nominal value of construction in euros, we assume the construction prices will rise at the same pace as they did in the south in 2000-06, that is, by 5.3%. These calculations translate into an annual average increase in nominal terms of 10.8% per year for a divided Cyprus and 14.2% per year for a reunited Cyprus. In a divided Cyprus, construction activity rises from EUR 1,366.5 million (EUR 1.4 billion) in 2007 to EUR 3,091 million (EUR 3.1 billion) in 2015. For a reunited Cyprus, construction activity rises from EUR 1.4 billion in 2007 to EUR 3,837.2 million (EUR 3.8 billion) in 2015, yielding an annual average peace dividend of EUR 392.6 million.

PEACE DIVIDEND: NEW CONSTRUCTION BUSINESS, EUR m

New construct'n business	2007	2008	Year 1 2009	Year 2 2010	Year 3 2011	Year 4 2012	Year 5 2013	Year 6 2014	Year 7 2015	Average 2009-2015
Reunited Cyprus	1366.5	1511.6	1734.8	2014.5	2348.5	2655.2	3002.0	3394.0	3837.2	
Year/year % change		10.6%	14.8%	16.1%	16.6%	13.1%	13.1%	13.1%	13.1%	14.2%
Divided Cyprus	1366.5	1511.6	1672.6	1851.2	2049.7	2270.2	2515.2	2787.8	3091.0	
Year/year % change		10.6%	10.6%	10.7%	10.7%	10.8%	10.8%	10.8%	10.9%	10.8%
Annual peace dividend	0.0	0.0	62.3	163.2	298.8	385.0	486.7	606.2	746.2	392.6

Real estate: annual peace dividend of EUR 155 million

Historical data from the southern part of Cyprus show that value added in the real estate market averaged 37% of construction value added in 1999-2006 (and is on a rising trend). In order to calculate the peace dividend for real estate, therefore, we have assumed for both the divided Cyprus and the reunited Cyprus forecast that value added in real estate is consistently 37% of construction value added. Since no data exist on the value of real estate in the northern part of Cyprus, we have assumed that it is the same proportion of the south as GDP, i.e. 14%.

Under this scenario, the real estate market in a divided Cyprus rises from EUR 505.6 million in 2007 to EUR 1,143.7 million (EUR 1.1 billion) in 2015. The real estate market in a

reunited Cyprus rises from EUR 505.6 million in 2007 to EUR 1,434 million (EUR 1.4 billion) in 2015, yielding an annual average peace dividend of EUR 155.3 million.

PEACE DIVIDEND: NEW REAL ESTATE BUSINESS, EUR m										
New real estate business	2007	2008	Year 1 2009	Year 2 2010	Year 3 2011	Year 4 2012	Year 5 2013	Year 6 2014	Year 7 2015	Average 2009-2015
Reunited Cyprus	505.6	559.3	648.3	752.8	877.6	992.3	1121.8	1268.3	1434.0	
Year/year % change		10.6%	15.9%	16.1%	16.6%	13.1%	13.1%	13.1%	13.1%	14.4%
Divided Cyprus	505.6	559.3	618.8	685.0	758.4	840.0	930.6	1031.5	1143.7	
Year/year % change		10.6%	10.6%	10.7%	10.7%	10.8%	10.8%	10.8%	10.9%	10.8%
Annual peace dividend	0.0	0.0	29.5	67.8	119.3	152.3	191.2	236.9	290.3	155.3

C. PROJECTIONS FOR TOURISM, EDUCATION, ACCOUNTING AND LEGAL

A reunited Cyprus would not only attract new tourists from Turkey, it would attract new tourists from the rest of the world. A reunited island would be more attractive to the visitor because of the greater variety of places to visit, the improvement of infrastructure and the coordinated redesign of the content of the tourist product. Tourists would have new ports of entry to the whole island. In particular, the Famagusta region can be expected to benefit from close access to an airport, a port and the rebuilding of Varosha. These developments would imply greater numbers of visitors and more revenue for all Cypriots in the business, whether in the north or in the south.

In addition, the peaceful coexistence that will prevail between Cyprus, Greece and Turkey after a solution to the political problem will allow the extension of the tourist product to include combined visits to Cyprus, parts of Turkey and parts of Greece, thus attracting an additional type of tourism to the island. Our assumptions are also backed up by enterprises in the business. According to an empirical study conducted in the second half of 2007, 98.6% of Turkish Cypriot and 79.3% Greek Cypriot tourist enterprises viewed the solution of the Cyprus problem as a “win-win” situation for the tourism sector.²¹

Tourism (ex Turkey): annual peace dividend of EUR 316 million

We have already forecast the additional boost to tourism from the Turkish market, which we estimate at EUR 385 million. In the following forecast, therefore, we project additional tourism from outside of Turkey. For the non-solution scenario, we assume that the two, separate tourism markets continue to rise in nominal terms at the same pace as in 2000-06, which is 1.3% for the south and 9.5% for the north. For the solution scenario, we assume that there will be an additional boost of 4% in nominal terms.

Under the divided Cyprus forecast, tourism revenue rises from EUR 2,194.9 million

²¹ *The Future of Tourism Industry in Cyprus: Divided or United?* (forthcoming 2008), multi-author research project co-ordinated by the Management Center and funded by the British High Commission.

(EUR 2.2 billion) in 2007 to EUR 2,679.9 in 2015. Under the reunited Cyprus forecast, tourism revenue rises from EUR 2,194.9 million in 2007 to EUR 3,277.5 million (EUR 3.3 billion) in 2015, yielding an annual average peace dividend of EUR 315.6 million.

PEACE DIVIDEND: NEW TOURISM BUSINESS (EX TURKEY), EUR m										
New tourism bus. ex TR	2007	2008	Year 1 2009	Year 2 2010	Year 3 2011	Year 4 2012	Year 5 2013	Year 6 2014	Year 7 2015	Average 2009-2015
Reunited Cyprus	2194.9	2244.4	2364.0	2491.5	2627.8	2773.7	2929.9	3097.5	3277.5	
Year/year % change		2.3%	5.3%	5.4%	5.5%	5.5%	5.6%	5.7%	5.8%	5.6%
Divided Cyprus	2194.9	2244.4	2296.6	2351.7	2409.9	2471.5	2536.9	2606.2	2679.9	
Year/year % change		2.3%	2.3%	2.4%	2.5%	2.6%	2.6%	2.7%	2.8%	2.6%
Annual peace dividend	0.0	0.0	67.3	139.8	217.9	302.1	393.1	491.3	597.7	315.6

Education (ex Turkey): annual peace dividend of EUR 162 million

As discussed in Section 5, a very dynamic tertiary education sector already operates in the northern part of Cyprus. Reunification is expected to boost the sector in the north further, since the education system will become a fully fledged part of the EU. The south will also benefit, since the whole of Cyprus will suddenly have at least 10 universities and will thus become a regional hub for education.

As with tourism, we assume that the annual bonus to growth in education income will be 4% in nominal terms (around 1% in real terms). Under a divided Cyprus scenario, foreign exchange income from tertiary education rises at the same (very fast) pace as it did in 2000-06 and increases from EUR 324.3 million in 2007 to EUR 2,534.6 million (EUR 2.5 billion) in 2015. Under a reunited Cyprus, scenario, it rises to EUR 2,974.7 million, (EUR 3.0 billion), thus yielding an annual average peace dividend of EUR 161.7 million.

PEACE DIVIDEND: NEW EDUCATION BUSINESS (EX TURKEY), EUR m										
New educ'n bus. ex TR	2007	2008	Year 1 2009	Year 2 2010	Year 3 2011	Year 4 2012	Year 5 2013	Year 6 2014	Year 7 2015	Average 2009-2015
Reunited Cyprus	324.3	417.5	551.1	728.3	963.6	1276.1	1691.1	2242.3	2974.7	
Year/year % change		28.8%	32.0%	32.2%	32.3%	32.4%	32.5%	32.6%	32.7%	32.4%
Divided Cyprus	324.3	417.5	538.6	695.6	899.5	1164.3	1508.1	1954.7	2534.6	
Year/year % change		28.8%	29.0%	29.2%	29.3%	29.4%	29.5%	29.6%	29.7%	29.4%
Annual peace dividend	0.0	0.0	12.5	32.7	64.1	111.8	182.9	287.7	440.1	161.7

Accounting and legal: annual peace dividend of EUR 103 million

As discussed in Section 5, the accounting, legal and merchanting businesses in the southern part of Cyprus have been one of the most dynamic sectors in recent years. Businesses are attracted by the advantages of EU membership, a 10% corporate tax rate and an array of double taxation agreements. Just as businesses use Cyprus to invest in emerging markets in eastern Europe from Cyprus, they are likely to use Cyprus in order to invest in Turkey, especially if a reunited Cyprus quickly signs a double-taxation agreement with Turkey. This will be of particular benefit to the accounting and legal professions in Cyprus.

As with education, we assume that the annual bonus to growth in accounting and legal services will be 4% in nominal terms (around 1% in real terms). Under a divided Cyprus scenario, foreign exchange income from accounting and legal services rises at the same pace as it did in 2000-06 (5.8%) and increases from EUR 607.9 million in 2007 to EUR 957.6 million in 2015. Under a reunited Cyprus scenario, it rises to EUR 1,164.6 million, (EUR 1.2 billion), thus yielding an annual average peace dividend of EUR 103.3 million.

PEACE DIVIDEND: NEW ACCOUNTING AND LEGAL SERVICES, EUR m

New acc'g and legal	2007	2008	Year 1 2009	Year 2 2010	Year 3 2011	Year 4 2012	Year 5 2013	Year 6 2014	Year 7 2015	Average 2009-2015
Reunited Cyprus	607.9	643.4	700.3	762.3	829.7	903.1	983.0	1069.9	1164.6	
Year/year % change		5.8%	8.8%	8.8%	8.8%	8.8%	8.8%	8.8%	8.8%	8.8%
Divided Cyprus	607.9	643.4	681.0	720.8	763.0	807.6	854.8	904.7	957.6	
Year/year % change		5.8%	5.8%	5.8%	5.8%	5.8%	5.8%	5.8%	5.8%	5.8%
Annual peace dividend	0.0	0.0	19.3	41.4	66.7	95.5	128.2	165.2	206.9	103.3

D. PROJECTIONS FOR FOREIGN DIRECT INVESTMENT

As discussed in Section 5, foreign direct investment (FDI) into Cyprus has underperformed in recent years, not least because of the division of the island. The normalization of political and economic relations between Cyprus and Turkey will eliminate the political risk currently embedded in the de facto division of the island and encourage foreign direct investors to invest in Cyprus, as they have done in the other new member states of the European Union. As mentioned above, investors will be offered a new bridge between Europe and Turkey, which will be Cyprus. Moreover, whereas FDI is currently concentrated on real estate, reunification should encourage a diversification into more productive areas of the economy.

Foreign direct investment: annual peace dividend of EUR 184 million

Our forecast below excludes FDI in construction and real estate, since this is included in our construction and real estate forecasts above. We therefore make a modest forecast, assuming that FDI will increase in nominal terms 3 percentage points faster in 2009-15 than 2000-06. Under a divided Cyprus scenario, inward FDI rises from EUR 1,476.8 million (EUR 1.5 billion) in 2007 to EUR 2,774.6 million (EUR 2.8 billion) in 2015. We project the FDI for a reunited Cyprus would rise to EUR 3,154.1 million (EUR 3.2 billion) in 2015 and yield an annual average peace dividend of EUR 183.9 million.

PEACE DIVIDEND: NEW FOREIGN DIRECT INVESTMENT, EUR m

New FDI	2007	2008	Year 1 2009	Year 2 2010	Year 3 2011	Year 4 2012	Year 5 2013	Year 6 2014	Year 7 2015	Average 2009-2015
Reunited Cyprus	1476.8	1597.9	1760.9	1940.6	2138.5	2356.7	2597.1	2862.1	3154.1	
Year/year % change		8.2%	10.2%	10.2%	10.2%	10.2%	10.2%	10.2%	10.2%	10.2%
Divided Cyprus	1476.8	1597.9	1729.0	1870.8	2024.2	2190.2	2369.9	2564.2	2774.6	
Year/year % change		8.2%	8.2%	8.2%	8.2%	8.2%	8.2%	8.2%	8.2%	8.2%
Annual peace dividend	0.0	0.0	32.0	69.8	114.3	166.5	227.3	297.9	379.5	183.9

THE TOTAL PEACE DIVIDEND IN EUROS

If we add new exports of goods to Turkey each year; new exports of services; additional domestic construction and real estate business; new income from tourism and education (excluding Turkey); additional income from accounting and legal services; and new, non-construction FDI, we see that the peace dividend rises from EUR 283 million, or 1.4% of GDP in 2009 to EUR 3,844 million (EUR 3.9 billion), or 10.3% of GDP in 2015 (see Summary table on next page). The annual average boost to business is approximately EUR 1.8 billion euros (over CYP 1 billion or more than YTL 3 billion). If we translate this into the annual dividend per family (household) in Cyprus, it comes to an annual peace bonus of approximately EUR 5,500 per household per year, or EUR 1,800 per person.

It should also be noted that in calculating the peace dividend we have only included exports of goods and services to Turkey, not the whole market for goods and services, which would also include imports. Clearly, companies involved in importing and distributing goods and services also stand to benefit substantially from the increase of trade in both directions.

Shipping and Ceyhan could make it even higher

We would expect that the actual total peace dividend to be even higher for a number of reasons. First, we have not taken into account in our main forecast the huge potential for transit and other services that arises from the Baku-Ceyhan oil pipeline. Even if Cyprus earns only 5% of the value of the 1.2 million barrels expected to be transported every day from Ceyhan in oil-related business, it could be expected to earn EUR 2 billion per year in the medium term.

Second, according to estimates from the Department of Merchant Shipping, the non-implementation of the Ankara Protocol cost the shipping sector in the south CYP 65 million (EUR 111 million) per year in 2004, which one can assume rises every year. We did not put these factors into our main forecast because the sources of the estimates are external, rather than based on historical data. However, these could more than double the annual peace dividend to the economy and to each household.

Third, the large merchanting sector could also benefit if Cyprus sets itself up as an intermediary in the supply of goods to and from Turkey. Finally, we have not included in our tables the impact on businesses of an increase in imports between Cyprus and Turkey.

PEACE DIVIDEND: SHIPPING AND CEYHAN BUSINESS, EUR m

New shipping/ oil transit	2007	2008	Year 1 2009	Year 2 2010	Year 3 2011	Year 4 2012	Year 5 2013	Year 6 2014	Year 7 2015	Average 2009-2015
Ankara Protocol	0.0	0.0	161.1	169.1	177.6	186.4	195.8	205.6	215.8	
Ceyhan oil pipeline business	0.0	0.0	250.0	500.0	1000.0	1500.0	2000.0	2000.0	2000.0	
Year/year % change		0.0%	0.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	4.3%
Annual peace dividend	0.0	0.0	411.1	669.1	1177.6	1686.4	2195.8	2205.6	2215.8	1508.8

A REUNITED CYPRUS: THE RECURRING BONUSES FOR BUSINESS		2008* Year 0 EUR m	2009* Year 1 EUR m	2015* Year 7 EUR m	Average increase** 2009-15 %	Annual bonus EUR m***	Bonus per household EUR ***
A. New exports to Turkey							
1.	Exports of goods to Turkey: with solution	25.1	31.9	134.5	27.1	-	-
2.	<i>Exports of goods to Turkey: without solution</i>	25.1	25.5	28.4	1.8	-	-
3.	Subtotal new exports of goods to Turkey (1-2)	0.0	6.4	106.1	-	46.3	139
4.	Exports of services to Turkey: with solution	516.6	645.8	2,463.4	25.0	-	-
	Of which:						
	Travel receipts from Turkey: with solution	213.2	277.1	1,337.7	30.0	384.8	1,155
	Transport income from Turkey with solution	51.7	62.1	185.3	20.0	21.8	65
5.	<i>Exports of services to Turkey: without solution</i>	516.6	592.3	1,346.4	14.7	-	-
	Of which:						
	Travel receipts from Turkey: without solution	213.2	233.4	402.0	9.5	-	-
	Transport income from Turkey: without solution	51.7	59.3	134.7	14.7	-	-
6.	Subtotal new exports of services to Turkey (4-5)	0.0	53.4	1,116.9	-	463.7	1,393
7.	New exports to Turkey bonus (3+6)	0.0	59.8	1,223.0	-	510.1	1,532
B. Additional construction and real estate business							
7.	Domestic construction: with solution	1,511.6	1,734.8	3,837.2	14.2	-	-
8.	<i>Domestic construction: without solution</i>	1,511.6	1,672.6	3,091.0	10.8	-	-
9.	Subtotal new construction business (7-8)	0.0	62.3	746.2	-	392.6	1,179
10.	Real estate business: with solution	559.3	648.3	1,434.0	14.4	-	-
11.	<i>Real estate business: without solution</i>	559.3	618.8	1,143.7	10.8	-	-
12.	Subtotal new real estate business (10-11)	0.0	29.5	290.3	-	155.3	466
13.	Additional construction and real estate bonus (9+12)	0.0	91.7	1,036.5	-	548.0	1,646
C. Other additional business							
14.	Tourism (excl. Turkey): with solution	2,244.4	2,364.0	3,277.5	5.6	-	-
15.	<i>Tourism (excl. Turkey): without solution</i>	2,244.4	2,296.6	2,679.9	2.6	-	-
16.	Subtotal new tourism revenue (excl. Turkey) (14-15)	0.0	67.3	597.7	-	315.6	948
17.	Tertiary education income (excl. Turkey): with solution	417.5	551.1	2,974.7	32.4	-	-
18.	<i>Tertiary education income (excl. Turkey): without solution</i>	417.5	538.6	2,534.6	29.4	-	-
19.	Subtotal new education income (17-18)	0.0	12.5	440.1	-	161.7	486
20.	Accounting and legal services: with solution	643.4	700.3	1,164.6	8.8	-	-
21.	<i>Accounting and legal services: without solution</i>	643.4	681.0	957.6	5.8	-	-
22.	Subtotal new accounting and legal services (20-21)	0.0	19.3	206.9	-	103.3	310
23.	Additional other business bonus (16+19+22)	0.0	99.2	1,244.7	-	580.6	1,744
D. Additional foreign direct investment (ex construction)							
24.	Foreign direct investment excl construction: with solution	1,597.9	1,760.9	3,154.1	10.2	-	-
25.	<i>Foreign direct investment excl construction: without solution</i>	1,597.9	1,729.0	2,774.6	8.2	-	-
26.	Subtotal new foreign direct investment (24-25)	0.0	32.0	379.5	-	183.9	552
27.	Additional foreign investment bonus (16+19+22+25)	0.0	32.0	379.5	-	183.9	552.2
28.	Total peace dividend (7+13+23+26)	0.0	283.0	3,884.0	-	1,823.0	5,474.0
	% of reunited GDP	0.0	1.4	10.3	-	-	-
Memorandum items: Other potential income							
	Shipping: implementation of Ankara protocol	0.0	161.1	215.8	5.0	187.3	563
	Transport and storage income from Ceyhan oil pipeline	0.0	250.0	2,000.0	47.2	1,321.4	3,968
	Potential shipping and oil transport bonus	0.0	411.1	2,215.8	35.5	1,831.5	5,500

* Expected exports/turnover/income. ** Increase in nominal euro terms. *** New post-solution business per year (average).

Source of main forecast: authors' forecasts based on Greece-Turkey growth and Cyprus' recent macroeconomic performance.

7. SOME “BLUE SKY” THOUGHTS AND SUGGESTIONS

We would like to end our research with what we call some “blue sky” thoughts and suggestions. These are some “what if” ideas that we believe would greatly support rapprochement at the same time as leading to substantial financial gains for all concerned.

A regional oil storage hub

Cyprus could take advantage of the growing amount of oil transit trade across its northern coastline that will come from the Baku-Tbilisi-Ceyhan oil pipeline by setting itself up as a regional oil storage centre. At present, in order to comply with its EU obligations on oil capacity, the southern part of the island rents expensive storage space from Greece. However, with an oil storage terminal, Cyprus could set itself up as a regional hub, earning income from renting space to others. Given that oil tankers will be passing anyway, it is better that Cyprus benefits from the trade, rather than only suffers from any environmental impact that the traffic might bring. The profits from this business could be ploughed back into environmental projects.

A friendship tunnel between Cyprus and Turkey

The second proposal is to build a tunnel between Cyprus and Turkey. As the small island economy of Bahrain has found from the King Fahd Causeway that links Bahrain to the much large market of Saudi Arabia, a physical link with the larger neighbour leads to a substantial increase in tourists. While 1.5 million tourists arrive by sea and air, 5.7 million arrive via the Causeway²², often for short weekend visits. Indeed, the link has been so successful that the government is now planning a 45-km bridge to Qatar as well. At present, both parts of Cyprus attract just over 3 million tourists per year by air and sea. A tunnel or bridge (which is now possible with new engineering technologies) between Turkey and Cyprus would not only bring substantially more tourists from Turkey, it would also link Cyprus with mainland Europe, with huge benefits for businesses as a whole.

²² Central Bank of Bahrain, *Economic Indicators*, September 2007.

An Egypt-Cyprus-Turkey gas pipeline

Egypt is already a substantial producer of gas and Turkey is fast establishing itself as an energy hub of Europe, with the Baku-Ceyhan oil pipeline, the Blue Stream gas pipeline from Russia and, most recently, the Turkey-Greece natural gas pipeline from Azerbaijan which opened in 2007. Cyprus could become part of this network by participating in a gas pipeline that would run from Egypt via Cyprus to Turkey and then link into the Turkey-Greece pipeline. Not only would this bring in substantial transit income for Cyprus, it would also raise investor interest in exploring Cyprus's natural gas deposits. At present, investors are only likely to be interested in any gas finds off Cyprus if they are in substantial quantities and they may currently be put off by Turkey's protests about exploration. A reunited Cyprus with a gas pipeline running through it would be a much more attractive option for hydrocarbons investors.

8. CONCLUSIONS TO THE PAPER

Rapprochement between Greece and Turkey has led to a boom in commercial relations between the two countries that has transformed Greece into one of the top ten foreign investors in Turkey and has turned Turkey into one of the fastest growing markets for Greece, especially for tourism. This remarkable increase in business, despite centuries of mutual hostility, suggests that businesses quickly overcome feelings of mistrust as soon as political conditions improve. These developments, combined with Cyprus's small size, indicate that the most lucrative opportunities for Cypriot businesses after a solution lie beyond the island, namely in doing business with Turkey. However, reunification is also expected to lead to substantial recurring benefits for businesses on the island as well.

The key sectors which we would expect to benefit are construction and real estate, tourism, tertiary education, and accounting and legal services, while exports of goods such as pharmaceuticals also stand to gain.

According to our calculations, the reunification of Cyprus would add, on average, each year:

- EUR 510 million in exports of goods and services to Turkey, of which EUR 385 million would be tourism and EUR 22 million would be transport
- EUR 618 million in total trade in goods and services with Turkey
- EUR 393 million per year in new business for Cypriot construction companies
- EUR 155 million per year in new business for Cypriot real estate companies
- EUR 316 million per year (excluding new business from Turkey) for Cypriot tourism enterprises
- EUR 162 million per year for the Cypriot tertiary education sector
- EUR 103 million per year for Cypriot accounting and legal firms
- EUR 184 million in new foreign direct investment (excluding construction and real estate) into Cyprus

The annual average boost to business amounts to approximately EUR 1.8 billion euros (over CYP 1 billion or more than YTL 3 billion), or an average of just over 10% of GDP by 2015. If we translate this into the annual dividend per family (household) in Cyprus, it comes to an annual peace bonus of approximately EUR 5,500 per household per year. This is around 20% of the current average salary in the southern part of Cyprus and an estimated 40% of the average salary in the northern part of Cyprus. This calculation is the least that can be expected since it focuses only on the sectors that stand most to gain. Moreover,

adding the potential benefits of the implementation of the Ankara Protocol (EUR 187 million per year) and the new business that can be generated from the Baku-Ceyhan oil pipeline (EUR 1.3 billion) would double the calculated peace dividend to EUR 3.6 billion, or EUR 11,000 per household per year.

With such large numbers it is clear that it is irrelevant to talk about whether the economic benefits would be greater for Greek Cypriots or Turkish Cypriots. Reunification has the potential to bring huge economic benefits to everyone on the island.

Naturally, with such a rapid increase in trade, Turkey would also benefit. We estimate that Turkey would gain an additional EUR 440 million per year in new trade with Cyprus. More importantly for Turkey, a normalization of relations with Cyprus will remove one of the key obstacles to Turkey's accession to the European Union, which in turn would be expected to generate an even larger increase in foreign direct investment than has already been witnessed.

It is tempting when we think about solving the Cyprus problem to get bogged down in the details of whether this settlement or that settlement would work. While this issue is an important one, it also tends to shift our attention away from the longer-term benefits. One of the reasons for conducting this research is to get our imaginations beyond the solution, to assess in a clear and rational manner the real opportunities for businesses over the long term. If we can get beyond the solution, get to the day *after* a solution, then our research strongly suggests that the benefits for all Cypriots would be immense and long-lasting: so good, ones hopes, that it will be enough to bury our differences forever.

APPENDIX A: NOTE ON FORECAST METHODOLOGY

We took the decision to use nominal growth rates (in euro terms) rather than real growth rates for all forecasts except for construction and real estate, for several reasons. First, the bulk of expected trade between Cyprus and the rest of the world is in services, which are far less sensitive to changes in global prices of products such as oil. Second, in order to make a robust forecast of exports of goods and services in real terms, we would have required accurate historical figures on export prices of goods and services (separately) and import prices of goods and services (separately) for each economy studied. These statistics are not available. Third, we know from previous experience of forecasting the economy of the southern part of Cyprus that, if we had estimated historical export and import prices from global trends in the prices of tradeable goods and services, and then used the same methodology to forecast future export and import prices, back-testing would also raise issues about the viability of the forecast. Finally, our main target in this report is the businessman and businesswoman, who is interested in how much a solution is worth in actual money terms. Nevertheless, we acknowledge that our decision to forecast exports and imports in nominal terms entails some risk that we have not fully accounted for changes in export or import prices.

APPENDIX B: REFERENCES

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Statistical sources

Cyprus (north): State Planning Organization; Department of Trade; Department of Tourism Planning

Cyprus (south): Statistical Service (Cystat); Central Bank of Cyprus; Eurostat

Greece: Bank of Greece; Statistical Service of Greece; Eurostat

Turkey: Turkish Statistical Institute; Central Bank of Turkey; Eurostat

Other sources: Central Bank of Bahrain, *Economic Indicators*; IMF economic forecast database; Global Property Guide, www.globalpropertyguide.com

APPENDIX C: STATISTICAL APPENDIX

Appendix Table 1 Greece: Current account flows with Turkey

Greece: current account flows with Turkey											
EUR m	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Exports of goods	54.3			132.2	189.7	128.6	154.7	170.3	216.2	402.2	544.1
Imports of goods	79.5			224.8	347.3	417.9	476.3	499.6	599.2	627.7	902.6
Exports of services	11.6			22.1	22.7	22.0	83.4	99.4	121.4	113.5	147.5
Transportation	11.6			8.2	13.3	12.5	15.8	18.8	21.1	28.4	50.2
Sea transport, freight								11.7	15.6	22.6	
Travel	0.0			5.1	5.1	3.4	60.2	68.1	86.0	64.3	69.0
Business travel										32.4	
Other personal travel										32.0	
Insurance services	0.0			0.1	0.1	0.2	0.7	1.5	1.4	2.1	
Other business services	0.0			7.0	2.1	4.2	4.2	6.8	8.3	8.9	
Misc. bus., prof, & technical services								6.2	7.7	7.6	
Imports of services	8.8			24.0	44.3	70.9	113.1	104.6	115.8	178.8	185.4
Transportation	3.2			15.9	35.7	55.9	37.4	47.6	47.7	57.6	88.4
Travel	0.8			3.6	2.7	2.7	64.3	45.0	52.9	100.8	70.2
Income (incl. interest, profits and dividends)	0.0			3.5	24.5	14.5	5.4				
Compensation of employees	0.0			2.8	3.7	3.7	2.7				
Investment income	0.0			0.8	20.8	10.8	2.7				
Current account, credit	66.0			159.5	237.7	166.4	247.9	304.2	355.4	547.8	728.9
Current account, debit	92.0			252.6	397.8	492.2	595.4	614.0	726.1	819.0	1,103.1
Current account, net	-26.0			-93.1	-160.1	-325.8	-347.5	-309.8	-370.7	-271.2	-374.2

Notes: Blank denotes not available.

Sources: Eurostat, Bank of Greece.

Appendix Table 2 Greece and Turkey trade in services

Greece and Turkey: trade in services, EUR m						
Year	Greece: Exports of services to Turkey	Year/year % change	Turkey: Exports of services to Greece	Year/year % change	Total bilateral trade in services	Year/year % change
1999	22.1		24.0		46.1	
2000	22.7	2.7	44.3	84.6	67.0	45.3
2001	22.0	-3.1	70.9	60.0	92.9	38.7
2002	83.4	279.1	113.1	59.5	196.5	111.5
2003	99.4	19.2	104.6	-7.5	204.0	3.8
2004	121.4	22.1	115.8	10.7	237.2	16.3
2005	113.5	-6.5	178.8	54.4	292.3	23.2
2006	147.5	30.0	185.4	3.7	332.9	13.9
Annual average 2000-2006		49.1		37.9		36.1

Note: Turkey figures derived from Greece imports.

Sources: Eurostat, Bank of Greece.

Appendix Table 3 Greece and Turkey trade in goods

Greece and Turkey: trade in goods, EUR m						
Year	Greece: Exports of goods to Turkey	Year/year % change	Turkey: Exports of goods to Greece	Year/year % change	Total bilateral trade in goods	Year/year % change
1999	132.2		224.8		357.0	
2000	189.7	43.5	347.3	54.5	537.0	50.4
2001	128.6	-32.2	417.9	20.3	546.5	1.8
2002	154.7	20.3	476.3	14.0	631.0	15.5
2003	170.3	10.1	499.6	4.9	669.9	6.2
2004	216.2	27.0	599.2	19.9	815.4	21.7
2005	402.2	86.0	627.7	4.8	1,029.9	26.3
2006	544.1	35.3	902.6	43.8	1,446.7	40.5
Annual average 2000-2006		27.1		23.2		23.2

Note: Turkey figures derived from Greece imports.

Sources: Eurostat, Bank of Greece.

Appendix Table 4 Greece and Turkey travel market

Greece and Turkey: travel market, EUR m						
Year	Greece: Travel receipts from Turkey	Year/year % change	Turkey: Travel receipts from Greece	Year/year % change	Total bilateral travel market	Year/year % change
1999	5.1		3.6		8.7	
2000	5.1	0.0	2.7	-25.0	7.8	-10.3
2001	3.4	-33.3	2.7	0.0	6.1	-21.8
2002	60.2	1,670.6	64.3	2,281.5	124.5	1,941.0
2003	68.1	13.1	45.0	-30.0	113.1	-9.2
2004	86.0	26.3	52.9	17.6	138.9	22.8
2005	64.3	-25.2	100.8	90.5	165.1	18.9
2006	69.0	7.3	70.2	-30.4	139.2	-15.7
Annual average 2000-2006		237.0		329.2		275.1

Note: Turkey figures derived from Greece imports.

Sources: Eurostat, Bank of Greece.

Appendix Table 5 Greece and Turkey transport market

Greece and Turkey: transport market, EUR m						
Year	Greece: Travel receipts from Turkey	Year/year % change	Turkey: Transport receipts from Greece	Year/year % change	Total bilateral transport market	Year/year % change
1999	8.2		15.9		24.1	
2000	13.3	62.2	35.7	124.5	49.0	103.3
2001	12.5	-6.0	55.9	56.6	68.4	39.6
2002	15.8	26.4	37.4	-33.1	53.2	-22.2
2003	18.8	19.0	47.6	27.3	66.4	24.8
2004	21.1	12.2	47.7	0.2	68.8	3.6
2005	28.4	34.6	57.6	20.8	86.0	25.0
2006	50.2	76.8	88.4	53.5	138.6	61.2
Annual average 2000-2006		32.2		35.7		33.6

Note: Turkey figures derived from Greece imports.

Sources: Eurostat, Bank of Greece.

Appendix Table 6 Turkey top export markets for goods

Turkey: Top export markets for goods								
USD m	1999	2000	2001	2002	2003	2004	2005	2006
Germany	20.6	18.6	17.1	16.3	15.8	13.8	12.9	11.3
UK	6.9	7.3	6.9	8.4	7.8	8.8	8.1	8.0
Italy	6.3	6.4	7.5	6.6	6.8	7.4	7.6	7.9
USA	9.2	11.3	10.0	9.3	7.9	7.7	6.7	5.9
Spain	2.9	2.6	3.0	3.1	3.8	4.1	4.1	4.3
France	5.9	6.0	6.0	5.9	6.0	5.8	5.2	5.4
Russia	2.2	2.3	2.9	3.3	2.9	2.9	3.2	3.8
Netherlands	3.5	3.1	2.8	2.9	3.2	3.4	3.4	3.0
Belgium-Luxembourg	2.3	2.3	2.2	1.9	1.9	1.9	1.8	1.6
Greece	0.4	0.4	0.5	0.6	0.9	1.2	1.1	1.6
EU	15,424.2	15,664.4	17,545.6	20,415.0	27,393.8	36,580.9	41,364.9	47,929.2
Total exports	26,587.2	27,774.9	31,334.2	36,059.9	47,252.8	63,167.2	73,476.4	85,528.4
% change		4.5	12.8	15.1	31.0	33.7	16.3	16.4

Source: Turkish Statistical Institute.

Appendix Table 7 Turkey top suppliers of goods

Turkey: Imports by region								
USD m	1999	2000	2001	2002	2003	2004	2005	2006
EU	22,530	28,527	19,824	25,689	35,140	48,103	52,696	59,338
Other European	4,172	6,149	5,738	7,487	10,341.5	15,757	20,385.9	25,692
Other Asian	5,073	6,933	4,884	6,530	9,644	15,500	20,581	25,634
Near and Middle Eastern	2,124	3,373	3,017	3,186	4,455	5,585	7,967	10,568
North American	3,257	4,168	3,390	3,421	3,741	5,114	5,823	6,932
North African	1,404	2,257	2,115	2,138	2,519	3,231	4,212	4,878
Other African	284	457	704	558	820	1,589	1,835	2,526
South America	452	551	410	541	1,012	1,272	1,747	2,130
Australia and New Zealand	157	305	232	313	247	302	321	399
Central America and Caraipts	91	80	41	103	169	209	287	335
Other	621	1,208	741	1,013	662	67	158	105
Total	40,671	54,503	41,399	51,554	69,340	97,540	116,774	139,480

Source: Turkish Statistical Institute.

Appendix Table 8 Cyprus comparative GDP indicators

Cyprus: Comparative GDP indicators, 2006	
GDP at current prices, EUR m	
Cyprus (north)	2,035
Cyprus (south)	14,278
North as % of south	14.3
GDP per head, EUR	
Cyprus (north)	9,147
Cyprus (south)	18,480
North as % of south	49.5
Real GDP growth (%)	
Cyprus (north)	7.8
Cyprus (south)	3.9
Sources: State Planning Organization, Statistical Service.	

Appendix Table 9 Cyprus (south): Tourism arrivals and revenue

Cyprus (south): Tourism arrivals and revenue										
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Arrivals ('000)										
Total	2,088	2,223	2,434	2,686	2,697	2,418	2,303	2,349	2,470	2,401
Year-on-year % change	7.1	6.5	9.5	10.3	0.4	-10.3	-4.8	2.0	5.2	-2.8
From UK	846	1,015	1,156	1,363	1,487	1,338	1,347	1,333	1,392	1,360
From Germany	250	208	239	234	214	174	129	162	183	153
From Greece	68	71	83	100	90	93	110	133	130	127
From Turkey (total)	0.000	0.000	0.148	0.173	0.250	0.099	0.065	0.213	0.228	0.254
Revenue										
Total revenue (CYP m)	843.0	878.0	1,022.0	1,194.0	1,271.6	1,132.3	1,015.0	982.3	1,005.7	1,027.3
Year-on-year % change	8.1	4.2	16.4	16.8	6.5	-11.0	-10.4	-3.2	2.4	2.1
Per person (CYP)	403.7	395.0	419.8	444.5	471.5	468.2	440.7	418.2	407.2	427.9
% of GDP	18.4	17.8	19.3	20.6	20.4	17.6	14.8	13.3	12.8	12.3
Source: Statistical Service.										

Appendix Table 10 Cyprus (south): Tertiary education

Cyprus (south): Tertiary education				
	2002/03	2003/04	2004/05	2005/06
University students	3,658	4,110	4,532	4,861
Cypriot	3,384	3,815	4,216	4,484
Non-Cypriot	274	295	316	377
Tertiary non-university students	14,613	16,739	15,546	15,726
Cypriot	9,605	10,355	10,961	10,473
Non-Cypriot (almost all private colleges)	5,008	6,384	4,585	5,253
of which at private establishments	4,963	6,344	4,552	5,211
Total tertiary education students	18,271	20,849	20,078	20,587
Cypriot	12,989	14,170	15,177	14,957
Non-Cypriot	5,282	6,679	4,901	5,630

Sources: Statistical Service, Statistics of Education, various years.

Appendix Table 11 Cyprus (north): Tertiary education

Cyprus (north): Tertiary education								
	1999	2000	2001	2002	2003	2004	2005	2006
Foreign students in tertiary education ('000)	1,524	16,533	16,782	17,611	20,683	25,102	31,279	n.a.
Revenue from tertiary education (USD m)	46.4	57.4	67.3	72.3	85.0	155.4	202.7	305.0

Source: State Planning Organization.

Appendix Table 12 Cyprus (south): Exports of transport services

Cyprus (south): Exports of transport services											
EUR m	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Total services	2,287	2,263	2,494	2,650	2,992	3,477	3,744	4,753	4,729	5,027	5,219
Transport	294	310	325	331	352	437	482	947	1,090	1,157	1,236
Sea transport	53	65	68	78	79	90	101	497	689	852	893
Sea passengers	8	11	10	17	21	24	28	3	2	60	61
Sea freight	0	0	0	14	9	11	13	118	215	231	237
Sea auxiliary	45	54	58	47	50	54	60	376	472	561	596
Air transport	242	245	256	253	272	347	381	451	396	290	304
Air passengers	161	166	158	162	171	188	206	226	200	190	200
Air freight	13	13	15	15	16	19	21	30	15	18	17
Air auxiliary	68	67	83	76	85	141	154	195	180	81	87

Source: Eurostat.

Appendix Table 13 Cyprus (south): Exports of goods

Cyprus south: Exports of goods (inc. re-exports)										
CYP m	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
UK	60.3	80.3	87.2	98.8	117.6	141.4	152.4	149.4	121.0	95.0
Greece	46.1	54.1	48.9	48.2	52.6	42.5	43.8	65.0	82.0	86.1
France	6.8	1.0	5.7	5.1	6.2	7.0	5.6	13.6	121.9	48.0
UAE	34.6	27.0	22.0	13.5	10.7	11.5	10.8	25.9	18.4	29.7
Germany	20.5	24.1	22.8	18.2	18.4	15.8	18.7	27.3	38.1	29.7
Italy	8.3	5.2	9.2	6.1	4.1	12.3	7.6	9.4	6.9	21.5
Lebanon	35.1	30.3	26.4	30.3	23.3	18.7	16.2	14.7	14.8	14.9
Russia	125.3	56.8	35.3	47.3	54.1	12.8	8.0	10.8	9.3	9.7
Netherlands	7.7	10.3	13.3	11.0	10.7	13.6	12.3	13.5	14.2	9.3
Japan	0.8	1.6	0.9	0.7	2.3	0.8	1.3	10.8	10.8	7.3
Memorandum items										
Turkey	1.7	1.2	6.2	6.4	3.3	1.9	0.2	0.1	0.3	0.03
Total exports	640.0	551.1	542.9	591.9	628.0	511.3	476.8	548.0	719.2	650.7

Sources: Statistical Service, Statistical Yearbooks (to 2002), website (2003-06) and personal contact for selected countries.

Appendix Table 14 Cyprus (south): Imports of goods

Cyprus south: Imports of goods										
CYP m	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Greece	136.0	155.5	163.6	206.1	225.2	237.3	275.8	405.6	506.8	559.8
Italy	156.9	178.4	176.6	212.1	223.2	229.7	226.6	281.7	300.4	368.5
UK	217.0	214.9	225.2	254.5	222.3	207.8	191.6	229.3	260.8	288.0
Germany	113.4	161.2	135.2	168.1	172.7	218.8	173.1	239.7	245.4	285.9
Israel	52.6	53.2	58.5	96.5	99.7	92.6	87.6	118.3	208.1	200.0
France	79.9	94.4	103.9	107.2	127.3	126.9	118.0	168.1	107.8	136.5
Netherlands	33.6	39.2	42.2	50.3	52.8	52.9	56.3	88.1	115.8	136.5
China	30.8	41.6	54.5	82.8	91.0	99.6	112.8	108.7	113.4	134.4
Spain	49.5	69.3	60.5	79.5	96.6	87.2	91.8	97.4	96.4	93.5
Japan	100.1	141.2	132.7	139.1	153.7	167.9	129.9	127.4	91.0	78.1
Memorandum items										
Turkey	0.1	0.0	0.1	0.3	0.4	0.5	0.7	4.4	8.6	5.1
Total imports	1,899.3	1,904.7	1,970.9	2,402.0	2,528.7	2,486.6	2,314.2	2,679.3	2,966.8	3,226.9

Sources: Statistical Service, Statistical Yearbooks (to 2002), website (2003-06) and personal contact for selected countries.

Appendix Table 15 Cyprus (north): Exports of goods

Cyprus (north): Exports by country										
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Total	57.7	53.4	52.4	50.4	34.6	45.4	50.8	62.0	66.6	64.9
Turkey	27.1	27.0	27.9	18.7	12.8	18.3	22.9	28.7	34.2	30.9
UK	15.0	16.5	15.9	18.8	11.5	11.9	11.9	13.5	13.8	8.4
Other EU	8.9	5.8	4.5	1.5	0.7	0.8	0.7	1.7	3.3	1.3
Middle East	1.9	1.5	2.2	3.9	2.9	3.7	3.8	4.3	6.8	11.5
US	0.3	0.2	-	0.2	0.5	0.1	-	-	0.1	-
Other countries	4.5	2.4	1.9	7.3	6.2	10.6	11.5	13.8	8.4	12.8

Source: Department of Trade.

Appendix Table 16 Cyprus (north): Commercial relations with Turkey

Cyprus (north): commercial relations with Turkey								
	1999	2000	2001	2002	2003	2004	2005	2006
Arrivals of tourists ('000)	414.0	433.0	365.1	425.6	469.9	599.0	652.8	715.7
From Turkey	334.4	347.7	277.7	316.2	340.1	434.7	488.0	572.6
Tertiary students ('000)	23.9	25.8	26.3	27.7	30.6	35.5	41.9	
From Turkey	13.6	14.6	14.8	15.3	18.4	22.6	28.6	
Exports of goods (USD m)	52.4	50.4	34.6	45.4	50.8	62.0	66.6	64.9
To Turkey	27.9	18.7	12.8	18.3	22.9	28.7	34.2	30.9
Imports of goods (USD m)	412.7	424.9	272.0	309.6	477.8	853.1	1,255.5	1,376.2
From Turkey	256.4	275.1	173.5	195.0	299.3	512.4	817.4	946.9

Source: State Planning Organization.

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The day after

This study is not intended to promote any specific solution to the Cyprus problem nor any political party or movement on the island. In analysing the commercial opportunities of a solution, the authors make one simple assumption: that the solution approved by majorities in both communities would be economically and politically sustainable, even if the specific constitutional arrangements would not be totally perfect in all aspects. This research therefore aims to move our imaginations beyond the solution, to assess the real opportunities for businesses over the long term.

Rapprochement between Greece and Turkey has led to a boom in commercial relations between the two countries that has transformed Greece into one of the top ten foreign investors in Turkey and has turned Turkey into one of the fastest growing markets for Greece, especially for tourism. This remarkable increase in business, despite centuries of mutual hostility, indicates that businesses quickly overcome feelings of mistrust as soon as political conditions improve. These developments, combined with Cyprus's small size, suggest that the most lucrative opportunities for Cypriot businesses after a solution lie beyond the island, namely in doing business with Turkey.

In order to give businesses on the island an idea of the value of these opportunities in money terms, the authors make projections for key sectors based on both a reunification and a continued division scenario. By subtracting the divided Cyprus from the reunified Cyprus scenario, the authors can calculate the annual business peace bonus for each sector: tourism, shipping, construction and real estate, tertiary education, and accounting and legal services.

The authors conclude that Cypriots stand to gain at least an additional EUR 1.8 billion per year in recurring benefits from a solution to the Cyprus problem. This translates into approximately EUR 5,500 for every family every year, which is the equivalent of 20% of the average salary in the southern part of the island and 40% of the average salary in the northern part. Moreover, the annual bonus could be almost doubled if other important regional developments, such as oil transit from Ceyhan in south-eastern Turkey, are taken into account.

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