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Part 2

The Republic of Cyprus in Perspective: the Record and Future Challenges

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Introduction

Cyprus is a small island (9.263 km²) in the Eastern Mediterranean. It gained its independence from British colonial rule in 1960. At the end of 2011 the population in the government controlled areas stood at 862.000.¹

Fifty-two years after its establishment and just eight years after membership to the European Union (EU) the Republic of Cyprus faces multidimensional challenges. It is engaged in a peaceful liberation struggle (against Turkey) which is more reminiscent of a 19th century context (as it also includes an interethnic conflict) while having to tackle the problems of the 21st century. These include overcoming the effects of the global economic crisis, moving toward a new economic paradigm, dealing with the challenges of a modern society within the context of a multicultural Europe, addressing illegal immigration, improving the level of education, of health

1. The population of the government controlled areas of Cyprus at the end of 2011 was 862.000 persons. <http://www.mof.gov.cy/mof/cystat/statistics.nsf>. This excludes the number of Turkish Cypriots (estimated to be around 100.000) and of the settlers (estimated at around 180.000) in the northern occupied part.

services and more recently the question of exploitation of its newfound energy resources.

Section 1 of the contribution addresses the circumstances of the birth of the Republic of Cyprus and also examines political and economic developments. It also discusses the 1974 events and the broader fallout.

Section 2 assesses the new geopolitical landscape which developed in the post 1974 period. It also underlines the importance of the recovery and of the economic miracle which followed the 1974 catastrophe. Attention is also given to repeated UN initiatives to address the Cyprus question in a conclusive manner as well as to the growing importance of the EU.

Section 3 addresses the political, economic and energy strategic objectives of the Republic of Cyprus. These include the solution of the Cyprus question in a way that restores the territorial integrity of the country as well as an enhanced role within the framework of the EU. It also stresses that Cyprus requires a new economic paradigm. The fact that Cyprus assumed the Presidency at the EU Council from July 2012 is also examined.

We then put forward some concluding remarks and raise certain questions in relation to future options and challenges.

1. Historical Background and Context

1.1. The Birth of the Republic of Cyprus

When the Cypriot State was created it was what is often described as “a reluctant Republic.”² The major objective of the EOKA (National Organisation of Cypriot Fighters) anticolonial struggle against the British throughout 1955-1959 was *enosis* (union with Greece).³ Greek Cypriots, about 80% of the population of the island, felt that this was a just cause. The Turkish Cypriot minority community, about 18% of the population, favoured *taksim* (partition) although within it an extreme section claimed that Cyprus should be given to Turkey. The remaining 2% consisting of Armenians, Maronites and Latins identified with the Greek Cypriots. The 1960 Constitution, based on consociationalism,⁴ was designed by the guarantor powers – Britain,

2. Xydis S. G., *Cyprus: Reluctant Republic*, Mouton Press, The Hague/Paris, 1973.

3. Holland R., *Britain and the Revolt in Cyprus 1954-1959*, Oxford University Press, Oxford, 1998.

4. Consociationalism, as a system of government in biethnic and multiethnic States, stresses the importance of consensus among the constituent ethnic, religious and/or linguistic groups. It also rejects the principle of majority rule. For a theoretical elaboration and further appraisal, see Lijphart A. (Ed.), *Democracy in Plural Societies*, Yale University Press, New Haven and London, 1977.

Turkey and Greece – and was presented as a compromise. In fact, and quite inevitably, it reflected the imbalance of power in the region.⁵

The early days of the Republic of Cyprus were characterised by intercommunal and intracommunal strife. The lack of political maturity and experience were not conducive toward a normalised political life. Furthermore, the constitutional structure itself did not encourage the creation of common objectives and a shared vision between the two communities. The sustained interventions of foreign powers did not make things easier. The defining period for the Turkish Cypriots was 1963-64 which led to their withdrawal from the government, the establishment of the so-called “green line” as well as the creation of more enclaves.⁶ Greek Cypriots felt that this was part of a broader Turkish plan for the partition of Cyprus. Conversely, most Turkish Cypriots felt there was a real issue of security.⁷

The events in 1963-64 augmented bitterness and distrust. The Republic of Cyprus was effectively governed by Greek Cypriots following the withdrawal of Turkish Cypriots from the government and the civil service. Turkey exercised absolute control over the Turkish Cypriots the primary allegiance of whom was not toward the Republic of Cyprus. At the same time the Turkish Cypriot enclaves began to breed the seeds of partition.

Cyprus was undergoing a socioeconomic transformation which created new stakes (*see section 1.2. below*). This, in conjunction with the military coup in Greece on 21 April 1967 led to a fundamental redefinition of Greek Cypriot objectives. President Makarios declared that “what is feasible does not always coincide with what is desirable.” A new policy of abandoning *enosis* and opting for a unitary State was subsequently defined through

5. Greece, as a guarantor power, was the weakest party in the Eastern Mediterranean. On the other hand, the relative strength and positions of Turkey and Britain respectively were well entrenched.

6. Violence broke out soon after President Makarios, the first President of the Republic of Cyprus, submitted on 30 November 1963, a set of 13 points for a suggested revision of the 1960 Constitution.

7. Kyriakides S., *Cyprus: Constitutionalism and Crisis Government*, University of Pennsylvania Press, Philadelphia, 1968, pp. 157-162.

a vast majority in the presidential elections of early 1968. Cyprus was seen to be moving along the lines of pragmatism and a promising future was foreseen. Tragically the coup of 15 July 1974 reversed this historical path.

1.2. The Overall Economic Environment

In 1960, when Cyprus gained its independence, the economy was relatively backward with almost half the labour force employed in agriculture, which accounted for about 17% of gross value added in real terms. There was limited infrastructure and the standard of living was very low. Cyprus had no endowments of natural resources and the size of the domestic market was extremely small; total population at the end of 1960 was 580.000.

Cyprus adopted the model of market economy supplemented with indicative planning from the public sector. From the very beginning Cyprus embarked on a process of rapid economic expansion. Between 1960 and 1973 GDP expanded at an average of 7.3% annually in real terms. Per capita income in money terms rose from 91.6 Cyprus pounds in 1960 to 330 Cyprus pounds in 1973. (On average, during the period the exchange rate was roughly £1:\$2.68). The fastest growing sectors in the period were manufacturing, construction and utilities. Cyprus also became a fast growing holiday destination. Considerable advances were also recorded in the finance and business services sectors. The Central Bank of Cyprus was founded in 1963 and it functioned in coordination with the Ministry of Finance. The banking sector was starting to develop and the ratio of loans to GDP rose from 35% in 1960 to 51% in 1973.

During this period 1960-1973 the role and contribution of the government was instrumental. Its Planning Bureau prepared five-year plans and the government budget included a development budget for infrastructure works. Working with the private sector the government followed moderate

fiscal and monetary policies. Price inflation averaged 2% annually with price pressures escalating in the latter part of the period. The budget was usually in surplus in the period and total public debt was almost non-existent rising from 3.7% of GDP in 1960 to 4.7% of GDP in 1973. In sum, the early period of the young Republic witnessed spectacular growth amidst conditions of macroeconomic stability driven largely by investment in infrastructure and productive capacity.

1.3. The Events of 1974 and the Broader Fallout

The crisis in 1974 was the culmination of foreign interventions in Cyprus. On 13 July 1974, M. Dekleris and O. Alticacti, two constitutional experts from Greece and Turkey respectively, finalised a draft for a comprehensive settlement of the Cyprus problem which was to be ratified on 16 July 1974 by the two negotiators, G. Clerides and R. Denktash.⁸ This agreement based on a unitary State with elements of local and communal self-administration on issues of low level politics and aimed at overcoming the stalemate following the 1963-64 constitutional and intercommunal crisis. But international attention and local public opinion at the time was not focused on the prospect of an imminent solution of the Cyprus problem, but on the brewing clash between President Makarios and the Greek junta.

On 15 July 1974 the Greek junta overthrew Makarios. For Ankara it was an unprecedented opportunity as both the Greek junta and the putschist Sampson regime in Nicosia were internationally isolated. Some analysts have supported that the Greek coup d'état against Makarios was supported or at least condoned by the CIA.⁹

8. Dekleris M., *The Cyprus Question 1972-1974: The Last Opportunity* (in Greek), Estia, Athens, 1981, pp. 266-273; Christodoulou M., *The Course of an Era: Greece, the Cypriot Leadership and the Cyprus Problem* (in Greek), Ioannis Floros, Athens, 1987, p. 623.

9. O' Malley B. and Craig I., *The Cyprus Conspiracy: America, Espionage and the Turkish Invasion*, I.B. Tauris, London/New York, 1999.

On 20 July 1974 Turkey invaded Cyprus. Ankara stated that “its intervention was intended to reestablish the constitutional order and to protect the Turkish Cypriot [minority] community.” On 23 July 1974 the Greek junta collapsed and C. Karamanlis returned to Athens to lead the country to the reestablishment of democracy.¹⁰ The putschist regime in Nicosia collapsed and G. Clerides – as Speaker of the House of Representatives – assumed the duties of Acting President in accordance with the Constitution. He immediately suggested to R. Denktash, the Turkish Cypriot leader the return to the 1960 Constitution.¹¹ R. Denktash and Ankara declined.¹²

With the reestablishment of democracy in Greece and of the constitutional order in Cyprus, international public opinion changed. Both Karamanlis and Clerides enjoyed respect and credibility throughout the world. Nevertheless, Turkey continued its military operations despite the negotiations (involving Greece, Turkey, Britain, Greek Cypriots, Turkish Cypriots and the UN) for a peaceful resolution. On 14 August, Turkey launched a second massive attack after the rejection of its ultimatum to the Republic of Cyprus to surrender about 34% of its territory. Greek Cypriot civilians were expected to evacuate this territory and allow the Turkish army to deploy. By 16 August 1974 Turkey had occupied 38% of the territory of the Republic of Cyprus, having committed atrocities and violations of human rights.¹³ Following 20 July acts of violence against Turkish Cypriot civilians by Greek Cypriot extremists were also reported. These acts were undertaken in response to the atrocities of the invading Turkish troops as well as of Turkish Cypriot forces against Greek Cypriot civilians. The Turkish Cypriots who used to be evenly distributed throughout the island were gradually transferred to the occupied area.

10. O'Malley and Craig, *op. cit.*, pp. 87-119.

11. On 15 November 1983 R. Denktash unilaterally declared the so-called “Turkish Republic of Northern Cyprus” which was and continues to be recognised only by Turkey. The Security Council of the UN condemned this action.

12. Clerides GL, *My Deposition* (in Greek), vol. 4, Alitheia Press, Nicosia, 1991, pp. 38-39.

13. Hitchens Ch., *Hostage to History: Cyprus from the Ottomans to Kissinger*, Verso Press, London/New York, 1997; O'Malley and Craig, *op. cit.*; Coufoudakis V., *International Aggression and Violations of Human Rights: The Case of Turkey in Cyprus*, Minnesota Mediterranean and East European Monographs, Modern Greek Studies, University of Minnesota, 2008.

2. The Economic and Geopolitical Landscape after 1974

2.1. The New Geopolitical Landscape After 1974

Had Turkey stopped its military operations on 23 July 1974 and contributed to the reestablishment of the constitutional order based on the 1960 agreements, few would have questioned its stated reasons for “intervening.” Retrospectively though, there is no doubt that Turkey committed ethnic cleansing, did not re-establish the constitutional order in Cyprus, occupied 38% of its territory, set up a puppet regime and has pursued a policy of colonization and demographic transformation. By the end of 2011 the population in the self-proclaimed “Turkish Republic of Northern Cyprus” (“TRNC”) was estimated at approximately 280.000 (180.000 settlers, 95.000 Turkish Cypriots and 5.000 others); this excludes the Turkish troops of occupation estimated at around 40.000. Furthermore, there has been systematic destruction of the cultural heritage as well as massive exploitation and

usurpation of Greek Cypriot properties.¹⁴ It became obvious that Ankara's objective was to bring Cyprus under its strategic control.

Despite the initial outcry and various strong resolutions of the UN and other international institutions, in essence no practical measures have been taken against Turkey. In November 1974, the UN General Assembly passed a unanimous resolution (3212) for the respect of the territorial integrity, sovereignty and independence of the Republic of Cyprus and for the withdrawal of all foreign troops. Ironically, Turkey voted in favour of this resolution. Subsequently, the UN urged bicommunal negotiations to address the problem despite the fact that the issue is multidimensional and with the bicommunal aspect not being the most important one. Not surprisingly, successive rounds of bicommunal negotiations did not lead to any results.

Following the events of the summer of 1974 there was new thinking about how to proceed with a final solution to the Cyprus problem. Initially Greek Cypriots were discussing the prospect of a multi-canton federation. The Turkish Cypriot side immediately revealed its preference for what came to be known as a bizonal bicommunal federation. The high level agreements of 1977 and 1979 entailed a very different approach than what had been discussed before 1974.¹⁵ For the Turkish Cypriot side these agreements nearly met their maximalist positions while for the Greek Cypriots they have always been perceived as a painful concession.

For the Greek Cypriots the rights of property, return of the refugees to their homes and settlement of all Cypriots throughout the island were (and remain) inalienable. For the Greek Cypriots it was logical to demand the return of their properties while the Turkish Cypriots' demand to live in an

14. Ioannides Ch. P., *In Turkey's Image: The Transformation of Occupied Cyprus into a Turkish Province*, Aristide D. Caratzas, New Rochelle NY, 1991; Coufoudakis, op. cit.

15. Bahcheli T., "Searching for a Cyprus Settlement: Considering Options for Creating a Federation, a Confederation, or Two Independent States", *Publius: The Journal of Federalism*, 30(1-2), 2000, pp. 203-216; Theophanous A., "Prospects for Solving the Cyprus Problem and the Role of the European Union", *Publius, The Journal of Federalism*, 30(1-2), 2000, pp. 217-241.

area under their own administration could be satisfied without violating the rights of Greek Cypriots. The Republic of Cyprus could construct on state land new homes for Turkish Cypriots living on Greek Cypriot property. Arrangements could be made so that even if all Greek Cypriots returned under Turkish Cypriot administration, there would still be a Turkish Cypriot majority in the northern part of Cyprus.

The Turkish Cypriot positions on these issues were entirely opposite. There would be “global” exchange of properties and compensations; the region administered by each community would preferably be ethnically homogeneous. Furthermore, the Turkish Cypriot interpretation of the new state structure had multidimensional implications. In essence, the central government would be very weak and the source of power would be the two ethnically homogeneous entities; these were later to be described as “constituent States” in the UN sponsored Annan Plan V in 2004.¹⁶

The arrangements envisioned by the Turkish Cypriot side would make it difficult to have one economy, one society and one State. The strict, almost absolute, bizonality clauses demanded by the Turkish Cypriot side negate the idea of an integrated economy. Yet the Turkish Cypriot side would demand convergence of living standards – without an integrated economy and without the free flow of factors of production. And there was no talk about convergence of productivity levels.

There were different perspectives on the decision-making processes too. It was one thing for Turkish Cypriots to have autonomy in the region under their administration; it was another to demand a 50-50 share in the central government. Greek Cypriots agreed that there could be effective Turkish Cypriot participation in government, but this did not translate arithmetically to participation on a 50-50 basis. Greek Cypriots stressed the supremacy

16. Palley C., *An International Relations Debacle: The UN Secretary-General's Mission of Good Offices in Cyprus 1999-2004*, Hart Publishing, Oxford and Portland Oregon, 2005.

of the central government in contrast to the Turkish Cypriot position that most power should emanate from the two zones which were regarded as political entities of equal, almost sovereign status.

Given the political and geostrategic factors it is no surprise that there has been no breakthrough over the years. The majority of Greek Cypriots view the Turkish Cypriot ideas for a solution as entailing “absolute control in the north” and “a partnership arrangement in the south.” This they consider as worse than partition.

2.2. Recovery and the Economic Miracle

The Turkish invasion of 1974 dealt a severe blow to the Cypriot economy. Almost 40% of the island’s territory came under the control of the Turkish army. This area included most of the citrus growing land, the most developed tourist infrastructure and about 70% of the country’s capital and natural resources. Cyprus lost 65% of tourist beds, 87% of hotels under construction, 83% of general cargo handling facilities, 55% of the coastline, 56% of mining and quarrying output, 48% of agricultural exports and 46% of plant production.¹⁷ Cyprus lost the port of Famagusta which handled more than 80% of cargo, and the only commercial airport in Nicosia.

About 200.000 Greek Cypriots, a third of the island’s population, lost their homes and livelihood and became refugees in their own country. The unemployment rate rose to almost 30% in the second half of 1974.¹⁸ Real GDP contracted by 17% in 1974 and by another 19% in 1975. The volume of exports fell by 20.8% in 1974 and by 11.4% in 1975. Tourist arrivals

17. Theophanous A., “Economic Growth and Development in Cyprus 1960-1984”, *Modern Greek Studies Yearbook*, 7, 1991, p. 111.

18. Department of Statistics and Research, Ministry of Finance, *Historical Data on the Economy of Cyprus 1960-1991*, Republic of Cyprus, Nicosia, 1994, p. 187.

dropped by 43.6% in 1974 and by 57.9% in 1975. Moreover, thousands of Greek Cypriots contemplated leaving the country and many of them did so.

Recovery efforts were centred on stimulating private sector activity with the proper mix of monetary and fiscal incentives. The focus was reconstruction, infrastructure build up and export oriented activities. The government's role was instrumental in providing the right framework of expansionary policies and incentives.

By 1978 real GDP returned to pre-invasion levels. The essence of the “economic miracle” was the survival and the continuity of the Republic of Cyprus. By the early 1980s’ some Greek Cypriots who had emigrated began to return. Unavoidably this “miracle” had shortcomings such as the unplanned expansion of urban areas and of the tourism sector which had adverse environmental effects. But without it Cyprus would have collapsed.

2.3. The UN Initiatives and Accession to the EU

On 4 July 1990 the Republic of Cyprus submitted its application for membership to the then European Community. It was believed that the prospect would facilitate the solution to the Cyprus problem. The Turkish side did not see this move positively. The intercommunal negotiations under UN auspices continued. In the summer of 1992 the UN Secretary General, encouraged by the US and the UK, submitted what had come to be known as the “Ghali Set of Ideas” for the solution to the Cyprus question. These ideas became the focus and the major issue of the 1993 presidential elections in Cyprus.

G. Clerides, the newly elected president, in cooperation with Athens, paid greater attention than his predecessors to the European prospect of Cyprus. One and a half years after the start of Cyprus’ accession negotiations with

the EU (March 1998), the UN Secretary-General K. Annan, encouraged by the US and the UK, began a new process of negotiations in the fall of 1999 for a settlement. This time the stakes were higher. In Washington the prevailing strategic thinking was that the EU could offer incentives for addressing several key issues simultaneously and effectively. Three of the major objectives were the following: (a) solution of the Cyprus problem and accession to the EU of a unified island in 2004; (b) EU candidacy for Turkey and subsequent accession negotiations with the objective of full membership; (c) resolution of all Greco-Turkish problems by 2004 and thus the advancement of peace, security and cooperation in the Eastern Mediterranean.

At the Helsinki European Council in December 1999, an agreement was reached by which the Union encouraged a solution to the Cyprus problem prior to accession without making the solution itself a requirement for accession. Simultaneously, Turkey was given candidate status. Ankara was expected to contribute toward the resolution of the Cyprus question and to resolve its differences with Greece by December 2004. The Helsinki decisions in December 1999 were considered a potential turning point.

Despite difficulties, the UN process continued. The final plan, Annan V, which was submitted to simultaneous referenda to the two communities on 24 April 2004, was broadly considered as not balanced. Inevitably this was reflected in the outcome: 76% Greek Cypriots voted “No” and 65.9% Turkish Cypriots (and settlers) voted “Yes.” And this despite the fact that all along it was the Greek Cypriot side which had sought reunification, with the Turkish Cypriot side maintaining strong reservations and opting for a more separatist approach.

The Turkish side claimed that the Greek Cypriots did not want to share power and wealth with the Turkish Cypriots. In fact, the Greek Cypriots rejected a plan which would have legitimised the outcome of the 1974 invasion and turned Cyprus into a Turkish protectorate with the possibility of dramatic demographic changes as it provided for most of the settlers to stay. Greek Cypriots also

felt that the provisions of the Annan Plan reversed many of the gains of the imminent EU accession and that there were inadequate guarantees against the inflow of more Turkish settlers, let alone that Turkey would again be a guarantor power. Furthermore, the plan in essence dissolved the Republic of Cyprus and called for a new state entity. Given also the strict bizonality conditions it would have been very difficult, if not impossible, to promote an integrated society and economy. It should also be mentioned that the Plan had also provided a Supreme Court consisting of 9 members: 3 Greek Cypriots, 3 Turkish Cypriots and 3 foreigners. In cases of stalemate this would have allowed the foreign judges to exercise great influence in the affairs of the country.

Despite what was perceived as a legitimate rejection of the Plan, the moral high ground of the Republic of Cyprus was shaken in the aftermath of the referendum. There were many factors which contributed to this: (a) an effective Turkish communications campaign blaming the Greek Cypriots for their “No” vote; (b) the lack of a post-referendum strategy on the part of the Republic and (c) the stance of the strategic allies of Turkey which essentially wanted Ankara to be absolved of its responsibilities over Cyprus so as to open the way for EU accession negotiations.

Had the UN, the US and the EU pursued a balanced approach in the spring of 2004, it is likely that there would not have been a failure of the process. Only days after the referendum the EU accepted the Republic of Cyprus as a full member without a solution to the problem. While Greek Cypriots were accused of blocking a perceived solution with their “No” vote on 24 April 2004, in essence it gradually became clearer that Annan Plan V had reflected the Turkish philosophy and strategic interests. Had the proposed solution been accepted, it would have created several problems in Cyprus and beyond. Indeed, the implementation of such a plan would have turned Cyprus into a protectorate of Turkey.¹⁹

19. Palley, *op. cit.*; Theophanous A., *The Cyprus Question and the EU: The Challenge and the Promise*. Nicosia: Intercollege Press, 2004.

The victory of the left-wing candidate D. Christofias in the presidential elections of February 2008 raised expectations about rapid developments towards the resolution of the Cyprus problem as he focused on the process of bicommunal negotiations and called for “a Cypriot solution.”²⁰ But despite Christofias’ flexible stance again there was no breakthrough.

Despite the continuation of its occupation of the Northern part of Cyprus and the perpetuation of the problems with Greece (and despite Ankara’s commitment to resolve them by December 2004), on 17 December 2004 the EU granted Turkey a date (3 October 2005) for the beginning of accession negotiations. Ankara was expected to sign and implement the Customs Union Protocol with the ten new member countries, including the Republic of Cyprus. Consistent with past policy Turkey never met this obligation.

In January 2008 Cyprus joined the Eurozone. The introduction of the euro held exceptional importance for Cyprus as it would implicitly require a unified political and economic structure in case of a solution. Indeed, if a unified Cyprus is to meet its obligations as a member of the Eurozone it must follow uniform and consistent economic policies which require coordination and cooperation. Furthermore, one should also consider the rising aspirations of young Cypriots on both sides. A dynamic and integrated economy is required for more jobs and opportunities to be created.

At the same time several issues raised by the Turkish Cypriot side such as the objective for separate central banks and a new currency in the federal State, other than the Cyprus pound, have been invalidated by the introduction of the euro. Indeed, the euro has the potential to be a unifying tool in Cyprus, economically, socially and politically.

20. Implicitly, however, a side-effect of this approach is that it minimised the responsibility of Turkey in the decades-long stalemate on the island. It also served to water down Ankara’s violations of fundamental rights of Cypriots and of international law.

In federal arrangements it is of utmost importance to advance a common value system, objectives and institutions. The euro serves these objectives in many ways. At the same time the euro entails responsibilities in relation to fiscal prudence and raises the issue of broader economic policy coordination. In sum, Cyprus' adoption of the euro also influences the type of the solution of the Cyprus question: reunification presupposes an integrated society, economy and political structure.

3. Strategic Objectives

3.1. Political Strategic Objectives

In 2012 Cyprus finds itself in a unique situation. It has to address an existential threat as Turkey continues to occupy almost 38% of its territory and has been pursuing an aggressive policy of encouraging Turkish nationals to settle in the northern part of Cyprus thus changing the island's demographic structure. Furthermore, Turkey does not recognise the right of the Republic of Cyprus to exist and has not fulfilled the minimum requirements that it has undertaken toward the EU. Cyprus also has seen its moral high ground eroded. This outcome has been the result of several factors including the perceived geostrategic and geoeconomic importance of Turkey and, consequently, the support of Turkey by major powers, Ankara's effective public relations campaign in conjunction with the clumsy approaches of Cyprus.

The major objective of Cypriot policymakers is the reestablishment of the territorial integrity and unity of the country. The great imbalance of power in

the region led Greek Cypriots to concession after concession which makes it difficult for the electorate to approve.²¹ The major question is: what model could lead to reunification while sustaining intercommunal peace, security and cooperation?²² Negotiations have been taking place on the basis of a bizonal bicomunal consociational federal model. The record of such models is not encouraging. For example, Bosnia is facing serious problems²³ while even Belgium has repeatedly experienced government crises. Not to forget that Czechoslovakia opted for a velvet divorce in 1993.

This is not to suggest that Cyprus should pursue partition. It is essential to recall that Cyprus is no longer merely a bicomunal country. On the contrary there are also other notable numbers of EU and third-country nationals. It should be also noted that it is estimated that there are about 180.000 Turkish settlers in the northern occupied part of Cyprus and 70.000 illegal immigrants in the government controlled area.²⁴

A multi-canton functional federation based on an integrationalist approach may indeed lead to a viable unified State. Yet this option is not on the negotiating table. For years now, the basis has been a bizonal bicomunal federation whose definition and interpretation have been subject to serious intercommunal and intracommunal disagreements.²⁵ Furthermore, as already noted, the role of Turkey in the equation is overwhelming. Indeed, the dilemmas for the Republic of Cyprus in relation to the form of a solution are great.

21. For the Greek Cypriots the major issue is Turkey, not the Turkish Cypriots. Within this framework Greek Cypriots believe that their major adversary is Turkey, not the Turkish Cypriots. In this context there is a great imbalance of power.

22. Theophanous A., *The Political Economy of a Cyprus Settlement: The Examination of Four Scenarios*, PRIO, Nicosia, 1/2008.

23. McMahon P. and Western J., "The Death of Dayton: How to Stop Bosnia from Falling Apart", *Foreign Affairs*, 88(5), 2009, pp. 69-83.

24. The official position of the Cyprus government is that the settlers constitute a political issue and within the framework of a solution they should return to Turkey. It is understood that for humanitarian and practical reasons some of them would stay.

25. It is not a surprise that there are disagreements about the form of a solution. Most Greek Cypriots would like to have an integrationalist approach while most Turkish Cypriots would opt for a loose relationship. It is also worthwhile noting that the two communities are not monolithic.

Cyprus has to also reassess its foreign and security policy challenges and priorities. For years it has remained attached to a doctrine of nonalignment and demilitarisation, while Turkey maintains 40.000 troops of occupation on the island and, while two British sovereign bases operate on the island often offering facilities to NATO and the US.

The Republic of Cyprus aspires to hold a successful Presidency of the Council of the EU which it assumed on 1 July 2012 (*see more on this in part 3.4.*). This prospect has also enhanced the debate about the position and the role of Cyprus in the region, the EU and the international community. Within the framework of new developments Cyprus has improved its relations with Israel while maintaining its traditional ties to the Arab World. Russia also continues to be a strategic partner for Cyprus. In the post-Cold War international environment such relations are not only compatible with EU membership, indeed they have become the norm.

3.2. Economic Strategic Objectives

For years Cyprus took pride in the “economic miracle” that it had achieved after the Turkish invasion and its devastating repercussions. In the process the Cyprus economy was transformed into a service-based economy with sizeable tourist and trade sectors, and more recently with a rising financial services sector. Income variability declined but exposure to exogenous shocks has increased as the degree of economic openness and the international expansion of the banking sector advanced considerably. International banking and business services accounted for a considerable part of recorded growth in recent years.

Cyprus entered into a recession in 2009 from a position of financial strength. Following accession to the EU in 2004 and entry into the Exchange Rate Mechanism in the summer of 2005, efforts to consolidate the public

finances intensified. As a result, the historically large budget deficits turned into surpluses in 2007 and 2008. However, measures taken in the wake of the crisis and the economic recession that ensued led to a sharp deterioration of the country's fiscal position adding considerably to public debt. According to the government, fiscal consolidation measures taken toward the end of 2011 if fully implemented may bring the budget deficit down to 3% of GDP in 2012.

The banking sector poses risks by virtue of its size and concentration and its large exposure to the situation in Greece. Total assets are currently about eight times the GDP indicating that the financial sector is large relative to the economy. The banking sector is concentrated: three banks dominate the sector. As a result, problems in the banking sector can quickly escalate to systemic proportions with serious economic repercussions.

Growth in the period 2006-2008 was largely credit-financed and supported by strong real wage growth, low unemployment, significant foreign direct investments in the property market and an improving business climate. Rapid credit expansion was driven by excess liquidity in the banking system. Following the decision to enter the Eurozone in January 2008, the Central Bank of Cyprus lowered interest rates, reserves and prudential liquidity requirements on euro deposits. The Central Bank also reduced the minimum liquidity requirement on foreign currency deposits from 75% to 70%. Credit expansion in the period was also supported by an inflow of non-resident deposits and an expansionary fiscal policy.

The overheating of the economy in the period 2006-2008 gave rise to vulnerabilities. There is high private indebtedness as measured by the ratios of company loans to GDP and household loans to GDP. Domestic credit to GDP rose to 297% in 2011, compared with 185% of GDP in 2000 and 140% in 1995. The ratio of company loans to GDP rose to 159% in 2011

compared with about 90% in 2001. Household loans at the same time rose to 132% of GDP in 2011 from about 90% in 2001.

The financial sector managed to weather the global economic crisis relatively well and resident and non-resident deposits held steady in the period. However, the big domestic banks, with considerable assets in Greece, have taken a hit by the private sector involvement in the country's debt restructuring. As a result Cypriot banks face significant capital needs to meet the requirements of the European Banking Authority. In this context the government has underwritten an equity rights issue in favour of the country's second biggest bank, Laiki Bank, for up to €1,8 billion or about 10% of GDP.

The Cyprus economy remains exposed to considerable risks: these include a deterioration of conditions in Greece, an intensification of the debt crisis in Europe and adverse shocks to world trade and fiscal adjustment. The total exposure of the country to Greece in terms of loans and bond holdings prior to the recent write downs, was approaching €30 billion which amounts to about 150% of the GDP. A further deterioration of conditions in Greece and the rest of Europe would also impact on Cyprus banks and the real economy. Hopefully though this scenario will not be realised.

In any case though, the model that Cyprus pursued successfully for years now needs major overhaul. Cyprus has to address structural problems and issues. For example, the composition of the labour market has drastically changed. A major dimension of this change is the fact that in the last 25 years the number of young Greek Cypriots seeking higher education has doubled so that today more than two out of three hold such degrees at various levels. There are high expectations in relation to their employment prospects which the current model cannot satisfy.²⁶

26. The prevailing economic situation characterised by considerable imbalances, does not produce adequate growth to support job creation. As a result economic activity has stagnated and the unemployment rate has been rising. Not only is it necessary to correct the imbalances and generate growth, it is also important to further diversify the economy into more high value added activities including education and health.

Cyprus also needs to address internal economic imbalances. After months of deliberations some measures were introduced in December 2011 to reduce the budget deficit. Nevertheless, additional fiscal measures are required to restore public finances and regain access to markets. To achieve this the government needs to reduce the relative weight of the payroll of public employees and better target social outlays. It has to also revisit the social security system and the public pension system. Only when these issues are effectively addressed will it be possible to restore public finances and regain credibility.

Furthermore, one cannot underestimate the economic issues and the challenges of reunification in the event of a solution to the Cyprus question. These range from the issues of socioeconomic convergence, legal harmonisation and property arrangements.²⁷ Besides, Cyprus has to also address illegal immigration which has become a serious problem. Almost all illegal immigrants come to the government controlled areas from the occupied northern part. Despite difficulties to check the 180 km long dividing line Cyprus has not yet applied to join the Schengen Area due to perceived political difficulties and complications.

3.3. Energy Strategic Objectives

The energy sector is undergoing significant changes on a global scale deriving from changes in the reserve mix, geopolitical uncertainties and climate change. Recent discoveries of natural gas in the Levant region and continued exploration will no doubt have a significant impact on the economic dynamics of the region.

27. Theophanous A., *European Cyprus: Constitutional Structure Economy and Society. Accession and Solution Scenarios* (in Greek), I. Sideris, Athens, 2002; Theophanous A., *The Political Economy of a Cyprus Settlement: The Examination of Four Scenarios*, PRIO, Nicosia, 1/2008.

Natural gas reserves in the region can be substantial. According to a US Geological Survey report released in March 2010,²⁸ the Levant Basin that stretches from the Sinai Peninsula to the northern border of Syria and from the coast into the Mediterranean Sea to the western side of Cyprus may hold 1.7 billion barrels of recoverable oil and 122 trillion cubic feet of recoverable natural gas.

The discovery of natural gas in Cyprus' Exclusive Economic Zone (EEZ) therefore, has the potential to change the dynamics of economic growth on the island. The Houston-based energy firm Noble Energy, which has been exploring in Cypriot waters, following the first tendering round of 2007, announced in December 2011 the discovery of an estimated 5 to 8 trillion cubic feet of natural gas deposits.²⁹ A second round of exploration and drilling licensing was concluded in May 2012 with considerable interest shown by international energy companies.

A switch to natural gas as a primary source of energy will have far reaching implications. It will affect electricity production, improve the trade balance as the country transforms into an exporter of natural gas, and significantly reduce carbon emissions. Also, becoming an energy producer and natural gas exporter will improve energy and economic security.

Currently electricity production in Cyprus is fuelled primarily by oil with natural gas playing no role at all. Converting electricity production to natural gas would be a major investment and is likely to require many years to achieve. Noble Energy is exploring the possibility of building a liquefaction facility in Cyprus to utilise any natural gas discoveries for exports to Europe and Asia. Additional benefits would accrue from spin-off businesses.

28. United States Geological Surveys (USGS), *Assessment of Undiscovered Oil and Gas Resources of the Levant Basin Province Eastern Mediterranean*, Fact Sheet 2010-2014, US Department of the Interior, 2010.

29. Kasinis S., *The Status of Hydrocarbon Exploration in Cyprus*, Presentation in the 1st Energy Symposium Cyprus, Nicosia, 26 January 2012.

A liquefaction plant would be a massive investment for the size of the Cypriot economy. Field development, pipeline construction to the coast of the island and the construction of a liquefaction terminal would cost about 10 billion US dollars according to Noble Energy. The construction of the plant would result in a new energy hub in Cyprus making the island a key location on the Mediterranean energy map. Revenues for the Republic of Cyprus would be significant on a long term basis.

The regional interest to develop energy resources creates an opportunity for discussions among countries in the region either on a bilateral or multilateral level. Israeli Prime Minister Benjamin Netanyahu paid an official visit to Cyprus on 16 February 2012, the first ever by an Israeli Prime Minister. His talks focused mostly on closer cooperation between the two countries in relation to natural gas exploration and sector development. A pipeline can be constructed to link the finds in the economic zones of the two countries. Liquefied natural gas can then be exported to Europe or Asia. Israel and Cyprus may consider linking their power grids following a proposal by Israel's Energy and Water Minister provided that such a project is technically feasible and financially viable. Also Greece's Environment, Energy and Climate Change Minister, said that Greece and Cyprus will examine the financial and technical aspects of linking the Cypriot power grid with that of Crete, Greece's largest island, with the prospect of linking the Cretan grid to the continental grid.

Besides Israel, Cyprus has also signed agreements delineating the Exclusive Economic Zone with Egypt and Lebanon. This form of cooperation will establish the foundations for the alliances in the future. It should be noted though that Turkey does not recognise Cyprus' EEZ and this has already begun to create complications.

3.5. The Cyprus Presidency of the EU Council

Eight years after its accession Cyprus took on the helm of the EU for the first time on 1 July 2012. The challenge is significant considering the difficulties that the Union is undergoing and given the continuing political problem that Cyprus itself is facing.

Nonetheless, the Cyprus Presidency will be called to deal with some of the most critical issues for the Union's future. Having set out its theme for *Working towards a Better Europe*, based on the principle of solidarity and on social cohesion, Cyprus will, in practical terms, have to deal first with the Multiannual Financial Framework, and to continue the ongoing and intense negotiations towards a final agreement.

Also, it will focus on the Europe 2020 Strategy, which aims at resource efficiency and sustainable growth, highlighting the importance of a more competitive Union based on a low carbon and green economy. In addition, the Common European Asylum System features as a top priority as is relaunching the Integrated Maritime Policy. An equally urgent and complicated challenge to be addressed is growing unemployment, especially among young people. The Cyprus EU Presidency has stated that it will focus on actions promoting job creation with special emphasis on youth.

Days before assuming the EU Presidency Cyprus was forced to seek the support of the European Stability Mechanism. Viewed from another perspective, it is an opportunity to promote the necessary reforms.

The Cypriot government has asked Russia for an additional €5 billion loan in July 2012; it had received one amounting to €2.5 billion in 2011. The left-wing government did not want to be associated with austerity measures that would inevitably be part of a stabilisation programme with the EU.

Interestingly enough this raised questions in several EU capitals about the implications of the relations between Russia and Cyprus at a time when the geopolitical significance of the Eastern Mediterranean is increasing. Nevertheless, as already noted, despite the fact that there are strong cultural, historical, economic and political links between the two countries, no conflict of interest is created with the commitments of Cyprus to the EU.

Concluding remarks

It is rare that a country finds itself in a situation where there is such a divergence between the best possible and the worse outcome. Since the Turkish invasion of 1974, 38% of the territory of Cyprus remains under occupation. There was considerable dislocation in 1974 but subsequently the economy embarked on a path of remarkable growth.

Since the partial lifting of restrictions to free movement across the UN ceasefire line, on 23 April 2003, there has been more interaction between the two communities and enhanced economic relations. However, the new environment does not constitute free movement of labour and capital and the integration forces are not allowed to take their course. The most important challenge after accession to the EU and the introduction of the euro is the reestablishment of the country's territorial integrity.

Cyprus is a test for Turkey's ability to move forward with a new mentality.³⁰ Turkey cannot be seen as a truly democratic country while keeping the northern part of Cyprus under occupation and striving for the strategic control of the whole island.

Despite past failures, the membership of the Republic of Cyprus in the EU combined with Turkey's desire to join the EU or, even, achieve a strategic partnership agreement, provides a framework for a breakthrough. In an era of multiple identities, the EU can provide the context for a common European identity that would make a unified Cyprus work. At the same time Greek Cypriots and Turkish Cypriots can also nurture their own ethnic and cultural identities. The EU, in this respect, may play a significant contextualizing role even though it has not yet acquired its full potential in addressing more effectively major regional and international problems.

Given the years of unsuccessful attempts for a comprehensive settlement it is important to consider other possibilities: from the bizonal bicommunal federal model in which power is essentially concentrated in two constituent States to an integrationalist model of functional federation. For this scenario to materialise, however, in addition to the consent of the Turkish Cypriot side, it is of utmost importance that Turkey finally recognises the right of the Republic of Cyprus to exist.

Cyprus has to also address new economic challenges. In addition to effectively coping with the current economic crisis it is essential that it also moves toward a paradigm shift. Within this framework fiscal rationalisation is required as well as moving to new engines of growth. The emerging energy sector constitutes a remarkable challenge involving both economic

30. The inflexible stance of Turkey on Cyprus is a complex phenomenon. It is not only an issue of traditional policy perspectives and national pride. In fact Turkish officials have repeatedly declared that because of geopolitical reasons Cyprus would have been considered important for Turkey even if there were no Turkish Cypriots on the island.

as well as political dimensions. It is essential that Cyprus positions itself in ways that allow it to play an enhanced role in the region and the EU.

52 years after Cyprus' establishment the EU Presidency is a huge stepping-stone towards the Republic's 'adulthood.' Under difficult circumstances it helps re-confirm its sovereignty and status. The government has repeatedly stated that the Cyprus problem will not interfere in the execution of the Presidency and that it shall handle the operation in particular issues pertaining to Turkey with an absolute sense of objectivity. It is fully aware, that if handled efficiently, the EU Presidency will provide credibility and future gains for its own objectives.