The day after III

The Cyprus peace dividend for Turkey and Greece

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The Day After III

The Cyprus Peace Dividend for Turkey and Greece

By

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FOREWORD:
HISTORY KNOCKING AT THE DOOR

In the first Day After report, the authors based their estimates of the peace dividend for Cyprus on the very rapid increase in external transactions between Greece and Turkey which followed the normalization of political relations between the two countries, initiated in 1999 by the then ministers of foreign affairs, George Papandreou and the late İsmail Cem.

Strange as history may be, it is once again knocking at the door of the neighbourhood of Greece, Turkey and Cyprus with a similar yet more critical opportunity for the normalization of political relations and the consequent growth of economic relations among the three countries.

A new phase of dialogue between the two communities in Cyprus for the reunification of the island began in 2008 and is expected to continue on the same basis despite the election of a new Turkish Cypriot leader.

Mr. Papandreou was elected to the premiership of Greece in October 2009, at the same time that the reformist government of Mr. Recep Tayyip Erdoğan began to voice the policy of "zero problems with neighbours." Furthermore, Mr. Erdoğan aspires to secure a certain and clear way for Turkey's full accession to the European Union, an ambition which has the official support of both Greece and the Republic of Cyprus. Impressive gestures of goodwill were undertaken by both prime ministers immediately after the election of Mr. Papandreou. This was followed up in May 2010 by a summit between Mr. Papandreou and Mr. Erdoğan in Athens, at which Mr. Erdoğan was accompanied by large delegation of ministers and business people. The messages coming from these political leaders are loud and clear.

"It is time to stop investing in military equipment and start investing in people," said Prime Minister Erdoğan, talking in Istanbul to a group of Greek and Turkish Cypriots, in February 2010, about his vision of converting the Eastern Mediterranean into an area of peace, cooperation and stability that will bring benefits to all.

"Political will is what is needed for the attainment of an agreement for the reunification of Cyprus and for the normalization of relations between Greece and Turkey," said Prime Minister Papandreou during his visit to Cyprus in April of the same year. "We also need to create conditions of trust between Greece and Turkey and between the Greek Cypriots and the Turkish Cypriots, for without trust no legal form of an agreement will survive through time."

At a meeting of the foreign minister of Turkey with the deputy foreign minister of Greece in Ankara, Mr. Davutoğlu reminded us of the earthquake diplomacy of 1999, while deputy foreign minister, Demitris Droutsas, spoke of the peace dividend that the solution will bring.

"The security of Turkey presupposes the transformation of the Eastern Mediterranean into a zone of peace, development and stability. And Cyprus is the key to achieving this change," said Ahmet Davutoğlu in an interview with the Greek newspaper "Τα Νέα," during his earlier visit to Greece.

Contrary to the recent past, including the period during which the team that became known as "The Three Ladies" wrote their first *Day After* report, these statements demonstrate that it is now commonly accepted that a settlement of the Cyprus problem that unites the island will bring huge benefits, not only to Cyprus but to Turkey and Greece as well, especially in these challenging economic times. Having estimated the benefits of a settlement that await Cyprus, this report seeks to quantify the benefits to Turkey, as well as previewing some of the benefits that await Greece.

In their first two *Day After* reports, the Three Ladies found that Cypriots will benefit from a peace dividend of EUR 12,000 per year per family, and that 33,000 new jobs await the unemployed on the island, on the basis of an average increase in the real GDP growth rate of three percentage points per year over a five-year period following the reunification of Cyprus.

The expected benefits of a normalization of relations among Cyprus, Turkey and Greece would stem from enhanced economic interaction between the three. This would be boosted by the additional business and investment that would come to the area from the rest of the world and especially the European Union, once the political risk and the uncertainty implicit in an unresolved Cyprus problem are removed from the equation.

ACKNOWLEDGEMENTS

The authors are, as ever, indebted to the PRIO (Peace Research Institute Oslo) Cyprus Centre (PCC), for supporting and funding "The Three Ladies" in this trilogy of *Day After* reports and for PCC's faith in our slogan, namely that "peace is more profitable than war".

In December 2009, the Three Ladies were honoured to be presented the Stelios Award for Business Co-operation in Cyprus[1], launched by Sir Stelios Haji-Ioannou, the "serial entrepreneur" and founder of easyGroup. The award not only encouraged the authors to continue their work, it also helped give legitimacy to the idea, often forgotten, that there are huge gains to be made from the reunification of Cyprus. The authors would like to express their thanks to Sir Stelios for empowering their efforts and enhancing the credibility of their message.

We would also like to thank Nicos Vassiliou of NV consultants for his detailed information about the Turkey-Cyprus water project. We would like to thank Vargin Varer of Armen Shipping for his comments on our transport forecasts. Thanks are also due to Dr. James Ker-Lindsay, Senior Research Fellow on the Politics of South East Europe at the European Institute at the London School of Economics and Political Science (LSE), who gave us some valuable guidance on Turkish military expenditure. Finally, we would like to thank The Washington Institute for Near East Policy for kind permission to reproduce the gas pipeline map in Chapter 7.

1 http://www.stelios.com/entrepreneurship/award-for-business-co-operation-in-cyprus.html

EXECUTIVE SUMMARY

This study is the third in the series of Day After reports prepared by the all-female team that has come to be known as The Three Ladies. In our first report, we analyzed the commercial opportunities that could arise from the reunification of Cyprus and quantified the peace dividend for the key sectors that would benefit. In our Day After II report, having analyzed the investment and reconstruction needs in the first few years, we went one step further by extending our analysis to the whole economy. We found that a solution would generate EUR 12,000 per year per family on the island, create 33,000 new jobs and raise the real GDP growth rate by 3 percentage points per year on average for at least the first five years.

In this Day After III report, we look beyond Cyprus to the region, analyzing the peace dividend that awaits Turkey after a solution that unites the island, while we also preview the benefits for Greece. We find that Turkey will not only make significant savings from property litigation and military expenditure but also stands to make huge financial gains from the transformation of the Turkey-Cyprus-Greece region into one of peace and stability. This, in turn, will have positive spillover effects for tourism, transport, financial and business services and energy.

On the savings side, using the precedent of property cases at the European Court of Human Rights as a guide, we find that Turkey's maximum savings from property litigation could be as high as EUR 89 billion, or 20% of GDP, while based on cases at the Turkish Cypriot Property Commission, its minimum saving would be EUR 24 billion, or 5.4% of GDP. Spread over ten years, this translates into a maximum savings of just under EUR 9 billion per year and a minimum savings of EUR 2.4 billion per year. Largely as a by-product of the Cyprus problem and northern Cyprus's lack of integration with international markets, Turkey spends hundreds of millions each year subsidizing the Turkish Cypriot budget. Once the Turkish Cypriot economy is opened to the world, these subsidies should decline rapidly, which we estimate would save Turkey EUR 480 million per year.

Savings on military expenditure in Cyprus are estimated at just over EUR 480 million per year, while savings on military expenditure in the Aegean, which can be expected as a positive by-product of a solution to the Cyprus problem, amount to an even higher EUR 1.8 billion per year, bringing total military savings to EUR 2.2 billion.

Regarding gains in the tourism sector, a solution would open up many new opportunities for regional tourism that are currently not available, as well as additional bilateral tourism with Cyprus and Greece. These two together, we estimate, would generate additional travel revenue flows of EUR 1.6 billion per year on average. Turkey's transport sector has stagnated since

2005, which may be connected to the fact that the sector is closed to the EU's third largest shipping fleet. We estimate that opening ports to the southern part of Cyprus would yield a minimum EUR 1 billion per year or a maximum EUR 1.3 billion per year. Adding EUR 412 million from gas transit brings the total revenue to EUR 1.7 billion per year.

Financial intermediation is the fourth largest sector of the Turkish economy, accounting for 10.6% of GDP in real terms; yet exports of financial and business services are currently minimal. With a solution that leads to the application of the EU *acquis communautaire* to the whole of Cyprus, Turkish banks and professional services firms will be in a position to take advantage of Cyprus's low tax regime to significantly broaden their presence in the European market by using Cyprus as a base. We estimate that this would generate EUR 7 billion in revenue from exports of financial and business services. Exports of goods, boosted by the opening of the transport sector to the third largest shipping fleet in the EU, would generate an additional EUR 2 billion per year.

The largest opportunity, however, comes from opening up Turkey's potential as an energy hub. As a direct by-product of the Cyprus problem, Turkey has been unable to open the energy chapter in its accession negotiations with the EU and this kind of uncertainty deters investors. On the other hand, a settlement of the Cyprus problem that reunites the island and brings peace and stability to the Turkey-Cyprus-Greece region would vastly increase foreign interest in the energy sector. We estimate that this, together with other opportunities created by a settlement, would lead to foreign direct investment (FDI) rising to EUR 33 billion per year from a recent peak of EUR 16.1 billion, according to Eurostat data in 2007. While this figure may seem high at first sight, it should be remembered that Turkey's FDI rose tenfold in 2004-06 and it is currently a tiny proportion of the country's GDP compared with the respective figure for the southern part of Cyprus.

According to our estimates, therefore, Turkey stands to gain savings of EUR 5.1 billion per year and export revenue of EUR 12.3 billion per year. Adding this all together yields a peace dividend of EUR 17.4 billion each year or 3.5% of GDP. In the context of a budget deficit that reached 5.5% of GDP in 2009, or of a current-account deficit which could reach 4.5% in 2010, this represents a significant peace dividend that awaits Turkey. Moreover, this figure does not include the estimated EUR 33 billion in gains from foreign direct investment.

Greece also stands to gain from a second phase of normalization with Turkey (subsequent to the first phase that began in 1999). Our preview of the economic benefits to Greece has identified savings of EUR 2.3 billion per year in military expenditure, as well as EUR 50 million per year of income from gas transit, EUR 110 million of additional tourism revenue and EUR 19.8 billion per year in FDI.

Many analyses of a solution's impact on the economy focus narrowly on the opportunities for intra-island trade. In the three *Day After* reports, we have sought to remind the public that the benefits will be far wider in scope. Not only would reunification create significant new opportunities for Cyprus to do business with Turkey, but, as this report will attempt to demonstrate, tremendous benefits also await Turkey and Greece if a peaceful resolution to this decades-old conflict can be found. Turning our predictions into reality is in the hands of the political leaders.

Figure 1 The peace dividend for Turkey

The peace dividend for Turkey **Additional annual inflows**	**EUR bn**
Tourism	1.6
Transportation	1.7
Opening of ports to Cyprus	1.3
Tariffs on energy corridors	0.4
Financial and business services	7.0
Financial	5.6
Business	1.4
Exports of goods	2.0
Total additional gross revenue per year	**12.3**
Savings on compensation payments (over ten years, low estimate)	2.4
Savings on budgetary transfers to northern Cyprus	0.5
Savings on military expenditure in Cyprus and Aegean	2.2
Total savings per year	**5.1**
Total peace dividend to Turkey per year	**17.4**
% of Turkey's GDP in 2009	3.5
Additional foreign direct investment	
Turkey	33.0
Greece	19.8

Source: Authors' estimates.

Chapter 1

APPROACH TO RESEARCH

An opportunity cost approach

In our *Day After III* study, we adopt an opportunity cost approach, as the best estimate of the cost of inaction. In other words, we estimate what the benefits would be if, alternatively to the current state of affairs, Turkey, Cyprus and Greece were cooperating together in an environment free of political problems.

We make a detailed examination of how specific sectors of Turkey's economy would benefit in terms of additional growth resulting from the unification of Cyprus. We also estimate the savings that can be made in terms of expenditure, both current and future, once the Cyprus problem is peacefully resolved. A similar approach is adopted with reference to Greece, though with a lesser degree of detail.

In essence, the opportunity cost approach was also the approach adopted in both our *Day After I* and *Day After II* reports, concerning the benefits accruing to the Cypriots themselves, once the political problem ceases to exist and hence no longer constrains growth.

Our estimates are based on the analysis of hard statistical data obtained from official sources, such as the websites of EUROSTAT, the European Commission, NATO, the Central Bank of Turkey, the Turkish Statistical Institute, the Ministry of Culture and Tourism of the Republic of Turkey, Bank of Greece (the central bank of Greece), the Cyprus Ports Authority, etc. While our approach is one of detailed statistical analysis, it is a non-formal analysis intended to be easily understood by the non-specialist as well as by the specialist.

All relevant hard data is presented in the report for the information of the reader and for his/her understanding and evaluation of our estimates and approach. Explicit reference is also made to any assumptions being made and to methods of work.

This third study in the *Day After* series (day after the reunification of Cyprus) concentrates primarily on the *identification and quantification of economic benefits that will accrue to Turkey* once there is an agreed solution to the Cyprus problem, a solution that unifies the island on the basis of the agreed framework of a bizonal bicommunal federation with political equality as defined in the relevant resolutions of the United Nations.

The Cyprus problem entails a large and growing bill for Turkey in three key areas: budgetary transfers to the northern part of Cyprus, military expenditure to maintain the large garrison on the island, and liabilities for property cases. In this report we shall quantify the sectoral economic benefits as well as the savings which Turkey could make in each of the above areas after a settlement of the Cyprus problem.

The study also previews *economic benefits that will accrue to Greece* once Cyprus is reunified and political relations with Turkey and the whole of Cyprus move further on the path of normalization.

Chapter 2

THE MACROECONOMY OF TURKEY

The reforms implemented in Turkey after the financial crisis of 2001 gradually led to economic stability, a sound Turkish banking sector and a return to positive rates of economic growth. These reforms, including the switch to a floating-exchange rate regime in 2002, the adoption of a full-fledged inflation-targeting regime by 2006 and the transformation of the Turkish banking system into a well-regulated and strong sector, meant that the country was comparatively well prepared to confront the global financial and economic crisis.

Figure 2 Turkey: main macroeconomic indicators

Turkey: main macroeconomic indicators	2001	2002		2007	2008	2009	2010f	2011f
Real GDP growth rate (%)	-7.5	7.9		4.7	0.9	-4.7	4.7	4.5
Inflation rate (%)	54.4	45.0		8.8	10.4	6.3	9.0	7.8
Unemployment rate % of civilian labour force/total labour force from 2007 (a)	8.3	10.3		10.3	11.0	14.0	13.9	13.4
Current-account balance (% of GDP)	1.3	-2.4		-5.9	-5.7	-2.2	-4.5	-5.4
General government balance (% of GDP)	-29.8	-12.6		-1.0	-2.2	-5.5	-3.5	-3.0
General government gross debt (% of GDP)	…	73.7		39.4	39.4	45.5	45.1	44.5
Purchasing Power Standard per inhabitant (b)	7,400	7,400		11,100	11,400	…	…	…
GDP per inhabitant in PPS (EU27=100)	37.4	36.2		44.6	45.6	…	…	…

(a) Based on new address-based population registration system. (b) EU27 = 25,100 in 2008.
f = forecasts.
Sources: Turkish Statistical Institute, European Economic Forecasts; Eurostat website;
Central Bank of Turkey, Financial Stability Report, No 2009; Inflation Report 2010.

Thus, the downturn was fairly shortlived and economic activity returned to positive growth rates in the last quarter of 2009, supporting the European Commission's estimate that GDP will increase in real terms by 4.7% in 2010, after declining by 4.7% in 2009. On the other hand, inflation, at 6.3% in 2009, lies above the Central Bank of Turkey's targets and is not expected to start converging to target-consistent levels until early 2011.

The current-account deficit shrank to 2.2% in 2009 with the fall in international energy prices and the decline in consumption, investment and imports. However, it is expected to rise to 4.5% in 2010 with the pick-up of economic activity and, with it, import demand.

As a result of the reforms following the 2001 crisis, Turkey found itself in a relatively strong fiscal position at the onset of the 2008-09 global financial crisis. With a fiscal deficit of only

2.2% of GDP in 2008 and a government debt of only 39.4%, the government was in a position to take measures to weather the crisis and boost economic activity without exceeding the 60% Maastricht criterion for government debt. (Turkey is not yet obliged to meet these criteria, but the thresholds serve as a benchmark of a country's fiscal health.) The general government deficit did expand to 5.5% of GDP in 2009 but is projected by the European Commission to start decreasing in 2010, as the economic recession recedes.

Nevertheless, the human toll of the financial crisis, as measured by the number of unemployed, is considerably high. Unemployment accounted for 14% of the total labour force in 2009. In its financial stability report of November 2009, the Central Bank of Turkey said that although "non-farm employment has returned to pre-crisis levels owing to the recovery in the construction and the services sectors," it also expects that "a durable recovery in unemployment conditions will take a prolonged period of time."

Per capita income is only 45.6% of the EU average at purchasing power standard (adjusted for the difference in prices). This low level points to the country's vast potential for economic growth and development, especially if it completes its way to full membership of the European Union.

Figure 3 Turkey: GDP by economic activity

Turkey: gross domestic product by economic activity in 2008 (current market prices)	TRY bn	EUR bn (a)	% share in nominal terms	% share in real terms
Agriculture, hunting & forestry	71.0	37.3	7.5	9.0
Fishing	1.5	0.8	0.2	0.3
Mining & quarrying	13.3	7.0	1.4	0.8
Manufacturing	153.5	80.5	16.2	23.8
Electricity, gas & water	20.3	10.6	2.1	2.1
Construction	44.7	23.4	4.7	5.9
Wholesale & retail trade	116.3	61.0	12.2	13.0
Hotels & restaurants	21.5	11.3	2.3	1.8
Transport, storage & communication	134.6	70.6	14.2	14.7
Financial intermediation	33.0	17.3	3.5	10.6
Ownership & dwelling	106.1	55.7	11.2	4.8
Real estate, renting & business activities	40.8	21.4	4.3	3.4
Public administration & defence; social security	36.4	19.1	3.8	3.0
Education	27.9	14.6	2.9	2.0
Health & social work	15.6	8.2	1.6	1.2
Other community, social & personal services	16.0	8.4	1.7	1.6
Private households with employed persons	1.7	0.9	0.2	0.2
Minus: Financial intermediation services ind. Measured	14.9	7.8	1.6	6.6
Plus: Taxes minus subsidies	110.9	58.2	11.7	8.4
Gross domestic product	**950.1**	**498.4**	**100.0**	**100.0**

(a) Average exchange rate in 2008: EUR 1=TRY 1.9064; source: European Central Bank, *Monthly Bulletin.*
Source: Turkish Statistical Institute website.

Manufacturing comprises by far the largest sector of the Turkish economy and has retained a more or less constant contribution to value-added creation over the last decade, accounting for 23.8% of GDP in real terms in 2008.

Transport, storage and communication is the second largest sector of the economy and its contribution to total real value-added creation has gradually and steadily risen from 11% in 1998 to 14.7% in 2008. Wholesale and retail trade accounted for 13% of real GDP in 2008, slightly down from its share of 14% a decade earlier. Financial intermediation is another major sector that has been growing in importance over recent years, accounting for 10.6% of GDP at constant prices in 2008, compared with a contribution to real growth creation of 7.6% in 1998.

The sectors of construction and of "ownership and dwelling" between them have accounted for a nearly constant share of around 11% of real GDP over the last decade.

As services sectors have grown, the contribution of agriculture, hunting and forestry to the economy of Turkey -though still significant- has declined, from 12.1% of real GDP in 1998 to 9% in 2008. This is evidence of the gradual evolution and diversification of the Turkish economy.

Figure 4 Turkey: selected balance of payments items

Turkey: selected balance of payments items (EUR billion)	2004	2005	2006	2007	2008	2009
Exports of goods	55.0	62.6	73.7	83.1	92.7	75.0
Imports of goods	70.6	86.0	103.6	113.9	127.6	94.7
Exports of services	18.4	21.5	20.3	21.1	23.7	23.6
Imports of services	8.2	9.2	9.5	11.4	12.0	11.9
Exports of goods and services	73.5	84.1	94.0	104.2	116.4	98.6
Imports of goods and services	78.7	95.3	113.1	125.3	139.7	106.6
Net current-account balance (a)	-12.5	-19.0	-27.2	-29.6	-30.0	-11.6

(a) Excluding current transfers.
Sources: Central Bank of Turkey, www.tcmb.gov.tr; exchange rates: European Central Bank, Monthly Bulletin.

Figure 5 Bilateral exchange rates

Bilateral exchange rates (period averages)	US dollar per euro	New Turkish lira (a) per euro
2004	1.2439	1,777,052
2005	1.2441	1.6771
2006	1.2556	1.8090
2007	1.3705	1.7865
2008	1.4708	1.9064
2009	1.3948	2.1631

(a) As of 2005 one new Turkish lira is equivalent to 1,000,000 old Turkish liras.
Source: European Central Bank, Monthly Bulletin.

Chapter 3

SAVINGS FROM PROPERTY LITIGATION

Property constitutes a large and growing liability

The non-settlement of the Cyprus problem constitutes a large and growing liability for Turkey because of the vast number of claims brought by Greek Cypriots for property in the northern part of Cyprus which they left as a result of the events of 1974. As every year passes, the value of land increases, claims for loss of use also rise and Turkey's liability grows. The largest case to date in terms of claims was brought in October 2009 in the USA. It is a class action suit brought by property owners against Turkey. The amount being claimed is a staggering US$400 billion, or 65% of Turkey's GDP in 2009.

The turning point as regards Turkey's property liabilities came with the landmark European Court of Human Rights (ECHR) judgment of Loizidou *v.* Turkey,[2] in which Turkey was deemed to be the liable party. In a number of cases since, Turkey has been found to be in breach of the European Convention on Human Rights Article 1, Protocol 1 on the protection of property. As of April 2010, the European Court of Human Rights (ECHR) had awarded EUR 2.6 million (excluding interest) in pecuniary damages, non-pecuniary damages and costs to Greek Cypriot plaintiffs in three cases: Loiziou, Demades and Arestis.[3] Moreover, the court has struck out another three cases in which Turkey paid a total of EUR 10.6 million[4] in friendly settlements via the Turkish Cypriot Property Commission. The Turkish Cypriot Property Commission was established in 2006 in response to ECHR cases and is funded by Turkey. As of April 2010, the Commission had paid out just GBP 43 million (EUR 48 million) for 94 cases. Thus, to date, the ECHR and Property Commission combined have awarded EUR 46 million.

While at face value this amount seems small, it is much larger when one considers that this sum relates to less than 100 cases out of approximately 1,400 applications to the ECHR. Since the Demopoulos v. Turkey decision,[5] which effectively acknowledged the Property Commission as an effective domestic remedy (albeit of Turkey), it now appears that most of these 1,400 claims will be settled by the Property Commission in northern Cyprus. However, settling claims via the Property Commission does not remove Turkey's liability. As explained below, in the absence of a solution to the Cyprus problem, property settlements via the Property Commission still constitute a significant and growing liability for Turkey.

2 Loizidou v. Turkey, Application no. 15318/89, judgments of 23 March 1995, 18 December 1996 and 28 July 1998.
3 Application nos. 15318/89, 16219/90 and 46347/99.
4 USD 1,000,000 in Tymviou v. Turkey and GBP 1,500,000 in Alexandrou v. Turkey.
5 Application no. 46113/99 et al., decision of 1 March 2010.

Turkey's maximum liability could be tens of billions

On the assumption that the class action claim for USD 400 billion will not be realized in full, the ECHR-related cases provide us with a firmer basis for estimating Turkey's total property liability in the event that all Greek Cypriots with property in the north decide to make a claim. Below we have made estimates based on three approaches: a) using the average award per square metre for a particular ECHR case in which that information has been made public; b) using the average award per case at the ECHR; and c) using the average award per square metre for cases settled at the Property Commission.

The Alexandrou case[6] gives details of the area in square metres of the plots for which Alexandrou made a claim. Having initially claimed for 109 plots, some of which had been transferred to other members of her family, Alexandrou reduced her claim to just 7 plots totalling 36,943 square metres. She was awarded GBP 1,500,000 (1.5 million) from the Turkish Cypriot Property Commission for compensation and loss of use. The average payment per square metre claimed was therefore GBP 41, or EUR 46.[7]

One can extrapolate from this figure to make an estimate for total liability for all land north of the UN-monitored buffer zone. According to the Republic of Cyprus Planning Bureau, Greek Cypriot privately owned property in the north amounts to 1,405 thousand donums, which is the equivalent of 1,950 million square metres.[8] If Turkey were to pay out EUR 46 for every square metre of privately held Greek Cypriot property in the north, Turkey's bill would amount to almost EUR 90 billion, or 20% of its GDP in 2009. Moreover, if one added the 58,000 donums owned by the Greek Orthodox Church in Cyprus, one could add another EUR 3.8 billion to the total.

However, one needs to take into account the fact that the Alexandrou case was a friendly settlement, in which not all of the land initially claimed was actually compensated.[9] Moreover, not all refugees will own land of similar value. A total of **EUR 90 billion might therefore be considered as the absolute maximum liability for Turkey**.

Another approach is to consider the three cases brought before the ECHR, for which an amount has been awarded for pecuniary and non-pecuniary damages as well as costs.[10] The total awarded to date has been just under EUR 2.6 million, or an average of just under EUR 858,000 per case. We can estimate how many potential cases there might be from figures on the internally displaced (known as refugees in Cyprus). According to Greek Cypriot sources, there were 162,000 Greek Cypriot refugees in 1974.[11] The average household size at the time was just under 4 persons,[12] implying that there were around 40,500 refugee families. If each

6 Alexandrou v. Turkey, Application no. 16162/90, judgment of 28 July 2009.

7 Using the average estimated exchange rate in 2009.

8 One Cypriot donum is 1,388 square metres.

9 Some of the plots were no longer under Alexandrou's name but it appears that the plaintiff also chose not to claim for all of the plots.

10 Loizidou, Demades and Arestis.

11 Press and Information Office: http://www.cyprus.gov.cy/moi/pio/pio.nsf/index_en/index_en.

12 Statistical Service, *Statistical Abstract 2000*.

of these families applied for either damages or compensation and was awarded EUR 858,000 million each time**, the total liability (excluding inflation and interest payments) to Turkey would amount to EUR 35 billion, or 7.8% of its current GDP**.

A third approach, based on more comprehensive data, is to consider the awards made by the Property Commission. As of April 2010, the Property Commission had awarded GBP 42 million (EUR 48 million) for an area of 3.9 million square metres. The average award per square metre has been EUR 12. If Turkey were to pay out EUR 12 for every square metre of privately held Greek Cypriot property in the north, **Turkey's bill would amount to just under EUR 24 billion**, or 5.4% of GDP.

Figure 6 Turkey's property liabilities based on precedent

Turkey's property liabilities based on precedent	
1. Based on average ECHR awards per square metre	
Total GkCyp affected private property north of Green Line (million sq metres)	1,950
Compensation per square metre paid to Alexandrou (EUR)	46
Total potential compensation liability based on Alexandrou v. Turkey (EUR million)	88,969
% of Turkey's GDP in 2009	20.1
2. Based on average ECHR awards per case	
Total number of ECHR cases awarded (excluding friendly settlement strike-outs)	3
Total awards to date (EUR)	2,573,558
Average award per case (EUR)	857,853
Total number of Greek Cypriot refugee families (162,000/4 persons per household)	40,500
Total potential compensation liability based on three ECHR cases (EUR million)	34,743
% of Turkey's GDP in 2009	7.8
3. Based on average Property Commission awards per square metre	
Total compensation paid to date (EUR)	47,710,844
Total area of property for which compensation has been paid (sq metres)	3,894,813
Total GkCyp affected private property north of Green Line (million sq metres)	1,950
Average compensation per square metre paid by Property Commission (EUR)	12
Total potential compensation liability based on Property Commission (EUR million)	**23,889**
% of Turkey's GDP in 2009	5.4

Source: Authors' calculations based on ECHR and Property Commission cases.

A settlement would substantially reduce liabilities

Whether the total liability amount is EUR 24 billion, EUR 90 billion or EUR 400 billion, Turkey clearly faces a huge and uncertain liability for property cases if there is no settlement of the Cyprus problem at a time when, like many other countries, it is struggling with a large budget deficit of some 6% of GDP and a weak global economy.

Of course, depending on the details of any property settlement in the current negotiations, Turkey may still be asked to contribute to compensation payments. However, using the last three versions of the Annan Plan as a guide, one can assume that its liabilities would be cut by 25% simply as a result of territorial adjustment.[13] Moreover, if one assumes that the property settlement will entail a mixture of restitution, exchange of refugees' properties, and compensation, then one can assume that Turkey's liabilities would be reduced even further. Finally, it may be possible to involve the private sector in a property settlement in such a way that it considerably reduces the cost to the taxpayer. This would further reduce any calls on Turkey for funding.

13 Under Annan V, the number of donums of Greek Cypriot property in the north would have fallen from 1.41 million donums to 1.04 million donums: Platis, Orphanides and Mullen (2006).

Chapter 4

EXPENDITURE SAVINGS: BUDGET AND MILITARY

Introduction

As we noted in more detail in our *Day After I* report, the economy in the northern part of the island has some serious handicaps, caused both by the fact that the Turkish Republic of Northern Cyprus (TRNC) is not internationally recognized and by inherent structural problems. The most significant by-product of non-recognition for the north is the landmark decision in 1994 of the European Court of Justice,[14] which precluded "acceptance by the national authorities of a Member State, when citrus fruit and potatoes are imported from the part of Cyprus to the north of the United Nations Buffer Zone, of movement and phytosanitary certificates issued by authorities other than the competent authorities of the Republic of Cyprus." Although this judgment never banned exports from Famagusta as such, it meant that Turkish Cypriot producers no longer enjoyed preferential access to European markets under the Republic of Cyprus's Association Agreement with the European Community. This made Turkish Cypriot products much more expensive on EU markets and therefore less competitive. Turkey signed its customs union with the EU the following year, which made trading via Turkey a much more attractive option for Turkish Cypriot traders. This, in turn, increased economic dependence on Turkey. At the same time, lack of integration with international markets (for example, the fact that international brands tend to shy away from northern Cyprus) also reduces competitiveness in the domestic economy, which keeps prices of goods higher than they would be otherwise.

Also because of non-recognition, 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 IMF support or full membership of the EU). The economy therefore remains unreformed, enforcement of tax-collection is weak and economic growth is highly dependent on spending by an inefficient public sector.[15] These handicaps mean that the administration regularly spends beyond its means and, since it cannot borrow on international markets, it depends on Turkey to fill the gap. Thus, by 2008 the budget deficit before grants and loans from Turkey was USD 369.6 million, or 9.3% of GDP and Turkey poured USD 558 million, or 14.3% of GDP into the economy in the same year.

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14 Case C-432/92, *The Queen* v *Minister of Agriculture, Fisheries and Food, ex parte S. P. Anastasiou (Pissouri) Ltd and others*, 5 July 1994.

15 "Economic Catching-up in the Northern Part of Cyprus: The Policy Challenges," Max Watson, Middle East Technical University 2010.

Figure 7 Turkey: financial assistance to Cyprus (north)

Turkey: financial assistance to Cyprus (north) (USD million)	Grants	Loans	Total
1975	32.4	…	32.4
1976	33.5	…	33.5
1977	16.1	…	16.1
1978	25.2	…	25.2
1979	17.9	…	17.9
1980	2.6	…	2.6
1981	32.6	…	32.6
1982	33.9	…	33.9
1983	40.5	…	40.5
1984	36.3	…	36.3
1985	35.3	…	35.3
1986	45.9	…	45.9
1987	34.8	…	34.8
1988	10.8	…	10.8
1989	15.7	…	15.7
1990	18.8	3.8	22.6
1991	26.3	23.6	49.9
1992	21.7	14.1	35.7
1993	26.5	…	26.5
1994	20.9	…	20.9
1995	27.3	…	27.3
1996	75.1	6.1	81.2
1997	63.7	16.4	116.0
1998	76.4	62.5	218.3
1999	65.3	56.0	135.2
2000	102.7	62.2	196.0
2001	49.4	126.3	175.7
2002	74.0	202.3	276.4
2003	109.3	181.6	290.8
2004	123.0	115.1	238.1
2005	153.7	217.1	370.8
2006	203.8	222.1	425.9
2007	218.3	209.1	427.3
2008	225.6	332.5	558.0
% of GDP in 2008	5.8	8.5	14.3
Cumulative since 1975 (USD)	**2,095.2**	**1,850.7**	**4,106.2**
Cumulative since 1975 (EUR)	1,609.8	1,422.0	3,154.9

Source: State Planning Organization.

Turkey could save EUR 480 million per year on subsidies

Moreover, the dependency of Cyprus (north) on aid/loans from Turkey increases every year. Turkey's assistance to the northern part of Cyprus is based on what are called the economic and financial protocols. Under the 2007-09 economic protocol, Turkey was due to provide TL 1.875 billion (approximately USD 1.4 billion), or around TL 600 million (USD 470 million) annually. As can been seen, however, it had already spent USD 558 million in 2008. The assistance pledged in the protocol recently agreed for 2010-12 is therefore even higher. According to this protocol, Turkey will provide TL 3 billion (approximately USD 2 billion) for the next three years. This is approximately 630 billion USD annually and is equivalent to a staggering 20% of GDP.

It should be possible to reduce this form of subsidy rapidly after a settlement, given the huge boost to the Turkish Cypriot economy that will come about as a result of a solution. A solution will provide legal certainty for investors in the north, will imply full EU membership and will open the way to vast trade, investment and tourism opportunities in the Eastern Mediterranean. Indeed, as we argued in our previous *Day After* reports, the whole of Cyprus will benefit from the various opportunities to develop economic relationships with Turkey—the biggest and most dynamic economy in the region—as well as Greece. The hundreds of millions of dollars which the Turkish taxpayer currently spends on subsidizing northern Cyprus is more likely to be replaced by profitable private-sector investment. We therefore estimate that, five years after a settlement that unites the island **Turkey stands to cuts its subsidy costs to northern Cyprus by around USD 600 million or EUR 480 million per year**.

And another EUR 480 million on Cyprus military spending

Precise data on how much Turkey spends on its military in Cyprus is lacking. One way of trying to estimate the figure more accurately is to derive it from published data on Turkey's total defence expenditure. According to NATO, in 2008 Turkey spent USD 13,324 million on defence and had armed forces totalling 496,000.[16] This translates into total equipment and personnel expenditure of just under USD 27,000 for every military individual employed. Estimates for the number of troops in northern Cyprus range from a low of 21,000 to a high of 44,000.[17] If we take the mid-point of 32,500 as our estimate, then Turkey might spend as much as USD 873 million per year on equipment and personnel in Cyprus. However, this is probably an over-estimate, given that it is unlikely that the most expensive military equipment is based on Cyprus. We can at least derive the amount spent on personnel from this figure, since NATO figures show us that 50.6% of all defense expenditure is on personnel. Thus, we can assume that Turkey spends an estimated USD 442 million per year just to pay the salaries of soldiers

16 NATO communiqué PR/CP(2009)009.

17 http://www.mfa.gov.cy/mfa/Embassies/copenhagenembassy.nsf/0/998EBBE0B1DDE5EBC125756000376805/$file/News%20from%20Cyprus%20February%207-13%202009.doc

based in Cyprus. For expenditure on military equipment, we assume that the amount spent in Cyprus is two-thirds of the total. According to these estimates, Turkey spends an estimated USD 158 million per year on military equipment in Cyprus. Adding the two together means that **Turkey spends an estimated USD 600 million (EUR 480 million) per year on its military operations in Cyprus**.

Figure 8 Estimated military savings in Cyprus and the Aegean

Turkey: estimated military savings in Cyprus and the Aegean	
Armed forces strength in 2008	496,000
Total military expenditure in 2008 (USD million)	13,324
On personnel, derived from known proportion of 50.6% (USD million)	6,742
On equipment, derived from known proportion of 27.4% (USD million)	3,651
On infrastructure, derived from known proportion of 3.3% (USD million)	440
Other, derived from known proportion of 18.7% (USD million)	2,492
Expenditure per person (USD)	
Total military and equipment expenditure per person employed, derived	26,863
Personnel expenditure per person employed, derived	13,593
Equipment expenditure per person, derived	7,360
Authors' estimates for Cyprus	
Armed forces in Cyprus (mid-point estimate)	32,500
Estimated personnel expenditure in Cyprus (32,500 x 13,593 (USD million))	442
Estimated military equipment in Cyprus (32,500 x (7,360 x 0.66)) (USD million)	158
Total estimated annual military expenditure in Cyprus (USD million)	600
Total annual potential savings on military expenditure (USD million)	
Savings on expenditure in Cyprus	600
Savings on expenditure in the Aegean (20% reduction)	2,665
Total annual potential savings (USD million)	**3,265**
Total annual potential savings (EUR million)	2,229

Source: NATO Financial and Economic Data Relating to NATO Defence unless otherwise indicated..

If previous attempts to resolve the Cyprus issue are a guide, one can assume that a settlement will lead to the withdrawal of the Turkish army to either zero or a negligible number.[18] Of course, many of the troops are on military service and might simply be deployed elsewhere. However, bearing in mind that Turkey's Prime Minister, Recep Tayyip Erdoğan, said "It is time to stop investing in military equipment and start investing in people," we have concluded that

18 In the third version of the Annan Plan (Main Articles, Article 8), all Greek and Turkish troops would be withdrawn upon Turkey's accession to the EU; in the fifth version of the Annan Plan (Main Articles, Article 8), 650 Turkish troops would remain "with the object of total withdrawal."

it would be presumptuous to assume what Turkey would do with the USD 600 million per year it saves on military spending in Cyprus, and have counted the whole amount as a savings which Turkey's policy-makers will decide how to reallocate.

Another significant area in which there could also be tangible financial gains is the Aegean. As pointed out to the authors by a regional security specialist,[19] if a settlement of the Cyprus problem also led to a reduction of tensions between Greece and Turkey, and therefore savings on military expenditure in the Aegean (for example on the warplane dogfights with Greece, naval commitments and border controls), then the indirect savings could be substantial. Geographically, Greece accounts for around one-third of Turkey's external border. At one extreme we could therefore estimate roughly that one-third of its expenditure would be reduced as a result of improved relations with Greece. However, we have been conservative and assumed that Turkey could cut its military expenditure by 20% as a result of improved relations with Greece that would derive from a settlement in Cyprus. This would translate into a savings of USD 2.7 billion per year on spending in the Aegean. **The total annual savings on military expenditure in Cyprus and the Aegean could thus reach USD 3.3 billion, or EUR 2.2 billion**.

[19] Dr. James Ker-Lindsay, Senior Research Fellow on the Politics of South East Europe at the European Institute, LSE.

Chapter 5

ENERGY: THE GREATEST OPPORTUNITY

Turkey sits in a region that it is very close to approximately 75% of the world's proven gas and oil reserves,[20] and this offers unique opportunities, as energy-producing countries seek to use Turkey as a channel to transport their energy resources to Europe. Turkey will therefore become an increasingly important energy bridge between Central Asia, the Middle East and Europe in the coming decades. Yet its potential is held back by the Cyprus problem, as will be explained below.

According to the Turkish Ministry of Energy and Natural Resources, the investment needs of the global energy sector will amount to USD 20 trillion by 2030. Approximately USD 4.3 trillion will be invested in petroleum and USD 3.9 trillion in natural gas. The main proportion of energy demand will be met within the region where Turkey is located.

In 2010 it is estimated that the natural gas needs of the EU will be 642 billion cubic metres, rising to 644 BCM in 2015 and 777 BCM in 2020. According to some estimates, the EU could import 277 BCM in 2010 and 427 BCM in 2020 to meet its demand for natural gas.[21] Meanwhile, the consumption of natural gas within Turkey itself is expected to increase to 45 BCM, 57 BCM and 67 BCM in 2010, 2015 and 2020, respectively.

Currently, the EU meets its demand for natural gas mainly by importing from Russia. However, the interruption of supply to countries such as Ukraine, and the military crisis in Georgia have increased the importance of the security of energy supply for the EU. Therefore the EU would like to decrease its dependency on Russia by diversifying energy sources and routes. A main source of diversification is Turkey. Given its geostrategic position, sitting at the gateway of the Middle East, the Caucasus and Central Asia, and its position for alternative pipeline routes, Turkey has the potential for the secure supply of energy; thus, it will become a vital energy hub and strategic player in the region.

According to the Turkish Investment Support and Promotion Agency, as an energy transit country, Turkey has the capacity to transport 121 million tons of oil per year to the world markets.[22] To put this into context, by 2012, the transit of oil supply via Turkey is forecast to be 6-7% of the global total.

20 Ministry of Energy and Natural Resources, www.enerji.gov.tr.

21 "Turkey as an energy corridor between the east and the west," Dr. Cenk Pala, Botaş Petroleum Pipeline Corporation Turkey.

22 http://www.invest.gov.tr/en-US/investmentguide/Pages/10Reasons.aspx

Indeed, according to Estrada (2006) Turkey will be the third largest gas supplier in 2020, supplying 120 BCM annually.[23] Turkey could even act both as a supplier and as a re-exporter owing to the surplus gained from imports. Estrada also notes that 70% of new all new gas supplies to Europe will come from Turkey in the near future.

The Baku-Tbilisi-Ceyhan pipeline, which connects the Caspian to the Mediterranean Sea, and the Nabucco gas pipeline project, which connects the Caspian region, the Middle East and Egypt with Turkey, Bulgaria, Romania, Hungary, Austria and further on to the Central and Western European gas markets, are the two main examples. Both projects are the most significant step in transferring Caucasus oil and natural gas to the EU via Turkey while bypassing Russia. Thus, they are the EU's primary projects for diversifying and securing its energy sources.

The position of Turkey as an energy hub is demonstrated by the following completed or ongoing gas and oil pipeline projects that transit Turkey.

- **Baku-Tbilisi-Ceyhan Crude Oil Pipeline**: Construction of the pipeline was completed in 2005. It became operational in 2006 and currently carryies 50 million tons of Azerbaijani oil per annum. It accounts for around 1.5% of global oil consumption. Investment costs are around USD 3.9 billion and Turkey is expected to receive around USD 200 million per annum as a transit fee in the initial years, rising to around USD 290 million per year between years 17 and 40.
- **Caspian-Turkey-Europe Natural Gas Pipeline** (Baku-Tbilisi-Erzurum Pipeline or Shah Deniz pipeline): This is the first step of the **South Caucasus Pipeline**. The main aim is to transport natural gas from Shah Deniz in Azerbaijan to Turkey via Georgia, and then further on to Europe (through the Nabucco and Turkey-Greece-Italy pipelines). The first step of the natural gas pipeline project, which became operational in 2008, is to transport 9.63 BCM Azeri natural gas from the Shah Deniz to Turkey, with the annual capacity of 20 BCM per year. Investment costs are estimated at around USD 1 billion.[24]
- **Nabucco Natural Gas Pipeline**: This pipeline transports natural gas from the Caspian and the Middle East to Europe. The project is due to be completed in 2013 and will have the capacity to carry 31 BCM natural gas per annum by 2020. Initially it is estimated to carry between 4.3 and 13 BCM per annum. The investment cost is EUR 7.9 billion (approximately USD 10 billion). It is expected to bring more than EUR 4 billion in investment to Turkey and create around 500 new jobs during the operation phase. Turkey will also gain EUR 450 million tax revenue annually.
- **Turkey-Greece-Italy Natural Gas Pipeline:** This is due to transport 12 billion cubic metres of natural gas per year, from the Caspian Sea to Italy and the rest of Europe through

23 European energy security: Towards the creation of the geo-energy space, Estrada, Aurelia M. 2006.
24 http://www.ebrd.com/projects/psd/psd2003/27637.htm.

Turkey and Greece. Some 3.6 BCM of natural gas would go to Greece and the rest would go to Italy. Completion is due in 2012 and the cost for the Greek-Italian section is estimated at around EUR 1.0 billion.[25] The Turkey-Greece section cost is USD 300 million.[26]

- **Transcaspian Turkmenistan-Turkey-Europe Natural Gas Pipeline**: This project involves the transportation of natural gas from Kazahkstan and Turkmenistan through Turkey to Europe. The cost is estimated at USD 5 billion. The projected capacity is 30 billion cubic metres of natural gas, with 16 billion for Turkey and the remainder for the rest of Europe. The cost is estimated at USD 5 billion.
- **Iraq-Turkey Natural Gas Pipeline**: A project to transport 10 billion cubic metres of natural gas per annum from Iraq to Turkey. However, as result of security concerns, this project has been delayed.
- **Egypt-Turkey Natural Gas Pipeline**: The project will transport 10 billion cubic metres of natural gas from Egypt to Europe via Turkey (2-4 BCM to Turkey and 2-6 BCM to the rest of Europe). It is the part of the Arab Gas Pipeline that exports Egyptian natural gas to the Middle East and Europe. The length of the pipeline will be 1200 km at a cost of USD 1.2 billion. The investment costs of the Turkey-Syria connection are estimated at EUR 71 million.[27] The connection is expected to be completed by 2011.

Just these projects alone involve investment of more than USD 20 billion and are crucial to transforming Turkey into an energy bridge. Moreover, construction of these pipelines would offer many more opportunities for energy-related businesses in Turkey such as storage facilities, terminals, etc.

Figure 9 Energy corridor investment involving Turkey (excluding Russia)

Total energy corridor investment involving Turkey (excluding Russian routes) (USD million)	
Baku-Tbilisi-Ceyhan Crude Oil Pipeline	3,900
Caspian-Turkey-Europe Natural Gas Pipeline	1,000
Nabucco Natural Gas Pipeline	10,000
Turkey-Greece-Italy Natural Gas Pipeline	1,500
Transcaspian-Turkmenistan-Turkey-Euro	5,000
Egypt-Turkey Natural Gas Pipeline (Turkey-Syria connection)	1,200
Total energy corridor investment	**22,600**

Source: Authors' compilation of sources.

25 http://www.greekembassy.org/embassy/Content/en/Article.aspx?office=9&folder=925&article=21335
26 http://www.nytimes.com/2007/11/19/world/europe/19greece.html
27 http://kommersant.com/p-13396/pipeline_construction/

As well as acting as an alternative supplier to the EU, Turkey is also increasingly acting as a transit hub for Russian oil and gas.

- **Blue Stream**: Turkey has signed an agreement with Russia to carry natural gas from Russia to Turkey under the Blue Stream project. The pipeline will operate at full capacity and will carry 16 billion cubic metres of natural gas annually. The total cost is estimated at USD 3.2 billion.
- **Blue Stream-2**: The leaders of the two countries have also started to discuss the Blue Stream-2 project (second pipeline), an expansion of Blue Stream 1 , to deliver Russian gas to Syria, Lebanon, Israel and Cyprus. However, this pipeline project is unlikely to get off the ground as long as the Cyprus problem exists.
- **South Stream**: In August 2009, the Prime Minister of Turkey, Recep Tayyip Erdoğan, and the Prime Minister of Russia, Vladimir Putin, signed a new protocol related to the South Stream pipeline. The main objective is to strengthen the security of EU energy by meeting the additional demand for natural gas. According to this protocol, the pipeline will be routed through the territorial waters of Turkey. The construction is due to start in 2010 and is estimated to finish in 2015. It will carry 63 billion cubic metres of natural gas. The estimated cost is around EUR 19-24 billion.
- **Samsun-Ceyhan :** In October 2009, Turkey, Russia and Italy signed a protocol to build the Samsun-Ceyhan pipeline for the delivery of crude oil from the Caspian. Initially it will carry 1 million barrels per day and then the capacity will increase to 1.5 million barrels per day. It will be operational in 2012 and the estimated cost is around USD 2 billion. The project aims to bypass the Bosphorus Strait and therefore ease the container traffic in the area.

Investment in these projects thus amounts to some USD 27 billion in addition to the USD 20 billion for non-Russian pipelines.

Both the EU-linked Nabucco and the Russian South Stream projects will deliver natural gas to Europe, but from different supply sources. There is some discussion about there being a contradiction between the South Stream project and the Nabucco project. However, since the energy demand of Europe will increase, some experts argue that the two projects are complementary rather than rivals. This appeared to be confirmed after the signing of the South Stream protocol, when the prime ministers made statements about this issue. “Erdogan said Nabucco and South Stream aren’t rivals and together will offer diversity. Putin said the South Stream project won’t shut out Nabucco.”[28]

[28] ‘Turkey Offers Route for Gazprom’s South Stream Gas Pipeline ‘, By Lyubov Pronina and Ali Berat Meric, Bloomberg, 6 August 2009, http://www.bloomberg.com/apps/news?pid=email_en&sid=a.TM4QijmIMk.

Government plans to invest USD 130 billion in energy

In addition to rising demand from abroad, population growth and the rapidly growing economy will also increase domestic energy consumption. According to estimates of Turkey's Ministry of Energy and Natural Resources, the energy sector in Turkey needs around USD 130 billion worth of investments until 2020. The government is therefore offering many incentives to increase investment in the energy sector. It is also promoting renewable energy production, as climate change is putting pressure on countries to decrease their dependency on fossil fuels. Turkey is very rich in renewable energy sources- solar, wind, geothermal hydropower and biomass. Solar energy is one of the most popular natural energy sources and Turkey has a very good potential given its high average sunshine hours per year. It also has a high potential for geothermal energy, estimated at 31,500 MW; this is among the highest in the EU. Among various sources of energy, hydroelectric power plants are preferred because they are environmentally friendly and low-risk (Ministry of Energy and Natural Resources). Turkey's potential is 36,000 MW.

Energy investment is held back by the Cyprus problem

These transit projects and investment in renewables are expected to increase the opportunities in the region and will stimulate FDI inflows to Turkey. However, although the projects are very critical for Europe in terms of energy security, the current political situation in Cyprus is one of the main threats to their realization and sustainability, for the following important reasons.

- Since Greek Cypriots have a veto over Turkey's EU membership, Turkey cannot join the EU as long as the Cyprus problem exists. Lack of certainty about EU membership will inevitably deter investors, especially in the energy sector, because a Turkey that is inside the EU, or firmly on the path to the EU, will be considered as a far more reliable supplier than a Turkey that is outside the EU. This uncertainty also deters Turkey from investing. In the words of one analyst, "Without a clear signal from the EU that Turkey will be joining the bloc, Ankara will shift its focus from the EU-centered pipeline politics to its own pressing energy needs."[29]
- More specifically, as a direct by-product of the Cyprus problem, Turkey has been unable to open the energy chapter in its negotiations with the EU. The Republic of Cyprus was one of the main countries calling in 2007 for the energy chapter not to be opened, in response to Turkey's attempts to prevent hydrocarbons exploration by Greek Cypriots. As long as local and foreign investors are uncertain about Turkey's future energy relationship with the EU, they will inevitably be more cautious about investment.

29 Jelena Vukotic, "Turkey's EU Dreams and European Energy Security: In the Pipeline?" www.rgemonitor.com, 10 September 2009.

- As another by-product of the Cyprus problem, there is no customs union in force between Turkey and the southern part of Cyprus. This means that Cyprus's position between gas-producer Egypt and transit-country Turkey cannot be leveraged and no part of Cyprus can be linked up to the Egypt-Turkey natural gas project, nor the Blue-Stream 2 project.
- It also means that Cyprus's deepwater port of Limassol cannot be used as a transshipment hub for oil transit from the Baku-Ceyhan and Samsun-Ceyhan oil pipelines.

On the other hand, a settlement of the Cyprus problem that unites the island and brings peace and stability to the Turkey-Greece-Cyprus region would vastly increase foreign interest in the sector. Moreover, in the run-up to EU accession Turkey could take advantage of Cyprus' position as the easternmost outpost of the EU. There would be spin-off benefits, such as opportunities for cooperation among Turkey, Greece and Cyprus in renewable energy, water management and environmentally friendly technologies for desalination plants.

Water pipeline will boost Turkey's geostrategic position

The planned water pipeline from Turkey to Cyprus would also strengthen the geostrategic position of Turkey and Cyprus, when one considers climate change and the shortage of water both in the region and on the island. It is estimated that 75 million cubic metres of water per year could be transported from Turkey to Cyprus at a much lower cost than the price of desalinated water. At an estimated cost of USD 400 million, Turkey and Cyprus could become a major source of water in the region with the capability of exporting to other countries such as Israel. Indeed, according to Nicos Vassiliou, an economist who has spent many years studying the project, the pipeline would not be really financially viable in the long term unless it could also export water elsewhere. And given the ability of the Republic of Cyprus to put diplomatic pressure on other countries doing business with northern Cyprus, the possibility of that happening would be greatly increased if there were a settlement of the Cyprus problem.

A massive boost to FDI

As this chapter has argued, cooperation among Turkey, Greece and Cyprus in the fields of energy and environment would greatly increase Turkey's opportunities as an energy hub. At present Turkey's true potential is seriously hampered by the unresolved Cyprus problem. In Chapter 11 we make an estimate of how much this and other spin-offs of a solution would mean for Turkey and Greece in terms of foreign direct investment (FDI).

Chapter 6

TOURISM: THE REGIONAL MARKET OPENS

A presentation of the Ministry of Culture and Tourism of the Republic of Turkey, in which it outlines tourism investment opportunities, includes a map on "how to reach Turkey."[30]

The map shows transport links from western Europe, Russia and Ukraine but no links from Cyprus or even Greece. The very concept of the map demonstrates explicitly the opportunities missed by not even picturing any link between Turkey and the rest of the world via Cyprus (or Greece) or indeed between Turkey and Cyprus itself.

Figure 10 Turkey: services, main credit flows, balance of payments

Turkey: services, main credit flows (EUR billion)	2005	2006	2007	2008	2009
Transportation	4.0	4.0	4.8	5.3	5.4
Travel (a)	14.6	13.4	13.5	14.9	15.2
Construction services	0.7	0.7	0.6	0.7	0.8
Other business services (b)	0.3	0.2	0.2	0.1	0.1
Total services					
Services, credit (incl others)	21.5	20.3	21.1	23.7	23.6
Services, debit	9.2	9.5	11.4	12.0	11.9

(a) Comprises only tourism. (b) including accounting, legal and merchanting services.
Sources: Central Bank of Turkey, www.tcmb.gov.tr; Ministry of Culture and Tourism, www.turizm.gov.tr;
Turkish Statistical Institute, www.turkstat.gov.tr.

Tourism generated around USD 22 billion or EUR 14.9 billion[31] for Turkey in terms of revenue from abroad in 2008. This accounted for only 3% of its GDP, although it accounted for 12.8% of exports of goods and services, and as much as 62.9% of exports of services alone in the same year.

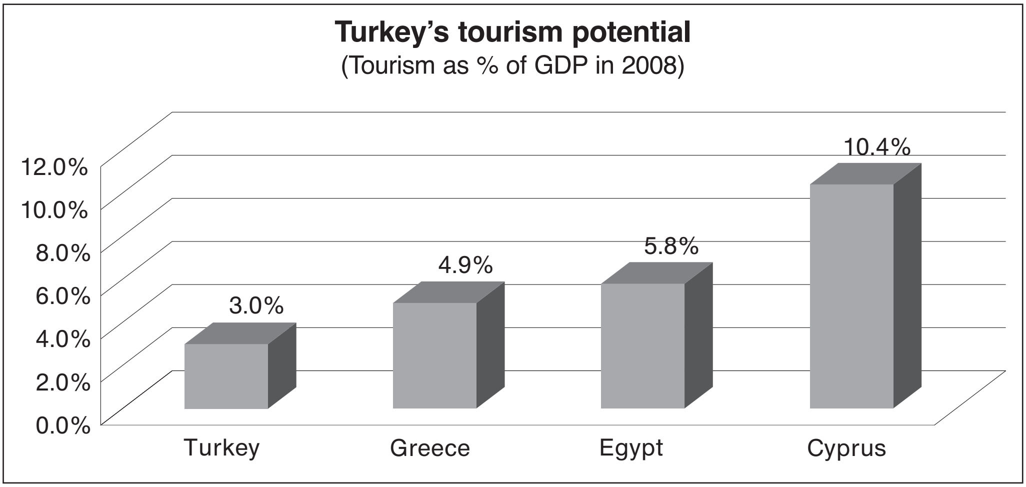
In neighbouring Greece, Cyprus and Egypt, the contribution of travel revenue to GDP was 4.9%, 10.4% and 5.8%, respectively, in 2008. Thus, the above brief look at the numbers suggests that even though travel and transport account for the bulk of exports of services,

30 http://www.kultur.gov.tr/genel/text/tr/YIGM/turizmkentleri/eng/index.htm. Unfortunately we were unable to make contact with the Ministry for permission to reproduce the map.

31 See table on exchange rates-source ECB monthly bulletin

there are still huge growth prospects for both these sectors in Turkey, which would lead to an increase in their contribution to overall GDP and to the sustainability of the current account. Comparing Turkey's revenue from tourism with those of its neighbours, one can say that in very rough terms, the contribution of tourism to GDP of Turkey has the potential to grow more than threefold.

Figure 11 Turkey's tourism potential: tourism as % of GDP in 2008



Data analyzed in our first *Day After* report[32] on current-account flows between Greece and Turkey demonstrate that after the partial normalization of political relations in the Papandreou-Cem era,[33] travel flows between the two countries increased 18-fold. More specifically, balance of payments travel flows from Turkey to Greece increased by 15 times, while travel flows from Greece to Turkey increased by 22 times.

Figure 12 Greece: travel flows with Turkey in Normalization Phase I

Greece: travel flows with Turkey in Normalization Phase (EUR million; annual average)	1999-2001	2002-2006	Average increase (no. of times)
Travel, credit (flows to Greece)	4.5	69.5	x15
Travel, debit (flows to Turkey)	3.0	66.6	x22

Sources: Bank of Greece.

32 The Day After: Commercial opportunities following a solution to the Cyprus problem http://www.prio.no/upload/Report-The%20day%20after.pdf

33 George Papandreou and İsmail Cem: Foreign Ministers of Greece and Turkey, respectively, in 1999.

Figure 13 Greece: travel flows with Turkey in 2001-09

Greece: travel flows with Turkey (EUR million)	2001	2002	2003	2004	2005	2006	2007	2008	2009
Travel, credit	3.4	60.2	68.1	86.0	64.3	69.0	73.0 (a)	85.0 (a)	86.0 (a)
Travel, debit	2.7	64.3	45.0	52.9	100.8	70.2	80.3	83.5	75.0 (b)

(a) Estimates on basis of number of arrivals and per person expenditure. (b) Estimated base on first three quarters.
Sources: Bank of Greece; Hellenic Statistical Authority.

We have termed the period from 1999 to 2006 as "Normalization Phase I." Uniting the island through a peaceful resolution of the Cyprus problem will lead to a further reduction in tensions and normalization of political relations between Turkey and Greece, since a major factor of insecurity and uncertainty will be removed from relations between the two countries and from the psychologies of Greeks and Turks. This can be expected to lead to a further expansion of travel flows between the two countries in what we have termed "Normalization Phase II."

Figure 14 Greece: travel flows with Turkey in Normalization Phase II

Turkey: tourism growth potential with Greece in Normalization Phase II (EUR million; annual average)	2002-2009	2010-2014	Average increase (no. of times)
Travel, credit (flows to Greece)	73.95	739.50	x10
Travel, debit (flows to Turkey)	71.50	1,072.50	x15

Sources: Bank of Greece; authors' forecasts.

In Figure 12 we assume that in the five-year period of Phase II (2010-14), annual average travel credit from Turkey to Greece will rise tenfold, compared with an 18-fold increase in Phase I. We also assume that the annual average travel credit from Greece to Turkey will increase 15-fold, compared with 22 times in Phase I. With these assumptions, we calculate an annual average flow of EUR 739.5 million in travel from Turkey to Greece and of EUR 1,072.5 million (EUR 1.1 billion) in travel from Greece to Turkey. In other words, Turkey stands to gain a gross increase of **EUR 1 billion per year in tourist receipts**.

Similarly, the normalization of political relations between a reunited Cyprus and Turkey that would follow a peaceful resolution of the Cyprus problem will no doubt lead to much greater numbers of Greek Cypriots travelling to Turkey, not least to visit historical Greek sites that are already popular with those who do visit.[34] Assuming that the implementation of an agreed solution is smooth and that confidence in Turkey grows, the number of all Cypriots visiting Turkey could grow to reach the same levels as the current flows of Greek Cypriots visiting Greece.

34 Already small numbers of Greek Cypriots have started to visit Turkey.

Figure 15 Greece: travel flows with Cyprus (south)

Greece: travel flows with Cyprus (south) (EUR million)	2005	2006	2007	2008	2009
Travel, credit (flows to Greece)	400.9	429.8	439.2	394.2	370.0 (a)
Travel, debit (flows to Cyprus (south)	103.0	66.8	75.4	79.3	71.0 (a)

(a) Estimates on basis of number of arrivals and per person expenditure. (b) Estimated base on first three quarters.
Sources: Bank of Greece; Hellenic Statistical Authority.

During the years 2005-09, Greece earned an annual average EUR 407 million in travel receipts from Cypriots. If we assume that Turkey could earn similar amounts, **Turkey would stand to gain an additional annual average inflow of around EUR 400 million in revenue from Cypriots travelling to Turkey.**

On top of the above additional flows from Greece and Cyprus alone, one should also take into consideration the triangle of Greece, Turkey and Cyprus as a combined destination. In a new normalized situation where political relations among the three countries will have smoothed out, where transit routes are opened, a combined visit to all three countries in the area would constitute a very attractive tourist product. **A mere one percentage point increase in travel credit flows to Turkey arising from this increased confidence in the region would yield an additional EUR 152 million of travel business to Turkey per year**.

Figure 16 Turkey: tourism growth potential

Turkey: total tourism growth potential (EUR million)	Additional annual flows
Travel inflows from:	
Greece	1,000
Cyprus	400
Rest of the world	152
Total additional annual travel inflows	**1,552**

Source: Authors' forecasts.

In total, therefore, the peaceful resolution of the Cyprus problem through the reunification of the island would yield an additional gross amount of **EUR 1,552 million per year to Turkey** in added credit flows into the travel account of the balance of payments of Turkey.

Chapter 7

TRANSPORT: LINKING UP WITH THE THIRD LARGEST EU FLEET

Transport, storage and communication is the second largest sector of the Turkish economy, contributing 14.7% to the country's total GDP in real terms. The sector was growing very fast in the 1980s and 1990s, at an average annual nominal growth rate of 71%. As a result of fast growth, the share of the sector to total GDP increased from about 11% in 1998 to 14.3% in 2005.

Nevertheless, real growth in the sector started decelerating after 2005, dropping from 11.7% in that year to 1.4% in 2008. As a result of the sharp deceleration there was a near stabilization of the share of the sector in overall GDP, at 14.7% in 2008, indicating that the deceleration of growth in transport, storage and communication had adversely affected overall GDP growth as well.

One of the reasons behind the slowing down of the sector may have been the decision to refuse business to "vessels and aircraft registered in Cyprus or whose last port of call was in Cyprus."[35] These decisions were taken in 1987 and 1997, respectively, and since the Republic of Cyprus has the third largest fleet in the European Union, one can assume that it had a significant negative impact on transport trade.

The opening of Turkish ports to all of Cyprus will therefore translate into the generation of new additional business arising out of the docking with Turkish ports of ships from the third largest fleet in the European Union and of ships of other nationalities that call at ports in the southern part of the island. Below we calculate how much this might mean to Turkey in financial terms.

Minimum estimate

A minimum estimate of additional annual business to Turkey from opening up its ports to the southern part of Cyprus is derived on the basis of the volume of cargo currently being loaded and unloaded at the ports of Cyprus in the south, as compared to the amount of cargo currently being loaded and unloaded at the ports of Turkey.

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[35] Extracted from the Commission's 2009 Progress Report on Turkey.

Figure 17 Turkey additional transport potential: minimum estimate

Turkey's additional transport potential: minimum estimate	2006	2007	2008
No. of ships calling at Cyprus (south) ports and currently not allowed to call at Turkish ports (a)	…	4,739	4,574
Cabotage transportation (million tons)			
Turkish ports(b)			
Loads (exports)	13,596	16,364	…
Unloads (imports)	14,683	18,742	…
Cyprus (south) ports (a)			
Loads (exports)	1,802	1,630	1,733
Unloads (imports)	6,685	6,738	7,219
Cyprus (south) as % of Turkey			
Loads (exports)	13.3	10.0	…
Unloads (imports)	45.5	36.0	…
Average Cyprus (south) loads as % of Turkey's loads	**29.4**	**24.0**	**…**
Turkey's current BOP transportation revenue (c), (EUR billion)	3.8	4.5	5.3
Freight	1.5	1.8	2.0
Other transportation	2.5	3.0	3.3
Additional transportation revenue from ships calling from Cyprus (south) ports, (EUR billion)			
Total	…	…	1.0
Freight (using load proportion of 10%)	…	…	0.2
Other transportation (using average cabotage proportion of 24%)	…	…	0.8
TL per EUR (d)	1.8090	1.7865	1.9064
USD per EUR (d)	1.2556	1.3705	1.4708

(a) Cyprus Ports Authority. (b) Chamber of Shipping of Turkey, 2007 Maritime Sector Report.
(c) Central Bank of Turkey, balance of payments, transportation revenue.
(d) European Central Bank, Monthly Bulletin, period averages.

Source: Authors' forecasts based on (a), (b), (c) and (d).

As can be seen from the minimum estimate table, the volume of cargo being unloaded at Cyprus ports is 36% of the corresponding volume unloaded at Turkish ports, while the respective proportion for loads (exports) is a lower 10% and the average is 24%.

Hence it can be safely assumed that if the 4,739 ships currently calling at Cyprus (south) ports would be allowed and encouraged to use Turkish ports as well, the volume of business at Turkish ports would increase by an additional average 24%. Applying this proportion to the "other transportation revenue"[36] in the balance of payments of Turkey yields additional transport

36 Services provided in ports including cargo handling, storage and warehousing, packing and repacking, towing, etc.

revenue of EUR 0.8 billion. Furthermore, applying the proportion of loads (exports) to freight revenue, i.e., increasing freight revenue by 10%, would yield an additional EUR 0.2 billion, **bringing total additional transport revenue on a balance-of-payments basis to EUR 1 billion per year**, according to our minimum estimate scenario.

Higher estimate

To the extent that account is taken not only of the number of ships calling at the southern ports of Cyprus but also of the number of ships carrying the Republic of Cyprus flag (there may be some overlap), we can make an estimate for additional "other transportation revenue."

There were 1,869 ships flying the Cyprus flag in 2008, according to statistics of the Department of Merchant Shipping, or 39.4% of the number of ships docking at Cyprus ports. If these ships start calling at Turkish ports and making use of other transportation services, then applying the above proportion to the "other transportation revenue" earned from the ships that dock at Cyprus ports, produces an additional EUR 0.3 billion of "other transportation revenue" into Turkey's balance of payments. Combining this with the minimum estimate brings **the total estimate of additional transportation revenue for Turkey to EUR 1.3 billion per year**.

Figure 18 Turkey's additional transport potential: maximum estimate

Turkey's additional transport potential: maximum estimate	
Additional business from opening to ships calling at Cyprus (south) ports, EUR billion	1.0
Additional business from opening to Republic of Cyprus fleet (1869/4739* 0.8)	0.3
Total additional transportation revenue per year	**1.3**

Source: Authors' forecasts.

Revenue from transit tariffs on Blue Stream-2

As outlined more fully in Chapter 5, energy security is a major concern for the European Union, and outlet security is a major concern for supplier countries like Russia. Therefore, Turkey's location between big energy producers and big energy consumers gives it an important role as a transit hub for oil and gas.

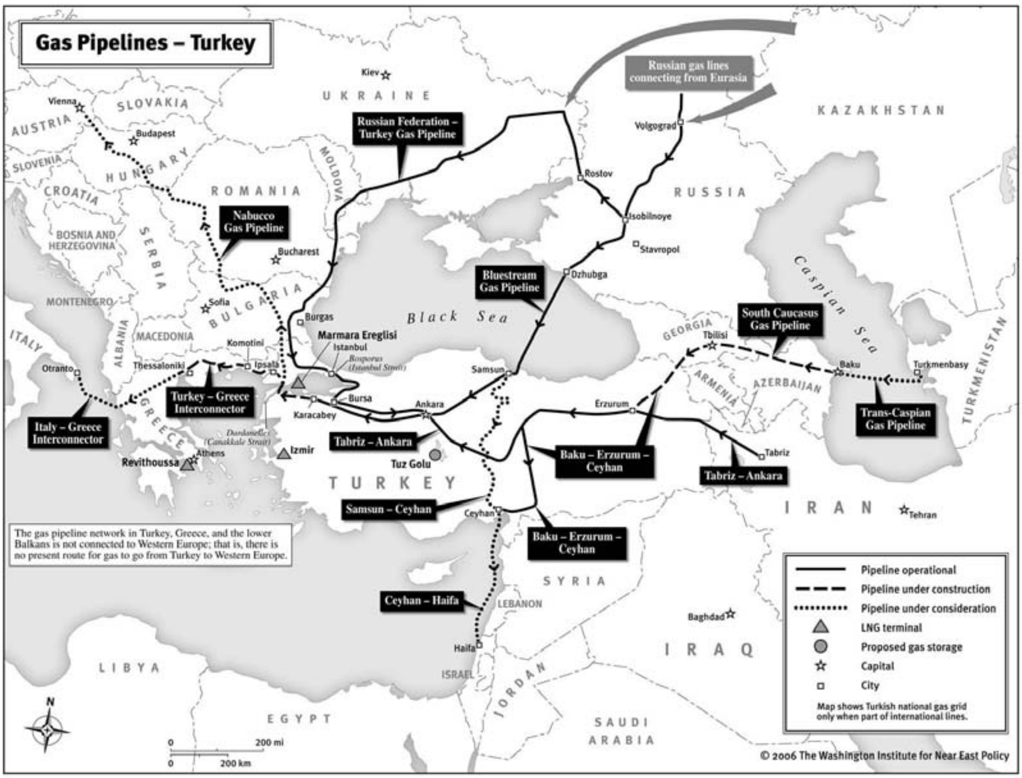
Figure 19 Pipelines

Pipelines	Length in km	Cost of construction EUR billion	Cost per km EUR 000	Gas vol billion cu metres
South stream (a)	900	8.6	10.0	…
Blue stream:				
Dzhubga to Samsun	1,213	12.1	10.0 (c)	10.1 (b)
Samsun-Ceyhan (c)	1,200	12.1	10.0	10.1
Ceyhan-Haifa (c)	1,200	12.1	10.0	10.1

(a) Source: Bloomberg. (b) 10.1 BCM in 2008; 9.5 BCM in 2007; 7.5 BCM in 2006.
(c) Estimates based on South Stream and Blue Stream.

Various proposed gas pipeline projects envisage using Turkey as a transit corridor from producer to consumer countries. These include Nabucco, South Stream and Blue Stream. Blue Stream-2 involves the construction of a gas pipeline to transfer Russian gas from Samsun to Ceyhan, vertically across Turkey, and then a submerged gas pipeline to Israel, from Ceyhan to Haifa. Blue Stream-2 is intended to enable gas deliveries to the Middle East, including Cyprus.

Figure 20 Gas pipelines through Turkey



It can nevertheless be safely assumed that this project cannot go ahead unless political and economic relations with all of Cyprus normalize. In other words, Turkey can look forward to a prompt materialization of Blue Stream-2 and to the concomitant revenues from the transportation of gas via the pipelines crossing its territory, only once the Cyprus problem is solved and relations between Turkey and the whole of Cyprus normalize.

It is therefore safe to ascribe the expected transportation revenue from the transit tariff on the usage of pipelines to the financial benefits that will materialize for Turkey once Cyprus is reunified.

On the basis of data published on the website of the East European Gas Analysis,[37] it is derived that a minimum transit charge of (USD 30 per million cubic metres (USD 30/mcm) and a maximum of USD 70/mcm applies as a transit tariff for the use of gas pipelines of similar length concerning the shipping of Russian gas to Europe.

Assuming that a similar volume of gas would flow annually through Samsun-Ceyhan and Ceyhan-Haifa as is currently flowing through Blue Stream-1 (10.1 BCM in 2008) and applying the rate of USD 30/mcm, yields an annual transit revenue for Turkey of USD 303 million or EUR 206 million for each leg of the pipeline, **or a total of EUR 412 million per year.**

Hence, the peaceful resolution of the Cyprus problem could yield an additional **annual credit flow to the transportation services of the balance of payments of Turkey of up to EUR 1.7 billion,** deriving from opening up Turkish ports to the southern part of Cyprus and from the materialization of energy projects that might not come to fruition in the absence of an agreed settlement.

[37] www.eegas.com.

Chapter 8

TAPPING THE POTENTIAL OF FINANCIAL AND BUSINESS SERVICES

Financial intermediation is the fourth largest sector of the Turkish economy, accounting for 10.6% of real GDP or 3.5% of nominal GDP in 2008.[38] Nevertheless, most business is generated domestically. In 2008 exports of financial services amounted to only EUR 572 million in nominal terms out of total value added creation in the sector of EUR 17.3 billion. Similarly, “other business activities,” which include mainly legal and accounting services as well as merchanting services, fetched only EUR 62 million of exports in 2008.

A mere comparison with the respective export revenues of Cyprus (south), whose economy is about 30 times smaller than that of Turkey, indicates the vast opportunities for Turkey to expand exports of these services once the country gains access to European financial markets through Cyprus.

Exports of financial services from the southern part of Cyprus amounted to EUR 745.2 million in 2008, i.e., 30% higher in absolute terms than the respective exports of Turkey. More notably, exports of “other business services” reached 1.4 billion in 2008, compared with effectively no exports from Turkey.

With the peaceful resolution of the Cyprus problem and the reunification of the island in a manner that will enable the application of the EU *acquis communautaire* (body of law) to the whole of Cyprus, Turkish banks will be in a position significantly to broaden their presence in the European market through setting up branches or subsidiaries in Cyprus.

In the same way, Turkish legal firms, accounting firms, architects/engineers offices and other professionals could set up base in Cyprus or cooperate with Cypriot firms in a United Cyprus to offer their services both in Cyprus and in other European countries.

Figure 21 Exports of financial and business services

Exports of financial and business services in 2008 (EUR million)	Cyprus (south)	Turkey	Difference
Financial services	745	572	173
Business services	1,396	62	1,334
Total	**2,141**	**634**	**1,507**

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

38 Lower deflators than for rest of economy.

A mere subtraction of absolute amounts indicates that Turkey could gain an additional export revenue of EUR 1.5 billion annually from the expansion through Cyprus of both financial intermediation and business services abroad. If, furthermore, one takes into consideration the difference in size of the two economies—scaled down by considerations of openness of the two economies—the figure becomes much larger.

Figure 22 Financial services in 2008

Financial services in 2008 (EUR million)	Cyprus (south)	Turkey	Difference (no. of times)
Exports of financial services	745	572	…
Value added creation	1,215	17,300	…
Exports as % of value added	61.3	3.3	x19
Degree of openness of economy			
Exports of good & services (EUR million)	7,586	116,400	…
as% of GDP	44	23.4	x2
Potential exports of financial services		5,633	x10
Memo item:			
Economy size (GDP)	17,248	498,400	x29

As a rough measure of degree of openness, we take exports of goods and services as a percentage of GDP, which was around 23% in the case of Turkey in 2008 and around 44% in the case of the southern part of Cyprus. Hence, on the basis of this measure, the degree of openness of the Turkish economy is about half that of Cyprus (south). Exports of financial services accounted for 61.3% of total value added created by the financial services sector in the southern part of Cyprus in 2008, while in Turkey exports of financial services accounted for only 3.3% of value added in the same year. Hence, the current contribution of financial services exports by the sector total in Turkey is 19 times less that in Cyprus (south). If we account for half the openness, then exports of financial services by Turkey could increase to account for around 33% of value added created by the sector, i.e., for around EUR 5.6 billion per year.

Although we were unable to make a similar calculation for business services, since the available breakdown of sectoral GDP data does not support it, the mere addition of the non-adjusted figure of EUR 1.4 billion to the above yields a **total gain for Turkey of EUR 7 billion in additional exports of financial intermediation and business services**, should the relations between Turkey and the whole of Cyprus completely normalize.

Exports of goods could gain EUR 2 billion per year

A settlement of the Cyprus problem can be expected to lead to increased trade in goods for Turkey in two ways: increased trade with the island of Cyprus and (much larger) increased trade in the region as a whole. At present, as a by-product of the Cyprus problem, Turkey will not allow any ships or aeroplanes that embark from ports in the southern part of Cyprus or carrying the Republic of Cyprus flag to disembark or land at Turkish ports. This means that trade between Turkey and the south is minimal. Turkey exported just EUR 7.7 million in goods to the south in 2009 and imported only EUR 482,000 worth.[39] Turkey's market for goods is therefore currently restricted to the northern part of Cyprus, with a GDP of EUR 2.5 billion in 2009. Through a solution, the market for Turkey could instead become the whole island with a GDP of EUR 19.4 billion.

After a settlement, exports of goods from Turkey to Cyprus can be expected to expand. The main goods are likely to be textiles, iron and steel products and transport equipment, Turkey's primary exports.[40] In addition, since the southern part of Cyprus is currently switching from heavy oil to liquid natural gas (LNG), Turkey is also likely to become a major supplier of LNG.

We have derived our estimate for additional exports of goods from Turkey to Cyprus and the rest of the world from our freight forecast in Chapter 7, where we forecast an additional EUR 0.2 billion per year. If freight income is assumed to be 10% of the total value of goods exported, then Turkey stands to gain **an additional EUR 2 billion per year on average in exports of goods as a result of a solution to the Cyprus problem**.

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39 Statistical Service, *Intra-Extra Trade Statistics*, January-December 2009.

40 Source: Economist Intelligence Unit, Turkey *Country Report*, July 2009.

Chapter 9

PREVIEW OF BENEFITS TO GREECE

In May 2010, the Eurozone partners of Greece[41] were helping the country with bilateral loans so that the Greek government could meet its debt obligations without having to resort for some time to costly financing from international markets. The Greek government's implementation of austere fiscal consolidation measures should return market confidence and establish a healthy basis upon which the Greek economy can eventually return to fiscal health, positive economic growth and job creation. Nevertheless, the required fiscal consolidation measures are so austere that positive growth is not expected to resume before the second half of 2011,[42] or even later.

Figure 23 Greece: main macroeconomic indicators

Greece: main macroeconomic indicators	2007	2008	2009	2010	2011
Real GDP growth (a) (%)	4.50	2.00	-2.00	-3.00	-0.50
Inflation rate (%)	3.0	4.2	1.3	3.1	2.1
Unemployment rate (b) (%)	8.3	7.7	9.5	11.8	13.2
Current-account balance (% of GDP)	-14.7	-13.8	-13.1	-10.3	-8.6
General government balance (a) (% of GDP)	-5.1	-7.7	-13.6	-9.3	-9.9
General government gross debt (% of GDP)	95.7	99.2	115.1	124.9	133.9
GDP per inhabitant					
At purchasing power standard (PPS), current prices	23,100	23,600	…	…	…
At purchasing power standard (PPS), EU27=100	92.8	94.3	…	…	…

(a) Later forecasts by the Commission put the decline of GDP at 4% in 2010 and 2.5% in 2011, with a lower fiscal deficit.
(b) Eurostat definition.
Source: European Commission, Spring 2010 Economic forecasts.

In August 1999 a strong earthquake hit İzmit in Turkey, bringing it down in ruins. A helping hand extended by the forward-looking Greek Minister of Foreign Affairs at the time, George Papandreou, went a significant way to supporting Greece's neighbour in a time of need. In September of the same year, Turkey's own forward-looking Minister of Foreign Affairs, the late İsmail Cem, was keen to reciprocate when another earthquake struck the vicinity of Athens in

41 In the context of a three-year joint programme with the IMF.
42 European Commission: Spring 2010 Forecasts.

Greece. In the wake of these earthquakes,[43] the two countries agreed to establish a joint standby disaster response unit.

These gestures opened the way for the normalization of political relations between the two countries and the concomitant spectacular growth of economic relations across the Aegean. It is no accident that in December of the same year the European Council meeting in Helsinki recognized Turkey's status as a candidate country while welcoming the launch of talks earlier in the same month aimed at a comprehensive settlement of the Cyprus problem.

Just over ten years later, Greece finds itself on its knees after a man-made disaster: that of economic mismanagement. Forward-thinking politicians on both sides of the Aegean can again join forces to face the disaster that has befallen one of the neighbours, in a way that would yield lasting benefits to all involved, in the same way that the earthquake diplomacy of 1999 yielded concrete political and economic results.

The current challenge facing George Papandreou, now the Prime Minister of Greece, and Recep Tayyip Erdoğan, the Prime Minister of Turkey, is a challenge to which both of these forward-looking leaders can successfully respond. Indeed, the visit to Athens in May 2010 of Mr. Erdoğan (and a large delegation of ministers and business people) demonstrates that the two men understand the value of peaceful cooperation.

The peaceful reunification of Cyprus can clearly furnish benefits not only to all Cypriots but also to both Turkey and Greece, to their neighbours in the Eastern Mediterranean and to their European partners. The much-needed enhancement of stability in the area, the new business opportunities that will be unleashed, the encouragement of foreign direct investment, the expansion of bilateral economic relations and the development of unhindered political and economic cooperation within the common family of the European Union can be the direct results of positively capitalizing on the "Cyprus Connection."

This chapter aims merely to preview—mostly in qualitative terms—the type of economic benefits that will accrue to Greece once Cyprus is reunified and political relations with Turkey and the whole of Cyprus completely normalize. A fully fledged quantitative estimate of the economic benefits that would accrue to Greece constitute the subject of further study. Below the authors present indicative estimates and/or analyses of the economic sectors, or types of expenditure, that would benefit from positive developments in the political field.

Energy corridors

Inasmuch as Turkey can benefit from the enhancement of its role as an energy corridor for Europe (and the Middle East), Greece has a similar and complementary capacity, as has already been evidenced by the agreement on the Burgas Alexandroupolis Oil Pipeline,[44] and

43 And a third one in November 1999 in Düzce, Turkey.

44 For the transportation of Russian and Black Sea oil, via Greece and Bulgaria, to Europe, the Mediterranean and the USA.

Greece's very recent agreement with the state of Qatar for an energy project at the port of Astakos, in western Greece.[45]

In the context of complete peace and trusting cooperation between the two neighbours across the Aegean that would arise from the reunification of Cyprus and the normalization of political and economic relations among the three, Greece and Turkey could complement each other in transferring oil and/or gas from the producing countries to Europe and the Middle East, making such a transfer more efficient and cost effective. They could also cooperate in the development of renewable energy sources.

Figure 24 New Greco -Turkish Pipeline

Greco-Turkish pipeline (a)	
Total length	600 km
Total construction value	EUR 2 billion
Annual transit revenue	EUR 100 million
Burgas Alexandroupolis oil pipeline	
Total Length	279 km
On Greek soil	118 km
Total construction value	EUR 1 billion
Samsun-Ceyhan gas pipeline	
Length	1,200 km
Annual transit revenue	EUR 206 million

(a) In addition to the existing ITG (Interconnector Turkey-Greece).

Assuming that, after relations between Greece and Turkey normalize completely, one additional Greco-Turkish pipeline will be constructed to carry oil or gas from producing to receiving countries, then on the basis of data regarding the Burgas Alexandroupolis Oil Pipeline and the Samsun-Ceyhan gas pipeline, we estimate that Greece could gain an additional gross construction output of around EUR 1 billion over the period of the materialization of the project, plus annual revenue of around EUR 50 million in transit tariff receipts.

Tourism

Tourism flows to Greece would greatly benefit from the attraction of a combined visit to the sunny and history-rich triangle of Greece, Turkey and Cyprus. If a mere one percentage point increase in travel credit flows to Greece arises out of an increased confidence in the area,[46] Greece would benefit from an additional EUR 110 million of travel business per year.

45 Part of a series of Qatar investments in Greece amounting to more than EUR 5 billion.

46 Same assumption as that made for Turkey.

Figure 25 Greece: travel credit

Greece: travel credit (EUR billion)	
2007	11.3
2008	11.6
2009	10.4

Source: Bank of Greece.

Shipping

The shipping business, which is already a very important growth-creating sector in Greece, would certainly greatly benefit from Turkey's abolition of restrictions related to ships flying a Republic of Cyprus flag or sailing from Cypriot ports. The abolition of such restrictions on both ships and planes would also greatly facilitate the flow of tourism among the three countries.

The potential for foreign direct investment

Both Greece and Turkey, as well as the whole of Cyprus, would benefit from the increase in FDI flows into the area, once the uncertainty due to the unresolved political problems between neighbours is removed. It would be especially encouraging for foreign investors to see a supposed enemy of Greece lending a helping hand to its neighbour in a time of need.

Figure 26 Foreign direct investment by country

Foreign direct investment by country	2004	2005	2006	2007	2008	2004-2008
						Annual average
Inward FDI flows (EUR billion)						
Greece	1.7	0.5	4.3	1.5	3.1	2.2
Turkey	2.3	8.1	16.1	16.1	12.4	11.0
Cyprus (south)	0.9	1.0	1.5	1.6	2.7	1.5
Total	**4.9**	**9.5**	**21.8**	**19.3**	**18.2**	**14.7**
Inward FDI flows (% of GDP)						
Greece	0.9	0.3	2.0	0.7	1.3	1.0
Turkey	0.7	2.1	3.8	3.4	2.5	2.5
Cyprus (south)	6.9	7.0	10.0	10.2	15.9	10.0
FDI Intensity (a) (%)						
Greece	0.7	0.4	1.8	1.2	1.0	1.0
Turkey	0.5	1.2	2.0	1.9	1.4	1.4
Cyprus (south)	5.6	5.1	7.4	7.9	15.6	8.3

(a) Average value of inward and outward FDI flows divided by GDP, in %.
Source: Eurostat website.

As the largest country of the three neighbours, Turkey naturally attracts the highest flows of foreign direct investment into its economy in absolute terms. Nevertheless, when the size of each country's GDP is considered, the southern part of Cyprus emerges as the most attractive destination for foreign investors. Similarly, Cyprus (south) has by far the highest FDI intensity, when accounting for both inward and outward direct investment as a percentage of the country's GDP.

A solution of the Cyprus problem would, in the eyes of potential investors, transform the whole area comprising the three countries into a common destination for investment. Thus, the relative attraction of Cyprus (south) could expand to cover the entire island as well as Turkey and Greece.

As figure 26 shows, in simple relative terms, Cyprus (south) attracted 10 times more inward FDI than Greece and 4 times more than Turkey on average in 2004-08. In terms of the intensity indicator—which also accounts for outward direct investment—Cyprus (south) attracts roughly 8 times more FDI than Greece and 6 times more FDI than Turkey.

With the attraction of the southern part of Cyprus spreading to both of its neighbours we estimate that Greece could potentially attract at least 8 times more FDI flows per year. **This would translate into an additional annual average FDI inflow of EUR 19.8 billion for Greece.**

Savings on military expenditure

Once there is no longer any reason to invest in defence against a neighbour, Greece would make huge savings in military expenditure that could then be invested in productive peace-time projects. Greece's expenditure on defence as a proportion of GDP, at 2.8% in 2008, is the second highest in NATO after the USA,[47] and a large part of this is directed at protecting itself from Turkey. Furthermore, as a recent example in Cyprus has indicated, the cost of military expenditure is not restricted to the money spent on defence but also extends to the foregone revenue from using the land to host military camps instead of putting it to profitable commercial use. And if this is true of Cyprus, it must be at least ten times as true of Greece with its many islands in the Aegean. In Chapter 4, we estimated that given its long border with Greece, Turkey could cut its military expenditure by 20% as a result of a settlement of the Cyprus problem. On the basis of the composition of geographical borders, the savings for Greece could be estimated to reach as high as 33% of its total defence expenditure. According to NATO data, Greece spent EUR 6.9 billion on defence in 2008. If expenditure were cut by 33%, Greece would save around EUR 2.3 billion per year.

[47] NATO press release, 19 February 2009, www.nato.int.

Chapter 10

TURKEY: THE IMPACT ON FOREIGN DIRECT INVESTMENT

Opportunities for foreign investors have opened up considerably

Opportunities for foreign investors in Turkey have opened up considerably in recent years, thanks to the new law on foreign direct investment in 2003, as well as structural reforms and the prospect of EU membership. As a result of these, the inflow of FDI increased dramatically in the early years. While cumulative inward FDI between 1996 and 2004 reached just USD 13.2 billion, in 2007 alone FDI reached USD 22.2 billion. However, the global financial crisis has taken its toll and in 2008 inward FDI fell by 19% to USD 18 billion. The decrease in FDI continued in 2009 and reached USD 7.6 billion, a drop of 58% compared with 2008. This decrease is comparable with the preliminary data on global FDI flows from the UNCTAD World Investment Report of 2009.

Figure 27 Turkey's FDI inflows, 1970-2009

Turkey: FDI inflows (a), 1970-2009 (USD million)	
1970	58
1980	18
1990	684
1999	783
2000	982
2001	3,352
2002	1,133
2003	1,751
2004	2,785
2005	10,031
2006	20,185
2007	22,214
2008	18,000
2009	7,560

(a) Including real estate purchases.
Source: YASED, International Direct Investments Report.

Regarding the sectoral distribution of FDI, in 2009 the highest share of total FDI inflows went into the energy and manufacturing sectors. As discussed in Chapter 5, according to Turkey's Ministry of Energy and Natural Resources, the investment needs of the global energy sector until 2030 will be USD 20 trillion and the greatest percentage of energy demand will be met within the region where Turkey is located. The Turkish government says that investment needs in the Turkish energy sector amount to USD 130 billion.

Figure 28 Turkey: sectoral composition of FDI

Turkey: sectoral composition of FDI (a) (USD million)	2002	2003	2004	2005	2006	2007	2008	2009
Agriculture, forestry, fishing		1	6	7	6	8	41	42
Industry	180	548	329	829	2,1	5,116	5,151	3,485
Mining and quarrying	2	14	73	40	122	337	152	194
Manufacturing	110	448	190	785	1,866	4,211	3,931	1,645
Electricity, gas and water supply	68	86	66	4	112	568	1,068	1,646
Services	442	196	855	7,699	15,533	14,012	9,541	2,167
Construction	…	…	3	80	222	285	331	460
Real estate & rental services	…	…	3	29	99	560	674	227
Financial sector	…	…	69	4,018	6,957	11,662	6,069	432
Other services	…	…	780	3,572	8,255	1,505	2,467	1,048
Total inflows	**612**	**745**	**1,190**	**8,535**	**17,639**	**19,136**	**14,733**	**5,694**

(a) Excluding real estate purchases.
Source: YASED, International Direct Investments Report.

The energy sector is one of the most important foreign investment fields, with Turkey's growing importance as a hub for energy transport routes and its own growing need for new energy resources to meet increasing demand.[48] The FDI statistics prove this statement. Even though FDI inflows decreased by around 58% in 2009, FDI flows into the energy sector in the same year rose by 54%. Moreover, as Figure 29 shows, the number of companies with international capital in the energy sector increases each year.

48 See report of speech by Rifat Hisarcıklıoğlu, the chairman of the Turkish Union of Chambers and Commodity Exchanges, www.turkeyfinancial.com/news/2007/02/22/foreign-direct-investments-soar-but-not-eby nough/

Figure 29 Turkey: companies with international capital

Turkey: companies with international capital (Number of companies)	2000	2001	2002	2003	2004	2005	2006	2007	2008
Agriculture, hunting, fishing and forestry	8	10	5	23	30	34	46	51	60
Mining and quarrying	8	6	18	12	31	51	49	82	93
Manufacturing	95	90	75	249	349	407	448	498	459
Food products and beverages	9	8	7	20	51	39	45	37	33
Textiles	3	10	13	58	52	67	51	50	20
Chemicals and chemical products	8	11	7	27	42	36	38	56	47
Machinery and equipment n.e.c.	9	6	7	19	23	27	52	46	44
Motor vehicles, trailers and semi-trailers	14	11	5	15	18	20	16	19	21
Other manufacturing	52	44	36	110	163	218	246	290	294
Energy	7	4	6	9	15	10	43	77	115
Construction	11	25	21	29	127	322	418	498	382
Wholesale and retail trade	144	163	204	403	797	722	780	827	802
Hotels and restaurants	36	52	42	62	77	167	202	212	226
Transport, storage and communications	45	46	46	83	209	229	269	298	300
Real estate, renting and business activities	54	42	37	87	225	503	683	860	692
Other community, social and personal service activities	29	24	35	72	88	168	231	226	268
Total companies with international capital	437	462	489	1,029	1,948	2,613	3,169	3,629	3,397

Source: Central Bank of Turkey.

But Turkey's FDI potential may have stalled

However, Turkey's EU membership negotiations have more or less stalled because of the Cyprus problem: eight chapters have been closed as a result of the non-implementation of the customs union with the southern part of Cyprus, and the energy chapter has been closed because of disputes over hydrocarbons exploration. A peaceful resolution of the Cyprus issue would unblock all of these chapters, leading not only to progress in Turkey's accession negotiations, but also to further adaptations of the country's laws and norms to the EU's *acquis communautaire*. This is important, because by aligning itself to EU norms and practices Turkey would become a much more attractive place to do business. In addition, as argued in our chapter on energy, unblocking the energy chapter would in itself attract investment in this highly promising sector.

As argued in previous chapters and illustrated in the chapter on benefits to Greece, there will also be a substantial boost to FDI of around EUR 33 billion arising from the reduction of tensions with Greece and the wider regional benefits. Thus, Turkey will also attract more FDI owing to its geographic location and geostrategic position. Stability in the region will tend to boost inflows of FDI particularly in infrastructure and energy. As a result of climate change, there will also be investment opportunities in various sectors such as renewable energy and environmentally friendly water and waste water treatment.

While these figures may seem high, one has to consider that the Turkish government is talking about investment of USD 130 billion (EUR 105 billion) in the energy sector over the next decade, and that in 2006-2007 Turkey attracted more than USD 20 billion in FDI—before investment in the energy sector had really taken off and without a solution to the Cyprus problem. As we have argued, a solution of the Cyprus problem would unleash a huge amount of potential for Turkey (and Greece), not only in the energy sector but also elsewhere.

As noted in this and the previous chapter, Turkey has a vast untapped potential for FDI, which would be realized much more easily with a peaceful resolution of the Cyprus problem. Based on our calculations of FDI intensity in Figure 26, we estimate that Turkey could attract at least 4 times more foreign direct investment than it does today. **This would translate into an additional average annual FDI inflow for Turkey of EUR 33 billion.** While this amount may seem high at first sight, it should be remembered that FDI as a proportion of GDP in Turkey is currently very low; that Turkey's FDI rose tenfold in the period 2004-06; and that the government plans to invest USD 130 billlion in energy over the next few years.

The three ladies who have prepared this third report in the *Day After* series are encouraged that their work reflects the constructive thinking of these two forward-looking leaders. This report takes the further step of estimating in concrete numbers the actual peace dividend that will accrue to both Turkey and Greece, once their Cyprus connection ceases to burden and constrain them, but instead releases the huge opportunities that await the neighbourhood of the three upon the prevalence of inspired vision.

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Ministry of Energy and Natural Resources of the Republic of Turkey

NATO

Statistical Service of the Republic of Cyprus

State Planning Organization

Turkish Statistical Institute

POSTSCRIPT:
THE CHALLENGE AHEAD

Throughout Cyprus's long history, the island's geostrategic position at the crossroads of three continents has made the island a desired target of possession or control. Today Cyprus has built on its geostrategic position through accession to the family of the European Union, jointly endeavouring for peace, stability and prosperity. Still, the non-resolution of the long-standing political problem adversely affects the lives of all Cypriots and limits the prospects awaiting the young.

The international community is currently confronted with the unique opportunity of benefiting from the advantages that the geostrategic identity of Cyprus has to offer, through a peace deal that will be designed and decided by the Cypriots themselves, and facilitated and supported by the international community.[49] Such a peace deal will yield benefits to all parties concerned, including the Cypriots, the Turks, the Greeks, the Europeans and all their neighbours and associates.

Turkey and Greece are confronted with the opportunity of establishing themselves as true peacemakers in the area, building on the desired identity of credible international players. At the same time, they can reap significant long-term economic benefits that would derive from the unleashing of opportunities that peaceful cooperation among neighbours and their associates has to offer.

This report was being completed on 14 May 2010, the day the Prime Minister of Turkey, Recep Tayyip Erdoğan, and ten of his ministers were making a historic official visit to Greece, signing 21 agreements of bilateral cooperation with the government of Prime Minister George Papandreou. The two Prime Ministers also agreed to set up between their governments a high-level Council of Cooperation, marking a new phase in the bilateral relations of the two countries, while the two Prime Ministers pledged to alternate annual visits to each other's country. The areas covered in the talks between the two delegations, as presented in the two Prime Ministers' joint press conference, included energy, sea transport, tourism, trade, environment and, most importantly, detente.

[49] Through, for example, the good offices mission of the Secretary-General of the United Nations.

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This study is the third in the series of *Day After* reports prepared by the all-female team that has come to be known as The Three Ladies. In our first report, we analyzed the commercial opportunities that could arise from the reunification of Cyprus and quantified the peace dividend for the key sectors that would benefit.

In our *Day After II* report, having analyzed the investment and reconstruction needs in the first few years, we went one step further by extending our analysis to the whole economy. We found that a solution would generate EUR 12,000 per year per family on the island, create 33,000 new jobs and raise the real GDP growth rate by 3 percentage points per year on average for at least the first five years.

In this *Day After III* report, we look beyond Cyprus to the region, analyzing the peace dividend that awaits Turkey after a solution that unites the island, while we also preview the benefits for Greece.

We make a detailed examination of how specific sectors of Turkey's economy would benefit in terms of additional growth resulting from the unification of Cyprus. We also estimate the savings that can be made in terms of expenditure, both current and future, once the Cyprus problem is peacefully resolved. A similar approach is adopted with reference to Greece, though with a lesser degree of detail. As always, our estimates are based on the analysis of hard statistical data.

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