

EUROPEAN INTEGRATION: THE CASE OF CYPRUS

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Abstract

The article is concerned with the extent to which the Association Agreement with the EU has affected Cyprus's level, pattern and direction of trade and the implications for EU membership. While there is evidence of constrained import trade creation between 1972 and 1993 there appears to have been net export trade contraction over the period. The trade deficit with the EU has declined in relative terms and there is a healthy surplus on services, yet the experience of the last two decades suggests that there are uncertainties about the benefits of EU membership.

Nevertheless, careful planning can bring new economic opportunities, and more importantly, full EU membership can provide the conditions for enhanced mutual security and sensitive trust building between the two communities.

Introduction-The Trade Policy Options

This article is concerned with the trade policy choices facing Cyprus. Like other countries bordering the Mediterranean Cyprus is of special interest to the European Union (EU). Moreover, given its historical relationship with Britain, Cyprus was also interested in establishing an agreement with the EU (then the European Economic Community) ¹ in the early 1970s when Britain was about to become a member. The first Association Agreement was signed in 1972 and came into force in June 1973. However, with the Turkish invasion in 1974 the Agreement was temporarily suspended and subsequently renegotiated and reactivated in 1978.

The main feature of the first stage of the Agreement was that the Community reduced the tariff on most manufactured goods from Cyprus by 70% although some quotas were imposed, mainly on textiles and shoes, because of the need to protect these industries within the Community. Agricultural exports which did not compete with Community production were granted substantial tariff reductions (e.g., carobs) but other items were treated less liberally (lower tariff reductions, quotas or off-season access only) if they posed a threat to the farmers of the Community. In return Cyprus agreed to begin to reduce its import tariffs on a range of Community

products.

The original Agreement had foreseen a second stage which would have created a customs union between Cyprus and the Community. It was not until 1988, however, after negotiations lasting almost two years, that the Protocol of the second stage of the Association Agreement, relating to the establishment of a customs union, came into force. The first phase of the Protocol, which it was envisaged would last for ten years, is concerned with the elimination of tariffs on goods entering the Union with the continuing exceptions on agricultural products which compete directly with farmers from member states. To reciprocate Cyprus agreed to gradually abolish tariffs on a wide range of Union industrial and manufactured goods. The second phase, over a period of five years, provides for the elimination of all remaining restriction on products agreed within the Protocol and the creation of a Customs Union with a common external tariff.

The Government of Cyprus has for several years taken the view that the creation a customs union is merely a stage in the process towards full EU membership. However, until recently Cyprus's application for full membership has been on hold as the EU has taken the view that a solution to the Cyprus problem is a prerequisite for membership. That position changed in 1994. At the Corfu Summit it was decided that the island's application for membership should not be delayed because of the continuing deadlock over the national problem and furthermore that the EU could play an important role in facilitating a solution.

The opportunities offered by EU membership for a political solution to the division of the island are of paramount importance and this is something we shall return to in the final section, but it is also vital to consider the related economic arguments. In order to give some insight into the likely economic effects of full membership it may be helpful to try to assess the impact of the Association Agreement and the subsequent Protocol on EU/Cyprus trade. This constitutes a major part of the paper.

The economic effects of economic integration are many and complex, although they are difficult to assess and even more difficult to measure in their entirety. Nevertheless, one of the most important effects relates to the so called static gains from trade and these form a central focus of the paper. For analytical purposes the effects of economic integration between Cyprus and the EU in the recent history of the island can be reduced to three periods, as follows. First, the period before June 1973, when the Association Agreement first came into force. Second, the period between 1973 and 1987, which covered the first stage of the Agreement. Third, the period since 1988 during which the first phase of the Protocol has been in operation.

The first part of this paper will attempt to evaluate the static gains from trade with the EU during both the first stage of the Association Agreement and the period after the signing of the Protocol. We begin by outlining the underlying theory of the static gains from trade.

The Gains from Trade

Most of the empirical studies measuring the impact of economic integration have confined themselves to the static gains. This is not because the other gains, including the dynamic gains, are less important than the static gains but rather that the difficulties of trying to measure the former are more formidable.

The static gains from trade are based on the Vinerian concept of net trade creation.² Economic integration, which removes or reduces tariffs, is expected to lead to a two-way expansion of trade (gross trade creation) between partner states. In terms of imports, gross trade creation is the result of both an increase in consumption due to lower prices and a decline in domestic production which is replaced by cheaper imports from within the union. Assuming that prices fall by the full amount of the reduction in the tariff it can be shown that the gain in welfare is equal to half of the gross trade creation multiplied by the tariff reduction. But there may be an additional complication. In so far as the economic union leads to a switch from low cost external producers to higher cost union producers there will be a loss to member countries equal to the level of 'trade diversion' multiplied by the cost differential. The net gains from trade in this case will be equal to the gains in welfare due to the combined production and consumption effects minus the loss of welfare due to trade diversion.

By the same reasoning, economic integration is also expected to encourage an expansion and possibly a diversification of exports. Export expansion is the reciprocal consequence of the trade creation and trade diversion effects produced by the integration.

Before we attempt to indicate the level and direction of trade creation, trade diversion and export expansion it is important to recognise that we are only interested in those changes which can be attributed either to the first stage of the Agreement or the first phase of the Protocol. This can be estimated by comparing the actual trade after the process of integration with what the pattern of trade would have been in the absence of the Agreement or the Protocol. The difference between the actual and the 'normalised' trade structure is attributed to the integration. There are a number of ways that the hypothetical structure of trade can be estimated although all available methods are fraught with difficulties.³ Moreover, it is also difficult to eliminate the effect of other factors that have influenced the structure of trade, and the introduction of time raises the additional problem of separating out the short-term static effects from the long-term dynamic effects. These problems notwithstanding we now turn to the actual pattern of Cyprus's trade.

The Pattern of Trade

We begin by considering the level of Cyprus's trade after the Association Agreement came into force. Lower tariffs resulting in a reduction in import prices should stimulate (gross) trade creation due to increased consumption and lower domestic production. Trade creation, therefore, implies that a larger share of

output (and consumption) has its origins abroad. We are primarily concerned with commodity trade creation but there is a complication in measuring it against GNP or GDP since in the long run the share of the primary and secondary sectors in total output falls while the share of the tertiary sector rises. This means that it is more appropriate to measure trade in relation to physical or commodity, i.e., non-service, output.

Table 1 shows that between 1970-72, the last three years before the Agreement came into force, and 1991-93 there was an increase in the proportion of imports to Primary and Secondary output from 89.6 per cent to 131.3 per cent. This trend is also repeated in the share of imports to GNP although the expansion is much less pronounced as one would expect. In terms of the overall level of trade it appears that both the Agreement stage (1973-87) and the Protocol phase (1988-) were periods of trade creation.⁴

TABLE 1
IMPORTS AND EXPORTS AS A PERCENTAGE OF GNP AND THE
PRIMARY AND SECONDARY OUTPUT OF CYPRUS IN 1970-72,
1985-87 AND 1991-93 (%)

	1970-72	1985-87	1991-93
% of GNP			
Imports	40.3	43.2	43.6
Exports	17.8	17.2	14.5
% of Primary and Secondary Output			
Imports	89.6	119.0	131.3
Exports	39.5	47.4	43.6

Source: Derived from *Imports and Exports Statistics 1993*, Table 1, vol. 1

Part A; and *Statistical Abstract*, various dates, Department of Statistics and Research, Ministry of Finance, Nicosia.

We shall be considering exports in more detail later but the evidence on visible exports in *Table 1* appears to be more mixed. When exports are considered in relation to GNP the figures indicate a small fall between 1970-72 and 1985-87 followed by a more pronounced decline to 1991-93. However, for reasons outlined above, it is more appropriate to consider commodity trade in relation to Primary and Secondary output. When we do this it is found that the share of exports increased between 1970-72 and 1985-87 but then declined to 1991-93, suggesting a period

of trade expansion followed by a period of trade contraction. Nevertheless, these findings refer to the total level of trade. It is important to consider to what extent the pattern is repeated at the sectional level of trade and between different trading partners. We begin by considering imports.

Imports

As *Table 2* shows there was an expansion in Cyprus's import trade in relation to primary and secondary output in all SITC sections between 1972 and 1987 although the biggest growth was in fuels (3), which was mainly accounted for by the rise in the price of oil over the period, and in chemicals and manufactured goods (5,6,8). The period 1987-1993 was also one of trade creation overall but it was concentrated in food, beverages and tobacco, crude materials and machinery and transport equipment (0,1,2,7,9). The remaining sections (3,4,5,6,8) experienced trade destruction.

TABLE 2
IMPORTS BY SECTION AS A PERCENT AGE OF PRIMARY AND
SECONDARY OUTPUT IN CYPRUS IN 1972, 1987 AND 1993

Section (SITC)*	1972	1987	1993
0,1,2	15.7	16.8	21.2
3	6.1	14.3	12.7
4	1.2	1.4	1.1
5,6	31.6	43.4	40.4
7	26.4	28.4	33.7
8	6.3	9.9	8.9
9	1.1	1.70	3.1

* The section titles are based on the *Standard International Trade Classification* (Revision 2) as follows:

Section 0	Food and live animals chiefly for food
1	Beverages and Tobacco
2	Crude materials, inedible, except fuels
3	Mineral fuels, lubricants and related materials
4	Animal and vegetable oils, fats and waxes
5	Chemicals and related products

6	Manufactured goods classified chiefly by material
7	Machinery and transport equipment
8	Miscellaneous manufactured articles
9	Commodities not classified elsewhere in the SITC

Source: Derived from *Imports and Exports Statistics*, various dates,
Department of Statistics and Research, Ministry of Finance, Nicosia.

From the data we have examined on imports it appears that the period 1972-1993 was one of overall trade creation, although during the second period (Protocol) there was trade destruction in fuels, animal and vegetable oils, chemicals and manufactured goods. Yet it is not clear from the evidence so far considered to what extent trade with the EU followed the same pattern.

Table 3 shows that total imports from the EU accounted for an increasing proportion of commodity output in Cyprus between 1972 and 1993, rising from 55.7 per cent in 1972 to 61.8 per cent in 1987 and 63.0 per cent in 1993. Both the initial Agreement and the subsequent Protocol appear to have been periods of trade creation. Yet *Table 3* further reveals that imports into Cyprus from the rest of the world also increased as a proportion of primary and secondary output and the expansion was even more pronounced than imports from the EU. This suggests that trade creation with the EU was not accompanied by trade diversion away from external producers. We now turn to consider this in more detail.

The figures considered so far do not take into account to what extent the apparent trade creation between Cyprus and the EU after 1972 was the result of the various EU agreements. The counterfactual would provide us with an estimate of what the share would have been if the agreements with the EU had not been signed. The difference between the actual and the counterfactual or normalised structure of imports is attributed to the agreements. There are a number of reference groups that can be used to normalise the export share but here we use two.

TABLE 3**THE PATTERN OF IMPORT TRADE OF CYPRUS IN 1972, 1987 AND 1993**

	1972		1987		1993	
	CY£m.	%	CY£m.	%	CY£m.	%
EU (12) Imports	76.5		405.0		683.3	
As Percentage of Primary and Secondary Output		55.7		61.8		63.0
R of World Imports	45.0		306.4		577.8	
As Percentage of Primary and Secondary Output		32.8		46.7		53.2

Source: Derived from Imports and Exports Statistics, various dates, op. cit.

Firstly we compare the change in the share of Cyprus's imports coming from the EU with a small normalising group of countries.

The normalising group considered here consists of three peripheral 'European/Mediterranean' countries: Israel, Turkey and Yugoslavia. The second way adopted here is to normalise Cyprus's imports from the EU according to Europe's share of imports from the EU. The derivation of the results, which are presented in *Table 4*, is considered below.⁵

TABLE 4
THE NORMALISED AND ACTUAL SHARE OF CYPRUS'S IMPORT TRADE
WITH THE EU IN 1972, 1987 AND 1993.

	Share of Imports from the EU (%)			
	1970	1985 (1985/70)	1991 (1991/85)	1991 (1991/70)
Cyprus: Actual	65.5	60.2	50.6	50.6
Change in the Share		(.92)	(.84)	(.77)
Normalising Group 1	47.3	36.8	44.6	44.6
Change in the Share		(.78)	(1.21)	(.94)
Cyprus: Normalised	65.5	51.1	72.8	61.6
Normalising Group 2	47.8	31.4	63.7	63.7
Change in Share		(.66)	(2.03)	(1.33)
Cyprus: Normalised	65.5	43.2	122.2	87.1

Source: Derived from IMF, *Direction of Trade Statistics Yearbook*, various dates and UNCTAD, *Handbook of International Trade and Development Statistics 1992*, UN, New York, 1993.

To estimate the changing share of imports between 1970 and 1985 which is due to the Agreement we compare the actual with the normalised share. Thus, if dMn = the change in the share of imports from the EU for the normalising group between 1970 and 1985; $Mc70$ = Cyprus's import share from the EU in 1970; and $Mc85$ = Cyprus's import share from the EU in 1985, the changing share due to the Agreement ($dMcnormalised85$) is given by $Mc85 - (dMn)(Mc70)$. With Israel, Turkey and Yugoslavia as the normalising group the estimate is:

$$dMcnormalised\ 85/70^1 = 60.2 - (.78)(65.5) = 9.1$$

and with Europe as the normalising group the estimate becomes:
 $dMcnormalised85/702 = 60.2 - (.66)(65.5) = 17.0$

Although there is a difference in magnitude, both estimates indicate that Cyprus's share of imports from the EU between 1970 and 1985 fell less sharply than they did for the normalising groups. If Cyprus's imports from the EU had

changed in line with the normalising group's imports the share would have fallen to 51.1 per cent or 43.2 per cent. The difference between the actual and the counterfactual is attributed to the effects of the integration. Without this positive effect of the Association Agreement on imports from the EU we can conclude that the trade creation observed in *Table 3* between 1972 and 1987 would not have taken place.

The corresponding estimates for the period 1985 to 1991 are
 $dMcnormalised_{91/851} = 50.6 - (1.21)(60.2) = -22.2$

and

$$dMcnormalised_{91/852} = 50.6 - (2.03)(60.2) = -71.6$$

Once again there is a difference in magnitude but both estimates indicate that between 1985 and 1993 the share of Cyprus's imports from the EU fell while for the normalising groups the share rose.

It follows that if Cyprus's imports from the EU had followed the same trend as for the normalising groups the share would also have risen and therefore it appears that the effects of the integration were negative. Despite this apparent negative effect of the Protocol on the share of imports from the EU there was trade creation between 1987 and 1993 as indicated in *Table 3*.

For the period 1970 to 1991 the results are as follows:

$$dMcnormalised_{91/701} = 50.6 - (.94)(65.5) = -11.0$$

and

$$dMcnormalised_{91/702} = 50.6 - (1.33)(65.5) = -36.6$$

When we consider the overall period 1970 to 1991 the estimates indicate once again that if Cyprus's share of imports from the EU had changed in line with those of the normalising groups they would have been higher than they were. Instead of 50.6 per cent the share from the EU would have been 61.6 per cent or 87.1 per cent depending on the normalising group.

These results are very sensitive to the reference groups used and the years being compared therefore they have to be treated with great caution and give only an approximate indication of the counterfactual. In summary, whichever of the two normalising samples are used, it appears that if Cyprus's import trade with the EU had changed in the same way as for the normalising group it would have resulted in a smaller share of imports emanating from the EU in 1985 and a larger share in 1991. The differences between the actual and the normalised trade structures in 1985 and 1991 indicate that the first period of the Agreement contributed positively to the trade creation between Cyprus and the EU but the second period (Protocol)

constrained the trade creation below its potential. Moreover, the overall period 1970-91 appears to have been one of constrained trade creation between Cyprus and the EU.

The declining share of total imports from the EU since the early 1970s indicates that while there was constrained trade creation between the EU and Cyprus this was not accompanied by trade diversion away from low cost external producers to high cost EU producers. On the contrary, despite the agreements with the EU, imports from the rest of the world grew more rapidly than those from the EU both in terms of total imports and as a percentage of primary and secondary output.

This leads us to consider the direction of trade in more detail. While the share of the EU in Cyprus's imports was falling, Asia's share was rising. By 1993 Asia accounted for 19.0 per cent of Cyprus's total imports compared with 17.6 per cent in 1987 and a mere 9.4 per cent in 1972. The major growth took place between 1972 and 1987 and this is particularly pronounced in manufacturing imports (SITC sections 6,7,8). By 1987, 93.3 per cent of the imports from Asia were for manufactured goods made up as follows: manufactured goods by materials (6) 26.5 per cent; machinery and transport equipment (7) 52.5 per cent; and miscellaneous manufactured articles (8) 14.3 per cent. Four countries-Japan, Hong Kong, Taiwan and South Korea-accounted for 84 per cent of Asia's imports into Cyprus and Japan alone accounted for 57.9 per cent. Between 1972 and 1987 Asia more than doubled its share of manufacturing imports into Cyprus. The breakdown for the three most important sections is given in *Table 5*.

The evidence provides confirmation that in the period since the signing of the Association Agreement in 1973 there has been no trade diversion to high cost European suppliers. Indeed in the areas of trade where the EU might be expected to hold a comparative advantage, namely in manufacturing, machinery and transport equipment, an increasing share of Cyprus's imports have been supplied by Japan and other countries of South East Asia.

TABLE 5
ASIA'S SHARE OF MANUFACTURING IMPORTS INTO CYPRUS
IN 1972 AND 1987

	1972	1987
Manufactured goods by materials	11.6	16.7
Machinery and transport equipment	11.8	37.7
Miscellaneous manufactures	13.8	29.4

Source: Derived from *Imports and Exports Statistics, 1972 and 1987, op. cit.*

Taking the period overall it appears that the agreements with the EU have so far resulted in constrained import trade creation and that by implication the growing share of trade with the rest of the world is largely the result of cost advantages. But this also means that the Cyprus economy has hardly begun the process of economic adjustment and structural change that will be required when the country achieves full membership of the EU and the process of economic integration becomes imperative. It is then that the trade creating and trade diverting effects of integration may become critical. Unfortunately, the continuing protection enjoyed by domestic producers and the recent growth of the import trade with the rest of the world seems to indicate that the period of adjustment may be painful and there could be considerable trade diversion to follow.

We now turn to consider the extent to which Cyprus's exports benefitted from the Association Agreement and the Protocol.

Exports

The tariff and quota concessions offered by the EU to Cyprus since the signing of the first Association Agreement in 1973 would be expected to stimulate a change in both the share and the composition of the EU's imports originating in Cyprus through the trade creation and trade diversion effects.⁶ The question for us to consider is whether the agreement has led to export expansion. This can be measured in two ways. First, in terms of the changing share of Cyprus's output that is committed to exports and, second, by the share of exports going to the EU. We begin with the former measure.

As we have already observed, *Table 1* gives figures on total exports in relation to both GNP and the level of primary and secondary output. Cyprus's exports as a share of GNP have shown a negative trend, declining from 16.8 per cent in 1972 to 16.5 per cent in 1987 and 13.2 per cent in 1993. However, for reasons previously outlined it is more useful to measure commodity exports in relation to domestic physical output i.e., primary and secondary output and this share rose from 37.3 per cent in 1972 to 45.4 per cent in 1987 before falling back to 39.8 per cent in 1993.

The above figures, and those presented in *Table 1*, refer to total exports, including re-exports, but if the latter are removed- the figures reveal that the resulting domestic exports fell in relation to GNP even more markedly, from 14.6 per cent in 1972 to 13.4 per cent in 1987 and 6.6 per cent in 1993. In relation to primary and secondary output the share of domestic exports followed the same pattern as total exports rising from 32.5 per cent in 1972 to 34.5 per cent in 1987 but then falling sharply to 19.0 per cent in 1993.

However, this in itself does not settle the issue of trade expansion. We need to specifically consider what was happening to EU/Cyprus trade. *Table 6* shows that both total exports, including re-exports, and domestic exports fell sharply in terms of GNP and primary and secondary output between 1972 and 1993.

Rather than pointing to trade expansion these statistics indicate export trade contraction between Cyprus and the EU over the period considered.

TABLE 6
CYPRUS'S EXPORTS TO THE EU AS A PERCENTAGE OF GNP AND
PRIMARY AND SECONDARY OUTPUT IN 1972, 1987 AND 1993

	1972	1987	1993
Total Exports to GNP	10.7	6.8	4.9
Domestic Exports to GNP	9.5	5.8	3.5
Total Exports to Primary and Secondary Output	23.9	18.7	14.9
Domestic Exports to Primary and Secondary Output	21.1	15.9	10.5

Source: Derived from *Imports and Exports Statistics 1993*, Table 1, vol. 1, Part A; and Statistical Abstract, various dates, Department of Statistics and Research, Ministry of Finance, Nicosia.

Table 7 provides further support for the trade contraction thesis. The share of total exports, including re-exports, going to the EU declined from 63.9 per cent in 1972 down to 37.4 per cent in 1993, with most of the decrease taking place before 1987.

However, this trend is affected by the growing importance of re-exports which increased from 12.9 per cent of total exports in 1972 to 24.2 per cent in 1987 and 52.1 per cent in 1993. By 1993 re-exports were earning more than domestic exports and 79.1 per cent of the former were going to the rest of the world, mainly the Middle East and Eastern Europe, compared with 42.9 per cent in 1972. Moreover, despite the Agreement with the EU, the rest of the world still accounted for 44.6 per cent of domestic exports in 1993 and when re-exports are added the figure rises to 62.6 per cent.

TABLE 7
THE DESTINATION OF CYPRUS'S EXPORTS IN 1972, 1987 AND
1993 CY£M

	1972		1987		1993	
	CY£m.	%	CY£m.	%	CY£m.	%
Total Exports ¹						
• EU (12)	32.8	63.9	122.3	41.0	161.5	37.4
- R of the World	18.5	36.1	175.7	59.0	270.0	62.6
Domestic Exports ¹						
• EU (12)	29.0	64.8	104.5	46.2	114.4	55.4
- R of the World	15.7	35.2	121.5	53.8	92.2	44.6

Note: 1. Domestic Exports exclude re-exports whereas Total Exports include them

Source: Derived from *Imports and Exports Statistics*, various dates, *op. cit.*

While re-exporting may be a profitable activity and an important source of foreign currency it has limited domestic linkages. In contrast domestic exports generate employment and increase the demand for home produced goods and services through a complex network of backward linkages. Moreover, it is domestic exports (and domestic imports) that are implicitly expected to respond to the creation of a customs union. Nevertheless, when we consider domestic exports, as opposed to total exports, going to the EU the situation appears to be more complex. The share going to the EU declined from 64.8 per cent in 1972 to 46.2 per cent in 1987 but then partially recovered to 55.4 per cent by 1993.

This rise in the share of domestic exports going to the EU after 1987 indicates trade expansion during the period of the Protocol yet it has to be seen in the context of a declining share in relation to both GNP and primary and secondary output.

Nevertheless, the crude figures do not establish to what extent the rising share of exports going to the EU after 1987 was due to the Protocol. It is important to estimate what the share would have been in the period after 1987 if the Protocol had not come into operation. The difference between the actual and the normalised structure of exports is attributed to the Protocol.

We use the same normalising groups as previously. The results which are presented in *Table 8*, once again have to be treated with great caution and give only a rough indication of the counterfactual. Nevertheless, although there is a difference in magnitude, both estimates point to trade contraction between 1970 and 1985. If Cyprus's exports to the EU had changed in line with the normalising groups exports the share would have risen to 53.2 per cent or 40.4 per cent, so that the trade contraction, attributed to the Agreement, amounts to -25.6 or -12.8 per cent respectively. In value terms this represents a loss of exports to the EU in 1985 of CY-53.9 million according to the upper estimate or cy-27 million if we take the lower figure, amounting to 3.6 and 1.8 per cent of GNP respectively.

TABLE 8
THE NORMALISED AND ACTUAL SHARE OF THE EXPORT TRADE WITH
THE EU IN 1970, 1985 AND 1991

	Share of Exports to EU(%)			
	1970	1985 (1970-85)	1991 (1991-85)	1991 (1991-70)
Cyprus: Actual	74.8	27.6	59.3	59.3
Change in the share	(.369)	(2.149)	(.79)	
Normalising Group ¹	44.3	31.5	45.3	45.3
Change in the share	(.711)	(1.438)	(1.023)	
Cyprus: Normalised	74.8	53.2	39.7	76.5
Normalising Group ²	60.6	32.7	52.8	52.8
Change in the share	(.54)	(1.615)	(.87)	
Cyprus: Normalised	74.8	40.4	44.6	65.1

Notes: 1 The normalising group consists of Israel, Turkey and Yugoslavia

2 The normalising group is Europe outside the EU

Source: Derived from IMF, *Direction of Trade Statistics Yearbook*, various dates and UNCTAD, *Handbook of International Trade and Development Statistics 1992*, UN, New York, 1993. The derivation of these results is given in Appendix 1.

For the period 1985-1991 once again there is a difference in magnitude but both estimates point to trade expansion. The share of exports going to the EU was 19.6 per cent or 14.7 per cent higher than it would have been if Cyprus's exports had expanded at the same rate as those of the normalising groups and this is attributed to the agreement. In value terms this represents a gain in exports to the EU in 1991 worth CY£48.7 million according to the upper estimate and CY£36.6 million if we take the lower figure, amounting to 1.8 and 1.4 per cent of GNP respectively.

Despite the rising share of trade with the EU between 1985 and 1991, and the evidence that it was the result of the agreement, the overall period 1970-1991 was one of trade contraction. *Table 8* reveals that the period 1970-1991 witnessed a decline in the share of Cyprus's exports going to the EU and the estimates of the trade contraction attributed to the agreement range from 5.8 to 17.2 per cent.

In summary it can be concluded that Cyprus has become less export trade oriented in the period since 1972 when the first Agreement with the EU was signed and this is reflected in the decline of domestic exports as a percentage of both GNP and primary and secondary output. Cyprus has partly responded to the poor export performance by expanding the re-export trade particularly with the Middle East and Eastern Europe. During the first stage of the Association Agreement there is also evidence that the share of exports going to the EU was declining, which reinforced a period of trade contraction. However, in the period since the signing of the Protocol in 1987 there is evidence of a larger share of exports going to the EU indicating a period of trade expansion, although this was not sufficient to reverse the negative trend in relation to GNP or primary and secondary output.

In summary it can be concluded that Cyprus has become less export trade oriented in the period since 1972 when the first Agreement with the EU was signed and this is reflected in the decline of domestic exports as a percentage of both GNP and primary and secondary output. Cyprus has partly responded to the poor export performance by expanding the re-export trade particularly with the Middle East and Eastern Europe. During the first stage of the Association Agreement there is also evidence that the share of exports going to the EU was declining, which reinforced a period of trade contraction. However, in the period since the signing of the Protocol in 1987 there is evidence of a larger share of exports going to the EU indicating a period of trade expansion, although this was not sufficient to reverse the negative trend in relation to GNP or primary and secondary output. The destination of Cyprus's domestic exports in the EU is revealing. The UK was and remains the single most important export market but its share of Cyprus's EU export trade fell sharply between 1987 and 1993 from 61.3 to 51.0 per cent after being at 66.2 per cent in 1972. The main growth of exports was to Germany whose share of the EU total went up from 10.5 per cent in 1987 to 17.0 per cent in 1993. Greece has become Cyprus's third most important export market in the EU with its share rising from 2.4 per cent in 1972 to 7.9 per cent in 1987 and 9.4 per cent in 1993. It is worth noting that the sub-period of trade expansion (1985-1991)

coincided with a shift in the destination of exports within the EU. Whether these changes were causally linked is not clear and may be worthy of further investigation, although this is beyond the intentions of the present paper.

We now turn to the commodity composition of exports and to consider whether the EU agreements resulted in a diversification of exports. There has been a pronounced shift in the composition of Cyprus's exports since 1972. At the beginning of the period 69.7 per cent of Cyprus's exports consisted of food, beverages and tobacco (SITC sections 0,1) and another 20.8 per cent was accounted for by crude materials (SITC 2). By 1987 food, beverages and tobacco accounted for only 35.8 per cent of exports and crude materials (SITC 2) a mere 3.2 per cent and the shares have remained relatively unchanged since. In contrast the industrial and manufacturing sectors (SITC sections 5,6,7,8) increased their share of exports from 7.5 per cent in 1972 to 57.0 per cent in 1987 before falling back marginally to 55.1 per cent in 1993. Yet, it is not clear to what extent these changes were due to the EU agreements.

In 1972, before the Association Agreement, 65.5 per cent of Cyprus's exports to the EU (mainly the UK which was still outside the EU) consisted of food (SITC 0) whereas this fell to 44.9 per cent in 1987 and 36.9 per cent by 1993. This is not surprising given the terms of the Agreement which specifically excluded or limited food and agricultural imports into the EU which competed directly with Union farmers. In contrast tariffs on manufactured goods were reduced considerably, apart from quotas imposed on sensitive items like textiles and shoes, and this is reflected in the rising share of SITC sections 5,6,7,8 from 3.0 per cent in 1972 to 47.8 per cent in 1987 and 55.4 per cent in 1993.

Nevertheless, a similar pattern is found with respect to the export markets in Arab countries. Food exports (SITC 0) always accounted for a relatively smaller proportion of total exports to Arab countries but even so there was a decline in the share from 27.8 per cent in 1972 to 10.0 per cent in 1987 and thereafter a recovery to 12.5 per cent in 1993. Once again, however, manufacturing exports expanded more rapidly with SITC sections 6,7,8 accounting for just over two thirds of the total in 1987 and 1993.

It must be concluded that since this remarkable shift in exports from primary products to industrial and manufactured products between 1972 and 1993 was replicated to a certain degree in all export markets, it was not entirely the result of the Agreement or Protocol.

Balance of Trade

Cyprus has had a deficit on trade for at least the last 50 years. The best trade performance was achieved in the early 1950s when export earnings covered over three quarters of imports but by 1972 the proportion was down to 42.2 per cent and it has declined steadily since then to reach 34.2 per cent in 1993. In contrast, in terms of GNP the trade deficit has remained relatively constant for most of the

period since 1972, when it stood at 23.0 per cent, although it grew in the 1990s to average 30.2 per cent between 1990-92 before settling back to 24.3 per cent in 1993. Although a large part of the trade deficit is covered by net invisible earnings, much of it from tourism which we will consider later, it is important to examine the sources of the deficit as it may give some indication of how the deficit might be affected by joining the EU.

Before considering the role of the EU in the trade deficit it is important to point out that Cyprus has a large surplus on trade with the Arab countries of the middle east. In 1993 the surplus amounted to CY£387.3 million compared with CY£60.9 million in 1987 and a deficit of, CY£3.2 million in 1972. This achievement has been largely based on the growth of exports and re-exports to the area which in 1993 amounted to CY£131.4 million representing over 30 per cent of total export earnings.

In contrast, the evidence on trade with the EU in the period since 1972 is that it accounts for the major part of Cyprus's trade deficit. Significantly the ratio of exports to imports in Cyprus/EU trade has declined from 43.6 per cent in 1972 to 30.2 per cent in 1987 and 23.6 per cent in 1993. This is part of the explanation for the rise in the deficit on trade with the EU from CY£47 million in 1972 to CY£283 million in 1987 and CY£522 million in 1993. Nevertheless, the EU trade deficit has hardly changed in relation to GNP, amounting to 16.0 per cent in 1993 compared with 15.4 per cent in 1972. Moreover, although the EU's share of the total trade deficit has fluctuated over the period, it was only marginally different in 1987 when it stood at 68.4 per cent compared with 67.0 per cent in 1972 and it has since declined to 62.9 per cent in 1993.

Two major factors were relevant to the recent fall in the share of the trade deficit accounted for by the EU. Firstly, it was related to the growth in the relative size of the trade deficit with the rest of the world. Apart from the EU, the largest deficit was with Asia and this had reached nearly CY£220 million by 1993, amounting to over a quarter of the total deficit. Secondly, the fall in the EU's share of the trade deficit was helped by the export trade expansion that occurred with the EU between 1987 and 1993.

We now turn to examine the changing distribution of the trade deficit within the EU since 1972. The most notable improvement has been in trade between Cyprus and the UK. Although the total trade deficit with the UK had grown from CY£12.7 million in 1972 to CY£91.2 million in 1993 this represents a fall in the UK share of the deficit from 18.1 per cent to 11.0 per cent over the period. In contrast there has been a growth in the deficit with Germany, France, Greece and Italy representing 9.6, 7.9, 8.6 and 15.2 per cent of the total deficit respectively in 1993. The most notable change has been in the deficit with Italy which stood at CY£126.1 million in 1993 and was larger than for any other country. The problem has been an inability to increase exports to Italy to any great extent. In 1972 exports to Italy were worth CY£1.4 million representing 2.1 per cent of total exports but in 1993 although

exports had risen to CY£5.4 million this was only 1.2 per cent of the total. In contrast imports from Italy over the period soared from CY£9.7 million in 1972 to CY£131.4 million in 1993.

The difficulties Cyprus has experienced in diversifying its exports across the EU market needs to be considered in relation to possible full EU membership. Before returning to this issue we briefly review developments in invisible trade.

Invisible Trade

It was pointed out in the previous section that the trade balance has been in deficit since before independence but it has also grown from approximately 14 per cent of GNP in the early 1960s to over 25 per cent in recent years (24.3 per cent in 1993). Nevertheless, this has not been a major problem since net invisible earnings have largely covered the trade deficit and the outstanding balance was met by foreign borrowing. For a number of years following the invasion both visible and invisible earnings grew more slowly than previously and the invisible surplus was covering less than 70 per cent of the trade deficit. Nevertheless, the shortfall on the current account continued to be covered by long term loans and private capital flows. More recently invisible earnings have been covering approximately 90 per cent of the trade deficit, but another development since 1989 is that Cyprus has come to depend more heavily on short term loans to cover any remaining current account deficit.

In the early years of independence British military expenditure on the island accounted for over 95 per cent of invisible earnings. The heavy reliance on foreign military expenditure has fortunately diminished considerably since then, although it is still an important invisible item earning CY£115.6 million in 1993, representing 14 per cent of the invisible balance. The declining significance of military receipts has been matched by the rapid inverse growth of earnings from tourism which are now the most important source of invisible earnings. In 1993 they accounted for over 76 per cent of the net invisible balance compared with 50 per cent in 1980, 12.5 per cent in 1970 and a mere 1.3 per cent in 1960.

A key question to consider is to what extent the growth of earnings from tourism is the result of the Association Agreement and the Protocol? *A priori* one would not expect the Agreement and Protocol to have had any direct effect on the number of tourist arrivals from the EU since tourism has not been subject to tariff preferences or quotas as has been the case with commodity trade. The evidence seems to bear this out. The UK is the single most important source of tourist arrivals accounting for over 50 per cent of all visitors in 1993. In 1973 the UK share was 43.9 per cent compared with only 14.3 per cent in 1959 so that most of the growth in the UK share took place before the Association Agreement. But, more significantly, the UK's preeminent position as the major source of tourism to Cyprus is directly linked to the large ethnic community in the UK and appears unrelated to the Agreement.⁷ Three other important EU members (France, Germany and Greece) accounted for

11.1 per cent of tourist arrivals in 1993 compared with 17.5 per cent 1973 and 15.7 per cent in 1959. Once again it seems that most of the growth took place before 1973 and although there have been fluctuations in the flows since then there is no indication of trade creation in tourism since the signing of the Agreement.

As indicated earlier these observations are not surprising but more significantly other factors have had a greater impact on tourist flows. Cyprus has benefitted from the world wide expansion of tourism as *per capita* incomes have risen, travel costs have fallen in real terms and people have had greater access to leisure time. But apart from this general effect, the evidence seems to indicate that the total number of visitors to Cyprus and their country of origin have fluctuated not only with the cycles of economic activity elsewhere but also more importantly with the changing political conditions in Lebanon and the Middle East and in Cyprus itself. It is noticeable for example how the absolute and relative number of tourists from Sweden grew, after her troops formed part of the UN contingent, and subsequently declined as the peace-keeping soldiers were reduced and finally withdrawn. In 1959 Sweden had accounted for less than 1 per cent of tourists in Cyprus, compared with a peak of 10.5 per cent in 1987 and 1988 and 4.2 per cent in 1993.

Tourist arrivals from other countries with a peace-keeping role, e.g., Austria and Finland, also followed a similar pattern.

Summary and Conclusions

The general case for economic integration or economic union is often justified in terms of the economic advantages to member states, yet economists frequently emphasise that the outcome is ambiguous and that the potential benefits are hedged with conditions and qualifications and will depend on the form and degree of integration. But the economic argument is not the core element in the decision by the government of Cyprus to seek full membership of the EU. The motivation is mainly political, that is it relates to the Cyprus problem. Nevertheless, the economic arguments remain important and cannot be ignored and it is also clear that they link to the political.

In the case of Cyprus it is not immediately obvious that economic integration within the EU will bring the expected economic benefits. Joining the EM may lead to greater economic and political interdependence with Europe and the performance of each member state will become increasingly linked to the overall economic performance as or if the Union moves closer to full economic and monetary union. There is inevitably a degree of uncertainty as to whether a re-alignment of Cyprus's external trade towards the EU, which will almost certainly be a consequence of membership, will necessarily benefit the country. Specifically, it is difficult to forecast what would happen to imports, exports and the direction of the trade balance if/when Cyprus joins the EU. This is partly because of the trading opportunities offered by the increasingly more open global market and in particular the markets of the Middle East and Eastern Europe, which have become important destinations for Cyprus's profitable re-export activity and have resulted in

substantial foreign earnings. This is given added significance because Cyprus enjoys a healthy trade surplus with the Middle East and many of the countries of Eastern Europe but has a substantial deficit with the EU which has grown considerably in absolute terms in the last two decades.

The experience of Cyprus during the Agreement and Protocol periods is not directly *relevant* to the future but the analysis of that period suggests that there are a number of crucial issues to consider. Firstly, much depends on the degree to which membership of the EU leads to greater import penetration and trade diversion due to the common external tariff, with high cost EU products replacing cheaper alternatives from outside. There is no simple answer to this issue nor can it be assumed that there will inevitably be net gains from trade.

Secondly, the extent to which Cypriot producers are able to penetrate EU markets. Cyprus has already enjoyed some of the benefits of export trade expansion with the EU in recent years, although as we have seen, in relation to both GNP and primary and secondary output exports to the EU have fallen since the early 1970s. Nevertheless, Cyprus should gain further from the liberalisation of trade with respect to quotas on textiles and shoes, tariff reductions and the removal of time deadlines on agricultural products. However, a great deal will depend on the ability of Cyprus to compete in these product markets against other southern European members. Cyprus is also still heavily dependent on the UK market for exports and the growing trade deficit with Italy points to the difficulties that may be experienced in achieving export trade creation without an enhanced marketing infrastructure. Moreover, Cyprus is no longer a low wage economy and if the country is to benefit from EU membership it may be necessary to adopt a flexible specialisation strategy. It follows that there will need to be considerable innovation, investment and structural change within agriculture and industry, in particular in the textiles, food and beverages sectors, to take advantage of lucrative niches in the EU market.

Thirdly, Cyprus's trade deficit is largely covered by the surplus on services but there may be problems here. The economy is heavily dependent on tourism but there is intense international competition in this industry both in terms of price and quality.⁸ It is noticeable in recent years that the number of arrivals has been rising but *per capita* expenditure by tourists has fallen (Planning Bureau, 1992, p. 45). More significantly, perhaps, tourist destinations are not subject to trade preferences and any future growth of tourism will not be directly affected by EU membership. On the other hand the introduction of European regulations relating to tourism and hotels and the adoption of the social chapter may make it more difficult for Cypriot hoteliers and restaurateurs to compete with other low cost destinations.

There are also fears that EU membership may ultimately lead to monetary integration and an inevitable harmonisation of regulations relating to banking and other services, e.g., shipping which may adversely affect the comparative advantage that Cyprus presently enjoys in providing off-shore services. This may not only affect foreign earnings which are considerable (CY£83 million in 1992,

Planning Bureau, *op.cit.*) but could have serious consequences for the lawyers, accountants and other professionals who are presently employed in these activities. If alternative job opportunities are not created elsewhere in the economy many highly educated professionals may be forced to seek employment elsewhere in Europe.

Monetary integration would also mean that Cyprus would need to introduce a degree of financial de-regulation. This might be expected to improve efficiency in the allocation of funds particularly if the financial sector operates under competitive conditions, although, as Arestis and Demetriades (1994) argue, in Cyprus there may be few benefits.⁹ Moreover, one of the consequences for Cyprus would be that the ceiling on interest rates and the limitations on capital movements would need to be removed. The effect of the latter relaxation might be to leave the Cypriot external account more vulnerable to short term capital movements. In addition, in so far as interest rates and the cost of borrowing would be expected to rise towards world levels this would put pressure on the government to reduce the budget deficit. This could mean a loss of fiscal independence and may force the government to reduce spending. In so far as it proves difficult to reduce current expenditure capital projects may need to be cut with possible adverse effects on the overall competitiveness of the economy.

A further concern relates to the effects of EU membership on industrial relations and the labour market (Ugur, 1995). To date a corporatist structure within the Cypriot labour market has helped achieve high levels of employment and low levels of industrial conflict which have contributed to the low inflation rate and had a positive effect on economic performance. The crucial question is to what extent the industrial consensus can be maintained in the face of the need for increased flexibility in the labour market. Much will depend on the ability of Cypriot businesses to maintain employment opportunities through the creation of new well paid high technology jobs. Failure to achieve this might mean an increase in low quality, low paid jobs which could result in greater industrial conflict and declining labour market performance.

There is no doubt that membership of the EU will bring new challenges to the Cypriot economy but it also brings new opportunities. Papaneophytou (1994) presents details of EU aid already given to finance various infrastructural, environmental and industrial projects and there is every reason to expect new loans and grants will be forthcoming as EU membership proceeds.

Furthermore, the preferential trading status that EU membership brings can also be expected to encourage an increased flow of foreign direct investment into Cyprus.¹⁰ In the short run there will inevitably be problems of economic transition but if the flexibility and dynamism of the economy and its people is maintained and the country is able to adapt and modernise its institutions it should mean that accession will not pose insurmountable problems.

Finally, perhaps the most important issue relates to the opportunity provided by EU membership for a solution to the Cyprus problem. There is no way of knowing

in advance whether Cyprus's accession to the EU prior to a political solution will bring re-unification of the island any nearer. Furthermore, although the two applications are not linked, unification may partly depend on what happens to Turkey's application for a customs union with the EU. But the new opportunity offered by recent developments is that EU accession can be linked to unification. Experience indicates that the unification of an underdeveloped region with a more economically advanced region may exacerbate the inequalities unless there is a significant transfer of resources into the backward sector.¹¹ Much may therefore depend on the willingness of the government of Cyprus and the EU to fund the economic restructuring which will be required to bring the economy of the North to the level of the South. This may be a necessary condition for a successful unification of the island and failure to make progress on how the development gap can be closed may encourage the Turkish Cypriot leadership to resist unification. The offer of prosperity is not, however, a sufficient condition for the establishment of trust. One of the important opportunities offered by EU membership is that it can increase the mutual security of all Cypriots but it is also vital that there is a period of trust building. The full participation of the Turkish Cypriots in the discussions relating to the accession could enhance the prospects for a solution.

Notes

1. The European Union was previously known as the European Community and prior to that the European Economic Community.
2. See Viner, J. (1950)
3. See for example Nevin, E.,(1990) ch.7
4. The figures in *Table 1* refer to total commodity imports. Imports for home consumption as a proportion of Primary and Secondary output increased more slowly from 88.6 per cent in 1970-72; to 105.1 per cent in 1985-87; and 109.5 per cent in 1991-93. In contrast domestic imports as a percentage of GNP showed a continuous decline as follows: 1970-72 - 39.9%; 1985-87 - 38.2%; and 1991-93 - 36.4%.
5. Ideally the normalisation estimates should have been based on 1972, 1987 and 1993 to allow comparison with other statistics but data limitations meant that 1970, 1985 and 1991 had to be used. This does not affect the broad validity of the results.
6. The trade creation and trade diversion effects provide a demand side stimulus to export expansion but they are neither a necessary nor sufficient condition for export growth. Much also depends on whether the beneficiary, in this case Cyprus, pursues an outward-looking or export oriented strategy.
7. Matsis (1992, p.115-116) points out that emigrant communities are not only a major source of tourist receipts but also represent important markets for products originating in Cyprus.
8. Wilson (1995) also points to the problems of an over-reliance on tourism and

generally takes a sceptical view of the benefits of EU membership for Cyprus.

9. Arestis, P. and P. Demetriades (1994) analyse the effect of financial liberalisation in Cyprus in the context of a small number of banks and conclude that it will have a negative effect on the efficiency of the financial markets in Cyprus and on the allocation of investment funds (quoted in Ugur, 1995).

10. Pomfret's (1986) study of Malta indicates that preferential trading status can result in accelerated foreign direct investment flows which in turn may bring marketing knowledge and other benefits to firms constrained by a small domestic market. Quoted by Yannopoulos (1989, pp.78-80 and 169-253).

11. For a general discussion on the effects of integration on EU regional disparities see El-Agraa (1994, pp. 355-364).

Appendix

1. To estimate the changing share of exports between 1970 and 1985 which is due to the Agreement we compare the actual with the normalised share. Thus if, dX_n = the change in the share of exports to the EU for the normalising group between 1970 and 1985; X_{c70} = Cyprus's export share to the EU in 1970; and X_{c85} = Cyprus's export share to the EU in 1985, the changing share due to the Agreement ($dX_{cnormalised85}$) is given by $X_{c85} - (dX_n)(X_{c70})$. With Israel, Turkey and Yugoslavia as the normalising group the estimate is:

$dX_{cnormalised85/701} = 27.6 - (.711)(74.8) = -25.6$ and with Europe as the normalising group the estimate becomes:

$$dX_{cnormalised85/702} = 27.6 - (.54)(74.8) = -12.8.$$

The corresponding estimates for the period 1985 to 1991 are

$$dX_{cnormalised91/851} = 59.3 - (1.438)(27.6) = 19.6$$

and

$$dX_{cnormalised91/852} = 59.3 - (1.615)(27.6) = 14.7$$

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