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DIRECTORATE OF
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Intelligence Memorandum

*Cyprus: Increasing Economic Dependence
on the USSR and Eastern Europe*

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
August 1968

INTELLIGENCE MEMORANDUM

Cyprus: Increasing Economic Dependence
on the USSR and Eastern Europe

Summary

Faced with an incipient hard currency deficit, Cyprus is prepared to rapidly expand its trade with Communist countries. A 1968 trade agreement with the USSR provides for a 50-percent increase in trade during a five-year period and for stepped up Cypriot purchases of Soviet machinery, equipment, and semimanufactured goods -- items formerly obtained almost entirely from Free World suppliers. The share of Communist countries in Cyprus' foreign trade rose from 3.5 percent in 1961 to 8.5 percent in 1967, and may reach 20 percent to 25 percent by the early 1970's.

A decline in two of Cyprus' largest sources of foreign exchange has begun: foreign military spending has diminished rapidly as British, Greek, and UN troops have been withdrawn, and exports of minerals are falling because of the exhaustion of mineral reserves. Other exports -- mainly foods -- are rising, but most are of low quality and are noncompetitive in world markets.

Cyprus, however, must expand exports to pay for imports and must increase imports to support economic growth. Trade with the Communist countries has offered a solution to this problem because these countries are willing to accept low-quality agricultural products from Cyprus in exchange for their

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own manufactures, which are also difficult to sell for hard currency.

Soviet interest in expanded trade with Cyprus probably has mainly a political motivation. The Soviet Union hopes to have an opportunity to increase its influence in Cyprus at a time when it is attempting to expand its presence in the Mediterranean. Soviet officials may also hope eventually to make some arrangement with Cyprus for use of naval facilities on the island.

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The Cypriot Economic Dilemma

1. The Cypriot economy has prospered since the advent of independence in 1960, despite continuous political strife and chronic trade deficits. Gross national product (GNP) in real terms has increased at an average rate of 6 percent per year and in 1967 reached \$400 million. Per capita GNP of about \$650 is among the highest in the Middle East. The balance of payments has been in surplus during most years because of expenditures by the large foreign military forces on the island (see Table 1). By March 1968, foreign exchange reserves were \$157 million -- enough to cover about one year's imports.

2. During the past few years, however, the Cypriot government has failed to act in recognition of the temporary nature of its income from foreign military forces or the precarious competitive position of its mines and farms, which produce almost all of its exports. The government chose to put most of its foreign exchange holdings in foreign securities and to ignore investment in Cyprus for the development of new sources of income. This shortsightedness came into sharp focus during 1967, when the Cypriot pound was devalued (by 14.3 percent in terms of sterling exchange, or by a 16.7-percent increase in the cost of dollar exchange), foreign military forces were reduced, and exports from the island's diminishing mineral reserves dropped sharply.

3. The weakness of Cypriot exports has been apparent for years. These consist of minerals (one-third of total exports) and agricultural products (more than one-half of exports). The mineral deposits, primarily copper, are rapidly running out and may be entirely exhausted by 1972. Agricultural exports are of poor quality and difficult to market. The value of total exports increased by 24 percent in 1965, by 15 percent in 1966, and by only 2 percent in 1967 (see Table 2). Devaluation was necessary in late 1967 to prevent a further decline in exports, but it is no solution to the problem. Imports must be increased if incomes are to continue to rise. The increase in imports and the poor growth prospects for exports are likely to cause a deterioration in the trade balance.

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Table 1

Cyprus: Balance of Payments
1963, 1966, and 1967

	Million US \$		
	1963	1966	1967 ^{a/}
Current account	-8.0	3.9	6.1
Trade balance, f.o.b.	-59.1	-56.6	-62.2
Imports	-114.3	-133.9	-143.1
Exports	55.2	77.3	80.9
Services balance	33.0	49.0	57.4
Government	45.1	64.7	68.9
Of which:			
Foreign military expenditures	42.8	61.9	N.A.
Travel	4.5	2.0	3.6
Freight and insurance	-10.9	-13.2	-14.3
Other services	-5.7	-4.5	-0.8
Transfer payments	18.1	11.5	10.9
Private	10.0	10.4	10.1
Central government	8.1	1.1	0.8
Capital account	6.4	9.8	10.1
Private investment	7.8	12.0	12.3
Central government	-1.4	-2.2	-2.2
Net errors and omissions	15.4	-0.8	7.0
Balance of capital and current accounts	13.8	12.9	23.2

a. Preliminary.

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4. At the same time, foreign exchange inflows from foreign military expenditures will decline. The island's principal source of foreign exchange, British military expenditures, has already fallen. The British reduced their spending to \$38 million in 1966, compared with \$45 million in 1961, and then announced their intention to cut spending by a further 20 percent. In view of the United Kingdom's present economic difficulties, further declines in British spending are likely.

5. During the past few years, the foreign exchange inflow from Greek and Turkish forces stationed on the island has amounted to about \$17 million annually,* enough to cover almost a third of the island's trade deficit. Withdrawal of these forces began in December 1967, however, and by the end of January 1968 an estimated 70 percent of these troops had been withdrawn. Foreign exchange inflows from the UN forces on the island are about \$6 million annually, and this military contingent is being cut back as well. If a Cyprus settlement is reached, the UN expenditure will cease.

6. Prospects are dim for the rapid growth of other foreign exchange sources. Foreign direct investment, for example, reached a peak of only \$6 million in 1965, and has since declined. Transfer payments, consisting mainly of emigrant remittances, amount to only about \$11 million annually and are not likely to increase substantially. Tourism has the best chance of becoming a more important foreign exchange earner. Because of the Cypriot devaluation, Western Europeans should be attracted by the island's lower prices in terms of their own currencies. But foreign travel receipts will increase substantially only if the island can maintain stable prices, continue its political calm, and develop improved tourist facilities. And even under the most favorable circumstances, gains from tourism will not fully offset

* Including grants from the Turkish government to the Turkish Cypriot community.

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Table 2

Cyprus: Composition of Foreign Trade a/
1964-67

	Value in Million US \$							
	1964		1965		1966		1967	
	Value	Percent	Value	Percent	Value	Percent	Value	Percent
Exports f.o.b.								
Beverages and tobacco	3.9	6.8	5.0	7.1	7.0	8.6	7.6	9.1
Crude materials	22.1	38.5	28.0	39.5	36.7	44.8	27.8	33.2
Of which:								
Asbestos	1.6		2.3		2.3		2.2	
Iron pyrites	4.3		4.6		6.0		6.9	
Copper concentrates	12.0		15.5		21.8		12.2	
Cupreous pyrites	1.4		3.0		3.7		3.3	
Food	24.1	42.0	31.4	44.3	31.6	38.6	39.4	47.1
Machinery and transportation equipment	3.9	6.8	3.4	4.8	3.1	3.8	4.1	4.9
Miscellaneous	3.4	5.9	3.1	4.4	3.4	4.2	4.8	5.7
Total	57.4	100.0	70.9	100.0	81.8	100.0	83.7	100.0
Imports c.i.f.								
Animal and vegetable oils	2.0	1.9	2.8	1.9	3.1	2.0	2.7	1.6
Beverages and tobacco	2.2	2.1	2.5	1.7	2.2	1.4	2.5	1.5
Chemicals	9.8	9.3	12.9	9.0	15.4	9.9	14.7	8.9
Crude materials	2.5	2.4	3.4	2.4	3.6	2.3	3.8	2.3
Food	21.0	20.0	21.6	15.0	22.4	14.5	24.1	14.5
Machinery and transportation equipment	19.3	18.3	35.3	24.5	36.1	23.3	38.4	23.2
Manufactured goods	27.4	26.0	39.5	27.4	42.8	27.6	46.4	28.0
Mineral fuels	9.5	9.0	10.1	7.0	10.6	6.8	12.0	7.2
Miscellaneous	11.5	10.9	16.0	11.1	18.8	12.1	21.1	12.7
Total	105.2	100.0	144.1	100.0	155.0	100.0	165.7	100.0

a. These data differ from balance of payments data because they are based on customs returns, which measure exports and imports as they cross customs frontiers. Balance of payments figures measure payments for traded merchandise, which differ in timing from movements of goods. Moreover, import figures here are c.i.f., whereas imports in the balance of payments are f.o.b. Because of rounding, components may not add to totals shown.

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the loss from military expenditures for many years.

7. On balance, Cyprus probably will lose between \$12 million and \$23 million in foreign exchange earnings in 1968, in comparison with 1967, as shown in the following tabulation (million US \$):

Increase in trade gap	-12	to	-14
Greek and Turkish troop withdrawals	- 7	to	-16
UK reduction of military bases	- 2	to	- 6
Tourist receipts	+ 9	to	+13
<i>Net losses</i>	-12	to	-23

Such losses would eliminate or cut deeply into the country's balance of payments surplus.

Trade with Communist Countries

8. To retain balance in its international accounts while continuing its development efforts, Cyprus is expanding and diversifying its bilateral trade with the USSR and other Eastern European countries. It finds the Communist countries willing to import Cypriot agricultural goods difficult to market elsewhere. The Eastern European countries, like Cyprus, are interested in conserving foreign exchange, and they are willing to accept low-quality agricultural goods if no hard currency is involved. Through agreements with Cyprus involving low-quality goods, the Communist countries also expand their markets and occasionally are able to dispose of their own surpluses of obsolete machinery and equipment.

9. In March 1968, Cyprus and the USSR signed a new five-year trade agreement that not only calls for a 50-percent increase in trade but also stipulates a shift of Cypriot imports from primarily raw materials to machinery, equipment, and semimanufactures such as

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gas pipe, wire, and pig iron. At present, Cyprus has six bilateral trade agreements with Eastern European countries* and will probably increase and diversify its trade with them if the terms of the new Soviet agreement prove satisfactory.

10. Cypriot imports from the Communist countries were \$3.2 million in 1961, exports to them were \$2.4 million, and this trade turnover represented 3.5 percent of Cyprus' total foreign trade. By 1967, Cypriot imports of \$11.3 million from Communist countries and exports of \$9.8 million accounted for 8.5 percent of total trade. On the basis of trends in trade with the Communist countries and the need to expand markets for poor-quality Cypriot products, the USSR and Eastern Europe could account for 20 to 25 percent of the island's total trade by 1972. The UK, currently Cyprus' most important trade partner (34 percent of total trade in 1967), probably will see its share of the trade decline.

11. In the past, Cyprus' imports from the Communist countries consisted mainly of fuel oil, timber, cement, and sugar. Cypriots have shown a strong preference for Western-made manufactured goods. The recent bilateral agreement with the USSR, however, indicates a willingness to shift to some Soviet-made manufactured goods if necessary. If pressured by a drain on the island's reserves, the government probably would not hesitate to impose controls on imports of Western consumer goods.

12. Imports of manufactures from Communist countries will be attractive to Cyprus if they can be paid for with commodities which are difficult or impossible to market in the West. Communist countries already absorb a considerable amount of Cyprus' agricultural exports, as indicated in Table 3.

* In general these agreements consist of commodity lists with set quotas that are renewable annually. Settlements are made through clearing accounts denominated in pounds sterling.

Table 3
Cyprus: Communist Countries' Share
of Cypriot Exports, by Selected Commodity
1961 and 1967

Commodity	Thousand US \$		Percent	
	1961	1967	1961	1967
Citrus fruit	862.4	4,286.0	14	34
<i>Eau-de-vie de vin</i> (Cypriot raisin alcohol)	92.4	2,269.2	15	97
Hides and skins	84.0	354.4	14	61
Leaf tobacco		229.6		99
Orange juice		125.2		89
Potatoes		810.6		8
Raisins	1,164.8	635.2	89	80
Wine in casks	47.6	324.4	4	11

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Low-quality Cypriot raisins and *eau-de-vie de vin* command such low prices in Western markets that it is unprofitable for the islanders to export them to the West. Other Cypriot exports, such as citrus fruit and potatoes, face increasingly heavy competition in Western markets from Israel, Spain, and other Mediterranean countries.

13. The Communist markets provide considerable scope for stimulating growth and diversification of Cypriot exports. In the short run, Cyprus could raise its output of citrus fruit, potatoes, and grapes for marketing in the Communist countries, although inadequate water resources would preclude large increases in the output of these crops for a number of years. The production of dryfarming crops such as tobacco, cotton, almonds, and olives can increase as Cypriot cultivation methods become more efficient. All of these products, as well as olive oil -- currently in surplus in Cyprus -- and wool, are difficult to market in the West because of low quality, but they probably could be sold in the Eastern European countries. A few Cypriot manufactured goods such as low-quality footwear and knitted clothing might be marketed in the USSR. It is also possible that bilateral trade will be stimulated in the future if Communist countries give Cyprus long-term credits for capital goods. Such credits, however, have so far been neither offered nor requested in Cypriot negotiations with Communist countries.

Prospects

14. In facing its international economic problems, the Cypriot government has no obvious alternatives to expanded bilateral economic relations with the Communist countries. Because of the island's heavy dependence on imports of economic necessities and the government's dependence on customs revenues, a policy of rigid domestic economic controls to improve the balance of payments would induce an unacceptable degree of economic hardship. Expanded economic ties within the sterling area appear unlikely because Cyprus cannot market many of its exports in the West and probably will receive less rather than more economic aid. Moreover, the British devaluation,

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the military reduction, and the cessation of British aid have shaken the confidence of many islanders in the desirability of heavy dependence on the United Kingdom. No other Western country is likely to extend the aid required by Cyprus to overcome its incipient balance of payments problems.

15. Soviet interest in expanded trade with Cyprus probably has mainly a political motivation. The USSR hopes to have an opportunity to increase its influence in Cyprus at a time when it is attempting to expand its presence in the Mediterranean. Soviet officials may also hope eventually to make some arrangements with Cyprus for use of naval facilities on the island.

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