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### THE CHALLENGES OF THE NEXT PRESIDENT Cyprus and the Global Transformation

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Quam multa fieri non posse prius quam sunt facta iudicantur?  
(How many things are judged impossible before they actually occur?)

Gaius Plinius Secundus (Pliny the Elder), *Naturalis Historia*, VII.i, 6

On the 28th of January, 2018 the Cypriot people voted in the first round of the presidential elections, and they are going to elect the next head of state on coming Sunday.

While it is the axiom of the local political culture that the Cyprus problem is the focal point of the national agenda and everything else comes second, no matter how controversial it may sound to some, it is essential to draw public attention to the fact that in view of the historical global transformation the world has entered, the long-term preservation of the national wealth, prosperity and the country's place in the "first world" must become the priority of the first order.

In no way trying to downplay the tragedy of the occupation and the rightful desire of hundreds of thousands of people to unify the country, nevertheless, it is relatively safe to argue that there are many in Cyprus, who agree that no unification will bring joy and satisfaction, if the issue of securing people's long-term prosperity and the country's wealth is neglected in the process, and Cyprus' place in the club of the rich states is put at risk. Unfortunately, such risks are there and will only be growing, if prudence is not practiced.

As Colin Gray, one of the world's renowned scholars of war, writes in one of his forty maxims on war, peace, and strategy: "Prudence is the supreme virtue in statecraft and strategy. .... The prudent strategist is alarmed by a policymaker

who is so fixated upon desirable goals and their anticipated benefits that risks are not properly assessed".<sup>1</sup>

Truth to be said, the world has accumulated enormous collective experience in dissolution or outright destruction of states, and almost no experience in how to unify them. And even when unification was happening, it was mainly achieved with iron and fire. The closest available successful and peaceful experience to look at was that of Germany almost thirty years ago.

No need to elaborate in detail on many important aspects such as administrative, regulatory, structural, linguistic, cultural and religious factors, all of which are no minor issues and make the German case very different from the Cypriot one, but it is important to emphasize two aspects of critical importance that played vital role in the success of German unification: economy and the historical environment.

By the time of unification West Germany was practically the strongest economy in Europe with enormous accumulated wealth, a country which was methodically ascending to its current position of an economic powerhouse. As for the Eastern Germany, no matter what they say in the West of the country, it was an accomplished state in its own name with a strong army, highly educated population and rich technological and scientific potential, which contributed substantially to future success of united Germany. However, even with all the available economic wealth, it is openly admitted today that the cost of unification will never be recovered by Germany – so expensive it was.

But Germany was also lucky. It escaped much of the pain and costs thanks to one more factor of critical importance, which many tend to overlook – it is timing. The unification happened when the collective West won the so called Cold War, when dissolution of the USSR eliminated the main geopolitical threat, and overwhelming peace set upon Europe and the Western world. The period of the 1990s and the first decade of this century became the golden era of an unprecedented economic growth, expansion to new markets and enormous profits. The global tide which was going up took united Germany with it and helped to compensate for the losses and minimize pain.

In Cyprus, having lived through economic destruction of 2013, overburdened with debts and struggling financial system, the Republic of Cyprus is planning to unite with the de-facto economically-subsidized by Turkey entity, which remained in isolation for almost half a century. Unfortunately, Cypriots reached the point of a possible unification at the time when the world has entered the period of a global paradigm shift, i.e. deep economic, technological and geopolitical transformation characterized by uncertainty, destabilization,

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<sup>1</sup> Colin S. Gray, *Fighting Talk: forty maxims on war, peace, and strategy*, Potomac Books, p. 131.

sluggish productivity, falling demand, unprecedented debts, growing inequality, emerging protectionism and a very vulnerable international financial system, which is still unable to overcome the effects of the crisis of 2007-08.

In contrast to Germany, which profited from European peace and prosperity of the 1990s as well as global economic expansion, Cyprus is in close proximity to the broader Middle East, the region of growing chaos, radical islamisation and militarization. The EU and the euro-zone, where Cyprus is a member, are facing economic and political challenges of historical proportions with yet unknown outcome. Britain, one the principal partners of the country, will be living through a very turbulent Brexit process for years to come, which will be affecting its economy and spending power of its population. And finally Russia, the island's main client for corporate and financial services over the last twenty years as well as the second biggest supplier of tourists, is in a long-term geopolitical confrontation with the West (with all the relevant consequences), its economy is in stagnation and suffering from deep structural deficiencies, which are aggravated by a long cycle of low energy prices. According to Russian own foreign policy experts, sanctions imposed on it by the West are there to stay for several decades to come with a strong probability that the new ones will be introduced in the future as tensions with the US intensify.

Cyprus benefited enormously from cooperation with its principal partners and neighbours over the span of the last forty years – they were the source of the island's impressive growth in prosperity and wealth. However, the world is changing fast and unpredictably, and fundamental problems of Cyprus' partners put now the country in a position, when it is running the risk of potential cascading crises. And the next Administration must be aware for that.

There are some economic reports, which make projections that unification of the island would create economic synergy, growth and influx of investments, which in turn, will help to cover the costs incurred during the process. In no way trying to call into question the professionalism and integrity of the authors of these reports, it is nevertheless important to point that the main weakness of such forecasts is that they are based on the false assumption that the old international system, which was in place since early 1980s, and on the back of which Cyprus had built its economy and wealth, continues functioning as before with global demand and productivity remaining strong and sustainable for years come.

Furthermore, due to the ongoing global shift, dramatic transformation of external factors (economic, technological, demographic, geopolitical), it is the structure of the local economic model itself that is gradually becoming the source of risk. Therefore, given the change of the global system we are already living through, it is no longer possible to consider unification of the island in isolation from the above-mentioned two critical factors: the economic model Cyprus has developed since late 1970s; and its interaction with and dependence

on the increasingly fluid and unpredictable international environment. It is therefore very important to elaborate in detail, which historical processes have shaped the Cypriot model, why it is facing growing risks and needs transformation in order to preserve people's prosperity as well as the country's place in the "first world".

The Cypriot service economy stands, primarily, upon its financial services and tourist sectors, supported by other segments such as shipping and to a lesser degree tertiary education. The roots of what was sometimes is called the "Cypriot economic miracle" lie in two global historical processes: the de-colonization of 1960-70s followed by the launch of financial globalisation in the 1980s.

The disintegration of colonial empires provoked flight of capital out of the newly independent states and created an urgent need for financial harbours where that capital could be conveniently parked. "Convenience" was the main criteria which meant low taxation, flexible regulation, preferably rule of English Law, Anglo-Saxon administrative and banking system and the availability of English-speaking lawyers, accountants and tax advisors. No wonder such an international network swiftly emerged, mainly, in small island-nations scattered around the globe, most of which happened to be former British dependent territories. The emergence of such convenient centres became quickly popular with many other international investors, who did not feel particularly comfortable keeping their capital in their respective countries of origin.

The deep economic crisis of the 1970s in the West required new mechanisms to re-start the economy. Reagonomics inaugurated the era of financial deregulation and globalisation. In the USA, the centre of the global economy, deregulation meant financialization, i.e. the unprecedented growth in size and scope of finance and financial activity in the economy, rise of debt-fuelled speculation over productive lending. Economic growth was achieved through stimulation of domestic consumption based on debt refinancing mechanism (for the mechanism to work, the lending rate should continuously keep falling).

On the international front, globalisation meant the lifting of barriers in the way of goods and financial capital flows. Thus, began the era of global consumerism and the financialization of the world economy.

Financial globalisation required the availability of the relevant international banking infrastructure and jurisdictions, which could facilitate the flow of international capital with minimum costs and maximum flexibility. The existing network of island-nations and other tax-heaven statelets contributed enormously to the process, which brought some of these nations (Cyprus included) unprecedented prosperity within quite a short space of time. If there had been no such centres, the very logic, scale and speed of financial globalisation would have created them anyway. The collapse of the former

socialist block and the opening of new markets accompanied by the emergence of China and other developing economies took globalisation into a new era.

Impressive economic growth in many parts of the world created a new middle class and the new rich, who were eager to travel, spend and consume without limits. Tourism has become one of the fastest-growing sectors and a global multibillion industry. The educational sector has internationalized and expanded as never before. The shipping industry exploded on the back of growing international trade, so did international business advisory services.

However, as it turned out, in the shadow of global economic expansion, severe imbalances of similar magnitude had been building up for decades: first, prosperity and the rise in living standards were achieved at the price of the accumulation of unprecedented debt of all types, and second, the global economy became the economy of exporters.

Almost all countries (including European nations, Japan, China, Russia and Brazil) became dependant on sales of their products and services abroad. The only major nation where growth is still driven by domestic consumption is the US. As it paradoxically turns out, directly or indirectly, all countries are selling to the USA and, at the end of this long and complex global consumption chain the average American Joe is standing.

The only problem is that, for decades, the average Joe could increase his consumption only through accumulation of debt which became possible thanks to a debt refinancing mechanism, which in turn, depended on a gradual reduction of interest rates. Thus, the Federal Funds Rate gradually went down from 20% in March 1980 to 0.00%-0.25% in December 2009 when the mechanism came to an end. The QE program which followed doubtless saved the global economy from collapse and brought temporary relief but the fundamental problems of revival of sustainable demand and reduction of debts were not solved. The Institute of International Finance (IIF) estimates that global debt level jumped by over \$US70 trillion in the past decade to a record high of \$US215 trillion.<sup>2</sup>

Programs similar to the Fed's QE pursued in other major economic powers produced no fundamental change: interest rates in the US and Europe have fluctuated a little above 0% for a decade; productivity in the global economy is not improving; growth is sluggish and the risk of another financial crisis still looms. Bank of International Settlements (BIS), central bank of central banks, wrote the following on the prospects of the world economy in its report: "One could speak of a "risky trinity": productivity growth that is unusually low, casting a shadow over future improvements in living standards; global debt

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<sup>2</sup> Scutt D., *Global debt has hit an eye-watering \$215 trillion*, Business Insider, 04.04.2017, <http://www.businessinsider.com/global-debt-staggering-trillions-2017-4>

levels that are historically high, raising financial stability risks; and a room for policy manoeuvre that is remarkably narrow, leaving the global economy highly exposed".<sup>3</sup>

Germany's finance minister warned last autumn that spiralling levels of global debt present a big risk to the world economy as well as to stability in the eurozone, particularly from bank balance sheets burdened by the non-performing loans.<sup>4</sup> This position was echoed in the IMF's 2017 Global Financial Stability Report and supported by the survey results among stock market participants conducted by Bloomberg.

It is vital to understand that the success of the Cypriot economy over the last almost four decades was the direct product of global economic forces as well as some historical geopolitical developments, at work since the early 1980s. All the main pillars of the local economy, i.e. tourism, financial/advisory services, shipping and tertiary education have risen on the back of financial globalisation, emergence of the global consumer middle class and economic growth driven by accumulation of debt.

This era is over, and the world has entered the new phase of emerging protectionism (or de-globalisation), erection of barriers, shrinking middle class, growing inequality, falling demand and sluggish productivity. These problems will be aggravated in coming years by noticeable aging demographic shift in the West, Russia and China.

The economic model Cyprus developed since the late 1970s served it well – it helped the poor devastated country to rise from the ruins and win the place in the "first world" within short three decades. Cyprus was also lucky to exploit to its benefit the colonial inheritance (legal, administrative, tax/financial systems and English-speaking population), climate/geographic factors as well as cultural/historical bonds to Russia/CIS and some East European countries at the time of financial globalisation, liberalisation, openness and relative international stability.

The tide is changing now. The global model of the last forty years reached its saturation point, so gradually does the Cypriot economic model. The world has entered the dangerous period of transition, i.e. when the old system is crumbling but the new one is only in the process of a slow and painful formation. At this stage, nobody can confidently tell how long the transition period will last – general consensus is ten to fifteen years. Unfortunately, it is also the general consensus that it will be quite a messy world, some ugly

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<sup>3</sup> Bank for International Settlements, *86<sup>th</sup> Annual Report*, BIS 2016, downloaded from <http://www.bis.org/publ/arpdf/ar2016e1.htm>

<sup>4</sup> Wolfgang Schäuble warns of debt-driven global financial crisis, *The Financial Times*, 03.10.2017, <https://www.ft.com/content/9de0533c-aab8-11e7-93c5-648314d2c72c>



manifestations of which we are already witnessing around the globe in military, economic and political spheres. If history is of any lesson, this is the period when states try to survive at the expense of each other fighting for shrinking resources. Today, in economic terms, these are the available consumer demand and the financial resources. At the same time, such transition periods are when countries fiercely compete to secure their places in the new world of tomorrow, frantically trying to “catch the new wave”.

And there is no place for illusions and complacency, because history knows many examples when countries were rising, flying high, then collapsed and never recovered. The most noticeable example is that of Argentina, which was the seventh largest economy in the world in the early twentieth century. But inability to create new engines of growth, and respond to the global paradigm shift has brought about the demise of its economy, from which, to this day, it has been unable to recover.

It is always an extremely difficult task to identify the right economic niches to target as potential engines of growth. But at a deeper level there are two critical factors, which stand behind long economic cycles, define the shape of the future, and therefore, can serve as a useful compass. These are demography and technology.

We have approached the time when the generation of baby-boomers born in 1950-60s began retiring. Millions of people, whose massive borrowing and spending was driving the international economy in the 1980s and 1990s now leaving the stage of active economic life, which will have profound impact on the demand and consumption patterns, in the Western world in the first place. Old people do not make big purchases as the young ones – they do not buy new houses and new cars, they do not have little children to spend for, and they even consume less food. Another issue with baby boomers is that they live longer, require health care and end-of-life care at a level never seen before, but at the same time, they did not leave enough children behind to replace them as a productive work force, which has to cover the costs, continue paying the debt and drive the economy forward. This situation is especially acute in Europe, Russia, Japan, Korea and some other countries of the Western world. In coming decades, the proportion of the population over sixty years of age will quickly be rising, whereas the proportion of the young generation under the age of twenty-five will be diminishing significantly, thereby creating serious pressure on the local economic and social welfare systems.

On the other extreme of the spectrum, poor and developing countries, especially, across Africa and the broader Middle East, are living through the period of demographic explosion. For comparison, the average fertility rate across the European coast of the Mediterranean from Cyprus to Spain (and generally across most of the EU) is 1.3-1.4 against the factor of 5 in sub-Saharan Africa. Up to 40% of the Middle Eastern population are people under

the age of thirty. And they live in increasingly acute conditions of water and land shortages, which will be the driving factor behind migration waves from the region for many years to come. Unfortunately, coupled with religious and ethnic tensions as well as institutional collapse and social strife in many parts, the region will remain the area of protracted instability, violence and humanitarian tragedy for a long time.

The situation for the region will also be aggravated by the growing energy independence of the US from the Middle Eastern supplies. Shale oil and gas revolution in the US as well as continued advances in technology help the US to gradually transform itself into an energy exporter and start competing on the international market for customers. The cost of production in the US is still higher but already economically viable. Further improvements in technology and operational efficiency in the coming decade will inevitably make American oil and gas more cost and price competitive, which will have profound impact on the global market, given the proportionate size of the US economy and the role it played as a net energy importer.

The US represents roughly 20% of the global economy. The very size of the economy, the status of the US dollar as a reserve currency, and generally the degree of American integration and power in the world, make it the object of constant international attention.

The financial crisis of 2008 shook America deeply and underlined the imbalances and serious vulnerabilities of its financial system, which it cannot fully overcome to this day. However, as it was mentioned earlier, in the aftermath of the crisis, monetary and economic policy pursued by the Fed and the Treasury did not allow the system, and together with it the rest of the world, to collapse. Since the crisis erupted, the debate about the demise of the US, which was popular in the 1970s, became intellectually fashionable again.

After the election of the new President in 2016 and his first year in office, now it is not unusual to hear in the expert community about American “withdrawal from the world”, “isolationism”, “decline” or “historical defeat and eventual collapse”. It is naïve to share any of these categorizations. It is obvious that the US have a lot of internal problems to address, its financial system needs further careful and methodical finetuning, and Washington also showed signs that it changes gradually the way it is engaging with the world.

It is obvious that the “Unipolar Moment”, which lasted twenty-five years and was prophetically predicted by Charles Krauthammer in 1990, is over. The world is gradually shifting to the multi-polar system. The US no longer has the overwhelming power it enjoyed since collapse of the USSR. But that is not to say that the US ceases to be the most potent country in the world measured by its aggregate power (military, economic, financial, diplomatic, technological and cultural). The US does not and cannot withdraw from the world due to its size



and integration with the international system. What changes is how the US will be interacting with the world, which new instruments and tools it will be using, and which new priorities it will be setting for itself.

It is premature to elaborate on this topic because at this stage no foreign policy expert can, more or less accurately, tell how exactly the US will behave. The only thing, which is clear is that the world is in transition to the new international balance of power in a very unpredictable way, and will remain in this state of flux and turbulence for years to come, before the new balance and the institutional framework gradually emerge.

However, there is one aspect in the whole "US isolationism" story, which special attention should be paid to. It is the transition to the new technological age. As it was mentioned above, America is on the way to gradual energy independence, and therefore its policy in the Middle East, inevitably, will be changing. Advances in shale oil/gas technologies is not the only area, where technological revolution is taking place. The US is on the way to gradual reduction of its dependence on foreign-manufactured low value-added goods.

Already today, roughly 10% (estimates vary depending on the source) of the US GDP is generated by the new-age industrial sectors based on robotics, AI, bio and nanotechnologies, and the new principals of management and operation. Those, who wait for the "imminent demise" of the US would be surprised to learn that, at least in part, behind the curtain of the so-called "isolationism" active transformation of the industrial and technological system is taking place. And the US is not the only country moving in this direction.

One of the biggest transformations we are going to witness in the not so distant future is transformation of manufacturing, which is gradually "returning" from the cheap-labour emerging market countries. There are already some new-age industrial manufacturing segments, where cost of production, for example, in France is as low as in Brazil. These technologies are still in their infancy, but they are already economically viable, developing quickly and gradually spreading. Transformation of the manufacturing is at full throttle in the most technologically-advanced countries with the US, Japan and Germany at the head.

New-age manufacturing based on robotics, AI and new materials will have most profound impact on many global industries and countries, especially those depending on production of cheap low value-added products. It will deeply affect the global logistical sector, and the shipping industry in the first place. Today, global shipping industry is dominated by container vessels carrying, mainly, low value-added goods from developing countries to the rest of the world. Gradual rise of the new-age manufacturing located in consumer countries will reduce the size of the industry. Shipping sector will not disappear, it will

adapt and transform, but it will shrink in size. Countries generating income from ship registration fees will see their income drop as a consequence.

Advances in IT, communication and computing sectors, development of platforms like blockchain will fundamentally transform banking and financial system as we know it. These technologies are making the system more transparent and bring the seller and consumer into direct contact, and many of the functions conducted today by lawyers and accountants will be replaced by automatic execution and verification technologies powered by AI. First successful experiments on execution of insurance contracts have already been conducted. Not every technology will take-off but the direction in which the next technological wave moving is clear. These changes represent a direct risk to any business model based on the provision of intermediary services, like many of those in the Cypriot financial/corporate sector, whose income comes from transaction fees.

Technological transformation, transition from one technological wave to the next does not happen overnight – it takes time before technologies spread and produce economy-wide positive effect. But the technological transition from the previous wave based on microchip to the new one based on robotics, AI and biotech is underway.

The new-age technologies do represent a long-term risk for the Cypriot economy and prosperity of the country, if no action on transformation of the economic model is taken. Argentina's demise as an economic powerhouse should always serve as an example.

No one should underestimate the power of change. Construction of Interstate Highway System in the US in 1950s led to gradual disappearance of hundreds of small towns across the country, automation of manufacturing and gasoline crisis of 1970s have turned Detroit from the automobile capital into a ghost city, and the list of examples goes on.

The new technological wave will be the era of producers and high value-added knowledge-intensive service providers, who will be selling and delivering their products and services directly to the final consumer. This is the direction where transformation should go. Cyprus must start gradually moving away from provision of low value-added intermediary services and climb up the value chain.

Calling for the transformation is easy. Developing the plan and make it rolling is difficult. The task may start looking almost impossible when there is shortage of resources: human, financial and technological.

The battle for the future in the technological domain is being waged by the richest and most resourceful countries in the world, which invest hundreds of billions in R & D, and mobilize millions of top-class scientists.

For any new knowledge-intensive sector to take off in Cyprus, two conditions must be met: massive capital investments, and high concentration of technical expertise. The country lacks both.

It is therefore vital to have a serious societal debate on how such a transformation can be achieved. One of the models, which can be considered is transformation of Cyprus into an international administration and logistical hub for international medical aid, relief and disaster management NGOs. Demographic, social-economic, military and environmental factors, unfortunately will intensify the risk of regional wars and humanitarian tragedies.

The country's geographic proximity to the major risk zones of the Middle East, Africa and Southern Asia, availability of modern logistical infrastructure, stability/safety and relatively low cost of operations can make it a solid candidate to become a major hub for NGOs as well as national and inter-governmental organizations dealing with medical relief and disaster management operations in zones of humanitarian catastrophes.

The government must develop a package of incentives as well as undertake a targeted "diplomatic offensive" to attract such entities from all around the world to open their regional and international offices on the island. That should include administrative and medical personnel, logistical operations via local ports/airports and storage of aid inventory/supplies, and probably their training facilities (for disaster/relief organizations).

The emphasis must be put on organizations dealing, specifically, with medical aid and relief operations. The NGOs must be provided with incentives and assistance to open on the island medical rehabilitation centres and sanatoriums, where patients (victims of wars and catastrophes) will be brought for treatment.

NGOs are not-for-profit organizations with access to multi-billion donor resources from all around the world (private, corporate, national and inter-governmental). Operations of medical rehabilitation centres in such a case will be financed by the not-for-profit capital of donors. NGO sector has one significant advantage over private one – its operations do not depend on profitability, economic cycles and stock market crashes, they do not close their operations when disaster strikes. On the contrary, their activities only intensify during periods of instability. Thereby, Cyprus could create additional industry with "counter-cyclical" economic characteristic.

Apart from the income the country could generate from the presence of NGO offices, personnel and logistical operations, the main objective of this plan is to create "fertile soil" for medical services industry and related sectors to take-off on the island. As it was mentioned earlier, for the knowledge-intensive industry to develop, two conditions are required: capital and high concentration of expertise.

The country has no enough available capital to invest on its own and it is not very competitive destination for investors in medical sector due to the lack of large-scale concentrated medical expertise. For this industry to take-off, two main conditions must be met: large concentration of doctors and patients. Medical relief NGOs by opening rehabilitation centres on the island, financed by not-for-profit capital will help the country to create the "fertile soil" for the industry.

Concentration of medical expertise, infrastructure and patients at a later stage will start attracting private capital, medical supplies companies as well as private investments in related segments, which will be developing as a spin-off such as laboratories, research and development activities, international start-up financing in medical services and equipment manufacturing.

Cyprus could have a chance to become an international hub in such a specialized area as the medicine of catastrophes as well as relief and disaster management operations. For the transformation to happen a solid long-term government policy is required and a constructive consensus of all political forces in the country independent of their ideologies or party loyalties.

Developing such a comprehensive action plan, building political and societal consensus around it, and setting the plan in motion will be the difficult but vital job of the next President.