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THE EXTENT OF FOREIGN DIRECT INVESTMENTS (FDI) IN THE TOURISM SECTOR OF NORTHERN CYPRUS

Okan Veli Şafaklı

ABSTRACT

Amidst the clamor of unstable political and economic developments, unrecognized political status and embargos by several countries, the foreign investment climate in Northern Cyprus is extremely challenging. Within the tourism sector of Northern Cyprus, foreign investments are quite rare and are channeled in favor of bigger, more established operations. This study examines the extent of foreign direct investments (FDI) for the tourism sector of Northern Cyprus and recommends ways to optimize the economic value of such investments. Findings reveal that the economic value of FDI in Northern Cyprus could be optimized either by further strengthening the region's current integration with Turkey, or by adopting the European Union route for its economy.

Introduction

There is no any contrary opinion from the viewpoints of economics that economic development and social welfare depend on investments. In such a way that investments contribute positively to production, employment and national income. Therefore, in every country authorities are bothered with increasing and encouraging investments in order to stimulate economy. These positive effects of investments can be created either by transforming domestic capital in investments or attracting foreign capital. Second alternative carries more importance in Northern Cyprus since insufficient and limited capital accumulation exists in this country. In this perspective, the basic aim of this study is to determine the extent of foreign investments for the tourism sector of Northern Cyprus and to recommend the ways of increasing its contribution to economy.

In this study, first of all the concept of foreign investments including the pros and cons of foreign investments, determinants of FDI and the impact of country risk on foreign investment decisions will be explained.

As it is clearly seen from the title of the study, the field of the research is foreign investments in the tourism sector of Northern Cyprus. Consequently, before concentrating on the foreign investments in this country, information will be given about the economy, investment climate and the tourism sector of Northern Cyprus.

Previous academic researches on the related fields and the various reports prepared by different departments of the state have been utilized in order to determine the extent of foreign investments for the tourism sector of Northern Cyprus in a qualitative and quantitative manner.

The absence of sufficient and reliable data about foreign investments in Northern Cyprus is the basic limitation of this study.

The Conceptual Framework of FDI

Foreign capital can be defined as financial or technological resources obtained by one country from another country that would be added to the host country's economic power in a short period of time and would be paid to the donor country in future (Uras 1979, p. 27). This sort of investments is in the form of an enterprise located in a developed country opening a branch or establishing a new organization in a developing country. The organization that is to be established can either be established completely by foreign capital or with the partnership of a native enterprise (Tuncer 1968, p. 29).

As a more specific technology, foreign direct investment (FDI) is a term used to denote the acquisition abroad of physical assets, such as plant and equipment, with operational control ultimately residing with the parent company in the home country. It may take a number of different forms including:

- The establishment of a new enterprise in an overseas country – either as a branch or as a subsidiary
- The expansion of an existing overseas branch or subsidiary
- The acquisition of an overseas business enterprise or its assets (Buckley 1996, p. 35).

The Pros and Cons of FDI

Economists tend to favour the free flow of capital across national borders because it allows capital to seek out the highest rate of return. Unrestricted capital flows may also offer the several other advantages (Feldstein 2000). First, international flows of capital reduce the risk faced by owners of capital by allowing them to diversify their lending and investment (Solnik 1991, pp. 1-2 ; Mengütürk 1994, p. 338). Second, the global integration of capital markets can contribute to the spread of best practices in corporate governance, accounting rules, and legal traditions. Third, the global mobility of capital limits the ability of governments to pursue bad policies.

In addition to these advantages, it is noted that the gains to host countries from FDI can take several other forms:

- FDI allows the transfer of technology—particularly in the form of new varieties of capital inputs—that cannot be achieved through financial investments or trade in goods and services(Karluk 1983; Eiteman and the Others 1998, p. 482).
- FDI can promote competition in the domestic input market (Seyidoğlu 1993, pp. 567-581).
- Recipients of FDI often gain employee training in the course of operating the new businesses, which contributes to human capital development in the host country.
- Profits generated by FDI contribute to corporate tax revenues in the host country.
- It can lead to benefits of cost reductions, improved quality of products and programs, enhanced customer preference and increased competitive leverage (Yip 1995, p.16).
- International management expertise;
- Access to new markets, particularly export markets;
- Indirect employment (e.g., for suppliers and business services); and
- Improved productivity and efficiency of local firms (e.g., through increased competition, technology spillovers) (Chaundy 2002, p. 25).

Of course, countries often choose to forgo some of this revenue when they cut corporate tax rates in an attempt to attract FDI from other locations (Seyidoğlu 1996, pp. 650-651). For instance, the sharp decline in corporate tax revenues in some of the member countries of the

Organization for Economic Cooperation and Development (OECD) may be the result of such competition. In addition to tax, the following concerns have also been raised regarding several issues:

- Potential jobs do not materialize or only last a short time;
- Many jobs are low pay, low skill jobs;
- Wage pressure in domestic sectors with low or slow productivity growth;
- Decline in market share of local firms;
- Limited local sourcing and linkages with the local economy;
- Reduction in local R&D activity and capability;
- Instability from over reliance on MNCs;
- Net cost of financial incentives; and
- A policy neglect of indigenous firms (NIEC 1992; Barry and Bradley 1997, pp. 1798-1811.).

In principle, therefore, FDI should contribute to investment and growth in host countries through these various channels.

The Determinants of FDI

Common findings of researches conducted toward the determinants of FDI can be compiled as follows:

- The most important determinants of FDI inflows to Central and Eastern Europe are country risk, unit labour costs, domestic and potential export market size, host market size, natural resources endowment, skills endowment, progress in transition reforms, gravity factors and economic and political stability. In turn, country risk is influenced by private sector development, industrial development, the government balance, reserves and corruption (Bevan & Estrin 2000, p. 2; Krkoska 2001, p. 3).
- The results of the paper exploring the linkages between political risk, institutions and foreign direct investment inflows show that government stability, the absence of internal conflict and ethnic tensions, basic democratic rights and ensuring law and order are highly significant determinants of foreign investment inflows (Busse & Hefeker 2005).
- According to the paper that analyses European Union FDI flows into the CEECs at a sector level, a statistically significant positive association has been found between FDI and market size, wage differential, the stage of the transition process and the degree of openness of the economy as well (Resmini 1999, p. 3).
- The eclectic approach emphasizes three conditions that must be satisfied to explain foreign production (FDI) by a firm. These three factors relate to **ownership** (firm-specific intangible assets such as technology, management expertise, marketing systems and human capital), **internalization** (transactions costs such as the cost of writing and enforcing contracts; protection of product quality; the ability to engage in strategies such as cross-subsidization, transfer pricing and predatory pricing; control of supplies or market outlets; and to avoid or exploit government intervention such as tariffs, quotas and tax differences) and **location** (the availability of natural and created resources; the price, quality and productivity of inputs such as labour, energy, materials and semi-finished goods; the availability and quality of infrastructure such as commercial, legal, educational, transport and communication; the spatial distribution of markets including size and growth potential; transportation and communication costs; psychic distance such as differences in language, culture and business customs; economies of centralization of R&D, production and marketing; investment incentives and disincentives such as tax rebates and performance requirements; and the economic system and policies of government such as tax rates and government regulations) (Dunning 1988).

- Empirical research conducted by Singh and Jun (1995) shows significant relationship between FDI and critical factors (political risk, business conditions, and macroeconomic variables) that influence direct investment flows to developing countries. According to this research, export orientation is the strongest variable for explaining why a country attracts FDI. This finding is in line with the secular trend toward increasing complementarity between trade and FDI
- According to the paper that analyses FDI in developing countries, determinants of FDI are categorized as *policy framework for FDI* (economic, political, and social stability; rules regarding entry and operations; standards of treatment of foreign affiliates; policies on functioning and structure of markets which is especially competition and policies governing mergers and acquisitions; international agreements on FDI; privatization policy; trade policy and coherence of FDI and trade policies; and tax policy), *economic determinants* (market seeking; resource/asset seeking; and efficiency seeking) and *business facilitation* (investment promotion; investment incentives; hassle costs; social amenities; and after-investment services) (Mallampally and Sauvart 1999).

The Impact of Country Risk on FDI

Country risk analysis (CRA) attempts to identify imbalances that increase the risk of a shortfall in the expected return of a cross-border investment (Meldrum 2000).

All business transactions involve some degree of risk. When business transactions occur across international borders, they carry additional risk not present in domestic transactions. These additional risks, called country risks, typically include risks arising from a variety of national differences in economic structures, policies, socio-political institutions, geography, and currencies. In other words, macroeconomic factors such as political instability (turnovers, revolution, fighting and wars) economic instability, (devaluation, inflation. recession and crisis) laws and administrative rules (taxes, and procedures of establishing foreign investments) can negatively affect foreign investments (Donald and the Other 1992 , pp. 1-2). Country risk analysis (CRA) attempts to identify the potential for these risks to decrease the expected return of a cross-border investment. In Japan and the EU, and certainly for Taiwan, the reason investment lags is, in the end, microeconomic. Europe and Japan suffer weak investment demand because of regulatory environments, labor laws and labor market institutions, high tax burdens, and heavy social overhead costs that discourage new start ups (Harris 2000).

Country risk analysis rests on the fundamental premise that growing imbalances in economic, social, or political factors increase the risk of a shortfall in the expected return on an investment (Parasız and the Other 1994, pp. 297-298; Oppenheim, 1993, pp. 37-39).

In this study, country risk has been divided into the six main categories of risk shown below. Many of these categories overlap each other, given the interrelationship of the domestic economy with the political system and with the international community. Even though many risk analysts may not agree completely with this list, these six concepts end to show up in risk ratings from most services.

Economic Risk

Economic Risk is the significant change in the economic structure or growth rate that produces a major change in the expected return of an investment.

Transfer Risk

Transfer risk is defined as limitations on the MNE's ability to transfer funds into and out of a host country without restrictions. When a government runs short of foreign exchange and cannot obtain additional funds through borrowing or attracting new foreign investment, it usually limits transfers of foreign exchange out of the country, a restriction known as blocked funds (Eiteman and the others 2004, pp. 450-451). In other words, it is the risk that a borrower will not be able to convert local currency into foreign exchange, and so be unable to make debt-service payments in foreign currency (IMF 2003).

Exchange Rate Risk

Exchange rate risk, also called currency risk, arises from the possibility that an unexpected change in exchange rates will alter the home currency value of repayment of loans by foreign clients (Eiteman and the Others 1992, pp. 294-295).

Location or Neighborhood Risk

Location or Neighborhood Risk includes spillover effects caused by problems in a region, in a country's trading partner, or in countries with similar perceived characteristics.

Sovereign Risk

Sovereign Risk concerns whether a government will be unwilling or unable to meet its loan obligations, or is likely to renege on loans it guarantees.

Political Risk

Political risk is the projection of possible losses that result from political and social sources. Such setbacks may come from government-imposed inconvertibility of currency; expropriation or nationalization by a government or political faction; international war or civil strife damage; contract repudiation by a government; negative government actions such as a unilateral tariff imposition; process deterioration – e.g., the inability to enforce copyright agreements; or event intervention such as the kidnapping of managers or executives by a guerrilla group (Howell 1999; Shapiro 1992, p. 504).

The Case of Northern Cyprus

In this study, the case of Northern Cyprus has been selected to explain the importance of foreign investments for the tourism sector. Therefore, firstly the economy and investment climate of Northern Cyprus and current position of tourism sector will be focused before concentrating on the foreign investments in Northern Cyprus.

The Economy Of Northern Cyprus

Liberal economic system has been adopted in Northern Cyprus. Under this system the promotion of the private sector with limited government intervention. The rational use of natural resources, the encouragement of investments that generate high value added and employment preserve their priority and importance. The Gross National Product has been 651,380,055 million TL (1 039.9 US\$ million) at current prices of 2000. In terms of their contribution to GNP the four most important sectors are public services, trade-tourism, transport-communication, and industry. The shares of these sectors in GDP have been 16.4%, 16.4%, 12.3% and 12.2% respectively in the year 2000. The share of agriculture was 7.9% for the some year.

GNP per capita has been 4,978 US\$ in 2000, which indicates that the Northern Cyprus is in

the category of middle-income country group.

Northern Cyprus has a well-trained work force. The educational system of high standards in the Northern Cyprus aims to develop the abilities of all individuals. There are 13 technical and vocational high schools and 8 higher education institutions. Five of these higher education institutions offer instruction in English. The working population was 89,327 in 2000, which constituted 42.7% of the total population. According to the sectoral distribution. Of the working population, public services occupied the biggest share, which was 20.2% of the total employment in 2000. The share of the other sectors in total employment in 2000 were as follows; agriculture 17.1%, construction 15.8%, business and personal services 14.6%, trade-tourism 10.8%, industry 9.7%, transport- communication 9.1% and financial institutions 2.7%. There isn't acute unemployment in Northern Cyprus. The official unemployment rate has been 1.6% for the year 2000.

The rate of inflation in Northern Cyprus is measured by the Retail Price Index, which is based on the results of Household Consumption Expenditure Survey. The last survey was conducted in the years 1998-1999 and was introduced as from January 2001. Changes in the indices show that a high rate of inflation has been prevailing in Northern Cyprus. The changes in Retail Price Index for the years 1998, 1999 and 2000 have been 66.5%, 55.3% and 53.2% respectively.

The economy of Northern Cyprus has the peculiarities of an island economy with limited resources so foreign trade emerges as the major sector of the economy. Northern Cyprus has adopted a liberal trade policy and practices no discrimination against any foreign country. She has established trade relations with more than 60 countries all over the world. The volume of foreign trade has been 475.3 million US\$ of which 89.4 % constituted the total imports in the year 2000. Export earnings were tantamount to only 11.9% of the total imports while the amount of trade deficit came true as 374.5 million US\$ in 2000.

The export shares of the main groups in total exports are as follows: ready-made clothing 38.3%; citrus fruit 26.6%; processed agricultural products 24.2%. The import shares of the leading groups in total are as follows: machinery and transport equipment 29.6%; manufactured goods classified mainly by materials 21.4%; food and live animals 14.3%; mineral, fuels, lubricants and related materials 10.5%; chemicals 8.2% (SPO 2002, pp. 4-6; DPÖ 2002, pp. 3-5).

Investment Climate in Northern Cyprus

From a foreign investor's perspective, Northern Cyprus is any country as any other country to be considered for FDI. Therefore, a rational investor will consider risk and expected return on investment as the basic criterion in addition to other determinants of FDI one in order to determine the country to make investment. The contrary to this criterion has been observed with the exception of Polypeck (UK Company) making investments in tourism and agricultural sectors because of the entrepreneur's Cyprus nationality.

There is no any doubt that foreign investors face very high rate of country risk and low possible expected return in Northern Cyprus because of political risk, economic instability and legal, bureaucratic and administrative difficulties encountered. These components are particularly important when compared with those of South Cyprus. In relation to foreign investments, South Cyprus is the most important competitor of Northern Cyprus since they share the Cyprus Island and carry almost the same characteristics of small island economics.

The basic factors that create high country risk and low possible expected return in Northern Cyprus can be summarized as follows:

- Northern Cyprus named as Turkish Republic of Northern Cyprus (TRNC) is not recognized by the international community except Turkey and she is seen as an area occupied by the Turkish army since summer of 1974 (Martin 1993; Bıçak & Akifler 1999).
- The economic embargoes imposed on the Northern Cyprus by The European Court of Justice in 1994 (TÜSİAD 1998, p. 15).
- There are no direct flights to Northern Cyprus except from Turkey. This factor increases the time and cost of flights and makes it less attractive for tour operators to deal with (Bıçak & Altınay 1999; Dayıoğlu 2002).
- The ruling of the European Court of Human Rights asserting that Turkey violates property rights in Cyprus (European Report 2000).
- The existence of United Nations (UN) shows continuation of cease -fire and possibility of war.
- Infrastructure problems such as water, electricity, roads and public transportation have not been solved yet (DPÖ 2001, pp. 208-209; KKTC Başbakan Yardımcılığı 2000, pp 14-15).
- There is the absence of institutional planning event in Northern Cyprus. In such a way that physical country plan and sectoral master plans have not been prepared and applied yet (Şafaklı & Özdeşer 2002).
- When Northern Cyprus is compared with South Cyprus as the most important and nearest competitor regarding attracting foreign investments, it is obvious that South Cyprus is more favorable investment destination. Because Northern Cyprus is behind the South Cyprus concerning economic and sectoral indicators. The contribution of tourism to GDP, employment, bad capacity and tourist arrivals (thousand) are 19 %, 9.7 %, 86151 and 2222,7 in South Cyprus respectively (www.stockwatch.com.cy; Dept. of Statistics and Research 1999, pp. 19; www.kypros.org). Whereas the same figures for Northern Cyprus are 3 %, 3.8 %, 8972 and 393 for the year of 1998 respectively (DPÖ 2002, pp. 70-71; TRNC Ministry of Tourism and Environment 2002, p.15, 58).
- Any economic instability of Turkey that consists of crisis, high inflation rates, interest rate changes, exchange rate changes and recession affects directly and indirectly Northern Cyprus.
- Serious potential environmental problems exist in Northern Cyprus. In addition to the absence of physical country risk, protection and development of environment do not depend on environmental plan. This plan has not been prepared and applied yet. Moreover, there is no any single authority planning, applying, organizing and coordinating the matters related to the environment.

Both South Cyprus and Northern Cyprus sharing the same island carry the characteristics of small island economics. Therefore, their economic development depends on tertiary sectors specially tourism due to diseconomies of scale, limited capital and market size, transportation costs and high vulnerability to external shocks (Kakazu 1994, pp. 4-8; Tahiroğlu 1993, pp. 72-73).

When geographic, climate conditions, historical heritage and current technological developments are considered as a whole, the following potential investment opportunities or possibilities can be observed:

- Northern Cyprus has comparative advantage in special interest tourism including “Sea Tourism” which is explained by “sea-sand-sun”, “Health Tourism”, “Yacht Tourism”, “Cave Tourism”, “Mountain Tourism”, “Farm Tourism”, “Hunting Tourism”, “Golf Tourism”, “Caravan Tourism”, “Religious Tourism” and “History Tourism” which are examined under one title as “Cultural Tourism” in most of the sources and shown as the varieties of special interest tourism (Şafaklı & Erkut 2001).
- National parks can be established.
- The build-operate and transfer model especially for energy sector can be applied.
- Students for the higher education from third world countries can be attracted.
- Since Cyprus is surrounded by sea and close to the oil producing areas, navigation, fishery, transportation and other related activities could be developed (KKTC Cumhurbaşkanlığı 2000, pp. 4-5).
- Industrial production not requiring huge amount of capital and not suffering from diseconomies of scale such as toys, software and assemblage can be preferred.
- In the communication sector, technological investments such as Voice Over Internet Protocol (VOIP) can be made.

Economic Importance and Financing Figures of Tourism Sector in Northern Cyprus

Tourism sector of Northern Cyprus carrying the characteristics of small island economics is given priority as the locomotive sector on the development of the country (Şafaklı 2004, p. 123). However, even though tourism played important role in the economy when tourism revenues and balance of payments are considered its contribution has not been enough to carry the full responsibility of locomotive position as shown in Table 1.

Table 1: The Economic Importance of Tourism Sector in Northern Cyprus (1993-2003)

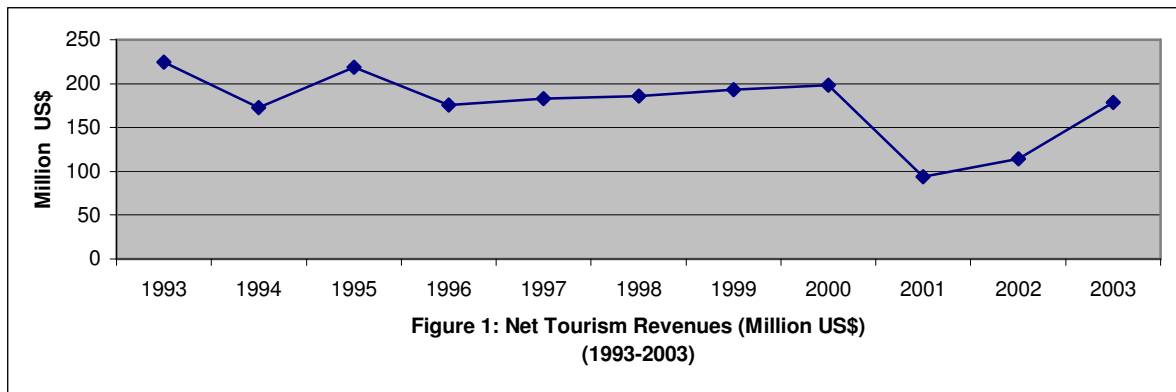
| Years | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| Net Tourism revenues (US\$) | 224,6 | 172,9 | 218,9 | 175,6 | 183,2 | 186 | 192,8 | 198,3 | 93,7 | 114,1 | 178,8 |
| Tourist Arrivals | 359313 | 351628 | 385759 | 365116 | 399364 | 393027 | 414015 | 432953 | 365097 | 425556 | 469867 |
| Revenue Per Tourist (US\$) | 625,0 | 491,7 | 567,4 | 480,9 | 458,7 | 473,2 | 465,6 | 458,0 | 256,6 | 268,1 | 380,5 |
| The Ratio of Net Tourism Revenue To Trade Balance (%) | 72,6 | 74,1 | 73,3 | 70 | 61,3 | 55,2 | 53,5 | 53 | 39,5 | 43,2 | 41,9 |
| Share of Tourism in GDP (%) (1977 Prices) | 3 | 3,3 | 3,3 | 2,8 | 3 | 3 | 3,1 | 3,2 | 3 | 3,4 | 3,2 |
| Share of Tourism in Employment (%) | 3,6 | 3,7 | 3,8 | 3,6 | 3,8 | 3,8 | 4 | 4,1 | 4 | 4,5 | 4,4 |

Source: 1- SPO (2004), *Economic and Social Indicators 2003*, State Planning Organization Follow up and Coordination Department, Nicosia, pp. 2-3, 11, 70-71.

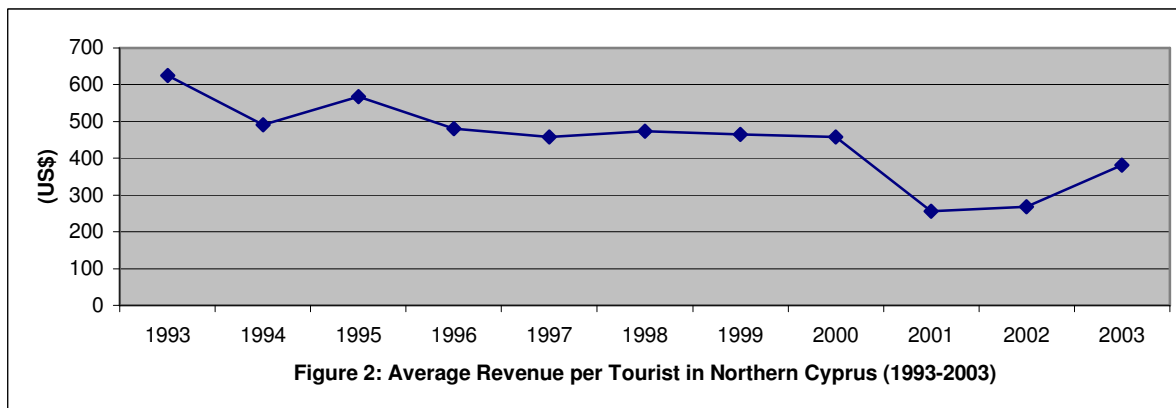
2- Tourism Planning Office (2003), *Statistical Yearbook of Tourism 2002*, TRNC Deputy Prime Ministry, Nicosia, p. 61.

3- Tourism Planning Office (2003), *Statistical Yearbook of Tourism 2003*, TRNC Deputy Prime Ministry, Nicosia, p. 57.

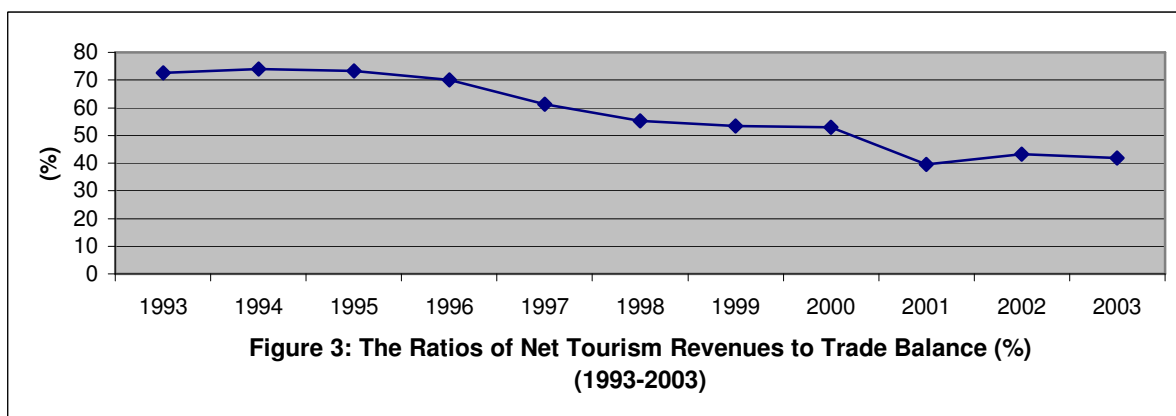
As clearly seen in Figure 1 tourism revenues did not show stability during the period between 1993-2003. Furthermore, they fell down when 1993 figures are considered. Such that tourism revenues of 2003 occurred approximately 80 % of 1993's with the effect of economic and foreign currency crises observed.



Expectedly, net tourist revenue showing the quality of tourist also did not show stability. Furthermore, there had been a net decrease in per tourist revenue when the years of 1993, 1995, 2000 and 2003 are analyzed (Figure 2).



Both the downfall of net tourism revenue and instability of per tourist revenue naturally influenced the share of net tourism revenue to trade balance in a negative way. As indicated in Figure 3, the share of net tourism revenue has begun to decrease since 1994, and the rate of 74.1 % in 1994 regressed to the rate of 41.9 % in 2003.



Share of tourism in Gross Domestic product (GDP) did not demonstrate remarkable change and limited to around 3 % during the years between 1993-2003. According to this, tourism proved to have lowest share in GDP. Such that, the shares of public sector, transportation-communication, trade, industry and agriculture reported for the year of 2002 were 15.1 %, 12 %, 12.7 %, 11.6 % and 10.6 % respectively (SPO 2004, pp. 10-11).

Contrary to expectations the assumed role of tourism as locomotive is not reflected according to financing and investment figures as shown in Table 2. Even though a relative increase has been observed, the share of tourism in fixed capital investments did not exist 6 %. More desperate issue of fact is realized when bank loans are taken into consideration. While the share of tourism in total private bank loans was 2 % in 1995, it regressed to the rate of 1 % in 2003. On the other hand, Development Bank credits to tourism sector showed the similar instability. While the Development Bank credits to tourism sector showed increases in US\$ terms till 1998, after this year it recorded enormous and hard to explain decreases as shown in Table 2:

Table 2: Fixed Capital Investments and Financing Figures of Tourism Sector in Northern Cyprus (1995-2003)

| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|--|---------|----------|---------|-----------|-----------|---------|----------|----------|--------------|
| Fixed Capital Investments of Tourism (Current Prices Million TL) | 161602 | 323437,2 | 1049479 | 2201158,6 | 3469195,3 | 5108314 | 5822411 | 10996958 | 10996958,4 |
| The Ratio of Tourism in Fixed Capital Investments (%) | 3,8 | 3,7 | 4,8 | 5,4 | 4,8 | 5,0 | 4,1 | 5,9 | 5,9 |
| Bank Loans to Tourism Sector (Current Prices Million TL) | 493305 | 714424,1 | 1533509 | 3832464 | 8782531 | 4438017 | 10454780 | 10454780 | 7.745.439,00 |
| The Ratio of Total Bank Loans to Tourism i(%) | 2,0 | 1,6 | 1,4 | 1,6 | 1,6 | 0,8 | 2,0 | 1,4 | 1,0 |
| Development Bank Credits to Tourism (US\$) | 3037109 | 5582698 | 7556133 | 10487036 | 9395259 | 2015564 | 780073 | | |

Source: 1- SPO (2004), *Economic and Social Indicators 2003*, State Planning Organization Follow up and Coordination Department, Nicosia, pp. 28-29, 48-49.
2- TRNC Development Bank

When compared with similar tourism centres in the Mediterranean region, the Northern Cyprus is well below its potential with regard to tourism indicators. First of all, The Greek Cypriot which has been controlling Republic of Cyprus, earns in excess of USD 2 billion annually from tourism compared with the TRNC earnings of around USD 200 million in a successful year. Furthermore, when the most vital indicators such as tourist arrivals, bed capacity, share of tourism in GDP and share of tourism in employment are compared in Table 3; tourism industry of Northern Cyprus lags behind its biggest competitor the South Cyprus. Specially it should be cited that, share of tourism in employment, share of tourism in GDP and average revenue per tourist in South Cyprus is approximately three, five and two and half times respectively greater than North Cyprus.

Table 3: Basic Economic and Tourism Indicators of North and South Cyprus (2003)

| | North Cyprus | South Cyprus |
|--|--------------|--------------|
| GNP (Million US \$) | 1283.7 | 10027.89 |
| Per Capita GNP (US \$) | 5949 | 13947 |
| Inflation Rate (%) | 12,6 | 4,14 |
| Number Of Accommodation Establishments | 128 | 951 |
| Bed Capacities | 11858 | 95185 |
| Number of Tourists | 469867 | 2303246 |
| Share of Tourism in Employment (%) | 4,4 | 13 |
| Tourism Receipts (Million US \$) | 178.8 | 1986 |
| Share of Tourism Receipts in GNP (%) | 13,9 | 19,8 |
| Share of Tourism in GDP (%) | 3,2 | 15,5 |
| Average Revenue Per Tourist (US\$) | 380,5 | 862,2 |

Source:1- SPO (2004), *Economic and Social Indicators 2003*, State Planning Organization Follow up and Coordination Department, Nicosia, pp. 2-3, 58-59.
2. <http://www.cyprus.gov.cy/cyphome/govhome.nsf/LookupIDs/9DBD25AB8A81C9FAC2256B6B002F977A?OpenDocument&languageNo=1>, May 29, 2005.
3- <http://www.odci.gov/cia/publications/factbook/geos/cy.html>, May 30, 2005
4- <http://www.studentsoftheworld.info/infopays/rank/PNBH2.html>, May 30, 2005

Foreign Investments in the Tourism Sector of Northern Cyprus

Encouragement of foreign investment is among the primary objectives of Northern Cyprus' development policy. Consequently those wishing to invest in Northern Cyprus can be sure of a positive Government attitude.

In accordance with its development policy Northern Cyprus is giving preferential treatment to export-oriented industries. Due to its small domestic market the authorities geared to export markets and they readily grant approval for foreign investment of such kind. Government policy also encourages capital / technology - intensive projects. Priority is given to those projects that facilitate transfer of modern technology, know-how and new management techniques into Northern Cyprus.

Cooperation between local and foreign firms in the form of joint ventures is actively promoted, and Northern Cyprus offers numerous advantages and incentives to the foreign investor including full protection of his property rights. Nationalization has never been part of government policy nor is it contemplated in the future. The Constitution of Northern Cyprus guarantees the right of private property while it does not discriminate between citizens and aliens (SPO 2002, pp. 8-9).

In Northern Cyprus, the lack of technology, capital and administrative knowledge is observed. For this reason, foreign capital has a great importance for the economy Northern Cyprus. Therefore, authorities urge to attract foreign investors by providing new incentives, and aiming to abolish all bureaucratic, legal and administrative obstacles discouraging the foreign investors.

In Table 4 and Figure 4, the amounts of foreign investments separated according to their origins are given. In addition to this, total fixed capital investments are given in table 4 in order to determine the place of foreign investment within the total fixed capital investment in Northern Cyprus. As it is shown, foreign investors have not even reached the 2 % of total fixed capital investments in any time. Regarding the origin of foreign investments, especially after 1999 the ratio of foreign investments from Third World Countries apparently decreased and the basic origin of foreign investments became Turkey.

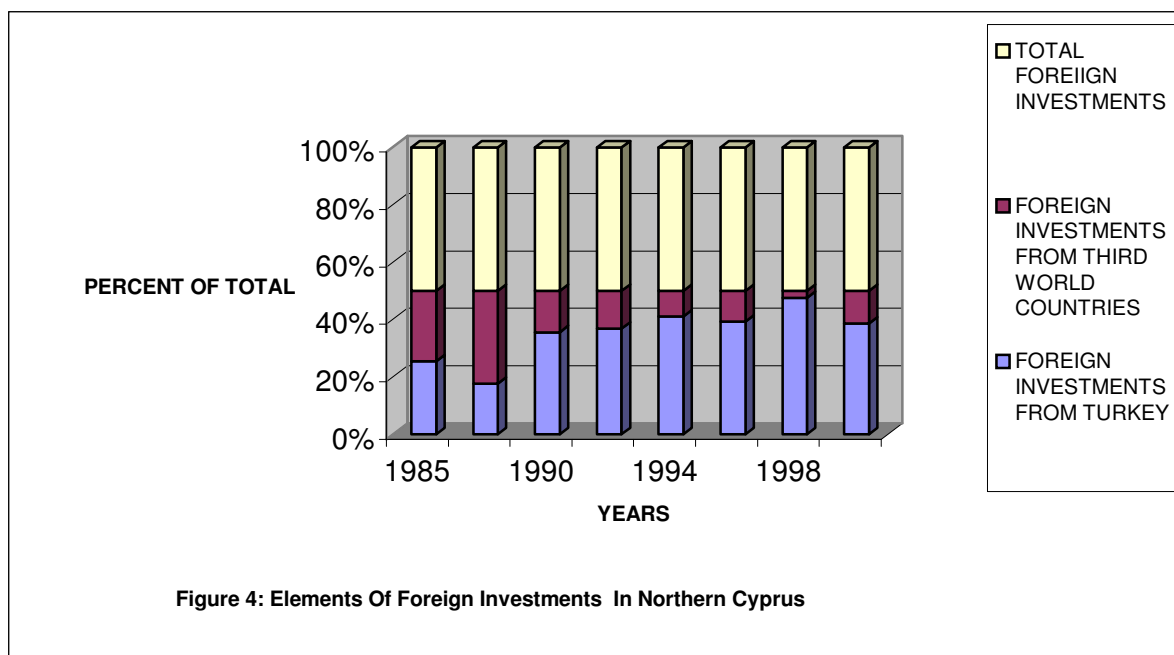
Table 4: The Amount Of Foreign Investments And Fixed Capital Investments In Northern Cyprus
 (Current Prices Million TL)

| | 1985 | 1987 | 1990 | 1992 | 1994 | 1996 | 1998 | 2000 |
|--|--------|--------|---------|--------|---------|---------|----------|-----------|
| Foreign Investments From Turkey | 14,2 | 86,7 | 2181,1 | 3573,2 | 19398,5 | 90496,3 | 700901,5 | 214999 |
| Foreign Investments From Third World Countries | | | | | | | | |
| (Foreign Currency Equivalent TL) | 13,7 | 158,8 | 881,1 | 1282 | 4248,2 | 24902,7 | 37793,6 | 64000 |
| Total Foreign Investments | 27,9 | 245,5 | 3062,2 | 4855,2 | 23646,7 | 115399 | 738695,1 | 278999 |
| Total Fixed Capital Investments | 21005 | 55982 | 236220 | 536155 | 2215174 | 8842789 | 41049517 | 102823020 |
| Foreign Investments/ Fixed Capital Investments | 0,0013 | 0,0044 | 0,01296 | 0,0091 | 0,01067 | 0,01305 | 0,017995 | 0,0027134 |

Excluding off-shore banks and firms

Source: 1- SPO 2002, *Economic and Social Indicators 2000*, TRNC Prime Minister State Planning Organization Follow up and Coordination Department, Nicosia, pp. 28.29

2- TRNC Ministry of State and Deputy Prime Ministry 2002



It is essential to identify the number of tourist accommodation establishments and bed capacity by categories in Northern Cyprus before quantifying the importance of foreign investments for the tourism sector in this respect. This data is detailed in Table 5. As it is seen in the table total number of tourist accommodation establishments and bed capacity in Northern Cyprus are 107 and figures of foreign investments in the tourism sector of Northern Cyprus are 13.3 % and 4.15 % respectively 10507 respectively. In this table, the percentage of total beds for each category is also given.

Table 5: The Number Of Tourist Accommodation Establishments And Bed Capacity By Categories In Northern Cyprus (2001)

| Categories | No. Of Units | Percent Of Total Units | No. Of Beds | Percent Of Total Beds |
|------------|--------------|------------------------|-------------|-----------------------|
| 1 STAR | 38 | 35,5140187 | 1398 | 13,30541544 |
| 2 STARS | 33 | 30,8411215 | 2202 | 20,95745693 |
| 3 STARS | 23 | 21,4953271 | 2855 | 27,17236128 |
| 4 STARS | 8 | 7,47663551 | 1932 | 18,38774151 |
| 5 STARS | 5 | 4,6728972 | 2120 | 20,17702484 |
| TOTAL | 107 | 100 | 10507 | 100 |

Source: Tourism Planning Office (2002), Statistical Yearbook of Tourism 2001, TRNC Deputy Prime Ministry, Nicosia. pp. 15,17.

In an interview we conducted on 4th of September 2002, Mr. Turgut Muslu as the assistant director of TRNC tourism planning office quantified the importance of foreign investments in the tourism sector of Northern Cyprus as detailed in Table 6. When Table 5 and 6 are analyzed together, the ratio of the number of tourist accommodation establishments and bed capacity of foreign investors to the total figures in the sector are 14.01 % and 27.96 % respectively. The most interesting finding to be pointed out is the importance of foreign investments for 5 stars category. 4 out of 5 tourist accommodation establishments belong to foreign investors. This is tantamount to 94.90 % of total bed capacity of 5 stars category and 19.15 % of total beds in the sector. Another interesting result is the origin of foreign investments in the tourism sector of Northern Cyprus.

Table 6: The Number Of Tourist Accommodation Establishments And Bed Capacity By Categories Of Foreign Investors In Northern Cyprus (2001)

| Categories | No. Of | No. Of | Percent Of Total |
|--------------|-----------|-------------|--------------------|
| | Units | Beds | Beds In The Sector |
| 1 STAR | 5 | 170 | 1,617968973 |
| 2 STARS | 2 | 144 | 1,370514895 |
| 3 STARS | 3 | 362 | 3,445322166 |
| 4 STARS | 1 | 250 | 2,379366137 |
| 5 STARS | 4 | 2012 | 19,14913867 |
| TOTAL | 15 | 2938 | 27,96231084 |

Source: Muslu, T., Assistant Director of TRNC Tourism Planning Office 2002, Conversation, 4 September.

The majority of foreign investors' tourist accommodation establishments have the origin of Turkey. There are only two establishments that are British originated. These are 1 star and 2 stars establishments. The ratio of these two establishments' number and bed capacity to the total figures of foreign investments in the tourism sector of Northern Cyprus are only 13.3 % and 4.15 % respectively.

Conclusion and Recommendations

As a conclusion, the basic findings of the paper confirm the conceptual foundations of FDI. In other words, the key premises of relevant theory asserting that there is an inverse relationship between country risk and FDI are observed in Northern Cyprus. Attracting foreign investments to the Northern Cyprus carries very important difficulties particularly because of the political risk component of country risk as mentioned before. When looked at the investment climate in, most of the determinants needed to attract FDI are missing in Northern Cyprus. The most vital determinants that are not at desired level are unit labor costs, market size, natural resources, gravity factors, economic and political stability, political risk, private sector development, transaction costs, transportation and communication costs, quality of infrastructure, bureaucracy, policy framework for FDI and investment incentives. Eventually, these critical determinants create high country risk that leads to the risk of a shortfall in the expected return of FDI.

The origins of foreign investments are also apt to the same theoretical foresight. Naturally, majority of foreign investors come from Turkey since the state of Turkey shares the high country risk by giving the full guaranty to the investment made in Northern Cyprus. Although this given guaranty, foreign investments in Northern Cyprus take the form of the acquisition of an existing enterprises or their renewal rather than the establishment of a new enterprise in order to minimize the inherent risk. Moreover, foreign investors hesitate to invest huge amount of capital and prefer to take credit from TRNC Development Bank. Eventually, this makes the quality and contribution of foreign investments questionable.

Foreign investments in the tourism sector of Northern Cyprus concentrated mainly on the 5 stars category tourist accommodation establishments. The most probable reason of this is the investment opportunity created after the prohibition of gambling in Turkey. This opened the way to Northern Cyprus as the favorable place for gambling tourism. Consequently, Turkey's businessman came to Northern Cyprus and acquired 5 stars establishments most suitable for gambling tourism.

In summary, there is not a favorable investment climate in Northern Cyprus because of the high country risk. So, this risk can be minimized either through solution to the Cyprus problem and European Union (EU) membership or further economic integration with Turkey

which is not within the scope of this paper. In addition to this, the following recommendations can also be made in order to attract FDI to Northern Cyprus.

- An efficient and stable policy framework for FDI should be formulated.
- Sectoral development of the country including environment should be institutionally planned. Specially, national physical plan and tourism master plan are vital for attracting and managing FDI activities.
- Efficient competition and other elements of free enterprise system, which is essential for the private sector development, should be actualized.
- Transportation and communication costs should be subsidized.
- In addition to quality of Infrastructure for touristic institutions, overall infrastructural quality of Northern Cyprus should be pursued.
- When considered Southern Cyprus, investment promotion and incentives should be brought to an attractive level.
- Bureaucracy for the FDI should be simplified.
- Because of the insufficient state budget, the build-operate and transfer model especially for solving energy problems can be applied.
- Alternative tourism such as “health”, “congress” and others considering the geographic and climate conditions of the country should be targeted. Furthermore, establishment of national parks can be proposed in this respect.

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