Bullying Cyprus to No End

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After prolonged negotiations, the government in Cyprus and the troika running Europe from above—the European Union (led by Germany), The European Central Bank and the IMF—announced a "deal" late March to resolve the crisis in Europe. It involved a 10 billion euro bailout that is expected to prevent a collapse of the Cypriot banking system by drastically restructuring it and keep the government running. But in return for that 10 billion euro, the Cypriot government has been pressured into mobilising an additional 5.8 billion euro to finance the so-called bailout that can render the whole exercise infructuous.

A chunk of that 5.8 billion would come from those holding deposits in excess of 100,000 euro in the two biggest banks in Cyprus—the Bank of Cyprus and the Laiki (or Popular) Bank. As part of the restructuring Laiki Bank will be closed down, and all deposits of 100,000 euro and less with it will be transferred to the Bank of Cyprus and would not be subjected to any loss since they are insured. Deposits exceeding 100,000 euro at Laiki would be shifted to a "bad bank" and similar-sized deposits at the Bank of Cyprus are to be frozen, so that a levy can be imposed on such deposits to garner a large share of the 5.8 billion that the Cypriot government has been required to place on the restructuring table. That levy has been speculatively placed at 30 per cent or more. It is unclear whether the balance deposits remaining after the levy in the "bad bank" version of Laiki would be worth their par value or would be required, along with shareholders and other investors, to suffer a further loss in value when the bad bank is liquated. In addition, funds of large depositors at the Bank of Cyprus would be replaced with equity as part of the recapitalisation plan. Non-insured depositors are set to suffer large losses the magnitudes of which remain uncertain.

This is being presented as an improvement over an earlier version of the deal that was being negotiated in which insured depositors in Cypriot banks would be subjected to a levy of 6.75 per cent and others of close to 10 per cent or more. The former levy would have amounted to reneging on the promise that deposit insurance implies and if it had been given the seal of approval of the troika would have sent out signals that would have had implications for banks elsewhere in Europe and the world. Uncertain about the fate of their savings kept with banks, depositors would have been encouraged to withdraw them and run at the first sign of bank weakness, destabilising the system. Sense prevailed and the proposal was dropped.

But the dropping of this version of the deposit levy (ostensibly advocated by the Cypriot government to reduce the hit on large foreign, especially Russian, depositors) from the deal is small recompense. The fact that even depositors (however large) could, like speculative investors in bonds and securities, be subjected to "haircuts" in times of difficulty is bound to reduce faith in the financial system. While that has global implications, its immediate effect could be felt in Cyprus when banks reopen after a long period when they were kept shut and depositors permitted only limited access through ATMs to their money. There is no guarantee that in the new environment a recapitalised Bank of Cyprus can mobilise adequate deposits and find the kind of borrowers needed for a return to profitability. Even as a purely financial bailout this deal may not realise its objectives.

But there is more to the deal than the restructuring of banks and a levy on large depositors. The deal is also expected to ensure that the access to outside funding is not accompanied by a significant increase in Cypriot public debt to finance the domestic share in the bailout package. It requires the government to mobilise from elsewhere any shortfall in its share of the bailout fund of 5.8 billion euro. During the negotiations, there was talk of using land (held by the Orthodox church), money from the pension funds and bonds linked to future revenues from recently discovered gas as sources of extra Cypriot funding. But reliance on even one or more of these can only be a beginning. Some "restructuring" of public finances in the form of a reduction in the fiscal deficit to GDP ratio and in the ratio of accumulated public debt to GDP is also inevitable. A period of severe austerity is predicted by all, worsened by the fact that even a restructured banking system would not be in a position to keep credit flowing, especially to small and medium businesses, when such credit is needed most.

Thus, it is the turn of Cyprus (after Ireland, Iceland, Portugal and Greece) to be the European nation under siege. The situation illustrates once more that though member countries of the European Union are part of a 'community' when times are good, they are alone and unwanted when times are bad. This leads not only to a sense of social and political betrayal. It also invites rebellion by ignoring the fact that the road to crisis in Europe is laid and paved during the good times, making the problem as much a European one as it is an Irish, Portuguese, Greek or Cypriot one.

Let us return to Cyprus. In terms of the conventional indicator of performance, GDP growth, between 2003 and 2008 the country recorded a comfortable average of 3.8 per cent, as compared to a much poorer 1.9 per cent in the case of the 17 Euro area countries as a group. However, the problem with Cyprus, as was true of many other less developed EU countries, was that much of this growth was not driven by the expansion of commodity production. Rather services, especially tourism, banking and real estate, were the growth centres. Services accounted for as much as four-fifths of GDP.

In this, banking growth in Cyprus was special. Reasonable interest rates, an accommodative banking sector and the lowered currency risk after Cyprus joined the European Exchange Rate Mechanism in May 2005 and the Eurozone in January 2008 meant that banks in Cyprus were a safe haven to hold deposits. They began attracting depositors from abroad, especially Russia. In the event, Cyprus became a small country with relatively big banks. Bank assets were, at their peak, as much as 8 times the country's GDP. This in itself was not a problem. Funding loans with deposit money rather than other forms of volatile and high cost capital is reflective of strength rather than weakness. Nor were these banks exposed to risky financial assets, being engaged predominantly in lending. Unfortunately, their credit was highly concentrated in terms of country exposure, with the private and public sectors in Greece and Cyprus accounting for 85 per cent of lending by the two big banks—Laiki and Bank of Cyprus.

That exposure meant the Eurozone crisis hit Cyprus hard. In February last year, Bank of Cyprus announced losses of 1 billion euro, while the Laiki Bank announced losses of 2.5 billion. The haircut on Greek government bonds and losses on lending to the private sector soon stressed the banks and rendered Laiki insolvent. In June 2012 the government recapitalised Laiki Bank and ended up owning 84 per cent of the bank's equity. But the environment was harsh, as a result of difficulties in the tourism and construction sectors resulting from the global crisis and the shift of its focus to the Eurozone. The economy registered negative growth of 1.7 per cent in 2009, low growth in 2010 and 2011, and contracted again (by 2.3 per cent) in 2012. As a result matters went out of hand. But this was not a case of a government gone berserk. As part of the adjustment to enter the Eurozone Cyprus had brought its government budget deficit down to 0.9 per cent in 2008. Even in 2010, after the crisis had hit, the deficit on the budget of the government in Cyprus was 5 per cent of GDP. The problem was that tied down by Eurozone conditionalities the government was in no position to reverse the downturn or bail out its oversized banks.

In sum, the problem in Cyprus was as much or more a problem of the Eurozone as a whole, rather than one internally generated. Yet Cyprus has received treatment very different from that given even to Greece., though the absolute size of the bailout of around 17 billion euros is small by recent standards. Since those likely to lose from letting the Cypriot banks slide or close and from imposing austerity on a small nation are not part of the core in the Eurozone, an extraordinary bailout has been imposed on the country. All that seems to have mattered is ensuring that outlays by the troika are limited even when the Cypriot government is prevented from borrowing to stay afloat. This does make the troika appear to be the neighbourhood bully. But more importantly it has damaged its credibility making it difficult for anyone to believe that if difficulties intensified in a larger economy like Spain or Italy the will and the intelligence needed to resolve the crisis exists. In each round of ostensible crisis-resolution the troika seems to be taking Europe closer to the big one rather than reversing what seems to be a steep decline. This will continue so long as the cost of protecting the euro and the Eurozone is borne by the periphery and not the core.

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