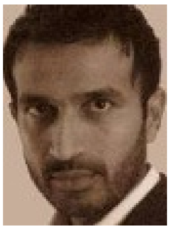
The Cyprus fiasco has all the hallmarks of a classic 'whodunnit'

by Blog Admin



Cyprus's parliament has rejected a proposed agreement to levy €5.8 billion from Cypriot bank accounts as part of the country's bailout deal. **Sony Kapoor** *argues that despite the extremely negative reaction to the proposal, the other options facing Cyprus are no more appealing. Seeking assistance from Russia through the gas company Gazprom might generate long-term complications for the country, and the collapse of the Cypriot banking system would have far more severe consequences than the proposed bank levy.*

The Cyprus fiasco has all the hallmarks of a classic 'whodunnit'. Someone somewhere took a decision that now no-one, nowhere, appears to have made – to impose an unprecedented levy on bank deposit holders in Cyprus. Most commentary on the deal has been terribly negative, sometimes alarmist: that it will spark off bank runs in Spain, or that it rips the shirts off the backs of the poor in Cyprus. There were some exceptions to this negative coverage, including yours truly.

One school of thought agreed with the need for a depositor bail-in, but was uncomfortable with not exempting depositors under the €100,000 deposit insurance cap (though technically such a limit is irrelevant for the clever levy that has been proposed). I belong to this school and did not criticise the concept of bailing-in depositors, having agreed with the IMF that this was both fair and unavoidable in order to make the numbers add up in the rescue of Cyprus.

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A second school of thought, much more widespread than the first one, believed that bailing-in depositors of any kind was a barmy idea that would fuel bank runs across the Eurozone. I believe that the alternative of sovereign default would have been much worse; it is impossible to imagine a safe banking system in a sovereign undergoing restructuring of debt. Remember how much capital Greek banks needed after it defaulted? In fact, Cyprus would probably not have needed a bailout if its banks had not incurred huge losses on holdings of Greek debt. Add to this the complication that half of Cyprus's sovereign bonds are under foreign (English) law, which makes a successful restructuring of sovereign debt much harder. Moreover, Cypriot banks hold large swathes of its sovereign bonds, so it would be further bankrupted by any sovereign restructuring.

A second alternative would have been that the EU and IMF give a full €17 billion loan to Cyprus, but this leads us back to sovereign restructuring, as Cyprus would have ended up with an unsustainable debt burden. A third option would have seen Cyprus get international aid or transfers (not loans), at least for some of the amount. This would have worked well for Cypriots, but it is unclear who should have given this aid or indeed why they would have done so. The possibility of a direct recapitalisation of Cypriot banks by the European Stability Mechanism (ESM), discussed under now-shelved plans for a banking union, would also have helped (provided this was done without a sovereign guarantee). But because the banks are essentially bankrupt and losses have already materialised, it would be highly unlikely that the ESM would ever get its money back in full. This then is again a transfer.

While such explicit or implicit transfers may be possible and may yet come about after yesterday's rejection of the Eurogroup deal by the Cypriot parliament, they will simply not be enough. Given how entrenched the belief that much of Cypriot bank deposits comprise dodgy Russian money is, it is hard to see any EU leader, particularly Angela Merkel, signing their own political death warrant by being seen to 'use scarce taxpayer funds to bail out Russian money launderers and oligarchs'. In any case, as Charles Goodhart and I wrote in the Wall Street Journal in January, the Banking Union has become a Sham.

A fourth option takes the form of an offer by the Russian gas giant Gazprom (in effect with the backing of the Russian government) to support the Cypriot banking system (thereby protecting the Russian oligarch depositors now) in exchange for rights for exploration and exploitation of what seem to be Cyprus's promising gas fields. The history of Africa and Latin America is littered with extortionary contracts with foreign mineral and oil firms, which take more than their pound of flesh of resource rents having struck juicy bargains with countries under duress. There is little reason to suspect that this deal would not carry a steep long-term price for Cypriots. They may win the battle with the Eurogroup, only to lose the war to the Russians.

A fifth option, put forward by Buchheit & Gulati focuses primarily on a forced extension of maturity of both the sovereign debt of Cyprus as well as bank deposits in excess of €100,000. This means that it falls somewhere between the discussion on bailing-in depositors and the restructuring of sovereign debt, and shares the burden of adjustment between the two. It does not discuss how the presently bankrupt Cypriot banks would be capitalised, so merely offers the possibility of extending the twilight zone that has existed in Cyprus since the restructuring of Greek debt bankrupted its banks. It is hard to see how this twilight zone could be allowed to continue much longer and in fact the ECB's threat to veto the continuing funding of the essentially bankrupt Laiki bank was one of the factors that forced the Eurogroup deal through.

So what are we left with?

First is the issue of 'whodunnit' – our instinct here is that despite the FT's excellent attempt at reconstructing what transpired, we will never really find out. It was some form of a collective decision trying to square a circle, but no-one had quite anticipated the almost universal condemnation of the deal, and the political earthquake of universal rejection by the Cypriot parliament. This matters a lot in terms of the very real trade-offs between tackling the Eurocrisis and tackling the democratic deficit, but it is not the focus of this piece.

Second, will this lead to widespread contagion? In my opinion the answer here is no, it will not. Cyprus is a known tax haven seeded with laundered money and a banking system worth 800 per cent of its GDP. Despite being wary of using clichés, we are forced to say that Cyprus, in this sense, is truly unique. Additionally, in all likelihood, any deal that will now be agreed in Cyprus will spare depositors under the €100,000 threshold. Depositors above that level do not enjoy any state guarantees in any case. Besides the situation in Spain and Italy is different enough for most people to understand that not much has changed in terms of how safe their deposits are, despite the so-called crossing of the Rubicon in Cyprus.

Third, who should pay? This is probably the hardest call to make. The alternative to the Troika support package or Gazprom deal is widespread bank failure. In such an event, there are large economic deadweight costs that will impose a burden on all Cypriot taxpayers, depositors and businesses. Given the limits of its sovereign financing capability, the Cypriot government will be unable to make insured depositors whole, so almost everyone in Cyprus will be worse off. This is why a sharing of the burden between depositors, taxpayers, as well as bank shareholders and bondholders is both fair and economically efficient.

Fourth, what will happen now? Provided a revised plan, with an exemption for small depositors, had been passed by the Cypriot parliament, not much would have happened. Contagion to other countries would have been limited and while depositors both domestic and foreign (Russian) would have withdrawn some funds, the ECB would have plugged the breach. All in all, a more progressive retrospective deposit to equity swap than the one that was agreed by the Eurogroup would probably have been a fair and economically efficient deal with limited contagion in the rest of the Eurozone. It is quite possible that even after the fiasco that the Cypriot deal has now become, such a deal may still be agreed.

However, the events of the last few days have probably sealed Cyprus's fate as a tax haven/financial centre for Russians, as they can no longer be relied on to have either the capacity or the political will to save their banking system. Coming closely on the heels of Iceland and Ireland – two other countries where bloated banking systems that were multiples of GDP proved to be too big to save – the lessons from Cyprus will also have ripple effects on other tax havens/financial centres.

The immediate problem Cyprus will face now is the prospect of large scale withdrawals, particularly by foreign depositors. Here the Buchheit & Gulati proposal to convert large deposits into term Certificates of Deposits (CDs) may have merit. Both capital and liquidity could then be provided by a conversion of large deposits into 15 per cent bank equity and 85 per cent CDs. This option, however, would likely annoy the Russians and may not be politically feasible. So the price that Cyprus may have to pay for partially bailing-in large depositors may be to lose the rest. The loss of funding, which is still likely to be a slow jog rather than a full run, can, at least in theory, be replaced by ECB and market funding of what will then be well-capitalised banks.

The fifth and final question is: what does this mean for the Eurocrisis? Here my thoughts are clear. Even before the Cyprus fiasco, the Eurocrisis had reached a 'point of almost no return' from which only a grand political bargain can rescue it. My thoughts on the general state of economic, financial, political and social affairs in the Eurocrisis, all of which Cyprus has made even worse, are captured in my recent piece 'The EU's self-defeating approach must end now'. All in all, the Cyprus saga almost surely spells either the beginning of the end of the Eurozone as we know it, or the end of the beginning (phase I) with a grand political bargain taking us into the next unknown.

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Note: This article gives the views of the author, and not the position of EUROPP – European Politics and Policy, nor of the London School of Economics.

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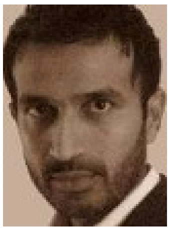

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