

Europe's Cyprus blunder raises important questions about the nature of EU decision-making and crisis management.

by Blog Admin

One week ago, the EU, IMF and European Central Bank agreed to a bailout for Cyprus that would involve a levy on the country's bank deposits. The terms of the bailout have been met with surprise and fury in Cyprus and across Europe, and were also rejected by Cyprus's parliament. [Nicholas Veron](#) writes that no matter the outcome, the crisis is likely to cause lasting damage to the trust of Eurozone households in the banking system, and to the EU's plans for banking union.



The late [Mike Mussa](#) of the Peterson Institute, a former Chief Economist of the International Monetary Fund (IMF), noted about some episodes of the late-1990s Asian financial turmoil that "there are three types of financial crises: crises of liquidity, crises of solvency, and crises of stupidity." This quip comes to mind when considering the developments of the past few days around Cyprus.

The March 16 announcement of an [agreement](#) backed by most European leaders and institutions as well as the IMF, which called for a tax (or possibly an unfavorable cash-for-equity swap) on holders of bank deposits, no matter how small, was a policy blunder that is likely to cost the European Union (EU) dearly.

The sequence that led to this "Saturday-morning plan" is well known. Greece's sovereign debt restructuring a year ago hit Cypriot banks that had bought Greek bonds, raising doubts about the Cypriot government's own solvency. Negotiations on a possible bailout by the EU had been seen as inevitable as early as mid-2012. But discussions were frozen until a general election in Cyprus last month. Unfortunately, the delay pushed the timetable of negotiation into German election cycle territory, constraining the latitude of the euro group of eurozone finance ministers, in which Germany is now the unquestioned central actor. Driven by the domestic German political debate, European negotiators were intent on forcing losses on large (read Russia-linked) Cypriot deposits as an indispensable component of the package.

To the surprise of many, the recently elected Cypriot president, Nicos Anastasiades, added a further twist to the tangled situation by suggesting a hit to small depositors as well. According to some reports, he wanted to limit the losses imposed on large depositors in order to preserve the island's future as an international financial center. All negotiators seem to have accepted this offer before realizing, too late, how damaging it might be to trust in the safety of bank deposits well beyond Cyprus. No easy or painless option was available for Cyprus. However, some of the Saturday-morning plan's flaws were avoidable.

First, the plan disregarded the lessons of financial history about the high importance of deposit safety, particularly for middle-class households (which is why there usually is an upper limit for explicit deposit insurance, harmonized at € 100,000 in the EU since 2009). Based on the experience of the early 1930s, it is virtually undisputed in the US that a breach of deposit insurance will primarily hurt the "little guys." Sheila Bair, the respected former Chairman of the US Federal Deposit Insurance Corporation, has [expressed](#) this view with reference to Cyprus. Similar lessons arise from the record of many recent emerging-market crises.

If it is true, as alleged, that Cyprus's own president was the one who recommended hurting small depositors, European negotiators were not justified in going along. After all, in November 2010 the Troika of the EU, the European Central Bank (ECB) and the IMF rebuffed the Irish authorities' proposal to "burn" the holders of senior unsecured debt in failed banks. Their concern was to prevent damaging contagion in the rest of Europe. A similar argument was more straightforward and sensible for Cyprus than it had been for Ireland, and should have led them to oppose Mr Anastasiades' proposal from the outset.

Second, the festival of [finger-pointing](#) in Brussels and across Europe following the Cyprus debacle shows that the negotiators had no “plan B” were the Cypriot Parliament to reject their initial scheme. One must wonder whether the EU is ready to handle the complex Russian side of the Cypriot equation, including the wisdom of [depending](#) on Russian goodwill for a solution to the current mess.

Third, the Saturday-morning plan raised profound questions about the democratic nature of EU decision-making. The problem is not that hard measures were to be imposed on the Cypriot population. A loss of autonomy, alas, is the inevitable consequence of the Cypriot state’s inability to meet all its commitments on its own, as Mr. Anastasiades had earlier [acknowledged](#). Moreover, Cyprus has earned no sympathy by rejecting the United Nations plan for the island’s reunification ahead of its entry into the EU in 2004, and for harboring Russian and Russian-linked financial activities widely presumed to be connected with money-laundering.

The problem, rather, lies in the extent to which the European crisis management is now being held hostage by German electoral politics. This dynamic is not new in the euro-crisis, but has reached new heights as Chancellor Angela Merkel’s main opposition, the Social Democratic Party (SPD), has identified Cyprus earlier this year as a “wedge issue” on which it could challenge her. The SPD calculation was to paint Ms. Merkel as too lenient with shady Russian oligarchs and their “black money” held in Cypriot banks, while she would presumably be prevented from responding because of a fear of destabilizing Europe’s financial system. In effect, Ms. Merkel called the SPD’s bluff by risking the euro zone’s first bank run. No wonder that placards on Nicosia’s streets carry slogans such as “[Europe is for its people and not for Germany](#),” or that Athanasios Orphanides, until recently the governor of the Cypriot central bank and a member of the European Central Bank (ECB)’s Governing Council, [complains](#) that “some European governments are essentially taking actions that are telling citizens of other member states that they are not equal under the law.”

It is too early to evaluate the lasting damage, but it is likely to be significant. The Saturday-morning decision-making process leaves an impression of incompetence and [groupthink](#), tainting all of the participating actors, including all euro zone finance ministers, the European Commission, the ECB, and the IMF. The EU’s earlier sense of purpose by committing to a banking union last June and [delivering](#) on its first step (the Single Supervisory Mechanism) in December has now been battered. So has the aura of statesmanship and control developed by Ms. Merkel and the ECB. Possibly most damaging, even if the deposit tax is reversed or adjusted, the trust of middle-class households throughout the Eurozone in the safety of their banking system has eroded. Hopefully there will be no immediate deposit flight in other countries than Cyprus. But in future crisis episodes, households will behave in a destabilizing way, assuming Europe’s deposit insurance arrangements are not profoundly reformed. There is an apt [parallel](#) with the Deauville declaration by Ms. Merkel and French President Nicolas Sarkozy, endorsing losses for Greek sovereign bondholders in October 2010, which started an 18-months cycle of increasingly negative market expectations throughout Europe.

What now? A week ago, the challenge in Cyprus was to close the fiscal gap with a bailout package. Now it is to close the fiscal gap, and to restore a minimal level of trust in the banking system, without which the economy cannot operate. This raises the bar. The obvious risk is of massive deposit withdrawals whenever the Cypriot banks reopen. Now that the seal on deposit safety has been broken, depositors will do their best to avoid additional taxation or expropriation in a few weeks’ or months’ time, no matter how many promises are made that this is a unique and once-and-for-all occurrence. Cypriot authorities are likely to address this with a mix of capital controls and deposit freeze, perhaps in the form of conversion of deposits to interest-bearing certificates of deposits, as recently [proposed](#) by Lee Buchheit and Mitu Gulati. But “financial repression” or even [incarceration](#) can only last for a limited period of time given the freedoms guaranteed by the EU treaty.

Unlike in previous euro-crisis episodes, there is little the ECB can do alone. The problem is fiscal at the core and must be addressed by elected leaders. They may conclude that it is best to let Cyprus default, impose capital controls and leave the euro zone, an [option](#) that was reported to be explicitly considered in European policy circles. But such a move would violate the promise of European leaders to ensure the

integrity of the euro zone, no matter what, and potentially set off a chain reaction, including possible bank runs in other euro zone member states, starting with the most fragile ones, such as Slovenia and of course Greece.

On the other hand, it is difficult to see how the risky scenario of a Cyprus exit could be avoided without further fiscal commitments by euro zone partners, including Germany. Their help could be in the form of additional direct transfers to Cyprus to plug the fiscal gap, or some form of guarantee of deposits that would come from the European rather than the national level. A quick but imperfect way to achieve the latter would be for a European entity, possibly the European Stability Mechanism, to provide an unconditional guarantee for a limited but sufficient period of time (say, 18 months) to all national deposit guarantee schemes in the euro zone, up to the € 100,000 European limit. Such “[deposit reinsurance](#)” has been rejected absolutely by European policymakers so far. It would constitute a major contingent financial commitment, even though the trust-enhancing effect would arguably result in an eventual net fiscal benefit for all. But it would be a powerful preemptive tool to make sure a scenario of retail bank run contagion does not materialize, and might also become the only option available to restore confidence if such a scenario were to become reality.

Assuming that the current situation is somehow brought under control, longer term questions beckon, beyond the geopolitical considerations related to Cyprus and its neighborhood. The breach of the deposit guarantee, materialization of the bank run threat, and probable consideration of capital controls will cast the euro zone debate on banking union in a new and starker light. Since mid-2012 and until now, the policy consensus in Europe had been to pretend that the question of supranational deposit insurance, with its direct links to the currently-frozen issue of fiscal union, was important but not urgent, and should be left out of the explicit banking union [agenda](#). This convenient stance will be harder to hold given the Cypriot experience. More broadly, the episode will contribute to an overdue debate about the democratic (or otherwise) nature of European decision-making and the effectiveness of its crisis management, two challenges more tightly [connected](#) than many observers realized. A first step might be to recognize the plan of March 16 as a mistake, and to have an honest debate about how it could have been avoided.

Many commentators are puzzled by the general lack of negative financial market reaction to the fast-unfolding events in Cyprus. The most likely reason, to be tested in the next few days, is that investors have been sufficiently impressed by last year’s whatever-it-takes commitments, particularly those by Ms. Merkel and ECB President Mario Draghi. The markets’ baseline assumption remains that a last-minute solution will be found after all the brinkmanship. Longstanding observers of the Eastern Mediterranean tend to project a darker mood, as they recall that this is a region in which individuals, groups and nations do not always act in their [self-interest](#). One can only hope that the market’s assessment is the correct one.

This article has also appeared at [Bruegel](#) and the [Peterson Institute](#).

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