

The Cypriot banking crisis shows that Europeans have yet to work out the answer to the question, ‘who pays?’

by Blog Admin

*The past week has been a tumultuous one for Cyprus, with negotiations and renegotiations towards a bailout for the country’s embattled banks. While an agreement has finally been struck, **Iain Begg** writes that the crisis is a direct result of an over-extended banking system: something that also affects other Eurozone members. The solution, to make bank depositors pay, could undermine confidence in the Eurozone’s banking system.*



Who pays? That is the critical question about how to cope with the problems affecting Cyprus. Indeed, it has been the question behind every phase of the crisis which has engulfed the euro area since the holes in Greek public finances were exposed in the autumn of 2009. Now, the contest to avoid being left facing the bill largely explains why Europe’s politicians have found it so hard to resolve the crisis.

The range of options is limited. Bank shareholders are usually first to pay, then bondholders may be expected to lose some of the nominal value of their holding – what is known as taking a ‘haircut’. If that is not enough, then banks turn to governments and central banks, effectively shifting the burden to tax-payers, whether in the country directly affected or in other countries. Loans from European partners, the IMF or elsewhere amount to the taxpayers of other countries assuming the risk that the bad debts of the country in trouble or its banks will not be paid.

So far, however, depositors in banks have mostly been protected from sharing the burden of dealing with a banking crisis. The main reason for this protection is that policy-makers have been concerned to avoid creating panic that could lead to systemic problems in the banking system as a whole. The fear is that if depositors lose confidence, the entire banking system would be at risk.

Cyprus is the latest in a string of countries that have had to confront the meltdown of a severely over-extended banking system. With bank assets estimated at a multiple of eight times GDP, Cyprus is a small country for which the banking system grew far too much. Like Iceland and Ireland a few years ago, Cypriot banks had welcomed depositors from abroad and offered them attractive terms. In the good times, this was mutually beneficial. Depositors obtained better returns – and limited scrutiny of the sources of their money – while the Cypriot authorities happily imposed low tax rates which, because of the sheer scale of the deposits, enabled them to collect large tax revenues.



The problem was what the Cypriot banks did with the money which was, at least in part, to lend to the

Greek government. As a result, when Greek sovereign bonds collapsed in value and investors were required to take a 'haircut', the Cypriot banks suddenly had a large hole in their balance sheets. Because of the scale of the problem, the Cypriot government lacked the means to rescue the banks as has happened in larger countries such as the UK (or even the US), and was forced to turn to its European partners for a bail-out.

While the sequence has become depressingly familiar, Cyprus has a number of features which make resolution of the crisis harder. First, there was an extended period of denial. The [outgoing President](#) of the country, knowing that elections were due in February 2013, managed to put-off dealing with the simmering crisis to avoid being blamed for harsh policies. This procrastination helps to explain why the European Central Bank, despite its President's announcement that he would do what it takes to safeguard the euro, has been threatening to cut off the flow of liquidity to the banks. Nicos Anastasiades, who only took office four weeks ago, was therefore immediately confronted with a rapidly worsening problem.

A second distinctive feature in Cyprus is that the retail depositors are the principal creditors of the banks, with much smaller involvement of bond-holders than in, for example, Ireland. Even wiping out the bondholders would not have been enough to raise the amount of money demanded by both IMF and the Eurogroup as the Cypriot share of the burden,

Third, as has been well-publicised, a large proportion of the foreign money in the Cypriot banking system is Russian owned. Some of that Russian money is widely believed to belong to organised crime syndicates and even some of the legitimate money is there because the depositors are trying to hide their money from the Russian authorities. To German eyes, this looks like tax evasion, and makes it that much harder to justify using the tax euros of honest Northern Europeans to resolve the crisis.

In addition, at just 0.2 per cent of the Eurozone economy, Cyprus is probably not big enough to have consequences for other euro area countries. Even a substantial default would have only limited repercussions for the other vulnerable countries, although Europe's leaders would do well to remember the law of unintended consequences. There were those, after all, who thought that there were few systemic risks in letting Lehman Brothers go bust in 2008.

In the games of bluff and counter-bluff that have been going on as the Cyprus saga unfolds, some of the proposals around who should pay have clearly been misguided. The initial plan to levy a tax on all depositors was guaranteed to draw opposition – and duly did. It could have led to the absurd situation where the life-savings of a grandmother with 10 thousand euros in her account attracted the same tax as a Russian oligarch with the same amount of money in his account to pay for the fuel for his private yacht.

It also became apparent that the Cypriot authorities wrongly believed that the Germans and the other northern Europeans would ultimately pay. However, the evident exasperation of the ECB and of such influential finance ministers as Germany's Wolfgang Schäuble should have been a warning to them. There is, too, moral unease about a Cypriot economic model so reliant on offshore banking.

The Cyprus problem will leave a number of legacies for the euro area. One is that depositors, who have been comprehensively protected up to now, can no longer assume that they will not be asked to pay, something that may shake confidence in other banking systems. Another is that a Europe-wide bank resolution mechanism is urgently needed. But perhaps most fundamentally, Europeans need to work out how to answer the 'who pays?' question, not just in relation to failing banks, but as a key element of European integration.

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