The lesson from Cyprus is that large bank deposits are potentially at risk in other struggling Eurozone countries.

blogs.lse.ac.uk/europpblog/2013/04/08/the-lesson-from-cyprus-is-that-large-bank-deposits-are-potentially-at-risk-in-other-struggling-eurozone-countries-charles-goodhart/

08/04/2013

The Cyprus crisis is likely to generate a number of political and economic problems for the country in the short term. **Charles Goodhart** *assesses the impact on Cyprus's economy and the fallout from the bank levy imposed on large depositors at Cypriot banks. He argues that although the potential for contagion to spread to other Eurozone countries has not yet been realised, the consequences for the European banking system could be severe.*

The Participants

The Cypriot banks held a large amount of Greek bonds, as well as loans to Greek borrowers, and they were driven into insolvency by the prior Greek disaster, (especially p.s.i., private sector involvement, e.g. for the Cypriot banks, in the Greek bail-out). This had been known for some time, but Cyprus is so small, and the sums involved sufficiently minor, that delay was feasible; and it allowed the participants to think in terms of principle rather than be pushed by issues of practicality.

The main issue of principle that drove the Troika – the European Commission, European Central Bank (ECB), and International Monetary Fund (IMF) – was the political hostility of voters in Germany and other Northern Eurozone countries to provide support for large, especially Russian, depositors in Cypriot banks, which provided tax-haven, and purportedly money-laundering, facilities for Ukrainian and Russian borrowers. The intention of the Troika was to provide funding for the Cypriot government, but to force the banks to recapitalise themselves by bailing-in their own large creditors. If that should destroy the tax-haven business plan of the Cypriot banks, so much the better.

The player in the game whose actions are, perhaps, most difficult to comprehend and to reconstruct is Russia. It was clear that Russian interests in Cyprus were one of the main targets, but apart from a few early squawks about the Commission's failure to consult and the exercise being improperly done, the Russian authorities have said, or done, almost nothing, despite the pleas of Michael Sarris, the Cypriot Minister of Finance. The amounts are small enough for the Russians to have bought out the banks and rescued the Cypriot government. But, whether the European authorities (and the US) would have allowed Cyprus to remain in the Eurozone (and EU) had it become a Russian vassal state is uncertain. Also the role of Cyprus as a money-laundering tax-haven will have reduced tax revenues in Russia, so the attitude of the Russian authorities to Cyprus was always likely to be ambiguous. And possibly they feel that the bail-out may yet fail, so they can pick up the pieces cheaper later. Anyhow, whatever the reason, the Russians have remained largely passive, at least for the time-being.

The Cypriot negotiators originally hoped to maintain their 'business model' by keeping the hair-cut on large uninsured depositors to below 10 per cent. With there being only a handful of bank bond-holders, this implied a sizeable (6.75 per cent) levy on smaller insured depositors. Although, probably out of exhaustion, the Troika initially accepted this, it soon got comprehensively shot down, both within and without Cyprus itself. The subsequent terms became much tougher on the uninsured depositors and on the Cypriot banks themselves, with Laiki driven into insolvency and closed, and the Bank of Cyprus Greek branches sold and its Chairman pushed out.

Following some twelve days of bank closure, Cyprus was subject, inevitably, to strict capital controls, its banking system in tatters and the economy facing a steep recession, with commentators fearing a decline in GDP of 20-25 per cent. The expropriation of deposits over €100,000 of as much as 40 per cent in the Bank of Cyprus, and probably much more in Laiki, will not just hit wealthy, and perhaps unsavoury, Russians, but also many decent upright Cypriot institutions, schools, hospitals, universities, and private sector companies. The pain, suffering and unemployment will be intense.

Credit: Max Garcia (Creative Commons BY NC SA)

Did the Cypriots have an alternative, given how horrible the current outcome is? Could they have simultaneously devalued, left the euro and defaulted on their external debts? They could then have recapitalised their banks using Cypriot pound bonds, while the devaluation would have made tourism more attractive. The main problem, I would guess, would have been their insufficiency in fuel (for the next few years until their shale gas reserves become available). Cyprus would not have been able to borrow abroad, and they would therefore have been forced to maintain a current account in balance, or surplus, from day one. Moreover, they would probably have been forcibly ejected from the EU, though it is arguable quite how detrimental this might be. We may never know how close Cyprus got to walking out.

Implications

Cyprus is being turned into a basket case, whether intentionally or not. This has numerous consequences. First, even after a massive bail-in and restructuring, much of the value of Bank of Cyprus assets will disappear (both Cypriot and Russian). Will the ECB be prepared to go on pumping money into the Bank of Cyprus as its depositors try to flee, its assets become non-performing, and its collateral disintegrates? But can it close down the only remaining nation-wide bank there? Meanwhile the pain is likely to make the current President and his party highly unpopular. Even if Parliament cannot vote on the rescue deal itself, a vote of 'no confidence' is always possible. And then what?

Outside Cyprus, the lesson is that (large) deposits are at risk, and that the Troika will, perhaps if forced by Northern public opinion, impose severe penalties on any Eurozone country whose banks are both fragile, and too large for the sovereign to save. Will this lead to contagion? Perhaps not. The *sang froid* of financial markets during the Cypriot imbroglio has been remarkable. But there is a risk. Should that risk eventuate, the potential destruction could be massive.

Please read our comments policy before commenting.

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.

Shortened URL for this post: **http://bit.ly/Zhl93S**

About the author

Charles Goodhart – *LSE Financial Markets Group*
Charles Albert Eric Goodhart, CBE, FBA is a Senior Economic Consultant for Morgan Stanley. He was a member of the Bank of England's Monetary Policy Committee from June 1997-May 2000 and a professor at the London School of Economics (1985–2002, Emeritus Professor since 2002).

-