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The euro zone as revealed in Cyprus

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Summary :

The expression of the bankruptcy of an economic model mainly centred on financial activities, the Cypriot crisis has resulted, quite logically, in the establishment of a financial assistance plan for the island, which thus becomes the fifth country in the euro zone to benefit from aid. The unusual nature of the bailout plan, which for the first time provides for a contribution from savers towards restructuring of the banking system, has given it an impact completely unrelated to the economic weight of Cyprus at European Union level, at the risk of transforming this financial micro-crisis into a major crisis of euro zone governance.

THE CYPRIOT CRISIS: A SYNTHESIS OF THE CRISES SUFFERED BY ITS PARTNERS

Regularly presented as a banking crisis, the Cypriot crisis is rather a combination of several factors that are specific to its economic model. Since partition of the island in 1974, local economic growth has been mainly achieved by two activities: financial services and tourism.

An advantageous taxation system [1], favourable interest rates and a tradition of consultancy inherited from British colonial days attracted numerous offshore funds to the country, encouraging at the same time the development of local banks, to a degree out of all proportion to the country's true economic potential. Assets held by Cypriot banks represent 7.5 times the island's GDP. Private Cypriot debt, which represents almost 3 times national wealth, is a good demonstration of this financialisation of the local economy.

This strategy has not been without consequences on the other aspect of the Cypriot economy: tourism, aided by the near-permanent sunshine on the island. The influx of capital encouraged the development of tourist infrastructures along the coasts, creating a dynamic in the building sector, at the risk of laying the conditions for a property bubble, in the same way as those that occurred in Ireland and Spain. As was the case in Spain, the role of local savings banks should be noted, these are cooperative societies, the governance method of which is still relatively opaque.

Over and above assistance given to the building sector, Cypriot banks, particularly the two main banks - *Bank of Cyprus* and *Laiki Bank* - at the same time invested massively in their Greek neighbour, a situation that was not affected when the crisis began in Greece. The possibility of benefiting from high returns increased overexposure of financial establishments to the Greek risk: exposure to the Greek public debt thus represented €27 billion, before the discount of February 2012, i.e. 140% of Cypriot GDP. In particular, €5 billion worth of Greek bonds were acquired in 2009 and 2010, without the Central Bank of Cyprus raising any kind of objection. Private Greek debts held by Cypriot banks are estimated at €22 billion, i.e. 120% of local GDP.

In addition to the outsized banking sector and the property bubble comes a third negative factor: the absence of competitiveness of the local economy and the consequent weight of public spending. These two elements are reminiscent of the Portuguese and Greek cases. Public spending now represents almost half of GDP compared to one third in 1995. Two thirds of the State budget is given over to social benefits and public sector salaries. Automatic indexing of salaries on inflation also makes any improvement of competitiveness merely hypothetical.

EUROPEAN INTEGRATION DEPENDANT ON CIRCUMSTANCES

Cyprus joined the European Union in 2004. Although

1. Corporate tax rate was 4.5% until Cyprus joined the European Union in 2004, when it was increased to 10%. Capital gains on property transactions and dividends are, also taxed only very slightly, or even exonerated.

some reservations were expressed at the time regarding the entrance of a country whose territorial sovereignty is relative due to Turkish occupation in the north, the island's financial strategy should doubtless have been subject to more detailed examination. The territory's attractive taxation system in particular makes it a hub for Russian and Ukrainian money, for which the application of standards on money laundering is only relative, in spite of the fact that Cyprus has signed up to international conventions in this regard, ensuring that the island is not included on the OECD list of tax havens.

The "European label" achieved by its joining the EU and then adoption of the single currency in 2008 increased the attraction of the island for former soviet block countries. Russian investments rose to over €78 billion in 2011, i.e. a third of all foreign investment in the island. The amount of assets owned by Russian companies and banks in Cypriot financial establishment amounts to $31 billion. There are also 35,000 Russian-speakers living on the island. .The companies they create in Cyprus then invest in Russia help to make Cyprus the leading investor country in Russia. A bond of economic dependency has therefore been created between Cyprus and Russia.

There was good reason for the fact that when Cyprus could no longer access the financial markets during 2011, due to investor distrust of the viability of the local financial system, Nicosia turned first of all to Moscow, without asking for any European intervention. A loan of €2.5 billion was thus granted to Cyprus by Russia in 2011. From a Cypriot point of view, this bilateral aid had a political advantage compared to European intervention: it exonerated Nicosia from the structural reforms that the European Union and the International Monetary Fund would have required of it.

But the short-term choice made by the Cypriot government fell up against two realities: aggravation of the economic crisis on the island, linked in part to the explosion of the property bubble, and restructuring of the Greek public debt in February 2012. This resulted in a loss of €4.2 billion for the banking sector, i.e. a quarter of national wealth, 3.8 of which for the country's two largest banks. The State was therefore caused to recapitalise *Laiki Bank* in an amount of €1.8 billion in May 2012. The aid granted by Russia was, at the same time, entirely absorbed by payment of the State's running costs.

In view of these difficulties, Cyprus' finance requirements were then estimated at €17.5 billion, i.e. the equivalent of national wealth: 10 billion were to be used to restructure the banking system, 6 for re-financing of a public debt that has been constantly increasing since 2008 and 1.5 for the payment of running costs, intended to deal with increased unemployment (11% of the active population compared with 3.5% in 2009) and the crisis (recession of 3.5% of GDP expected in 2013 after a contraction of 2.3% in 2012). In view of its inability to find new funds through bilateral agreements with Moscow or Peking, Cyprus requested aid from the European Union in June 2012.

THE SLOW GESTATION OF THE EUROPEAN UNION BAILOUT PLAN

It was nine months before the request for intervention resulted in a concrete plan. There were two reasons for this delay.

The first was due to the Cypriot authorities. The demands made by the Troika during its assessment missions in July and November 2012 were seen as unbearable for a long time by the Communist government of President Demetris Christofias, in power until February 2013. The international financial backers' plan to implement an austerity programme, putting a stop to indexation of salaries and payment of the thirteenth month, increasing retirement age or increasing company tax was vetoed by the President until November 2012. But aggravation of the crisis and the absence of any alternative solution nevertheless made him relax his position, which did remain inflexible, however, on the question of privatisations.

The second was due to the doubts raised by the IMF and some European Member States, such as Germany or the Netherlands, about sustainability of the Cypriot public debt if a loan of €17 billion was granted. The public debt would in fact have reached 140% of GDP, compared with 91.2% at the end of 2012. In addition to this legitimate concern came a basic reservation concerning the size of the local banking sector and its compliance with European standards in terms of transparency. On the strength of the Irish experience it was a case of ensuring that the tax payer alone was not called on to bear the cost of recapitalising the banking system. Particularly since the Cypriot banking system tended to serve the interests of Russian depositors. A reduction in the size of aid and contributions by both debtors and depositors gradually came into being in the discussions in spite of Cypriot government opposition on this point. To get over this, the Eurogroup postponed conclusion of the plan until March 2013, since the presidential election of 17th and 24th February 2013 was set to result in political change (President Christofias was not standing for re-election), and it was hoped that a more cooperative government would be in place.

THE PLAN OF 16TH MARCH: THE CYPRIOT CRISIS CHANGES DIMENSION.

Although the intention of getting depositors involved in the restructuring of the banking sector may have seemed laudable, the terms defined on 16th March 2013 nevertheless resulted in the Cypriot crisis taking on a European scale, not commensurate at first sight with the island's economic weight (0.2% of European Union GDP).

The will of the new Cypriot government, led by Nicos Anastasiades, to preserve Russian interests, and the will of the Eurogroup and the IMF to restrict the amount of European aid, resulted in a solution in part contrary to community law. The plan provided for gradual taxation of all bank deposits: 6.75% below €100 000 and 9.9% above that amount. Deposits of less than €100 000 represent 30 of the €68 billion in liquidities currently held by the banks. These provisions were to provide the Cypriot authorities with almost €5.8 billion. In addition to this sum was international aid of €10 billion, to be paid subject to the implementation of structural reforms and an audit of the banking system with a view to evaluating the impact of money laundering within the system.

Establishment of a tax on deposits of less than €100 000 angered the Cypriot people. This reaction was partly legitimate since this tax actually contradicts the 1994 directive on deposit guarantee schemes (DGS), revised in 2009 [2] which guarantee all deposits without exception up to the amount of €100 000. Above this amount an investment is considered risky. The Commission intends, in fact, to reinforce the scheme by means of a project to modify the DGS directive, as well as a draft directive on the resolution of banking crises presented in June 2012. Even though the Eurogroup underlined the specific nature of the Cypriot situation to justify these measures, there was indeed contradiction with one of the main commitments made by the European Union when the economic and financial crisis started in 2009. A fact that could not fail to create the conditions for panic amongst small savers in the euro zone countries currently in difficulty. However the Cypriot Parliament's decision to vote against these measures and the care taken by the Eurogroup to go back on its position on 18th March 2013 did limit the risk of panic and the risk of bank run throughout Europe.

The fact remains, however, that the unusualness of this approach, and its legitimate rejection by the Cypriot Parliament have contributed to making the final negotiations surrounding this fifth financial aid plan a new test for the solidity of the euro zone, whereas it was not apparent from the initial situation that this would be the case. At the risk of generating a further caricature of European action like the one on the role of the European Central Bank. The ECB had announced that it no longer wanted to provide the Cypriot banks with emergency cash if no agreement could be reached on recapitalisation of the banking system. Deemed hastily to be a monetary blockade, this decision was based nonetheless on a logical postulate: emergency cash can be allocated to solvent banks only, which was no longer the case for Cypriot financial establishments.

2. http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0368:FIN:EN:PDF

THE OUTLINES OF THE CYPRIOT BAILOUT PLAN

The principle of private sector participation in restructuring of the banks is nevertheless maintained in the new mechanism. The solution put forward at the start of negotiations by the IMF, that is to say increased participation by the creditors of the country's two leading banks, the ones most in difficulty, has been maintained.

To start with, the plan enacts the bankruptcy of the country's second largest bank, *Laiki*. It is split in two, a *bad bank* is created to manage assets considered to be toxic as well as deposits of over €100 000. A 40% tax will be levied on these deposits. Risk-free loans and deposits of less than €100 000 are transferred to the *Bank of Cyprus*, the country's leading bank. The Bank of Cyprus will also take over *Laiki Bank*'s debts, contracted with the European Central Bank and estimated at €9 billion. A tax on deposits of over €100 000 has also been decided on and should affect 37.5% of amounts; 22.5% of these amount are also frozen. Depositors will receive, in return, shares in the bank's capital. Closure of *Laiki bank* and the taxes levied within the *Bank of Cyprus* should mean collection of almost €6 billion, intended notably to recapitalise the bank. This "bail-in" mechanism for the banks means, at the same time, a reduction by half of the local banking sector. The agreement provides for the establishment of a capital movement control mechanism with a view to avoiding any kind of bank run.

The agreement also includes the outlines of the first aid plan, signed a week earlier: increase in company tax rates from 10 to 12.5% and of capital gains tax from 10 to 22%, evaluation of money laundering risks within the local banking system, privatisation of public transport, electricity and telecommunications companies, increase in VAT (17 to 19%), raising of retirement age from 65 to 67.5 years between now and 2018, freezing of public sector pensions and the cutting of 4 500 public sector jobs. These provisions should enable Cyprus to achieve a 4% budgetary deficit between now and 2018. The memorandum of agreement between the European Union, the IMF and Cyprus should be signed in April. The amount of European Union and IMF aid granted in return amounts to €10 billion, with an interest rate set at 2.5%. This aid should mean that public debt remains sustainable (100% of GDP by 2020).

At the same time the agreement invites the Cypriot authorities to renegotiate the terms of the loan granted by Moscow in October 2011. Its interest rate and term should therefore be amended.

WHAT ECONOMIC MODEL FOR CYPRUS?

The country's economic model is now extensively challenged by the bailout plan. The island's attraction for foreign finance companies will doubtless be stalled by the implementation of the tax on deposits of over €100 000, as well as by the increased company tax and capital gains tax rates. The drain of capital observed during the final negotiations on the aid plan has already been estimated at €5 billion. In this respect note should be taken of the Russian position, for whom the *Bank of Cyprus* is the preferred banking establishment. Notwithstanding the losses recorded the European plan guarantees *in fine* the viability of the Cypriot banking sector and protects it from general bankruptcy.

Tourism may also be affected by Russian disinterest in the country. The sector's vitality remained high during the 2011 and 2012 summer seasons, with the presence of Russian tourists. Such questions are being raised at a time when competition from Greece, Israel and Turkey is increasingly keen. Those countries enjoy more developed, less costly air links, and Cypriot hotel facilities are starting to look less modern.

The discovery of a reservoir of natural gas off the Cypriot coast was often put forward by the local authorities as a solution to the crisis suffered by the country, a guarantee to be brought to negotiations on international aid. The 25th March plan does not, however, take this into account; commercial exploitation will not begin before 2019 at the very earliest. Problems regarding the ownership of these reserves are also starting to occur with Turkey. It would appear that there is a long way to go before conversion of the Cypriot economy to the Norwegian model.

The social consequences of banking restructuring should not be underestimated either. The closure of *Laiki Bank* means that 8 000 jobs will be lost, i.e. 1% of local population. The 11 000 jobs in the *Bank of Cyprus* do not appear to be guaranteed either, after the end of the establishment's planned restructuring. These threats to jobs come within a gloomy context, impacted by growth in unemployment since the start of the decade, which could reach 15% of the active population by 2014.

Such economic difficulties will not be without incidence on the local GDP, already set to decrease mechanically with the reduction in the size of the banking sector. The question of sustainability of the Cypriot public debt, which is set to increase, still remains. There is therefore a hard task ahead for President Nicos Anastasiadies' government, in place since 1st March and partly discredited by the agreement of 16th March. The Economy Minister, Michalis Sarris, resigned on 3rd April 2013, just as a commission of enquiry was set up to determine the origins of the crisis.

THE EUROGROUP IN THE LIGHT OF CYPRUS

One of the main lessons of the crisis lies in the insufficiencies observed in Eurogroup functioning. In response to the wanderings of the Cypriot government between defence of Russian interests and the protection of small-scale savers, came a kind of guilty hesitation on the part of the Eurogroup, and particularly its new president, Jeroen Dijsselbloem. The Eurogroup did not take responsibility for the 16th March plan, whilst at the same time hammering home the need for Cyprus to find self-financing of €5.8 billion, before this figure finally disappeared from the agreement made on 25th March. Even the very question of the specific nature of the measures adopted, their exceptional character, restricted to the Cypriot case, on which everyone appeared to have agreed, was shattered when the president of the Eurogroup said that this mechanism could, in fact, serve as a model for resolving other future crises, before withdrawing his statements and being contradicted by both the European Commission and the European Central Bank. It would now appear more essential than ever for the euro zone to get itself stable governance, capable of taking coherent, audible decisions, which incur the responsibility of those who take them. In any case, the Cypriot crisis has underlined the fact that the current debate on reinforcement of the institutional aspect of the Economic and Monetary Union has not yet succeeded.

More widely, one must wonder about the new tax levied on deposits of over €100 000 on the books of the *Bank of Cyprus* and *Laiki Bank*. An example such as this could lead in the future to big depositors scattering their deposits throughout several banks, at the risk of weakening the major European establishments. Also, the planned European deposit guarantee scheme, considered to be one of the pillars of the banking union project, would appear to have been made more fragile by the solution found for the Cypriot banking problem. It should be noted that the difficulties encountered by the Italian bank *Monte dei Paschi di Siena* appear to have increased since the plan announced on 25th March. In this respect the Cypriot crisis has not pressed the accelerator in favour of banking union in the way that the Greek, Irish and Portuguese crises created a dynamic for plans to strengthen the Economic and Monetary Union.

CONCLUSION

Highlighting the inadequacy of its economic model to financial reality, the crisis affecting Cyprus has resulted in a European aid plan that requires a profound change in its economic and social structures. The island is entering a new period in its history and has to establish an economic alternative, which is currently difficult to evaluate. Gas income, presented as the cure for all the evils of the financial system is still a long way off. It is perhaps time for the government to envisage starting the reunification process again, a process that failed in 2004. Political reconciliation would not be without impact in economic terms. An independent study published in 2009 pointed out that reunification could help to grow GDP by 3% for 5 years, creating 33 000 jobs.

With regard to Economic and Monetary Union, the Cypriot crisis has just demonstrated that its functioning is still very fragile. Considered to be a minor crisis, it has again highlighted the limits of European governance, at the risk of adding further uncertainty to the current crisis. The response to the financial crisis that is hitting the euro zone therefore also involves the establishment of an institution capable of tempering market irrationality. During the Cypriot crisis the Eurogroup was not that institution ….

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