

Cyprus: Aphrodite to the rescue?

By [Céline Antonin](#) and [Sandrine Levasseur](#)

For two weeks Cyprus sent tremors through the European Union. If the banking crisis that the island is going through has attracted much attention, it is essentially for two reasons. First, because the dithering over the rescue plan led to a crisis of confidence in deposit insurance, and second, because it was the first time that the European Union had allowed a bank to fail without coming to its aid. While the method of resolving the Cyprus crisis seems to represent an institutional advance [\[1\]](#), insofar as investors have been forced to face up to their responsibilities and citizens no longer have to pay for the mistakes of the banks, the impact of the purge of the island's real economy will nevertheless be massive. With its heavy dependence on the banking and financial sector, Cyprus is likely to face a severe recession and will have to reinvent a growth model in the years to come. In this respect, the exploitation of natural gas resources seems an interesting prospect that should not be ruled out in the medium / long term.

To grasp what is at stake in Cyprus today, let us briefly recall the facts. On 25 June 2012, Cyprus requested financial assistance from the EU and the IMF, essentially in order to bail out its two main banks (Laiki Bank and Bank of Cyprus), whose losses are estimated at 4.5 billion euros due to their high exposure to Greece. Cypriot banks were hit both by the depreciation of the Greek assets they held on their balance sheets and by the partial write-down of Greek debt under the second bail-out plan (PSI Plan of March 2012 [\[2\]](#)). Cyprus estimated that it needed 17 billion euros in total over four years to prop up its economy and its banks, about one year of the island's GDP (17.9 billion euros in 2012). But its backers

were not ready to give it this much: the national debt, which had already reached 71.1% of GDP in 2011, would become unsustainable. The IMF and the euro zone thus came to an agreement on a smaller loan, with a maximum amount of 10 billion euros (9 billion financed by the euro zone and 1 billion by the IMF) to recapitalize the Cypriot banks and finance the island's budget for three years. Cyprus was in turn ordered to find the remaining 7 billion through various reforms: privatizations, an increase in corporate tax from 10 to 12.5%, and a windfall tax on bank deposits.

Initially [\[3\]](#), Nicosia decided to introduce a one-off tax of 6.75% on deposits of between 20,000 and 100,000 euros and 9.9% on those above 100,000 euros, and a withholding tax on interest on these deposits. Given the magnitude of the resulting protest, the government revised its approach, and the taxation of deposits gave way to a bankruptcy and restructuring. The solution adopted concerned the country's two main banks, Laïki Bank and Bank of Cyprus. Laïki was closed and split into two: first, a "good bank" that will take over the insured deposits (less than 100,000 euros) and the loans from the ECB to Laïki [\[4\]](#), but which will also take over its assets and ultimately be absorbed by Bank of Cyprus; and second, a "bad bank" that will accommodate the stocks, bonds, unsecured deposits (above 100,000 euros), and which will be used to pay off Laïki's debts [\[4\]](#), according to the order of priority associated with bank liquidations (depositors being paid first). In addition to absorbing the "good bank" hived off of Laïki, Bank of Cyprus will freeze its unsecured deposits, some of which will be converted into shares to be used in its recapitalization. To prevent a flight of deposits, temporary [\[5\]](#) capital controls were put in place.

This plan introduces a paradigm shift in the method of resolving banking crises in the European Union. At the beginning of the euro zone crisis, in particular in the emblematic case of Ireland, the European Union considered that

creditors had to be spared in the event of losses, under the logic of “too big to fail”, and it called on the European taxpayer. But in 2012, even before the declaration of Jeroen Dijsselbloem, Europe’s doctrine had already begun to bend [\[6\]](#). Hence, on 6 June 2012, the European Commission proposed a Directive on the reorganization and resolution of failing credit institutions, which provided for calling on shareholders and bondholders to contribute. [\[7\]](#) However, the rules on creditors are to apply only from 2018, after approval of the text by the Council and the European Parliament. This type of approach is now being tested experimentally in the Cyprus crisis.

Heavy consequences for the real economy

The situation of the country before 2008

In the period preceding the global economic crisis, the Cypriot economy was thriving, and indeed in 2007 even in danger of overheating. Over the period 2000-2006, its GDP grew on average by 3.6% per year, with growth of 5.1% in 2007. The unemployment rate was low (4.2% in 2007), with even some labour shortage as a result of the emigration of Cypriot nationals to other EU countries. The influx of foreign workers into Cyprus helped to hold down wages. Consumer spending and, to an even greater extent, business investment, which were largely financed through credit, were particularly dynamic starting in 2004, with growth rates that in 2007 reached, respectively, 10.2% and 13.4%. Inflation was moderate, and in this generally positive context, Cyprus qualified to adopt the euro on 1 January 2008.

In this pre-crisis period, the Cypriot economy – a small, very open economy – relied in the main on two sectors: tourism and financial services.

The two key sectors of the Cypriot economy

Revenue from tourism (Table 1) has provided a relatively

stable financial windfall for the Cypriot economy. This (non-cyclical) flow brings in approximately 2 billion euros annually. [8] As a share of GDP, however, the weight of tourism has decreased by half since 2000, to a level of less than 11% in 2012. Likewise, the share of tourism in the export of services fell sharply during the last decade: in 2012, it accounted for 27% (against 45% in 2000). Over the last 15 years, the number of tourists has fluctuated somewhat between 2.1 million (in 2009) and 2.7 million (2000), compared with about 850,000 people who are residents of the island.

Financial services constitute the other pillar of the Cypriot economy (Table 2). Two figures give a clear idea of its significance: bank assets accounted for more than 7.2 times GDP in 2012 (with a maximum of 8.3 achieved in 2009), and the stock of FDI in the sector “Finance & Insurance” is estimated at more than 35% of GDP, *i.e.* more than 40% of all FDI inflows.

Table 1. Weight of tourism in Cyprus

	2000	2004	2009	2012
Tourist revenue				
In millions of €	2 040,1	1 678,4	1 493,2	1 926
In % of GDP	20,5	13,3	8,9	10,8
By tourist (in €)	759	715	697	781
In % of services exports	44,8	32,6	25,0	26,8
Tourists (1000s of people)	2 686	2 349	2 141	2 465

Source: Central Bank of Cyprus and National statistical office. Author's calculations.

Table 2. Weight of the banking sector in Cyprus

	2007	2008	2009	2010	2011	2012
Banking assets						
In billions of €	92,9	118,1	139,4	135,0	131,6	128,1
Relative to GDP	5,8	6,9	8,3	7,8	7,3	7,2
Stock of FDI in the Finance and Insurance sector						
In billions of €						6,4
In % of GDP						35,6
In % of total FDI						41,6

Source: Central Bank of Cyprus and National statistical office. Author's calculations.

As major sources of wealth for the Cypriot economy, these two sectors have played an important role by, at least until 2007,

compensating (partially) the considerable deficit in the balance of payments, which has risen continuously since the early 1990s and fluctuated at around 30% of GDP since 2000 (Table 3). The “fuel” bill has been an increasing burden on imports into Cyprus, mainly due to higher oil prices: the energy bill has tripled over the last decade, rising from 461 million euros in 2000 to 1.4 billion in 2011. As a percentage of GDP, the rise in energy costs has also been very visible, as it has shot up from 5% of GDP in 2000 to 8% in 2011.

Reducing the size of the financial sector therefore raises the question of a new growth model for the Cypriot economy, *i.e.* its “industrial conversion”.

Table 3. Extract from the balance of payments of Cyprus

In millions of € (unless stated otherwise)

		2000	2004	2007	2008	2009	2010	2011
Balance of goods								
Exports	Total	1 011	936	1 083	1 190	971	1 137	1 404
	o/w “re-exports”	600	521	578	643	491	570	777
Imports	Total	4 104	4 578	6 353	7 367	5 692	6 517	6 311
	o/w “fuels”	461	503	895	1 247	880	1 157	1 381
Exports - Imports	Total	-3 093	-3 641	-5 271	-6 176	-4 721	-5 381	-4 907
	Total (% of GDP)	-31 %	-29 %	-33 %	-36 %	-28 %	-31 %	-27 %
Balance of services								
Exports	Total	4 552	5 147	6 579	6 538	5 779	6 049	6 262
Imports	Total	1754,40	2 201	2 841	2 937	2 416	2 467	2 676
Exports - Imports	Total	2 797	2 946	3 739	3 601	3 363	3 583	3 586
	Total (% of GDP)	28 %	23 %	24 %	21 %	20 %	21 %	20 %
Balance of goods and services								
Exports - Imports	Total	-295	-696	-1 532	-2 575	-1 358	-1 798	-1 321
	Total excl. “fuels”	165	-192	-637	-1 328	-479	-641	60
	Total (% of GDP)	-3 %	-6 %	-10 %	-15 %	-8 %	-10 %	-7 %
	Total excl. “fuels” (% of GDP)	2 %	-2 %	-4 %	-8 %	-3 %	-4 %	0 %

Source: Office statistique national, Eurostat et banque centrale de Chypre. Calculs des auteurs.

The temptation to exit the euro

The plan decided by the Troika undermines the island’s growth model by penalizing the country’s hyper-financialization, and condemns it to years of recession. To avoid a long convalescence, the idea of leaving the euro zone has taken

root, as it did in Greece. However, leaving the euro zone is far from a panacea. Regaining monetary sovereignty undeniably offers certain advantages, as is described by C. Antonin and C. Blot in their note, [Comparative study of Ireland and Iceland](#): first, an internal devaluation (through lower wages) would not be as effective as an external devaluation (through exchange rates); second, fiscal consolidation is less costly when it is accompanied by a favourable exchange rate policy. Nevertheless, given the structure of the Cypriot economy, we do not think that leaving the euro is desirable.

In fact, upon leaving the euro, the Central Bank of Cyprus would issue a new currency. Assuming it remains convertible, this currency would depreciate vis-à-vis the euro. By way of comparison, between July 2007 and December 2008 the Icelandic krona lost 50% of its value vis-à-vis the euro. Such a depreciation would have two consequences:

– One, an improvement in competitiveness (the real exchange rate has appreciated by 10% since 2000), which would boost exports and help reduce the deficit in the balance of trade in goods and services (Table 1). Since the accession of Cyprus to the European Union in 2004, this balance has deteriorated as a result of several factors: first, the slowing of inflation from 2004 related to pegging the exchange rate to the euro, which encouraged the growth of real wages at a higher rate than productivity gains; and second, the boom in bank lending, with the substantial decline in risk premiums on loans as a result of accession to the EU [9]. Consumption was boosted, the competitiveness of the Cypriot economy deteriorated, and imports increased. Would exiting the euro reverse this trend? This is the argument of [Paul Krugman, who supports Cyprus leaving the euro zone](#) by evoking a tourist boom and the development of new export-oriented industries. However, according to our calculations, a 50% depreciation in the real exchange rate would result in an increase in the value of exports of 500 million euros, including 150 million from

additional tourism revenue. [\[10\]](#) As for imports, they are weakly substitutable, as they are composed of energy and capital and consumer goods. Given the weakness of the country's industries, Cyprus will not be able to undertake a major industrial restructuring in the short or medium term. There are therefore limits to improvements in the trade balance. Furthermore, inflation would increase, including through imported inflation, which would lead to a fall in consumer purchasing power and mitigate any competitiveness gains.

– In addition, the devaluation would substantially increase the burden of the outstanding debt, but also of private debt denominated in foreign currency. Net foreign debt in Cyprus is low, at 41% of GDP in 2012. In contrast, public debt reached 70% of GDP, or 12.8 billion euros. 99.7% of the public debt is denominated in euros or in a currency that is part of the European Exchange Rate Mechanism (and thus pegged to the euro), and 53% of this debt is held by non-residents. In addition, the deficit was 6.3% of GDP. If Cyprus no longer had the euro, it would without doubt default on part of its public debt, which would temporarily deprive the country of access to foreign capital, and thus require the kind of violent fiscal consolidation that Argentina went through in 2001.

The exploitation of natural gas resources

The crisis in Cyprus raises the question of the natural gas discoveries in the south of the island in the early 2000s. According to the US Geological Survey, the Levant Basin located between Cyprus and Israel could contain 3,400 billion cu.m of gas resources. By way of comparison, [the entire EU has 2,400 billion cu.m](#) (mainly in the North Sea).

Cyprus thus has *a priori* a major natural gas bonanza, even if all of the deposits are not located in its Exclusive Economic Zone (EEZ). At present, only one out of the twelve parcels of land belonging to the Cypriot EEZ has been subject to

exploratory drilling, and in December 2011 a deposit of 224 billion cu.m of natural gas was discovered. According to the Government of Cyprus, the value of this field, called Aphrodite, is estimated at [100 billion euros^{\[11\]}](#). The exploration of the other eleven parcels belonging to the Cypriot EEZ could prove successful (or even very successful) in terms of natural gas resources. As the licenses for the exploration of these eleven parcels are in the process of being awarded by the Cypriot authorities, the EU could have used the (sad) occasion of the rescue package to secure a portion of the aid granted to Cyprus on its gas potential. Why did the EU not seize on such an occasion?

For the EU, the discovery of the natural gas reserves is good news, in the sense that the exploitation of these deposits will help it to achieve the energy diversification that it values so highly. However, several problems have arisen, problems that darken the prospects for exploiting the gas fields in the very near future. First of all, the discovery of gas reserves in the Levant basin has revived tensions with Turkey, which occupies the northern part of the island of Cyprus and which believes it has rights to the exploitation of the fields. The growing number of Turkish military manoeuvres reflects an effort to impose its presence in the areas being surveyed and could lead to an escalation of violence in the region, especially since the Greek-Cypriot authorities (the southern part) have been working with Israel to defend the gas fields. [\[12\]](#) Second, even assuming that the Greek-Turkish dispute is resolved, the exploitation of the gas will require heavy investment in infrastructure, in particular the construction of an LNG tanker whose cost is estimated at 10 billion euros. Finally, there will be no immediate return on the investment, as it will take at least eight years to put in place the necessary infrastructure. In these conditions, it is understandable why the EU did not take the opportunity to secure some of the aid to Cyprus against these gas resources: exploitation is still too uncertain and, in any case, the

horizon is too distant (given the immediacy required for a response to the crisis).

Furthermore, the EU would likely wind up in an awkward situation vis-à-vis several countries. If the EU supports Cyprus in the gas dispute, this comes down to supporting Israel, at the very time that the EU is holding negotiations on Turkey's membership and is trying to build good relations in the region, including with the regimes that have emerged from the "Arab Spring". In addition, two pipeline projects are already in competition: the South Stream project, linking Russia to Western Europe by 2015, and Nabucco, connecting Iran, via Turkey, to Western Europe by 2017. A new gas pipeline connecting the Cypriot fields to the European continent would further reduce Russia's bargaining power, by shifting the centre of gravity of natural gas southwards. This would promote greater dispersion and intensify geopolitical divisions in Europe, between a Northern Europe (including Germany) supplied by Russia and a Southern Europe dependent on the Middle East and Turkey.

Conclusion

If in the immediacy of the crisis the EU has made the right choice (that of the "bad" and "good" bank), the question is posed in the medium / long term of a new growth model for the Cypriot economy. Given the comparative advantages of Cyprus, the exploitation of natural gas seems to offer the only serious solution for the economy's conversion. However, for this strategy to be achievable, the EU will have to take a clear position in favour of Cyprus in the Greek-Turkish dispute.

Not only would the exploitation of the gas bring Cyprus energy self-sufficiency, it would also constitute a major source of revenue for the island. Energy costs would cease being a burden on the balance of payments (Table 1). This is especially important, because, even though tourism (another

pillar of the economy) has provided a stable (non-cyclical) source of income since 2000, it is not immune to geopolitical events in the region or to new competition over tourist destinations, in particular from the “Arab Spring” countries.

Consider this simple calculation. Suppose Cyprus manages to maintain its tourism revenues at the level of 2 billion euros (an assumption that, despite the caveats outlined above, is nevertheless realistic); in the absence of industrial restructuring, if the share of the banking sector in the economy is halved (as desired by the Troika and common sense), then Cypriot GDP would return to its 2003 level, or slightly less than 12 billion euros. And GDP per capita would fall by about a third...

Industrial reconversion is thus important for the Cypriot economy, just as for other economies in crisis... except that Cyprus has Aphrodite.

[1] See [Henri Sterdyniak and Anne-Laure Delatte, “Cyprus: a well-conceived plan, a country in ruins...”](#), OFCE blog, March 2013.

[2] See Céline Antonin, [Would returning to the drachma be an overwhelming tragedy?](#), OFCE Note no. 20, 19 June 2012.

[3] For more on the dithering on the rescue plan, see [Jérôme Creel, “The Cypri-hot case!”](#), OFCE blog, March 2013.

[4] These loans, granted via Emergency Liquidity Assistance (ELA), amount to 9 billion euros.

[5] Article 63 of the Treaty of the European Union prohibits restrictions on the movement of capital, but Article 64b authorizes Member states to take control measures for reasons of public order or public safety.

[6] “If the bank can’t recapitalize itself, then we’ll talk to the shareholders and the bondholders. We’ll ask them to contribute in recapitalizing the bank. And if necessary the uninsured deposit holders”, statement by Jeroen Dijsselbloem, 25 March 2013, to the *Financial Times*.

[7]

<http://www.revue-banque.fr/risques-reglementations/breve/les-c-reanciers-des-banques-mis-contribution>

[8] The tourist revenue of Cyprus depends in the main on tourists from Britain (43% in 2011), Russia (14%), Germany and Greece (6.5 % each).

[9] On the factors worsening the current accounts, see [Natixis, Retour sur la crise chypriote, novembre 2012](#).

[10] Estimation made using the elasticities calculated by the [IMF](#).

[11] Not far from Aphrodite, 700 billion cu.m of deposits were discovered in the Israeli EEZ, proof that the region is rich in natural gas.

[12] The tensions between Cyprus (southern part) and Israel were resolved (peacefully) by the signing of a treaty in December 2010 defining their respective exclusive economic zones (EEZ). The two entities also plan to cooperate in the construction of common infrastructures to exploit the gas. See [the analysis of Angélique Palle](#) on the geopolitical consequences of the discovery of these natural gas resources in the Levant basin.

Cyprus: a well-conceived plan, a country in ruins...

By [Anne-Laure Delatte](#) and [Henri Sterdyniak](#)

The plan that has just been adopted sounds the death knell for the banking haven in Cyprus and implements a new principle for crisis resolution in the euro zone: banks must be saved by the shareholders and creditors without using public money. [\[1\]](#) This principle is fair. Nevertheless, the recession in Cyprus will be deep, and the new extension of the Troika's powers further discredits the European project. Once again the latest developments in the crisis are laying bare the deficiencies in euro zone governance. It is necessary to save the euro zone almost every quarter, but every rescue renders the zone's structure even more fragile.

Cyprus never should have been accepted into the euro zone. But Europe privileged expansion over coherence and depth. Cyprus is a banking, tax and regulatory haven, which taxes companies at the rate of only 10%, while the balance sheet of its oversized banking system is nearly eight times its GDP (18 billion euros). Cyprus is in fact a transit hub for Russian capital: the Cypriot banks have about 20 billion euros in deposits from Russia, along with 12 billion euros in deposits of Russian banks. These funds, sometimes of dubious origin, are often reinvested in Russia: Cyprus is the largest foreign investor in Russia, to the tune of about 13 billion euros per year. Thus, by passing through Cyprus, some Russian capital is laundered and legally secured. As Europe is very committed to the principle of the free movement of capital and the freedom of establishment, it has simply let this go.

Having invested in Greek government debt and granted loans to Greek companies that are unable to pay due to the crisis, the island's oversized banking system has lost a lot of money and

has fostered a housing bubble that burst, resulting in heavy losses. Given the size of the banking system's balance sheet, these losses represent a significant share of national GDP. The banking system is in trouble, and as a consequence the markets speculated against Cypriot government debt, interest rates rose, the country plunged into a recession, and the deficit deepened. In 2012, growth was negative (-2.5%); the deficit has reached 5.5% of GDP, the public debt has risen to 87% of GDP, the trade deficit stands at 6% of GDP, and the unemployment rate is 14.7%.

The country needed assistance both to finance itself and to recapitalize its banks. Cyprus requested 17 billion euros, the equivalent of its annual GDP. Ten billion euros of loans were granted, of which nine will be provided by the ESM and one by the IMF. From a financial point of view, the EU certainly did not need that billion, which merely gives the IMF a place at the negotiating table.

In exchange, Cyprus will have to comply with the requirements of the Troika, *i.e.* reductions of 15% in civil servant salaries and 10% in spending on social welfare (pensions, family allowances and unemployment), the introduction of structural reforms, and privatization. It is the fourth country in Europe to be managed by the Troika, which can once again impose its dogmatic recipes.

Cyprus is to lift its tax rate on corporations from 10 to 12.5%, which is low, but Europe could not ask Cyprus to do more than Ireland. Cyprus must increase the tax rate on bank interest from 15 to 30%. This is a timid step in the direction of the necessary tax harmonization.

But what about the banks? The countries of Europe were faced with a difficult choice:

- helping Cyprus to save its banking system amounted to saving Russian capital with European taxpayers' money, and

showed that Europe would cover all the abuses of its Member States, which would have poured more fuel on the fire in Germany, Finland and the Netherlands.

— asking Cyprus to recapitalize its banks itself would push its public debt up to more than 150% of GDP, an unsustainable level.

The first plan, released on 16 March, called for a 6.75% contribution from deposits of less than 100,000 euros and applied a levy of only 9.9% on the share of deposits exceeding this amount. In the mind of the Cypriot government, this arrangement had the advantage of not so heavily compromising the future of Cyprus as a base of Russian capital. But it called into question the commitment by the EU (the guarantee of deposits under 100,000 euros), which undermined all the banks in the euro zone.

Europe finally reached the right decision: not to make the people alone pay, to respect the guarantee of 100,000 euros, but to make the banks' shareholders pay, along with their creditors and holders of deposits of over 100,000 euros. It is legitimate to include those with large deposits that had been remunerated at high interest rates. It is the model of Iceland, and not Ireland, that has been adopted: in case of banking difficulties, large deposits remunerated at high rates should not be treated as public debt, at the expense of the taxpayers.

Under the second plan, the country's two largest banks, the Bank of Cyprus (BOC) and Laiki, which together account for 80% of the country's bank assets, are being restructured. Laiki, which was hit hardest by developments in Greece and which was more heavily involved in the collection of Russian deposits, has been closed, with deposits of less than 100,000 euros transferred to the BOC, which takes over Laiki's assets, while it also takes charge of the 9 billion euros that the ECB has lent it. Laiki customers lose the portion of their deposits

over 100,000 euros (4.2 billion), while holders of Laiki equities and bonds lose everything. At the BOC, the excesses of deposits above 100,000 euros are placed in a bad bank and frozen until the restructuring of the BOC is completed, and a portion of these (up to 40%) will be converted into BOC shares in order to recapitalize the bank. Hence the 10 billion euro loan from the EU will not be used to resolve the banking problem. It will instead allow the government to repay its private creditors and avoid a sovereign bankruptcy. Remember that the national and European taxpayers are not called on to repair the excesses of the world of finance.

This is also a first application of the banking union. Deposits are indeed guaranteed up to 100,000 euros. As requested by the German government, the banks must be saved by the shareholders and creditors, without public money. The cost of bailing out the banks should be borne by those who have benefited from the system when it was generating benefits.

From our viewpoint, the great advantage is ending the poorly controlled financial status of Cyprus. It is a healthy precedent that will discourage cross-border investment. It is of course regrettable that Europe is not attacking other countries whose banking and financial systems are also oversized (Malta, Luxembourg, the United Kingdom) and other regulatory and tax havens (the Channel Islands, Ireland, the Netherlands), but it is a first step.

This plan is thus well thought-out. But as was modestly acknowledged by the Vice-President of the European Commission, Olli Rehn, the near future will be very difficult for Cyprus and its people. What are the risks?

Risk of a deposit flight and liquidity crisis: unlike the initial plan, which called for a levy on all deposits, the new plan is consistent with reopening the banks relatively quickly. In fact, the banks are staying closed as long as the authorities fear massive withdrawals by depositors, which

would automatically lead to a liquidity crisis for the banks concerned. However, as small depositors are not affected and large depositors have their assets frozen until further notice, it seems that the risk of a bank run can be ruled out. A problem will nevertheless arise when the large deposits are unfrozen. Their almost certain withdrawal will very likely result in a loss of liquidity for the BOC, which will need to be compensated by specially provided liquidity lines at the ECB. Some small depositors who take fright could also withdraw their funds. Similarly, holders of large deposits in other banks, although in less difficulty and thus not affected, could worry that the levies will be extended in the future and therefore try to move their money abroad. Cyprus remains at the mercy of a liquidity crisis. This is why the authorities have announced exceptional controls on capital movements when the banks reopen, so as to prevent a massive flight of deposits abroad. This is a novelty for the EU. But the transition, which means shrinking the Cypriot banking sector from 8 times the island's GDP to 3.5 times, could well prove difficult and may have some contagion effects on the European markets, since the banks will have to sell a significant amount of assets.

Risk of a long recession: the halving of the size of the banking sector will not take place painlessly, as the entire economy will suffer: bank employees, service partners, attorneys, consultants, auditors, etc. Some Cypriot companies, along with some wealthy households, will lose part of their bank holdings.

However, the plan requires simultaneous fiscal austerity measures (on the order of 4.5% of GDP), structural reforms and the privatizations so dear to Europe's institutions. These austerity measures, coming at a time when key economic activity is being sacrificed, will lead to a lengthy recession. The Cypriots all have in mind the example of Greece, where consumption has fallen by more than 30% and GDP

by over 25%. This shrinkage will lead to lower tax revenues, a higher debt ratio, etc. Europe will then demand more austerity measures. Seeing another country trapped in this spiral will further discredit the European project.

Some desire to pull out of the euro zone has been simmering since the beginning of the crisis in Cyprus, and there is little chance that it will die out now.

It is therefore necessary to give new opportunities to Cyprus (and to Greece and Portugal and Spain), not the economic and social ruin imposed by the Troika, but an economic revival involving a plan for industrial reconversion and reconstruction. For example, the exploitation of the gas fields discovered in 2011 on the south of the island could offer a way out of the crisis. It would still be necessary to finance the investment required to exploit them and generate the financial resources the country needs. It is time to mobilize genuine assistance, a new Marshall Plan financed by the countries running a surplus.

Risk of chain reactions in the banking systems of other Member States: the European authorities must make a major effort at communications to explain this plan, and that is not easy. From this point of view, the first plan was a disaster, as it demonstrated that the guarantee of deposits of less than 100,000 euros can be annulled by tax measures. For the second plan, the authorities must simultaneously explain that the plan is consistent with the principle of the banking union – to make the shareholders, creditors and major depositors pay – while clarifying that it has a specific character – to put an end to a bank, fiscal and regulatory haven, and so will not apply to other countries. Let's hope that the shareholders, creditors and major depositors in the banks in the other Member States, particularly Spain, will allow themselves to be convinced. Otherwise significant amounts of capital will flee the euro zone.

Risk of weakening the banking union: the Cypriot banking system was of course poorly managed and controlled. It took unnecessary risks by attracting deposits at high rates that it used to make profitable but risky loans, many of which have failed. But the Cypriot banks are also victims of the default on the Greek debt and of the deep-going recession faced by their neighbours. All of Europe is in danger of falling like dominoes: the recession weakens the banks, which can no longer lend, which accentuates the recession, and so on.

Europe plans to establish a banking union that will impose strict standards for banks with respect to crisis resolution measures. Each bank will have to write a “living will” requiring that any losses be borne by its shareholders, creditors and major depositors. The handling of the Cyprus crisis is an illustration of this. Also, the banks that need capital, creditors and deposits to comply with the constraints of Basel III will find it harder to attract them and must pay them high rates that incorporate risk premiums.

The banking union will not be a bed of roses. Bank balance sheets will need to be cleaned up before they get a collective guarantee. This will pose a problem in many countries whose banking sector needs to be reduced and restructured, with all the social and economic problems that entails (Spain, Malta, Slovenia, etc.). There will inevitably be conflicts between the ECB and the countries concerned.

Deposit insurance will long remain the responsibility of the individual country. In any event, it will be necessary in the future banking union to distinguish clearly between deposits guaranteed by public money (which must be reimbursed at limited rates and must not be placed on financial markets) and all the rest. This argues for a rapid implementation of the Liikanen report. But will there be an agreement in Europe on the future structure of the banking sector between countries whose banking systems are so very different?

The Cypriot banks lost heavily in Greece. This argues once again for some re-nationalization of banking activities. Banks run great risks when lending on large foreign markets with which they are not familiar. Allowing banks to attract deposits from non-residents by offering high interest rates or tax or regulatory concessions leads to failures. The banking union must choose between the freedom of establishment (any bank can move freely within the EU countries and conduct whatever activities it chooses) and the principle of liability (countries are responsible for their banking systems, whose size must stay in line with that of the country itself).

In the coming years, the necessary restructuring of the European banking system thus risks undermining the ability of banks to dispense credit at a time when businesses are already reluctant to invest and when countries are being forced to implement drastic austerity plans.

In sum, the principle of making the financial sector pay for its excesses is beginning to take shape in Europe. Unfortunately, the Cyprus crisis shows once again the inconsistencies of European governance: to trigger European solidarity, things had to slide to the very edge, at the risk of going right over the cliff. Furthermore, this solidarity could plunge Cyprus into misery. The lessons of the past three years do not seem to have been fully drawn by Europe's leaders.

[\[1\]](#) The over 50% reduction of the face value of Greek bonds held by private agents in February 2012 already went in this direction.

The Cypri-hot case!

By [Jérôme Creel](#)

In advance of a more in-depth study of the crisis in Cyprus and its impact on the euro zone, here are a few thoughts on the draft agreement reached last Monday morning, 25 March, between the Cypriot Presidency and some of the donors.

This [proposal](#) provides for the winding up of a private bank, Laiki, and shifting of its insured deposits (under 100,000 euros) to another private bank, the Bank of Cyprus, as part of its recapitalization. Deposits in the Bank of Cyprus in excess of 100,000 euros will be frozen and converted into shares. Ultimately, the Bank of Cyprus should be able to achieve a capital ratio of 9%, complying with applicable EU banking legislation. In exchange for these provisions and for an increase in taxes on capital gains and corporate profits, the European institutions will contribute 10 billion euros to Cyprus. Bank deposits guaranteed under the rules in force in the EU will still be insured, while the increase in capital gains taxes will reduce the remuneration of deposits in Cyprus, which have been above the European average.

In one week, the negotiations between the Cypriot authorities, the IMF and Europe's institutions have led to radically different results. For the part of the rescue plan needed for the viability of the banking system, the Cypriot President was apparently faced with a choice between a levy on all depositors, including "small savers", and a bank failure that would entail financial losses only for shareholders, bondholders and "big savers" (those with deposits of over 100,000 euros). It thus took a week for the democratically elected representative of a Member State of the European Union to give in and uphold the interests of the many (the general interest?) over the interests of the few, a handful of bankers.

The March 25th draft agreement also included a very interesting reference to the issue of money laundering. Cypriot banks will undergo audits to better understand the origin of the funds they collect. This time it did not take a week, but rather years for members of the Eurogroup to deal formally with a basic question about the operation of the Cypriot economy. Beyond Cyprus itself, there is reason to wonder whether there isn't funny money in the EU too.

One final thought about the International Monetary Fund, the donor partner that together with the European Central Bank and the European Commission makes up the Troika. It seems that it set many of the requirements: should we conclude that the IMF has much more bargaining power than the ECB and the European Commission, that it is the leader of this Troika? If this is so, it would raise some problems: first, the ECB and the Commission are supposed to defend the interests of Europe, which would not be the case if these two institutions were under the thumb of the IMF. Second, we should not forget that during the recapitalization of April 2009, the IMF received additional funds from the EU countries, which was a wise decision on their part if their representatives anticipated that soon they would need recourse to bailout funds, with the funds allocated to the IMF returning back to the EU in the form of loans. That said, having the IMF dictate drastic conditions for qualifying for bailout funds that have largely been contributed by from the EU itself is questionable, and would undermine the process of European integration.