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Insisting on the Same Recipe: A First Assessment of the Cyprus Bailout Deal

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On early Monday, March 25, we witnessed the latest in a series of "rescue" deals for European countries in crisis. Following another dramatic meeting of the Eurogroup, it was announced that the countries of the Eurozone had agreed on a €10 billion loan programme for Cyprus. However, this bailout package came at a high price: Laiki Bank (the second largest bank of the island based on assets) will be broken into a "good" and a "bad" bank; the "good" bank will be absorbed by the Bank of Cyprus (which is the largest bank of the island), whereas the "bad" bank will be wound down. During this process, losses will be covered by the shareholders, creditors (bondholders) and depositors of the bank, the latter for the amount of their deposits exceeding the €100,000 threshold of guaranteed deposits. The emergency liquidity assistance (ELA) liabilities of Laiki Bank to the European Central Bank (ECB), worth €9 billion, will be transferred to the Bank of Cyprus, which will be recapitalized. The sums required for this recapitalization, and consequently, the size of the "haircut" on the deposits of the Bank of Cyprus (exceeding €100,000), will depend on the capital required to ensure a capital ratio of 9%. Moreover, it was also agreed that Cyprus must restructure and shrink its financial system, so that its domestic banking system (which is disproportionately large compared to its GDP), will come down to the European average by 2018. Finally, in order to avoid the phenomenon of a "bank run", special administrative measures have been agreed, which include a series of controls and restrictions on the free movement of capital.

Since its announcement the bailout agreement has been the subject of intense international debate and analysis. Despite the fact that Cyprus represents only a small percentage of the Eurozone GDP (a mere 0,2%), the decisions concerning the island are particularly important in the context of crisis management by the European authorities and the International Monetary Fund (IMF), since such decisions generate a precedent that influences the expectations of markets and citizens for the future management of the crisis. This was illustrated clearly by the international impact of the unexpected first decision of the Eurogroup on March 15, for a haircut on deposits below €100,000, which shook confidence in the only aspect of the financial system that had remained intact until then. In this context, many analysts and politicians -especially in Europe- welcomed the agreement of Monday with much relief, describing it as a good solution which fixes the errors of the previous agreement.

Assessing the Deal

The assessment of such a decision needs to rely on two criteria: a) the effectiveness of the agreed measures for achieving the bailout objectives, and b) the "justice" of the measures. The second criterion is as important as the first one, since it is necessary for the long-term effectiveness of the measures and the sustainability of the adjustment programme; the satisfaction of citizens' sense of justice is a necessary precondition for political stability and social cohesion in a country that undergoes a crisis. Political and social conflicts that arise from a sense of unjust treatment, or even humiliation, of an entire society, undermine the implementation of necessary economic

and financial reforms. As a result, adjustment gets derailed - we have already seen this happening in many countries – including Greece.

As far as the effectiveness of the announced measures is concerned, one has to admit that the decision has certain significant positive aspects. The decision of the European partners preserves the banking system of Cyprus, with the exception of Laiki Bank, preventing thus a total collapse of the financial system and therefore the economy of Cyprus. The latter was certain to come, following the decision of the ECB (according to its regulations) to stop financing those Cypriot banks that were not considered solvent any more. In addition, it was agreed *not* to use the €10 billion bailout package for the recapitalization of the two major banks of the island. On the contrary, the restructuring costs of these banks will be borne by their shareholders, creditors and depositors; in this way, the necessary funding for Cyprus is reduced, preventing a further increase of its public debt. The latter reached 86,5% of GDP at the end of 2012. The new loan, approximately equal to 56% of Cyprus' GDP, is expected to raise its debt to 140% in the coming years, before starting to decline. In this sense, the decision of the Eurogroup is positive for the sustainability of the Cypriot public debt.

This reading of the Eurogroup decision, while adopted by many analysts, is nonetheless incomplete, because it ignores the dynamics of the crisis and the collateral damage of the deal on the real economy of Cyprus. To start with, the significant haircut of deposits in the islands' two major banks could lead to a massive outflow of capital. The imposition of controls on capital movements in a monetary union cannot continue indefinitely. Despite the -encouraging- fact that the citizens of Cyprus appear to have reacted calmly, it is almost certain that a large proportion of capital will be shifted out of Cyprus by foreign depositors and investors, once they are able to do so. This means that we cannot yet make accurate estimations on the capital needs of banks, which could be significantly higher than those projected until now. In turn, such a development means that Cyprus may need extra funding, which however, would increase further its public debt and undermine its sustainability. Alternatively, the same method of imposing a haircut on deposits could be used for a second time (possibly for other banks as well), but such a perspective should be considered catastrophic: it would lead to a definitive collapse of confidence in the financial sector of the island.

At a second level, the huge impact of recent decisions on the economy of Cyprus does not seem to have been included into the assessment of the deal so far. The rapid shrinking of the banking sector (which represents more than 40% of Cyprus' GDP), in combination with the credit crunch that will result from the restructuring of Cypriot banks, are expected to result in a deep recession. It is certain that the bailout decisions will lead to a significant revision of current projections regarding the course of the Cypriot economy (which foresee a recession of 3,5% in 2013). This means that the preliminary memorandum that was agreed last November, has to be significantly revised. Either Cyprus will require more funding (undermining the sustainability of public debt once more), or it will be forced to implement even tougher austerity measures in order to reduce its financing needs; however, as we have seen in the case of Greece, such a development could lead to a vicious cycle of recession, austerity and eventually deterioration of the country's debt prospects.

As far as justice is concerned, the Eurogroup decision is probably the most fair adopted so far in the context of the crisis. It is fair in the sense that it imposes losses to those who either bear responsibility for the way the banking system operated until now, or profited from it. Thus, unlike the cases of Ireland and Spain, the burden of bank losses was not passed on to taxpayers, not even to the banking sector as a whole. The agreement provides for the sharing of the costs by the shareholders, creditors and depositors (beyond the threshold of guaranteed deposits) for the banks that got themselves in trouble. Neither deposits in other banks nor taxpayers are affected. Therefore, one could argue justice has been done in the case of Cyprus.

The problem with this line of reasoning is that -although it is theoretically correct- it does not take into account the consequences of the programme for the economy of Cyprus, which may invalidate in practice any theoretically good intentions. Therefore, if the fast shrinkage of the Cypriot banking sector leads to a dramatic decline of GDP and a vicious cycle of recession and austerity, the negative consequences of such developments will not be directed to some parts of the Cypriot society; they will affect the entire society and, as it is often the case, their effect will be more intense for the lower social strata. In this context, the proclamations of a just treatment for Cyprus, will have

lost their meaning.

In Conclusion…

When assessing the agreement for Cyprus, it is obvious that once again, the adopted solution, although more just and rational that previous European decisions, it belongs to the same model of handling crisis that has been followed so far, a model with a poor record on both the effectiveness and justice fronts. The reasons for the insistence of Europe on programmes that prioritize austerity and encompass a punitive element for past mistakes and excesses can be largely attributed to the political game in individual countries and particularly Germany and the new power configuration that has emerged during the crisis, where Germany has become the undisputed economic hegemon of the EU.

It is obvious that Cyprus had adopted a unsustainable economic model, based on the provision of favourable tax and financial treatment of international investors. Moreover Cyprus European partners are right in criticizing Cyprus for its disproportionately large financial sector (approximately 800% of its GDP), which led to the creation of a big financial bubble (it is telling that Cyprus' private debt as a percentage of GDP reached 287.5% in 2011, far larger than the Eurozone average of 163.8% and more than double than that of Greece at 125% of GDP). Having said that, this does not mean that the appropriate approach to Cyprus' bailout is a combination of punishment and rescue, particularly since the former undermines the latter.

Unfortunately, a different kind of approach, not only for Cyprus but for the wider European crisis, does not seem probable in the foreseeable future. Given the political dynamics in Europe it does not seem likely that a more solidarity-based approach is feasible, one that would assign fiscal consolidation, which is necessary, a lower priority and focus instead on structural reforms, without however undermining the economic recovery of the countries in crisis. It remains to be seen whether the development of the crisis in Cyprus could spark such a re-orientation.

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