

Counting the options in Cyprus: the good, the bad and the ugly

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First, let's clarify that a bailout for Cyprus was necessary. Without this, the major banks in Cyprus would collapse in a matter of days, if not hours. People would lose their savings, financing of small and large businesses would come to a halt, panic would spread across markets and the public, and a tremendous crisis would engulf the real economy (with lost jobs, incomes, and people's fortunes). The ECB could delay this, by continuing to provide liquidity to the Cypriot banks, but this would not offer a long-term solution.

It is now clear that politically and institutionally there was no appetite to continue supporting the Cypriot banks through liquidity provision and this is why a political agreement – a bailout – was needed. In plain terms, a bailout was necessary because the ECB could not – and, for many, should not – continue providing a lifeline to the Cypriot banks in perpetuity, while depositors in these banks continued to enjoy high returns and less-than-perfect scrutiny on their financial transactions. If we take this as a given, then what were the possible options?

Option one. The Eurozone (with or without the IMF) could provide the whole amount needed (estimated at €17bn) to recapitalise the Cypriot banks. This would be the easiest solution for Cyprus and well within the Eurozone's capacities. Nobody would lose any money and the 'lenders of last resort' would eventually recover their 'investment' once the banking system in Cyprus managed to clean-up its balance sheets and return to profits. But such a solution would raise issues of legitimacy and morality, as it would seem to be using-up European tax-payers' money to provide direct subsidies to non-Eurozone investors, bailing-out investments that are perceived to be linked, in part, to money laundering. Of course, moral considerations was not the only source of reservations: political considerations are also, or more, important here. If this option was followed, the Eurozone would lose its 'stick', its ability to pressure Cyprus to abandon its current banking model (based on low taxes, high interests and weak scrutiny of financial transactions), downsize its banking operations and lower its dependence on Russian capital. Whether this can be seen as a legitimate political concern is an open question. But I would think that for the morality of the "layperson in the street", this shouldn't sound as too bad an idea.

Option two. The Eurozone (again, with or without the IMF) could provide a loan to the Cypriot government, who could then use the funds to recapitalise their banks. On the face of it this would seem rather idiotic (why impose a burden of public finances, if the recapitalisation can be implemented directly?). But, as a matter of fact, this is the solution that has been implemented elsewhere, for example in Greece. The logic of this is that it maintains the 'stick' on the side of the Eurozone, putting pressure (through conditionality) on the receiving government to implement reforms (in the case of Cyprus, on the banking system – so as to reduce external dependences and introduce more scrutiny on financial transactions, eventually restoring the balance between the financial and real economy). The problem with this option is that it would increase public debt to hugely unmanageable levels: the immediate effect would be an extra debt burden of about 100% of GDP (taking the total to 170% of GDP overnight). As the government would then have to implement extreme austerity measures in order to reduce its debt, this would lead to a recession perhaps many times more severe than the one seen in Greece. The economy would enter into a vicious circle of austerity and recession with no way of getting out – ever – unless the country decided to leave the Eurozone and default on its debts. Surely not a solution anybody would favour.

Option three. The Eurozone and IMF could provide some funds for the recapitalisation, leaving a gap that would have to be covered by the depositors. This is the option that has been followed. But it is not cost-free: there are two fundamental problems with this. First, taxing deposits goes against existing principles about the security of deposits (and, in the context of the Eurozone crisis, existing practice to guarantee deposits up to €100,000 across the Eurozone) and of course creates public discontent. Second, this “departure from market norms” transmits shockwaves to the markets, which feel that their investments are not protected. Especially for the large foreign investors (typically, “the Russians”), this would seem as a punitive move and could push them to withdraw their deposits, their investments and – through the Russian government – their support to the Cypriot economy. It appears that the Cypriot government (or the Germans and the IMF – we will never know the full truth about this) decided to balance between the two problems, by spreading the cost between the domestic/small depositors and the foreign/large depositors (mind you, this somehow assumes that domestic equals small – which is not always the case). As it turns out, in doing so it has managed to alienate – and infuriate – both. As I am writing these lines it is not yet clear what will be the exact details of the levy imposed on deposits. But it seems that the government is moving towards a rebalancing of the burden towards the large depositors in order to stay closer with the “fundamental principle” of protecting small deposits (to the value of €100,000 – makes you wonder what is small and what is not...). In doing this, it is unclear whether it increases, or reduces, the overall risk to the banking system – both in Cyprus and in the Eurozone at large: by protecting the ‘small depositors’ it helps perhaps avoid a potential bank-run by “the average person”; but by targeting ‘large deposits’ it makes large investments in the Eurozone less secure and may indeed scare away some liquid investments. It is easy to see why: if a small Eurozone country such as Cyprus can impose unilaterally a haircut on large deposits, then what is there to stop larger countries in the Eurozone – Spain, Italy, perhaps even France – to do the same at some point in the future? This can easily lead to substantial capital outflows from banks across the Eurozone, thus destabilising the whole system: in such a case, the Eurozone – and the ECB – will need many multiples of the €17bn they refused to provide to Cyprus in order to save the European banking system. So, either with a ‘bank-run’ or with a more traditional ‘capital flight’, the stakes are truly very high – although in my view the probability of this scenario materialising is extremely low.

So, right or wrong, Cyprus and the Eurozone had to decide among three options: the good (full and direct bank recapitalisation), the bad (recapitalisation through a loan to the Cyprus government), and the ugly (a haircut – solidarity levy – on deposits). It seems to me that the “good” was not politically feasible (it almost never is!). And, so, the “ugly” is perhaps as good as it gets. The details may change, but the solution will remain ugly: if ‘small’ depositors are not protected to the value of €100,000, the credibility of the deposit guarantee policy throughout the Eurozone will be shattered; if large depositors – “the Russians” – are singled out, this may lead to more instability in the Cypriot banking system than that avoided through the bailout. So, the solution is definitely ugly. But what are the options?