Cypriot Crises & Policy Fiascos: Al Arabiya Op-ed

For Cypriots, the euphoria that accompanied Cyprus' joining the EU in 2004 and entry into the Eurozone in 2008 has faded into a distant memory that is turning into a waking nightmare. Cyprus is one of the smallest economies of the EU, with a relatively low level of sovereign debt and a high but manageable budget deficit. So where did the crisis originate and why is it threatening Eurozone financial stability?

Cyprus has a large banking system (assets in excess of 900% of GDP), which is highly concentrated with too big to fail and too big to save banks. Its outsized offshore financial centre , with light handed regulation and low taxation, attracted deposits from Russia and other countries, becoming a tax haven, with 30 per cent of deposits from outside the euro zone and non-resident deposits exceeding its GDP.

It's two biggest banks, the Cyprus Popular Bank (Laiki) and the Bank of Cyprus invested heavily into Greek bonds which have lost more than 70% of their value and bad loans. The banks became insolvent and turned to their government for a bail-out. In turn, in the now unfolding financial drama, Cyprus became the latest Eurozone country to seek a bailout from the EU.

A troika to the rescue?

The response of the Troika (the ECB, EU Commission and the IMF) was to request a co-funding of bail-out funds: Cyprus is to raise 5.8 billion euros as a pre-requisite for 10 billion euros in bail-out funds. To raise the 5.8 billion euro, the government proposed an expropriatory tax of 10% on deposits over EUR 100,000 and 6.75% on deposits below it. This was bluntly rejected by Parliament. Imposing a tax on depositors is not the way to resolve the bank crisis. Iceland which faced similar circumstances allowed its banks to fail. It is best to recognize bank losses, allocate them between stakeholders and put in place measures to prevent a recurrence. Bank equity holders should be the first to bear losses, before junior debt holders. Senior debt holders and non-insured depositors should be next, while insured depositors should be last. In the Cypriot case the banking system should be restructured with Laiki and other banks split into a sound part (capitalized by the government and European funds) and a 'bad legacy' part with losses borne by large depositors and other creditors.

Taxing depositors creates negative incentive effects, a run on the banks and a capital outflow. In an attempt to prevent this, the Cypriot Parliament has passed legislation allowing the imposition of capital controls. Apart from the policy unfairness, taxing insured deposits will generate contagion effects across the Eurozone: what is to prevent other countries imposing a capital levy on bank deposits? Little Cyprus could become the detonator of the next round of the euro crisis, destroying trust in banks and fuelling a bank run in vulnerable countries like Spain, Italy and Portugal. Another casualty is the credibility of European crisis management. The Cypriot problem has been brewing and known for more than a year when the banks lost on Greek debt they were holding. Delay in dealing with it has exacerbated the problem and turned into systemic risk for the Eurozone.

Geopolitical interests

Whatever the final outcome, Cyprus will emerge with weaker if not dismal economic and financial prospects. It will have to restructure its banking system and will be fiscally constrained as it seeks to finance its higher level of sovereign debt. But what about Cyprus's natural gas gold mine? Will these not save the day? The estimates (from the IEA) are that exploiting the natural gas deposits (5 trillion and 8 trillion cubic feet) will require investment of some $10-$12 billion over the coming 7-8 years. This is a substantial investment given the size of the Cypriot economy. Gas revenues are expected to reach $3 billion by 2020, of which $1 billion would accrue as tax to the government. Could Cyprus securitise its future gas revenue, selling rights to future gas for cash now? In principle that is feasible. But Cyprus should not use its future gas wealth to bail out its banks. It should aim to create a sovereign wealth fund.

The crisis does however create an opportunity for countries that have an interest in Cyprus' gas, including Israel, Russia, Turkey and potentially Qatar. A deal with Russia has fallen through with the government unlikely to provide funds to bail-out large tax evading or money laundering Russian depositors. Europe would also veto such an intervention given Russia's past use of gas supplies for political gain. Qatar could be a partner for exploiting Cypriot gas given its knowhow in exploiting offshore gas fields and its financial capabilities and eventually linking up to a pipeline from its gas fields. Israel which has signed an agreement with Cyprus has an incentive to monopolise its hold on Eastern Mediterranean gas supplies given its large gas fields (Tamar and Leviathan). Turkey on the other hand might use Greek Cypriot weakness to negotiate assistance against a redistribution of revenues between the Greek and Turkish parts of Cyprus. The crisis has jeopardised Cyprus's ability to exploit its promising natural resources.

Three major lessons emerge from the Cypriot crisis. One, small economies with large financial centres (Iceland, Ireland, and Cyprus) and inadequate supervision & regulation are highly vulnerable to external shocks and to banks becoming hedge funds. Two, taxing "insured deposits" or nationalising pension funds is a recipe for financial disaster and bank runs. Three, badly resolved banking sector crises can threaten long-term economic prospects.

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