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What happened in Cyprus[1]

Athanasios Orphanides, Ph.D.[2]

Economic and political background in Cyprus

Cyprus joined the EU in 2004 and immediately wanted to get into the euro area for the express purpose of completing as quickly as possible the union with the core of Europe. It was done because the public thought that would be beneficial for political reasons, not economic reasons. The strategic location of the island has made it a target over the millennia of various powers, and the country is just too small and weak.

There are several reasons why Cyprus could develop a large financial sector over three decades ago. It had double taxation treaties with a number of countries, the Soviet Union for example. That means, if profits are booked and earned and taxed in Cyprus, they are not taxed again in the other country. Russian deposits are in Cyprus because it has a low corporate tax rate, much like Malta and Luxembourg, which annoys some people in Europe.

In addition, Cyprus has a legal system based on English law and follows English accounting rules. It has a well-educated work force that can provide financial services, and a high concentration of lawyers and accountants. As a result of that, a lot of foreign interests, including from Russia, have a number of corporations based in Cyprus and organize their international business globally from Cyprus. This model is similar to what we see in other countries: for example, there are even more Russian interests in the Netherlands and in Luxembourg.

The financial crisis in Cyprus

A number of factors played a role in producing the crisis in Cyprus. The global financial crisis and exposure to Greece made Cyprus vulnerable. But the outcome was determined by decisions taken by the previous government in Cyprus as well as the broader malfunction of the euro area over the past three years.

Two months after Cyprus joined the euro area [in January, 2008], there were presidential elections and the Cypriot public elected as president a communist, Demetris Christofias. The public was convinced he could solve the political problem Cyprus had with Turkey and reunify the island. The issue was not economic.

If one thing has become clear over the last five years in Cyprus, it is that the euro area, which is not just a market economy but a currency union with strict rules, is not compatible with a communist government. Why is this important? This government took a country with

[1] This text is taken from an interview given to The Economist on March 28, 2013.

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excellent fiscal finances, a surplus in fiscal accounts, and a banking system that was in excellent health. They started overspending, not only for unproductive government expenditures but also they raised implicit liabilities by raising pension promises, and so forth.

Because of the fiscal policies that the government pursued, it damaged the confidence of international investors and lost access to international capital markets in May of 2011. If the government had behaved as other governments did, they would have asked for assistance from the EU at that time, in May of 2011. The size of the banking sector and exposure to Greece were known risks but at that time there was no banking problem in Cyprus and the structural adjustments necessary to restore fiscal stability in the country were rather minor. As with any country with a large financial sector, a solid fiscal position was crucial to avoid creating doubts about the ability of the sovereign to serve as a temporary backstop, in case that became necessary. I was there at the time and as the central bank governor I was warning the government that not dealing with this issue in the context of the euro area crisis was extremely dangerous. Others had also warned the government, including ECB President Trichet. They were not willing to do anything because as a communist party they did not want to incur the political cost of adopting consolidation measures.

Munitions explosion destroying main power station

Then on July 11, 2011 there was an explosion that destroyed the power station producing more than half the power supply of the island. It was triggered by 100 or so containers of ammunition stored in the sun for two years next to the power station. The containers were part of a shipment going from Iran to Syria that was intercepted in Cypriot waters after a tip from the U.S. The president took the decision to keep the ammunition.[3] Cyprus did not have a severe recession in 2009 from the global crisis. The slowdown was fairly mild. But after the explosion, the economy was thrown into a recession. I recall that on July 18 I sent a confidential letter to the president and leaders of all parties, calling for urgent measures to avert a crisis. Instead of heeding the warning, my letter was leaked to the press and my calls for action severely criticized by the government.

The same month the European Banking Authority put the two largest Cypriot banks, which are being targeted now, through a stress test along with other banks in the EU. The results were published on July 15, 2011. Both banks passed the stress tests. If the government had applied at that time for a reasonably small package from the troika, they could have fixed the fiscal problem fairly easily. Again, they didn't, because they didn't want to do structural adjustments. Instead, they started lobbying the Russian government to give them a loan that would help them finance the country for a couple more years, and Russia came through, unfortunately, in retrospect, with 2.5 billion euro which is a big chunk of money for a country with a 17 billion euro GDP. I say unfortunately because as a result the government could keep operating and accumulating deficits without taking corrective action.

[3] An independent prosecutor found that Christofias ignored repeated warnings and pleas to destroy or safeguard the ammunition, apparently in hopes of one day returning it to Syria or Iran.

The haircut on Greek debt in October 2011

The next important date was the October 26-27, 2011 meeting of the EU council in Brussels where European leaders decided to wipe out what ended up being about 80% of the value of Greek debt that the private sector held. Every bank operating in Greece, regardless of where it was headquartered, had a lot of Greek debt. There were subsidiaries of French banks operating in Greece and a Portuguese bank, that were wiped out. Our two largest banks had major operations in Greece and significant exposure, so the Greek part of the operation and the bond holdings suffered a lot of damage. For Cyprus, the writedown of Greek debt was between 4.5 and 5 billion euro, a substantial chunk of capital.

The second element of the decision taken by heads of states was to instruct the EBA to do a so- called capital exercise that marked to market sovereign debt and effectively abruptly raised capital requirements. The exercise required banks to have a core tier-1 ratio of 9%, and on top of that a buffer to make up for differences in market and book value of government debt. That famous capital exercise created the capital crunch in the euro area which is the cause of the recession we've had in the euro area for the last 2 years.

For Cyprus, the combination of haircut and stress test meant that after taking measures, the two largest banks needed about 2 billion euro of additional capital to be recapitalized according to the guidelines of the EBA. That was the first time someone could say: 'Your banks require assistance.' After losing more than 4.5 billion on the haircut on the Greek debt, this suggests how much capital they held before.

The heads of states decision also said that if banks were not able to raise capital on their own, then the country is responsible for finding the capital and injecting it. The president of Cyprus agreed and did not ask for any provision to protect the country. Since all the holdings of Greek debt were public information (they had been published with the July EBA stress test), everyone could calculate what the haircut meant for the banks and since the Cypriot government was out of the markets the implications could be foreseen. You could say, well if they hadn't entered a program before, they should have considered it now. But again they did not want to ask for assistance, because the troika would have forced them to make structural adjustments which the government did not want to do.

The impact of banking supervision

Because the government did not take the necessary steps, the banking supervision had to take action. The Basle II framework that governments adopted internationally, and that the EU supervisory framework during this period also incorporated, specifies that holdings of government debt in a states' own currency are a zero-risk-weight asset –that is these assets are assigned a weight of zero in calculating capital requirements. This is the reason why ECB President Jean-Claude Trichet and most central bankers and supervisors were so alarmed at the prospect of the governments introducing credit risk (as was done in Deauville in October 2010) and at the prospect of considering defaults (as was done starting in late July 2011) in euro area sovereigns. It turned the supervisory framework in place upside down.

To mitigate risks, the supervisor can ask a bank to raise additional capital. In Cyprus this was done and the two large banks raised significant amounts in 2009, 2010 and even as late as early 2011. After the government lost access to markets in May 2011 this became much harder, virtually impossible.

Still, by spring 2012, with an additional 2 billion Euro the banks could have met the EBA 9% plus capital buffer core-tier 1 set for the capital exercise. That was roughly 11% of GDP and would not have been an issue if the government had not lost market access, as in that case the government could have injected this amount in any bank that needed it by issuing public debt.

The ECB and the governors in general had been arguing before that capital exercise was done that the governments should have agreed to make the EFSF/ESM available for direct recapitalization of banks instead of asking each government to be responsible for the capitalization. That element created the adverse feedback loop between banks and sovereigns. They forced the stress test and recapitalization before they could reach an agreement on how to find resources for the recapitalization. Mario Draghi characterized the private sector involvement on Greek debt, in association with these elements, as similar to a European Lehman in an FT interview.

Intensification of the crisis

When my term ended on May 2, 2012, the recapitalization had not been completed. Instead of focusing on a solution, however, the government engaged on an assault on the banking system and started rallying on the slogan that the banks were responsible for all ills in the economy in preparation for the February 2013 election.

Starting in July 2012, the press was reporting that the banking system needed 10 billion euro of capital, citing sources at the central bank. Some reports suggested the numbers were deliberately exaggerated as the issue had become part of the February 2013 presidential election campaign. When the press started reporting such unrealistically high numbers I became extremely concerned and warned in an interview that if the central bank was generating such high numbers it risked putting into question the sustainability of the country's debt. Under standard IMF sustainability analysis, the country's debt could be deemed unsustainable and the troika might ask for some form of a haircut. Indeed, the debt sustainability analysis created the debate over whether there should be some form of bail-in associated with the program in Cyprus.

Following a downgrading in late June 2012, all three major rating agencies rated the sovereign paper Cyprus below investment grade. According to ECB rules, that made the government debt not eligible as collateral for borrowing from the eurosystem, unless the ECB suspended the rules, as it had done for the cases of Greece, Portugal and Ireland. In the case of Cyprus, the ECB decided not to suspend the eligibility rule. This was important because if Cyprus debt had remained eligible as collateral, Cyprus banks could continue to buy treasury bills and continue financing the needs of the country for some time. The ECB

was trying to convince the Cyprus government that it had to make structural adjustments and fiscal adjustments and by that point in June, get into a program.

By triggering the loss of eligibility of the government debt as collateral, the ECB telegraphed to the government it had to go to the troika. The Cyprus government did formally ask for troika assistance in June of 2012, on the same day the Spanish government asked for assistance for its banking system. Even then, had the government accepted that they needed to make structural adjustments and negotiated a program, which could have been done over two weeks, the government would have obtained financial assistance. If capital needs of banks had not been exaggerated, there would be no sustainability issue.

Again, the government did not do that. They did not want to negotiate. According to press reports, the ECB communicated to the Cyprus government around November that if it did not engage in serious negotiations, it would consider cutting off liquidity. When that occurred, the government agreed to bring the troika back and negotiate a program. That program and a memorandum of understanding (MOU) were completed in December. Its elements included major reductions in pension benefits, major reductions in wages and salaries for the broader public sector and privatizations of government owned or semi-government owned corporations. It also included the suspension of cost of living adjustments, which were incompatible with being in the euro area.

All these were agreed to in principle by an MOU. The government took them to parliament and the parliament immediately adopted them. What was not clear was what was negotiated about the banking system.

Recent events

In the February election the communist candidate was defeated and a conservative president, Nicos Anastasiades, took over on March 1. He wanted to complete the adjustment program that had been delayed so long as soon as possible, in an honest manner. Cyprus expected a program with similar terms to those faced by the other countries. Instead, he was effectively ambushed by the other governments at the very first meeting of the European council that he attended and the associated eurogroup meeting. On March 15-16, the other governments confronted the new president and new finance minister with blackmail: either you haircut deposits or we shut down the economy; the ECB would cut off liquidity to the banks.

The Cyprus parliament had already passed a number of laws that influenced the current and future spending and pensions. And they were also in the process of finalizing how they would do privatizations of the semi public companies. So all the standard elements you'd expect in other programs had been done or were being done.

The question is: Why did they attack retail deposits in this manner? This had never before been a requirement of any other program. And why did the German government insist in the last three days that there should be a bail-in? The only logical explanation I could see is that Angela Merkel's government faces re-election in September of 2013 and the SPD [the Social

Democratic party, the principal opposition to Ms Merkel's Christian Democratic Union] has made it an issue: it does not want to support a loan by the German government to Cyprus because, they claim, that would be like bailing out the Russian oligarchs. This is how Cyprus got caught up in the German election.

In the previous three programs [Greece, Ireland and Portugal] the SPD supported Merkel's government on making the loans, but they were not as close to the election as this one. The SPD, I believe, was trying to differentiate its position. This presented a dilemma for Merkel's government. If she suggested that a loan be given to Cyprus to bail out money from Russia, this would not go well with the debate in Germany. So it was incredibly convenient to say that all the depositors, including Russian depositors, be asked to be bailed in. To support this reasoning, unsubstantiated statements were being made in the German press that deposits in Cypriot banks reflect money laundering and that the banking model of Cyprus could not be allowed to continue. The objective of the March 16 plan to confiscate part of deposits was none other than to damage irreparably the Cypriot banking system.

Conclusion

The politics, in my mind, is what makes this episode so ugly. Some governments, to serve their own national or narrow political interests, arrived at a decision that inflicts irreparable damage to Cyprus. This is similar to the blunder in Deauville with PSI that injected credit risk into sovereign government debt. The governments have created risk in what before last week were considered perfectly safe deposits. This is going to have a chilling effect on deposits in any bank in a country perceived to be weak. This will mean the cost of funding will increase in the periphery of Europe and as a result, the cost of financing for businesses and households will increase. That will add to the divergences we already have and make the recession in the periphery of Europe deeper than it already is. This is really a disaster for European economic management as a whole.