THE UNEXPECTED CYPRUS PARADIGM
CYPRUS IS FORCED TO RECONSIDER TROIKA'S NON-VIABLE CHOICE

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Cypriots were fully aware of the serious problems their economy was facing and that the inevitable bailout – which also became bail-in as well - agreement was going to be austere. It must be made clear that there was a willingness to address these problems quickly and substantively. Fiscal rationalization had essentially started in December 2012. The new government which took over on March 2 2013 had begun to push further. Eventually the political climate on the island was such that the people were prepared for a gradual paradigm shift. In this effort Cyprus had expected the solidarity of the Eurogroup and above all Berlin.

The March actions and decisions of the Eurogroup came as a shock. In reality what has happened is an unprecedented attack on Cyprus financial sector which takes the country back decades. The Eurogroup decisions entailing the resolution of the Popular Bank, the severe haircuts on depositors of the Bank of Cyprus and its further heave burdening with the ELA obligations of the Popular Bank have paralyzed the financial system of the country. The financial restrictions are much worse than those imposed in the immediate aftermath of the 1974 Turkish invasion and occupation of 37,4% of the territory of the country. For example, Cypriots today cannot break a time deposit in any financial institution for the purposes of a transaction even for health purposes.

In essence, the banking system of Cyprus has been cut to pieces and its public robbed with a viciousness that raises serious questions about the existing value system in the EU. Inevitably there are serious disruptions on all aspects of life. The Troika decisions on Cyprus have pushed the country from a recession to a depression. The damage in economic terms is huge – comparable to the 1974 fallout. The euphoria that existed in Cyprus before

the accession to the EU has deteriorated dramatically turning into deep bitterness.

It should also not escape our attention that over time severe misperceptions were created about Cyprus; for example that it was a money laundering centre, a casino economy, and above all that it was a state that caused the EU recurring headaches. It also seems that some quarters in the EU had held a grudge that in 2004 the Greek Cypriots had rejected the UN plan for the solution of the Cyprus Problem. As if in a referendum one has to vote what others think is good for them!

But it is now emerging that the Eurogroup's vindictiveness against Cyprus is beginning to backfire. This is not only an attack on Cyprus; it undermines the entire concept of the euro and worse still of all modern banking systems which are based on fractional reserves for banks, backed by one or another form of governmental guarantee. It remains to be seen how this will end.

Undoubtedly Cyprus will suffer and sooner or later the country will have to opt to temporarily return to its national currency, the Pound (which would in essence be the Cypriot Euro). The earliest this is done the better for the prospects of creating the preconditions for putting an end to the depression. As far as the Eurozone is concerned, it seems that if there is no change of philosophy and economic directions other countries will follow Cyprus accordingly. It is not an exaggeration to also note that if the current economic policy pursued by Germany persists the future of the Euro itself will be at stake.

Be that as it may, a major question that is raised is whether Cyprus can get out of the recession/crisis/depression within the framework of the philosophy of the Memorandum and the current architecture of the Eurozone. Unfortunately this is not possible because of three major factors:

(a) A huge fiscal cliff;

(b) A great negative wealth effect as a result of the decision of the Eurogroup in March 2013 and the developments thereafter;

(c) Serious internal and external restrictions to capital flows and a crippled financial sector.

Nonetheless, the crisis can be addressed within the architecture of the Eurozone if the EU changes fundamentally its philosophy and direction. This would involve a very generous Marshall Plan, allowing the country to have discretionary fiscal policy (including higher deficits) until it exits the crisis, unconditional access to ELA and absolute relaxing of the internal financial controls. In the absence of such an approach inevitably Cyprus has to seriously examine the possibility of temporary exit from the Eurozone and the introduction of a national currency.

The policy plan could combine elements of Roosevelt's policy in the 1930's in the USA to address the depression and Reagan's philosophy in the 1980's to stimulate the economy. Such a strategic policy mix will include an expansionary fiscal policy allowing for deficits in the immediate short run as well as tax decreases – VAT from 18% to 13% and Corporate Tax from 10% to 9% instead of the proposed tax increases by the Troika.

The suggestions also entail keeping the current deposits in Euros while the debts will be paid in the new national currency, the Pound or the Cypriot Euro. The amount that will be lost for the banks due to the devaluation will be compensated by the Central Bank. This will not lead to high inflationary pressures as the monetization will be spread over an extended period of time. For example, assuming that the private debt is about €56 billion and that the Pound will be depreciated by 20% and that the average debt period is about 15 years: this means that the Central Bank will pay 11,2 billion Pounds for the whole period of 15 years, in other words 0,747 billion Pounds annually. By the same token similar arrangements could be made for the internal public debt which amounted to €7,3 billion (48,4% of the GDP) at the end of 2012.

It should be noted that in any economy there is an optimum level of Money Supply/Stock. In the case of Cyprus the amounts involved are such that the monetization process will not cause any serious problem. The fact that current deposits will initially stay in Euros will be an additional factor which will contain inflationary pressures. Cyprus can work in ways so that inflationary pressures are avoided or at least kept to the minimum.

Last but not least, exiting the Eurozone and adopting a new national currency is a necessary but not sufficient condition for recovery and for embarking on a new path of growth and development. Indeed it is essential that the country moves gradually toward fiscal rationalization while looking into new engines of growth and for a new economic paradigm.