CYPRUS: SIX REASONS FOR STAYING WITHIN THE EURO AND ONE QUESTION ABOUT WHETHER IT CAN

Michalis Attalides, Rector, University of Nicosia
Antonis Polemitis, Managing Director, Ledra Capital LLC
Stavros Zenios, Professor of Finance and Management Science, University of Cyprus

As in many arguments about a political and/or economic situation, in the argument about whether Cyprus should be in or out of the Euro, there is a tendency for the confusing and invalid conflation of a number of issues.

One issue is the cause of the crisis. The communist party, AKEL, which bears much responsibility for Cyprus reaching this state, tends towards arguments deceptively implying that the current condition of Cyprus is due to the Euro Group and the Troika. However, Cyprus has 14% unemployment, while still having experienced only a minor impact from Troika measures.

Herman van Rompuy referred to "years of mismanagement", which every Cypriot knows is true. The main attribution of responsibility to the euro is that being in the euro area contributed to the attractiveness of Cyprus to foreign (including Russian) depositors. However the economic problems were the result of the world economic crisis combined with three other factors: The first was that, based on the foreign deposits, Cyprus bankers followed an expansionary policy of loans and investments, and (second factor), a profiteering attitude which verged on gambling. When the crisis came, the banks faced severe liquidity problems and the second largest bank of the island became insolvent. Policymakers and the regulating institutions, the Ministry of Finance, or the Central Bank of Cyprus, fell short in their job.

The second issue is the treatment of Cyprus by the Troika and the Euro Group, just two weeks after Nicos Anastasiades became president, after the end of the term of our previous, communist president, Demetris Christophias. The new president had committed himself to immediately negotiating, agreeing and signing a Memorandum of Understanding on the bailout.

The treatment he received from the Troika and the Euro Group has caused shock all over the world. Other Mediterranean and small members of the EU should be warned. After showing patience with anti-EU Christophias for months, they exposed Anastasiades to pressure and deadlines, threatening to suddenly cut off Emergency Liquidity Assistance funds to the banks, assistance which had been provided for over a year to one bank that many local analysts considered insolvent, by-passing ECB policies.

The reasons given both by the Euro Group president and the sole large power active in the EU now, Germany, for the harsh treatment of Cyprus are deceptive or straight-forwardly wrong. They are deceptive because they never mention that, though with many weaknesses, the Cyprus economic model, which is based on services, and not heavy industry, functioned and was not in danger of collapse, until the Euro Group decided the PSI to the Greek public debt, which landed the Cyprus banks with a 4.5 billion euro loss, equivalent to 25% of the country's GDP. We are not aware of any other country suffering similar losses, since Finland was hit by similar proportionate loss of GDP with the collapse of the Soviet Union.

It was negligent for both the Cyprus Government and the European Council that Christophias was allowed to agree to the PSI without being clearly warned on the consequences for Cyprus, and without any measures being taken for the security of a small Euro Group member state. These two factors alone should have induced extra understanding on the part of the Euro Group for their, at least moral, obligation to support the recovery in Cyprus.

Additionally, the measures insisted on contain injustice for innocent people. Of course the two large banks have the main responsibility. But who are the human bearers of this responsibility? It is clear that those responsible are the shareholders who elected the boards, the boards who appointed the directors and other officials, the officials who made the decisions, and finally those who bought the bonds of these banks. What is the responsibility of depositors in these banks, who are the least sophisticated parties involved and who had been informed that these very same banks had passed the EU "stress" tests, conducted by financial regulators?

In the last few days, it has also been revealed that Cyprus has suffered a further 5.5 billion loss through the emergency financing (ELA) of branches of Cyprus banks in Greece, not directly, but through their Cyprus headquarters. In a remarkable act of injustice, adding insult to injury, the Greek Branches have been taken over by a large Greek bank at fire sale prices but the ELA debt has, with the Euro Group decisions, remained in Cyprus. It is transferred to the second, surviving Cyprus bank, creating a further total indebtedness of 11 billion euros.

Finally, the justification proposed for this collective punishment are the so called black Russian deposits reported by the German secret service to exist in Cyprus. Not a single case has been named, and not a single figure. If the proof is the existence of wealthy Russian depositors, how does this differentiate Cyprus from the other EU countries? In any event Cyprus has accepted inspection by relevant international bodies, which implies acceptance of any measures for improvement which they propose.

Furthermore, the theoretical “victim” of the Russian tax structuring through Cyprus, is not Germany, but the Russian Treasury; yet Russia renewed the double-taxation treaty that is the basis for these fund flows just months ago and has been critical of the bailout approach. Clearly, Russia finds that the advantages of having a EU jurisdiction with English law as a channel to funnel investment into Russia outweigh the lost tax revenue. The EU should be applauding Cyprus for using its competitive advantages (skilled workforce, rule of law, etc) to draw tax revenue into the EU, not demonizing it and aiming to destroy decades of work in building the high skill infrastructure needed to support this industry.

Finally the Euro Group has no legal basis to call for a shrinking of the banking sector in Cyprus, any more than Cyprus has one for calling for a shrinking of the motor and arms sectors in Germany. Nor is there any basis for calling for an increase in corporate taxation in Cyprus, any more than there is for calling for a reduction in Germany.

All this is good reason for reflection on the part of EU members, and particularly of the Euro Group members. But are these reasons for Cyprus to leave the Euro? The crucial issue is that this decision should not be taken on the basis of whether injustice was done to Cyprus by the Euro Group (which injustice is also balanced by a 10 billion euro loan on favourable terms at a time when the markets will only lend to Cyprus at impossible terms), but strictly, and this is the third broad issue, on the basis of whether staying or leaving is in the interests of Cyprus. There are at least six reasons why leaving the euro is not in the interests of Cyprus:

1. Economists who advocate leaving the euro do so in order to minimize the cost, in terms of deflation, depression, and human suffering, which will come from the Troika/Euro group measures. But no one has quantified this cost.
2. Nor have any of the economists who argue for leaving the euro quantified the cost of returning to the Cyprus pound, and so the relative cost of the two have not been clearly, or even approximately compared. Clearly, in the case of leaving the euro there will be enormous devaluation. This will dissipate savings across the economy and not only for the 45% of deposits which are in the two largest banks, will make repayment of external financial obligations impossible, and will also make imports almost impossible in a country that imports almost everything it consumes other than tomatoes and oranges. (Even lemons are imported from Argentina for part of the year).
3. Only Paul Krugman has hinted at the consequences of leaving the euro, while advocating it, saying that Cyprus will develop its economy through cheap mass tourism and agriculture. Surely Professor Krugman did not mean to suggest that Cypriots (70% of current school leavers with tertiary education), will return to being waiters and farmers. Moreover, agriculture’s growth is limited by

the arid climate and tourism is already at capacity levels for at least 2 of the 4 months of the tourist season. It is hard to imagine either area contributing more than 2-3% of additional GDP growth, however much Cyprus devalued.

4. No one has ever left the euro area and the terms are unknown. In the case of Cyprus and the current internal balances in the EU, the terms could turn out to be harsh. The 10 billion Stability Fund loan has still not been given, and in case of leaving the Eurozone will merely need to be sought elsewhere(!). But the eleven billion Emergency Liquidity Assistance loan has already been taken. What would be the terms of repayment? Would Cyprus default on the loan? In that case, would Cyprus remain in the Union, and on what terms?
5. If Cyprus, in the best case, becomes a black sheep of the EU, and in the worst case is forced to leave, would Cyprus be in a better geostrategic situation than it is now, with the US as well as the EU supporting its sovereign right to the natural resources in its exclusive economic zone?
6. Will, in case of exit, Cyprus be in a position to rebuild its economy through the three or four avenues which offer themselves?
   (a) Tourism will probably continue developing in either case.
   (b) Rebuilding trust in its financial services will be much easier within the euro, than with a devaluing currency, and being a defaulting debtor.
   (c) Its energy deposits will strengthen its economic and political position in the EU, but only if they can be securely exploited. More likely within than without.
   (d) The use of the energy deposits are also necessary for the re-establishment of its credibility as a financial centre and economic growth in general. The stability and solidarity fund, already legislated for, must immediately come into effect, will receive its main credibility from future energy receipts, and will be crucial for maintaining social peace, restoring growth, and returning every last euro of all depositors who have been unjustifiably, if necessarily taxed, is also a necessary measure for restoring confidence in Cyprus as a financial centre .

   Unfortunately, Cyprus and the EU also have one terrible question before them:

   Will Cyprus be forced out of the Euro Area? The 11 billion ELA Loan which, to our horror was revealed a few days ago, and which will end up being a debt of the biggest bank, the Bank of Cyprus, even though 9 billion euros of the loan was made by the second biggest (failed) bank, Laiki Bank, may end up completely choking the market, thus, through total paralysis, pushing Cyprus to either default or print some kind of money, either action possibly forcing it out of the Euro area.

This is a possibility unless the Euro Group and the ECB find a way to absorb this amount and save Cyprus from total economic suffocation. It is economically and politically correct that they should do so because this sum is almost exactly equivalent to the sum of losses that Cyprus is not responsible for: The 4.5 billion which Cyprus lost with the European Council decision for the Greek debt PSI, plus the 5.5 billion of European Liquidity Assistance which went to the Greek branches of the two ailing Cyprus Banks.