

THE EUROZONE, CYPRUS AND THE OPTIONS FOR THE FUTURE

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It should be clear to everybody by now that the haircut on bank deposits should never have been thought up by the Eurogroup and the Troika, and should never have been accepted by Cyprus. For economics is not just mathematical model, it also has a lot to do with psychology, and if people are afraid of the future they will become more cautious. This has been evident for a while in Cyprus, as people cut spending and bank deposits of residents increased in the middle of recession. Barclays confirms the psychological effect by stating that they estimate that the haircut of deposits in Cyprus will reduce deposits in Europe as a whole by 15 billion a year.

It is yet another example of how the western world has mismanaged the economic crisis from the beginning in 2007, and continues to fail to find a way out, despite trillions of printed bank notes disguised as monetary easing issued in USA and European Union member currencies. Most commentators now agree that allowing Lehman Brothers to fail was a mistake which made recovery from the initial phase of the currency more difficult, and that excessive austerity has a much larger negative multiplier on economies than realized, and that the only way out is through growth. Yet ideas on stimulating growth are rare indeed, however, though everyone says it is essential, the universal response being "Where is the money for growth going to come from?".

At the same time governments are losing their powers to act either because of tea party economics forcing austerity on a recession to cut debt despite high unemployment, or because credit rating agencies focusing on debt and not growth reduce government bonds to junk and force fiscal crises on states. The credit rating agencies by failing to consider growth policies in their assessments are actually pulling the whole system world-wide downwards by emphasizing book keeping and arithmetic, rather than focusing on the economics of recovery and allowing growth policies to be implemented by Governments.

The aim of this paper is to put forward a policy response to the current situation faced by Cyprus in order to enable the development of a strategy to get us out of the straight jacket we are in and get back to growth. To be able to have a strategy however, we first have to consider what has occurred, how we dealt with it, what the immediate risks are and how we can deal with the immediate issues that will have to be faced and develop a strategy for growth. Within this context the consideration of a possible exit from the Eurozone takes central place either because Cyprus maybe forced to leave, or because it maybe a way out of the downward spiral, or in order to understand better the present situation. Discussion of a euro

exit is healthy because we improve our understanding of where we stand and what the options are.

In fact the haircut on deposits is an attack on the Cyprus model of development which until 2008 was remarkably successful, and was based on low taxes, development of services, attraction of international businesses and the comparative advantages of the island, notably the weather and its educated labour force. It is therefore imperative to consider what are the options before us and how do we get out of this mess, and all options should be considered and studied systematically and in depth. We have reached this desperate situation owing to the blinkered view with which the previous government everything through a socialist dogma, while the present government has blinkers on that are made in Brussels. We need to think out of the box and reject dogma and focus on what is logical and can work, in a systematic manner.

The first point that has to be made is that we should stop painting everything blacker than black, and remember that in 1974 all the banks were bankrupt, there were 200,000 displaced persons (160,000 plus those close to the ceasefire lines who left for security reasons), massive unemployment, the most developed areas and all the investments made in the north were destroyed or out of reach, and Government revenue was just not there. The planners studied the situation and stated that it would take 25 years to recover the lost capital (more in terms of wealth including land). In fact by following a pure Keynesian policy by printing money, co-operating all together and utilizing one year's imports worth of foreign exchange reserves, recovery of GDP was achieved in less than 5 years.

That is the beauty of having one's own currency, but it has to be combined with a growth strategy, and measures designed to minimise inflation. It should be noted that there was no devaluation (and essentially no black market in Cyprus pounds) and the country never ran out of foreign currency because growth created inflows of foreign currency. Throughout the period up to the 2008 accession to the Eurozone Cyprus had exchange controls, something which is essential in a country which has 40,000 Turkish troops across the Green Line to the north and where any political problem can cause money flight. In view of this experience where the situation was must worse than at present, it is essential that the return to the Cyprus pound be seriously studied both in legal and economic terms.

The second reason why we must study the possibility of a return to the Cyprus pound is to avoid being ambushed again by what was Eurogroup blackmail, that is the withdrawal of emergency liquidity assistance or some other constraint at short notice. Some will argue that since we have agreed with the Eurogroup that will not arise again, and now there is only Plan A. In fact Haris Georgiades, the new Minister of Finance has just said

exactly that, which is totally wrong, highly dangerous and either naïve or arrogant. There is no one way ahead, because as most economists agree there is a real danger that Cyprus will be unable to meet its obligations because the haircut could send us into a downward spiral and government revenues will making it impossible to meet obligations. Therefore Cyprus may be called upon to undertake another haircut. In that eventuality Cyprus should be prepared to walk out of the eurogroup meeting, assess the situation and if necessary leave the Eurozone.

To be able to walk away from another damaging and unjustified position imposed by the Eurogroup, Cyprus should have printed Cyprus Pounds at the ready. One is not in a position to play poker and bluff, if the proposals are unacceptable Cyprus should be ready to reject them. Not only will this enable resistance of another damaging imposition by the Eurogroup, it would also strengthen Cyprus's bargaining position and facilitate agreement with the Eurogroup on measures more acceptable. Therefore, the return to the pound has to be studied seriously and prepared for just such an eventuality.

One technical issue that has to be examined so as not to blacken the whole picture is the difference between wealth and income, the two should not be confused. In 1974 the loss of wealth in terms of land, infrastructure, capital investment and housing was enormous. Yet recovery was achieved in GDP within a short period (recovery in wealth at constant prices has not been calculated, but it may have been surpassed by the late 1990's). The haircut itself massively reduces wealth, but the income effect will be somewhat milder depending on what happens to loans (ie. working capital to keep companies going). In 1974 a trick introduced to spur investment to restore the capital lost (hotels, factories and working capital etc) was to put some deposits in all banks aside for businesses for investment and working capital purposes which could only be released after Central bank approval. Something like that will be needed and will deal with one of the obvious disadvantages of the haircut, and also the reluctance of banks to give loans.

It is absolutely essential that Cyprus should consider in a systematic manner what are its options in dealing with the situation, especially in future negotiations with the Eurogroup, and that a plan for growth be prepared. The Government promises that soon it will announce its proposals for stimulating growth, but there is no indication that it is considering Cyprus's options in the event that it cannot meet the obligations of the memorandum.

The options that should be examined are as follows:

- Euroexit whether voluntary or pushed.
- Memorandum exit through a loan from another source. But with the offer of real benefits to the lender, as well as higher interest rates. This is also the view of the House of Representatives.

- Re-negotiation of Cyprus debt to spread out repayments or haircut bonds or loans.
- Controlled bankruptcy (not necessarily a disaster).
- Utilization of future revenues from hydrocarbons.
- Sale of Cyprus assets (property, state corporations, Hydrocarbon plots etc).

All the above should be studied carefully with help from outstanding lawyers and economists from abroad with experience in cooperation with Cyprus Layers and academics, because we are likely to enter discussions in the next couple of years if we fail to limit the resulting fall in GDP arising from the Memorandum and get back to growth quickly. There should be brainstorming as to consider other options and to study them well.

The proposed strategy given that the memorandum has been agreed and the Government is committed to its implementation, and that we are not in a position to renegotiate it at this stage, is as follows:

1. Cyprus should print Cyprus Pounds just in case the country is ambushed again, and study the policies that would mitigate the negative effects of a return to the Cyprus Pound.
2. Cyprus should insist on a European policy of managed withdrawal from the Eurozone, if a country so desires.
3. Cyprus should insist on a way out from the Memorandum in the event that it repays the loans to the Troika.
4. Cyprus should build up its foreign currency reserves or its gold holdings (currently about €600 mln).
5. Cyprus should cooperate with other countries in the Eurozone to create an alliance of the south.
6. Cyprus should renegotiate its loans.
7. A serious study of all options should be undertaken.
8. An effective growth policy should be studied and introduced.
9. Agreement should be reached on a strategy that meets the requirements of the memorandum, minimises GDP losses and encourages growth.

The concept underlying this approach is one of strengthening the BATNA of Cyprus, that is the Best Alternative to a negotiated settlement. If negotiations appear that they will not lead to a reasonable settlement, then one should have the capability to walk out and implement the next best alternative. Knowledge of the BATNA that you have, if it is a viable alternative, strengthens your position in the negotiations because you have a way out, something better than that offered to you. But you have to be realistic and assess your BATNA properly, because these are dangerous times, and there is no solidarity or reasonableness in the European Union, so you have to be sure that there is a workable alternative and develop that in case it is needed.