CYPRUS BAIL-IN BECOMES A RESCUE BLUEPRINT… IN A HOUSE OF STRAW

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Five years on from the bankruptcy of the Wall Street bank, Lehman Brothers, and Europe is still licking its wounds. Incontrovertibly this is the worst financial crisis in post-war European history, triggering severe budgetary and banking crises in many member states of the Union. The crisis has highlighted many of the inherent weaknesses of the supranational financial institutions, bringing down the house of straw on which the Economic and Monetary Union (EMU) had been built. Although modelled around the European Central Bank (ECB), the EMU effectively lacked the instruments that could guarantee a strictly coordinated economic policy, as well as an institutional mechanism that could restore economic stability in times of crisis and attract capital investments in times of market uncertainty.

As borrowing costs fell dramatically after the introduction of the Euro, in line with Germany's historically low interest rates, new member states had access to great amounts of capital from the ECB and a frenzied borrowing process began. In the absence of a European rating agency, the risk and uncertainty caused by this uncontrolled borrowing was not evaluated correctly. Governments found themselves with unsustainable debts and the sole institution of the Eurozone, the ECB, was not able to handle the situation. Apart from the fact that a European stability mechanism was non-existent (while it should have been established from the beginning), the absence of a single fiscal authority, with the jurisdiction to set a common fiscal policy across the Eurozone, became a most acute problem and the ECB was unable to respond to the crisis through an expansionary monetary policy. This absence of a fiscal authority also meant that the ECB had no one to count on for both short-term and long-term financial control.

In the absence of such solid regulations, and following multi-trillion government bailouts, the March Eurogroup meetings on Cyprus experimented on a new rescue model: a 'bail-in'. In contrast to the 'bailout' recipe – by that time widely used in the European periphery – the 'bail-in' deal involved bank creditors bearing losses for failed banks. By transferring the financial burden on shareholders, bondholders and large depositors, the German-led group of countries supporting this new model aimed at ensuring that taxpayers would no longer be the first in line to take on the burden of banking failures. This would eventually break the link between sovereign debt markets and banks.

Following the second Eurogroup meeting on Cyprus of 24 March 2013, Dutch Finance Minister and Eurogroup Chair, Jeroen Dijsselbloem, commented that the Cyprus bailout could serve as a model for others. The statement ruffled feathers and he soon had to retract it by tweeting that Cyprus was of course a special case! Even though Dijsselbloem's initial statement was considered by some to be very unfortunate, it is doubtful that it was a slipup. Just four days later in fact, the ECB Governing Council member Klaas Knot stated that there was "little wrong" with Dijsselbloem's recipe for dealing with future Eurozone banking crises: "The content of his [Dijsselbloem's] remarks comes down to an approach which has been on the table for a longer time in Europe. This approach will be part of the European liquidation policy." It is no secret in fact that this idea was for years being discussed in the highest circles of the European banking sector.

It comes as no surprise then that the latest Union decision has been for Europe-wide 'bail-in' rules – Cypriot style! And it comes as no surprise that Dijsselbloem welcomed this decision by hailing the agreement as a major step towards a banking union and away from state funded aid to recapitalise or bailout troubled banks across Europe. Even though the need of reviving the momentum to move towards a banking union is not being questioned, what IS being questioned is whether this is a brick-step towards that direction. The reservation relates to the fact that, in case of bail-ins, the obvious way to avoid bank runs is by imposing capital controls, as is happening in Cyprus right now. But even this cannot be a permanent policy and cannot prevent or mitigate fears of future bank runs. Moreover, this measure is not in line with EU principles of free capital movements; even worse, such capital controls, which prevent the trading of the currency, can eventually cause huge discrepancies in the currency across Eurozone members.

If the EU wishes to preserve the Euro, it is imperative to restore lost confidence in its financial system. The EU is attempting to do this in the absence of a fiscal union – an unpopular scenario as it involves sacrificing state sovereignty on fiscal management. This only leaves policy-makers with one option: a banking union. This should entail, at a very minimum, a single supervisory mechanism (SSM) for banks, which will be led by the ECB; at a maximum, a single resolution mechanism (SRM) to handle bust banks, but this is difficult as the EU Treaties provide no base for such mechanism. The EU is currently working towards this direction, with the SRM currently in the making. It is believed that the latter will be established by the time the ECB assumes full supervisory responsibilities as the region's single banking supervisor, at some point in late 2014 or early 2015.

So in the post-experimental era, the EU is reluctantly getting its skates on to work towards revisiting some of the anomalies and institutional weaknesses emanating from the foundations of the EMU structure. The new structure should be able to guarantee stability, not just to the countries of the affluent North, but also to those of the weaker South. The ultimate aim should be that next time the financial “wolf-pack” blows the wind of crisis the direction of this house of straw, the “little PIICGS” will be living in a house of bricks.