THE CYPRUS (UN-) PRECEDENT!

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It took almost two years after Cyprus had lost access to sovereign debt markets and about a year after it had formally applied for financial assistance to conclude a bail out agreement with the troika. This delay and procrastination may have been more tragic and irresponsible than we can now possibly think. This for the simple reason that the economic and political environments that we operate in, this time and age are risky and fluid. Neither does Europe have a fixed template for managing its debt crisis, other than learning by doing. Why then wait on the basis of assumptions that may prove unfounded? The European electorates on the other hand, in a context of governments seeking re-election, may be limiting the options that would otherwise be available. There is a disconnect in Europe, in that the prevailing electoral thinking is more national where the broader context is increasingly more supranational.

The decision on Cyprus had been eventful, unprecedented and ironically tragic for the Cypriots in particular. But its consequences may not necessarily remain confined within the bounds of a small island, that besides, it constitutes, as it has been repeatedly stated, a mere 0,2 percent of the European economy.

Initial discussions between the new government in Nicosia, and the Troika immediately after the February presidential elections focused on debt unsustainability, an issue that was raised insistently by the International Monetary Fund. The due diligence exercise by Pimco concluded that bank recapitalization needs would be €8,9 billion under the adverse scenario, not counting the €1,8 billion capital injection into Laiki Bank in June 2012. Government new funding needs and debt refinancing for the next three years, bring the total package of financial assistance to €17 billion arguably projecting the debt ratio to 140%-150% of GDP by 2020. That was deemed unsustainable and the IMF refused to participate unless measures were taken at the outset to secure debt sustainability.

At the Eurogroup meeting of Friday 15 March, a first deal was struck in the early hours Saturday, for a €10 billion bailout and a so called stability levy on the deposits of all banks and credit cooperatives, in order to recapitalize Laiki and Bank of Cyprus. The agreement was a radical departure from previous bailouts. The stability levy would be laid on the uninsured depositors (at 9,9%) as well as on the insured depositors (at 6,75%). This would fetch €5,8 billion much of which from non-resident Russian depositors.

In a later teleconference on 18 March, the Eurogroup corrected the initial decision to bail in the insured depositors and its statement said: *The Eurogroup continues to be of the view that small depositors should be treated differently from large depositors and reaffirms the importance of fully guaranteeing deposits below EUR 100.000. The Cypriot authorities will introduce more progressivity in the one-off levy compared to what was agreed on 16 March, provided that it continues yielding the targeted reduction of the financing envelope and, hence, does not impact the overall amount of financial assistance up to EUR 10bn.*

The vote in Parliament that took place the following day, 19 March, was an outright rejection, misguidedly so, we dare say!

The subsequent agreement that was reached at the 25 March Eurogroup meeting was vastly different than the initial agreement that Parliament so light-heartedly rejected less than a week before: two of Cyprus' largest banks – Laiki and Bank of Cyprus – would undergo restructuring. Laiki would be resolved immediately and Bank of Cyprus would be recapitalized through a conversion of uninsured deposits into equity and with the full contribution of equity shareholders and bondholders. Cyprus will agree to a Memorandum containing measures for structural reforms, fiscal consolidation and privatisation.

The European Union had taken a hard line on Cyprus imposing thus a course of action that will prove highly disruptive and might possibly necessitate further assistance in the not so distant future. The island's banks were overextended with assets at a point exceeding GDP by eight times. The size and structure of Cypriot banking was unique in some ways, and individual banks had remained heavily undercapitalized with little capital between equity holders and depositors. But the bailing in of depositors is a new and potentially destabilizing precedent in Europe.

For Cyprus, a country with limited internal capital resources, the agreement will be highly disruptive. But it raises a wider question for Europe: whether or not foreign depositors will accept that Cyprus was a singular and unique case as much as Greece was before! If not, and if foreign corporations decide to pull at least part of their cash out of European banks, then this might eventually lead to liquidity crisis in Europe.

The question then becomes, why did the Eurogroup and Germany in particular, decide this course of action creating this liquidity risk? With Jeroen Dijsselbloem saying that the model used in Cyprus could be used in future bank bailouts, even if he withdrew this remark afterwards, Cyprus cannot be seen entirely as a unique and singular event.

We might then conclude that perhaps, options are indeed limited, and that hence, decisions on Cyprus mark a turning in the strategy that seeks to manage the debt crisis. Put another way, the banking system in Europe is too big to bail out if it comes to a serious crisis. Any solution thus, will have to involve the loss of depositors' money. This concept is a game changer, and it remains to be seen how unique Cyprus can be!