Taboo broken, twice! – Fiat Euro! 12/2013

The crisis was hidden in Cyprus. We broke two different taboos. Moscow-Cyprus: booked out.

During the last months we been listening the eurozone leaders repeatedly saying that the crisis is over. Spanish banks rescued, Italian and Spanish bond yields low, the Irish returned to the market. Greeks and Portuguese still demonstrate but their governments keep dragging the proposed reforms like apathetic mules under the benevolent eye of the Troika, which is handing out deadline postponements for compliance with the limits easily. And suddenly - Cyprus.

Cyprus, along with Slovenia, has been in the shadows of the PIIGS problems already for quite few months. Everyone knew that Cyprus would need help, but this would be in comparison to other states so small that it was not exciting. There is a new president in Cyprus after the recent elections, who is much more inclined to taking help from the Troika compared to his predecessor. The official signal was an ECB announcement that, as of last Tuesday, it would stop providing liquidity to Cypriot banks through the ELA program, in other words - it will prohibit the Central Bank of Cyprus from printing additional euros. Cypriot banks are depleted due to their binding to Greece and losses coming from the Greek haircut. A traditional rescue event associated with hands shaking and salmon sandwiches could begin.

Cyprus is small, but the Cypriot banking sector is relatively large, seven times larger than the Cypriot GDP. In absolute terms, it is still small. But this also implies that should Cyprus be rescued only by funds from the permanent euro-wall, its public debt would jump far above 100% of GDP. Troika suddenly realised that the rules are to be followed and the ESM rules (though vaguely - article 13) say that a loan may be provided only to a country, that will be able to service the in turn increased debt (at least according to their models). Somebody malicious could say that rather than ESM rules, the upcoming German elections in September played the crucial role in demanding savers' contribution to the bailout. There are around 20 billion euro of savings and other few billion of investments of Russian citizens in Cyprus. A rescue of those by the German money would be, say, unpopular...
Out of the less than 16 billion euro required, Europe prepared 10 billion pile from the ESM. Cyprus is supposed to get the rest on its own and quickly. Here comes the first surprise. Cypriot government agreed with Eurogroup that they will get this money by taking them directly from the savers via a special tax levied on their deposits, even on those deposits that are supposed to be guaranteed by the Cypriot equivalent of Deposit Protection Fund.

Although many whispered about such possibility for some time already and the exodus of few billions euro of deposits in February showed that some took this idea very seriously, for most of the world this came as a shock. Politicians and their friends managed to quickly swipe their money abroad already few days before and people began to besiege ATMs in an attempt to save part of their money from taxation. Flights from Moscow to Cyprus were sold out in a while.
The tax rate is not very high - many Slovak self-employed or contract workers will lose much more due to the higher taxes effective as of the beginning of this year. But the thing making the Cypriot case different is that one of the fundamental taboos of the crisis was broken. Thou shall not touch savers in the banks!

The second taboo fell two days later, when the Cypriot Government did not approve the proposal they agreed on previously. It was the first time a country on brink of a bankruptcy said NO. Troika and the whole eurozone were let standing with their mouth wide opened.

Cypriot banks are closed, residents can still withdraw 800 euro a day from the regularly re-stocked ATMs, but all business transactions and with them the whole economy just froze. ECB is threatening to stop ELA from Monday on, but this time for real, they say. Pinky swears!
New solutions are being proposed on the spot. These include seizure of pension savings and social funds, exchanging deposits for Cyprus and Gas bonds, selling the rights for future natural gas production, which was by the way only discovered recently. The hot candidates are: taxing deposits in excess of a certain amount, or so-called Icelandic way - taxing foreign savers.
Some are raising their hopes on Russia, a country that they have had traditionally close relationship with (40% of foreign direct investments to Russia comes from Cyprus, or better said from Cyprus based Russian firms), which saved the country already once in 2011 with a €2.5 billion loan. But the Russians currently only have a single concern, to get their money out of the country rather than sending there even more. They would also require solid collateral for the loan. It is however highly questionable whether these pigs in a poke named gas resources or a naval base in the Mediterranean are sufficient attraction for so much money.
Whatever turns out to be the result, Cyprus is only a small island in the end. We sent 240 billion euro to Greece, pledged 100 billion euro to Spanish banks. Regarding Cyprus, we are only talking about a handsome sum of 10-16 billion. The important point here however is how

the outcome will affect the PIIGS. If Cyprus managed to push the ECB and the rest of the Troika to a more favourable package, other countries will be motivated to break the rules even more than they were before. On the other hand, if the measures affect savings in banks (and in this case it does not matter whether all savings or only the large ones), then this can lead to even more capital outflows from the periphery than in the past and force the local banks to close down.

These are no longer endless negotiations under Acropolis, or a constant subterfuge and rejecting help in Madrid. Cyprus froze and the solution must come within a few days. Eurocrisis is not over, instead, it came to a new level. We can still continue buying time as usually and simply pouring money into the country via various channels, but a new uncertainty in the euro area is already growing.

Cyprus filled almost all space in this week's issue. Anyway, let us reveal some news from other parts of Europe. Firstly, due to the Dexia bank rescue, Belgium will exceed the 3% deficitconstraint and become another candidate for the mythical fine no one ever seen. Secondly, one of the main French fighters against tax havens, the budget minister Jerome Cahuzac, resigned because he is being investigated due to a bank account in Switzerland. Additionally, after a fall due to the one-off transfer to the newly created "bad bank", the portion of bad loans in Spanish banks started growing perilously again. And for the very end: Francis became the second largest employer in the U.S.
We wish you a very nice week!

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