Cypriot Financial Crisis: Its causes and impact on Financial Markets

Cyprus is a tiny island located in the Eastern Mediterranean that is famous for its beautiful, sandy beaches, exquisite food cuisine, and warm climate. However, for a 10-day period during last March it became the epicenter of a financial storm that threatened markets in Europe, but also in other regions of the globe. That was due to a political decision taken by Eurogroup (meeting of the Finance Ministers of the Eurozone) on March 15th for a bail-in of depositors across all banking institutions (foreign and local) in Cyprus, in order to save the country's banking system and in particular the two biggest banks, Laiki Bank and Bank of Cyprus (BOC, hereafter). The decision called for a levy (haircut) of 6.7% for all insured deposits (less than €100,000) and 9.9% for all uninsured deposits (above €100,000) in order to raise €5.87 billion needed for their recapitalization. The agreement also called for an extra bailout package of €10 billion needed for the country's fiscal needs for the next several years as well as for recapitalization of other banks and cooperative institutions. This was the first time that a bail-in approach was used by Troika (comprised of the European Central Bank (ECB), the European Commission, and the International Monetary Fund (IMF)) in dealing with Eurozone's sovereign debt and banking crisis, and it rattled financial and currency markets across the globe. A few days later, Cyprus' parliament decided to vote against this decision, causing an even bigger stir of markets, fearing of an eventual bankruptcy of the country. Then, on March 25th a new and final decision was reached that closed down Laiki Bank, wiping out all uninsured deposits, transferring Laiki's assets and liabilities (insured deposits and funding taken through the Emergency Liquidity Assistance (ELA) of the ECB) to BOC, and applying a massive haircut on the uninsured deposits of BOC (ended up to be 47.5%) in order to recapitalize the bank. But before analyzing the impact of these decisions on financial and currency markets as well as the economy in general, allow me to provide a brief background of the history of the Cyprus' economic crisis.

Cyprus has experienced a prosperous period through the years leading to the global financial crisis, fuelled by a booming construction industry as well establishing itself as a regional financial center. The country provided an efficient tax service, the lowest corporate tax rate in Europe, a solid banking system, and numerous highly-educated professionals providing accounting, legal, and other fiduciary services. In addition to the high deposit rates provided by local banks, the outcome was a flood of foreign money coming to the island as well as a large number of registered foreign companies. Instead though of using the expanding deposit portfolio to finance more productive sectors of the economy, it was mainly used to finance the construction industry creating a real estate "bubble".

Even with the arrival of the global financial crisis in 2007-2008, the direct effects on the country's economy were minimal as the local banks were not exposed to the "toxic" assets that were so detrimental to the collapse of banking giants across the globe. However, there was an indirect effect as troubles in other European countries resulted in lower demand for the housing market as well as a drop in revenues from tourism. The lower revenues, coupled with increased, unjustified at times expenses have reversed the budget surpluses of 2007/08 into a

deficit of 6% in 2009 (see Table 1). Furthermore, the rising level of the country's debt (see figure 1), and the over-exposure of the banks in Greece (either through loans given out, or investment in Greek government bonds) led to downgrades by the rating agencies. The end result is that by May 2011, Cyprus could no longer borrow at a reasonable/sustainable rate from the foreign markets. At that point, every effort should have been made to alleviate the worries of foreign investors, improve the ratings, and return to the foreign markets. If that was not possible, the government should have asked for financial assistance from Troika by signing a memorandum. Instead, few measures were taken, and those proved insufficient to correct the problem.

Then, in July of the same year, there was a major accident in the country with the explosion of 98 containers full of ammunition that destroyed the nearby power plant, causing a major damage to the economy. On top of that, at the end of October 2011, we had the infamous Greek PSI (private sector involvement) on government bonds (i.e. a major haircut) that resulted in an overnight loss of about €4.5 billion from the investment of our banks in those securities (around 25% of the country's GDP). The country's leaders, still insisting to avoid the signing of a memorandum that would force them to take drastic measures to reverse the negative situation, managed to obtain a €2.5 billion loan from the Russian Federation to cover some of the government's needs. The banks on the other hand, have tried in vain to obtain from private investors the necessary funds needed for recapitalization to achieve the desired capital ratio set by the EBA (European Banking Authority). Thus, Laiki and Bank of Cyprus were forced to ask for state aid to achieve the desired ratio. The government then, unable to help since it could no longer borrow from the foreign markets, had to seek help from Troika at the end of June 2012. Although a plan for the MoU (Memorandum of Understanding) was provided by Troika at the end of July, there was no signing of it and negotiations were slow, inevitably prolonging the signing of it until after the presidential elections of February 2013. This unjustified delay in reaching an agreement caused a major damage to the economy, resulting in the catastrophic decisions taken by Eurogroup in March 2013.

Although most of the blame of what transpired in Cyprus lies on Cypriot shoulders, at the same time, the way that Troika handled the Cyprus' economic problem was by no means effective. This was the first time that a bail-in approach was used to solve a European sovereign debt and banking crisis, and left a precedent that rattled the trust to the banking system, not just in Cyprus but also in other Eurozone countries. Instead of using the European Stability Mechanism to recapitalize banks directly and thus break up the link between banking and sovereign crisis, they decided to shut down one of the banks and enforced the other one to recapitalize using their depositors' money. Ordinary people, that trusted the banks and placed most of their life savings with them, have lost them overnight. The banking sector, so vital for the economy, has lost its credibility and will take a lot of time and effort to regain it.

Financial markets have responded accordingly to the crisis. The shares of BOC are suspended from trading from the Cyprus Stock Exchange until the Fall of 2013 (to have enough time for the recapitalization and the issuance of new shares), while Laiki shares have completely vanished. At the last trading day, prior to March 15th, 2013, BOC share price closed at just above 20 cents, while Laiki traded at around 4 cents (compare that to prices of more than €12.50 and €10 for

BOC and Laiki, respectively, back in 2007). The Cyprus crisis also had a negative impact on other financial as well as currency markets, although that was short-lived as the economy is so small that it did not carry any systemic risk, as some feared.

Looking forward, the country has a long and difficult path to economic recovery, but I am optimistic about it. I firmly believe that a crisis is a unique opportunity to fix long-standing problems. For the first time in the country's history, several structural problems are actually being tackled, as this was enforced through the MoU. Specifically, the MoU calls for restructuring of the banking sector, correction of the fiscal imbalances, as well as correction of the long-standing structural problems (health/pension/labor reforms, a smaller and more efficient government sector, and privatization of state-controlled enterprises, among others). Thus, despite the austerity measures that inevitably will lead to a deeper recession in the immediate future, in the medium- to long-run the impact of the Memorandum can lead to a healthier economy that is based on more sound fundamentals.

	2007	2008	2009	2010	2011	2012 (estimates)
Debt Level (% of GDP)	58.8	48.9	58.5	61.5	71.6	85
Budget Surplus/Deficit (% of GDP)	3.6	0.9	-6	-5.3	-6.1	-6
Real Growth (% of GDP)	5.1	3.6	-1.9	1.1	0.5	-2.5

Table 1 – Economic Statistics for Cyprus (2007-2012)

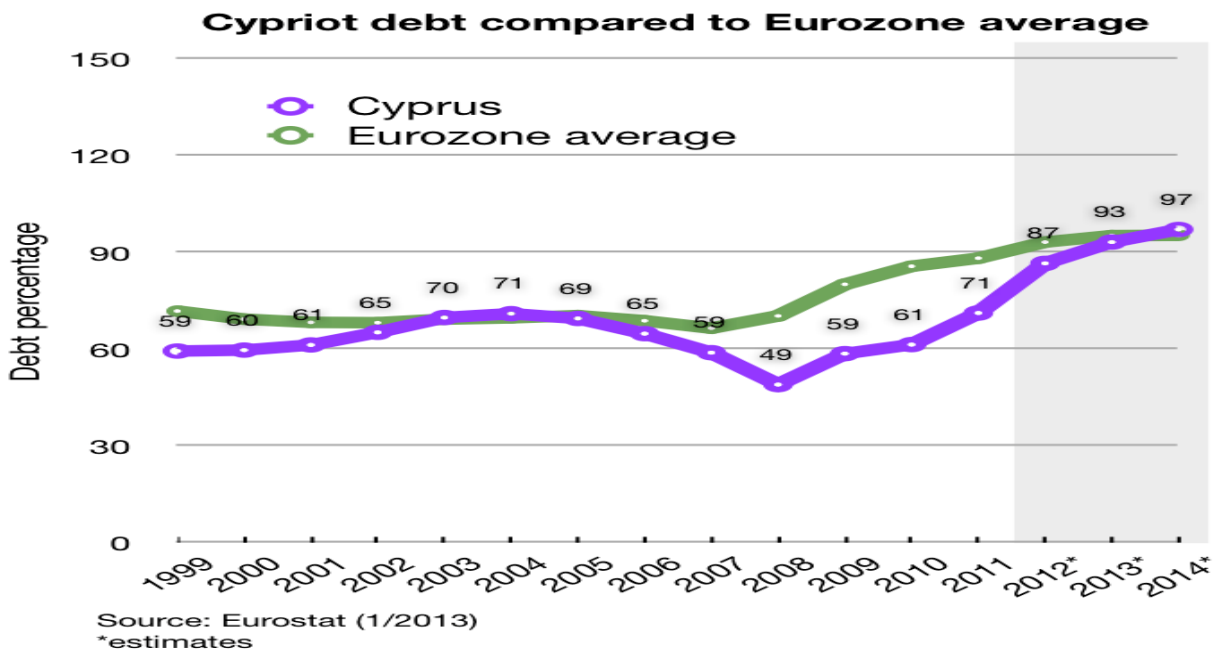

Figure 1 – Cypriot Debt compared to Eurozone Average (1999 – 2014)