

The Curious Case of the Cypriot Crisis

Before the 2008 crisis, Cyprus appeared to be another euro-zone success story. Output and employment were strong, inflation was low, and the public finances were sound, with debt and deficit levels well below euro-zone averages. However, vulnerabilities had begun to emerge in 2004 after EU accession.

Expectations of euro adoption triggered large capital inflows into Cyprus. These external flows contributed to economic growth and were construed at the time as one of the benefits of adopting the euro. Sadly, however, they also led to overheating, fueling a mounting external current account deficit, rapid credit growth, a real estate boom, and rising unit labor costs.

As in Ireland and Spain, Cyprus's initial bonanza from adopting the euro was squandered on real estate investment. Regrettably, in addition to promoting a local real estate boom, Cypriot banks also lent heavily to Greek borrowers. This exposure became Cyprus's Achilles' heel.

"Not Smart to Say the Least"

After the Greek crisis in 2008, a large and growing proportion of the loans to Greek borrowers became non-performing, rendering the Cypriot banking system insolvent. Cyprus's pretensions to becoming an offshore financial center and its success in attracting large foreign deposits, especially from Russia, compounded the problem. With banking sector assets amounting to about eight times Cyprus's tiny GDP (0.2% of euro-zone GDP), resolving the banks was well beyond Cyprus's financing capacity. The initial attempt of the troika (EU, ECB, and IMF) to bail out the Cypriot authorities was deeply flawed, and included tapping guaranteed bank deposits to finance bank resolution. ECB President Mario Draghi later termed these policies "not smart to say the least."

The Mouse that Squeaked

The troika's policy prescriptions set a number of uncomfortable precedents for the euro-zone, violated the concept of deposit insurance, and undermined the quintessential feature of what it means to be part of a monetary union. Fortunately, the widely shared initial fears that the troika's misconceived policy package would fatally undermine confidence in peripheral banks did not materialize. The market reaction through early April has been relatively muted, and concentrated on bank stocks, which fell sharply throughout the euro-zone. There have so far been no bank runs and no discernible uptick in capital flight.

This relative calm reflects a number of factors. First, the most counterproductive policy — the decision to confiscate 6.75% of all guaranteed bank deposits and 9.9% of deposits over €100,000 not subject to guarantee — was repudiated by all concerned. Second, an extended bank holiday and the indefinite "temporary" imposition of capital controls have so far forestalled a collapse of the Cypriot banking system. Third, the troika has convinced citizens of the periphery that Cyprus's unusually large and deeply troubled banking system makes Cyprus an exception, not a precedent. Finally, the small size of the Cypriot economy and of the absolute level of financing needed helped ease concerns over contagion.

Redefining "Whatever it Takes"

Assertions of Cypriot exceptionality notwithstanding, the Cyprus debacle raises some troubling concerns. Tail risks were greatly eased by ECB promises at end-July 2012 to "do whatever it takes" to preserve the integrity of the euro-zone. Markets interpreted this to mean that the ECB would provide open-ended financing. After Cyprus, "whatever it takes" has a more sinister ring.

First, the troika effectively turned deposit insurance on its head. Instead of governments guaranteeing the deposits of retail depositors, retail depositors may be forced to underwrite bank solvency, increasing the risk that depositors will now bolt at the first hint of trouble. Second, the free flow of capital and the acceptance of a single currency are quintessential features of a monetary union. Capital controls are anathema, and suggest that a "Cypriot euro" is worth less than other euros, undermining the integrity of the euro-zone. As long as capital controls are in place, Cyprus is effectively not in the euro-zone.

In our scenario analysis for 2013, we identified policy missteps as a major source of potential instability. Before the curious case of the Cypriot crisis, we little imagined just how egregious the policy blunders might be. Although the market reaction to the troika's bungling has so far been localized and muted, Cyprus reminds us of the inherent fragility of the deleveraging process and underscores the vulnerability of markets to misbegotten policies.

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