Cyprus: Aphrodite into hell

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The documents outlining what the EU-IMF Troika 'bailout' for Cyprus were leaked on 10 April 2013 (EC Cyprus debt sustainability 110413 EC Cyprus Estimate of financing needs ESMT 110413). These documents spell out the hell that faces the island of beautiful Aphrodite for the majority of its residents over the rest of this decade. According to the EU Commission, real GDP will contract 8.9% this year and another 3.9% next year. Domestic demand (spending on wage goods and investment) will fall 13.9% this year and 5.9% next year. Investment, crucial to future growth, will drop a staggering 29.5% this year and another 12% next year.

After that, the EU Commission reckons economic growth will be restored at 1-2% a year. But that's not likely, given the huge collapse in investment envisaged and with the public sector being decimated (contracting consistently through the next five years at least). The EU thinks that economic growth can be restored by 2015 although it demands that Cypriot government make fiscal austerity 'savings' on its budget equivalent to 8% of GDP over the next three years. At the same time, Cyprus must sell €400bn of its foreign exchange reserves and privatise state holdings equivalent to €1.4bn. Indeed, of the €23bn that Cyprus needs to fund its government and the recapitalisation of the banks through to Q1 2016, Cyprus must find €13bn, while the EU-IMF contributes less at €10bn under draconian conditions. So much for European solidarity and unity in a common purpose.

Even then, by 2016 the public debt ratio to GDP will rise from 86% last year to 126% in 2015 and will not get below 100% of GDP this decade, if ever. So if the Troika's aim is to get Cyprus back into 'fiscal' line after its banking profligacy, it cannot do it, whatever the hell Cypriots have to endure over the next seven years. So it is very likely that if Cyprus stays in the Eurozone, it will require yet another bailout or even more austerity.

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For a start, the EU assumes that the cost of recapitalising Cyprus' bust banks will be €11.7bn, mostly paid for by Cyprus liquidating Laiki Bank and applying the 'haircut' to bank depositors over €100,000 and bondholders. But what happens when the so-called 'emergency' capital controls are removed? Will there be a huge outflow of deposits from the Bank of Cyprus and out of the island? If so, then the refinancing costs of the Cypriot banks will rise again. Either the ECB will have to allow the Central Bank of Cyprus to offer even more Emergency Lending Assistance, or the EU-IMF bailout will have to be increased.

Capital controls run against the whole principle of the Single Currency. By restricting and blocking euros leaving the island, the government is reducing the ability of businesses to trade and for foreigners to invest (if they now want to!). Some economists argue that this means that the Cypriot euro is not the same as a German euro. That's not so – yet. Capital controls mean that there are just less Cypriot euros available – it's a restriction on funds for business and living. A Cypriot that visits Germany with a Cypriot euro (with its national face on one side) can still use it in Germany. And the ECB is still funding Cypriot banks and thus creating more Cypriot euros that are on a one-to-one value with a German euro. But if capital controls stay in place for any length of time, then Cypriot businesses may be forced to use IOUs and bills to fund transactions. Then those IOUs will start to fall in value against the 'scarce' euro and a parallel currency will appear (Cypriot IOUs). That's something that has happened in many countries with a shortage of foreign currency. But that cannot be officially recognised in Cyprus if the island is to stay in the Eurozone.

I have described how Cyprus got into the mess in previous posts (http://thenextrecession.wordpress.com/2013/03/20/cyprus-what-a-mess/) – mainly by the Cypriot elite allowing their island to become a haven for tax dodgers, particularly Russian oligarchs to stash their cash. Also, the Cypriot bank leaders tried to make big profits by buying Greek government bonds, only to lose billions when the Troika imposed a haircut on their value in the last Greek bailout. And what did the Euro leaders, the bank regulators and the ECB do about this Icelandic-style banking greed emerging before their eyes? – nothing.

When the then governor of the central bank of Cyprus was asked about Cypriot bank exposure to Greek debt, Athanasios Orphanides replied: "*With respect to the exposure of Cypriot banks to Greek debt, we have examined the situation and we have come to the conclusion that even though there is exposure in our banking system, that exposure is manageable because our banks are very well capitalized ... even in the highly unlikely situation of imposing losses on the holdings of Greek debt, our banks would manage to weather that. To understand how well capitalised our banking system is, a comparison may be useful. Our banks already meet the stricter capital requirements that are being phased in under Basel III.*" (Interview on Bank of International Settlements site April 2011, http://www.

bis.org/review/r110805a.pdf?frames=0). So much for Basel-3 regulation.

But it's not just fat-cat investors or Russian oligarchs facing losses from the banking collapse and deposit haircuts under the deal with the Troika. Ordinary Cypriots who built up savings are the ones facing real disaster. Thousands of bank workers will see hundreds of millions in their pension funds kept as bank deposits disappear and thousands of jobs are to go. "*Everybody here stands to lose a lot of money, the money you worked for your whole life*", said bank worker Marios Koullouros. "*I've been working at Laiki for 27 years.*" The government asserted than pension funds in Laiki accounts wouldn't be lost, but transferred to the Bank of Cyprus. Nonetheless, they could take a hit of as much as 60 percent of their value.

So would it be better to recognise this disaster as irreparable and opt for Cyprus to leave the euro? Right-wing President Nicos Anastasiades is against Cyprus leaving the euro. But the main opposition communist party has decided that it wants to pull out. A smaller opposition group wants to stay in the euro but kick out the troika – the European Commission, the European Central Bank and the IMF, a similar position to SYRIZA in Greece.

As usual, the 'euro leavers' fail to recognise that leaving would be a hellish nightmare too. As even Reuters Breaking News pointed out, if Nicosia brought back the Cyprus pound, it would plummet in value by 50-60%. Such a massive devaluation would savage the wealth of all 'insured' euro depositors in the banks – a much bigger haircut than is being applied to richer depositors now. Devaluation would fuel inflation. Cyprus is a small open economy. All the oil is imported. Over 80 percent of the textiles, chemicals, electronics, machinery and automotive vehicles are imported too. Cyprus also relies on cheap immigrant labour in its agricultural and tourism industries. Following a devaluation, their cost in local currency would rise. All this would mean that any gain in competitiveness from a cheaper Cypriot pound would soon be eroded.

The island's economy would suffer a further shock because it is running a current account deficit of somewhere around 5 percent of GDP. Given that Cyprus has limited access to hard currency reserves (indeed, it is selling off what it has), this deficit would have to vanish overnight. Imports would slump. But so would domestic production, given its reliance on imports. In such a scenario, Nicosia would not be able to avoid defaulting on its debts. Following a 50 percent devaluation, these would be double their current value when expressed in local currency.

Of course, Nicosia could opt to default on its debts and refuse to repay. As I argued in previous posts (http://thenextrecession.wordpress.com/2013/03/25/cyprus-sold/), Cyprus could pay for the recapitalisation of its bust banks itself without having to take a Troika bailout. There are at least €30bn in deposits held by tax-dodging foreign-based individuals and companies. A 50% levy on foreign-based deposits plus the writing off of bank debt and the restructuring of the banks would raise €20bn, more than enough to sort out the banks and provide support for bank workers and others that may have a case of need. And there is €2.5bn in bank bond debt held by foreign banks (including Greek) that could be written off. That more than matches the funding requirements of the government even assuming it honours all its debts to foreign banks which hold most of Cypriot debt. Residents of Cyprus could be exempted from any haircut.

If the four largest banks were restructured into one state-owned bank with any worthless assets siphoned off and sold, that would reduce the ultimate cost of any recapitalisation. Bank staff could be guaranteed a job in the state-owned banking system or retraining on full pay for a new job. Then a democratically-run banking system can be established, owned by the Cypriot people and garnering deposits from citizens and lending it back to residents and small businesses on the island.

Instead, this deal protects senior bank bond holders (other banks), threatens thousands of bank jobs, imposes severe fiscal austerity and a permanent depression in the Cypriot economy for the rest of this decade, at least. The island of Aphrodite has no more than 1 million people and its main trade is with the rest of Euro bloc. So it would need to build a campaign within Europe to fight the Troika measures and opt for an alternative based on using the resources of Cyprus (gas reserves) and all Europe in a plan for jobs, investment and growth based on commonly-owned banks and major industries. So far, such a campaign looks very unlikely.