The Cyprus *Difference*

The eurozone can't unring the bell on bank deposits.

BY DOUGLAS J. ELLIOTT

Sometimes a small island can make a big difference to the course of history. Cyprus may be one of those cases, as a result of the debacle of the first bailout deal and its metamorphosis into a much improved, but still risky, revised deal. It sometimes strikes me that the eurozone's leaders are like Russian roulette addicts. Several times now they have metaphorically loaded a bullet into one chamber of the revolver and spun it, creating or aggravating a very risky situation that required a summit to work into the wee hours of the morning to craft a deal. Having done this several times while surviving the pull on the trigger, they seem to be convincing themselves that the revolver will never fire. I believe an underlying cause of the terrible original proposal for Cyprus was a level of official complacency that the overall euro crisis was winding down and therefore it was possible to take a little risk with financial stability.

The first Cyprus deal was a total fiasco for which no one will currently admit responsibility. (If there were not so many witnesses, I am sure a number of officials would deny even being at the negotiating table.) It started falling apart upon first contact with reality. The revised deal is much sounder, but it leaves us with two major problems for the euro area as a whole and a disaster for Cyprus.

The best news is simply that an agreement of any kind was reached, allowing European support to flow to Cyprus and preventing, for now anyway, the possibility of an exit from the eurozone. It is also very good news that insured bank depositors in Cyprus will be protected after all, eliminating a terrible precedent with repercussions

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across Europe. Further, there are real advantages to inflicting large losses on the uninsured depositors and the bondholders of the two largest Cypriot banks. This is by far the strongest message Europe has ever sent that people must pay attention to the strength of the banks with which they deal. It brings the hope that market discipline will finally be a significant aid to outright regulation in ensuring that European banks act prudently at all times.

The first risk is the flip side of passing losses on to those who put their money in banks. In practice, Europe has a long tradition of protecting all depositors, not just the insured ones, and, in most cases, the bondholders as well. For example, the much vaunted, and highly successful, Swedish bank rescues included guarantees for all liabilities. Over time, in reaction to this, there may be major flows of deposits from the weak banking systems in Europe to the stronger ones, further exacerbating credit crunches in the periphery. The European Central Bank and national central banks can offset these flows, but only with further distortions that carry costs of their own. Weaker banks, and those in weaker countries, will find their borrowing costs rising on bonds as well, as investors take heed of the lessons of Cyprus. Even banks in strong countries are likely to see costs increase over time, as depositors and investors react to this major change in regulatory regime. These costs will generally be passed on to customers, potentially further slowing economies down, at least modestly. (The European Central Bank can partially counteract this effective tightening of credit conditions, but it is already close to "pushing on a string": hitting conditions where it is difficult to ease further and have any effect.)

Some counter this concern by pointing out that there do not yet appear to be major flows out of national banking sectors as a result of these fears. That is indeed good news, or at least the absence of bad news, but it leaves the strong possibility that the reaction has merely been delayed. In all likelihood, a new national banking crisis in the eurozone, or even elsewhere in Europe, will see far faster outflows than in the past, now that it has been demonstrated that uninsured depositors can easily lose money. Remember, roughly half of all the European deposits are uninsured,

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either because they exceed the €100,000 guarantee limit or because they are of a class of deposits, such as those from other financial institutions, that are not insured in that country. Even if the insured deposits stay in the banks, a substantial outflow of uninsured deposits could sink a banking system. It is true that the European Central Bank can fill the cash gap, but they are only supposed to lend to the banks against sound collateral and the banks may not have nearly enough. Doubtless the collateral standards will be loosened, but there are practical and political limits to how far this can go without triggering a revolt by the stronger countries in the eurozone who might ultimately have to bear the cost if the collateral proves insufficient to prevent ECB losses.

The second problem is that we cannot "unring the bell" of potential hits to insured depositors. The first Cyprus deal raised the real possibility that insured depositors across Europe could lose money if their banking systems and national governments became too weak. The strong reactions to this, and its complete elimination from the final deal, reduce this damage considerably, but it will remain in people's minds. If there is another serious banking crisis in a weak eurozone nation, depositors may be more prone to move their funds to safer banks and safer countries, in a classic bank run.

One of the mistakes the eurozone leaders made was to assume that because there were so many unique and difficult aspects to the situation in Cyprus, no one would see the original bailout deal as a precedent for how depositors in other countries would be treated. This logic has two problems. First, ordinary people do not have the information to make that judgment effectively, because it assumes a great deal of knowledge of the thought processes and political situations of leaders across Europe. Second, these same citizens have noticed that a unique situation in Greece led to government bonds defaulting and now a

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unique situation in Cyprus almost led to insured depositors losing significant amounts and will lead uninsured depositors to lose much more. How is a citizen of Malta or Slovenia or Portugal or Spain or Italy to judge whether their particular unique national situations will warrant yet another unique and very painful response? One could make at least a surface argument in each of those countries for government bondholders or bank bondholders or depositors to take a big hit.

The remaining risks are about Cyprus itself. The economy will be severely damaged by the deal and the turmoil around it. A severe recession will be exacerbated by the losses taken by businesses and others with large, and therefore uninsured, bank deposits, and by the restrictions on banking transactions that may remain for some time. Confidence, of course, has been badly shot. Further, nearly a fifth of the Cypriot economy consists of financial services, a sector that will shrink very sharply now. There will also be other conditions imposed on Cyprus as part of the larger agreement with the eurozone and the International Monetary Fund that will likely hurt in the short run even if they may be for the best in the long term.

It is going to be extremely difficult for a fast-sinking Cypriot economy to produce the results necessary to hold the country's debt down to a sustainable level. Thus, we are being set up for a future round of tense negotiations to either bring in more eurozone support or take drastic actions such as a bond default, similar to that of Greece. Such a default would carry at least some contagion risk for the rest of the eurozone, unless the larger crisis is essentially resolved by then.

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In short, there is no cause for real celebration, but there is reason to feel relieved that disaster was avoided and some of the ill effects of the debacle of the original deal have been erased.

The biggest risk of all remains the political and institutional one. What, if anything, has changed in the eurozone's decision-making mechanisms to prevent another summit from reaching an equally disastrous result? We are going to have further bailout negotiations and crisis summits. They will need to be handled better and it is impossible to know if they will be. I have said all along that I believe the strong likelihood is that Europe will muddle through and I continue to believe that. It's the other possibility, the one-in-ten or one-in-five chance of a disaster scenario, that wakes me in the middle of the night. A series of national defaults or a withdrawal from the euro would likely create severe recession in Europe and might put the United States back into recession while also slowing growth in China and the rest of the emerging markets. ◆