



Europe's Next Wild Card: Cyprus

Jacob Funk Kirkegaard explains the curious and complex politics of the upcoming Cyprus bailout, in which loans from Russian oligarchs will have to be restructured as part of the deal.

Transcript of interview recorded December 21, 2012. © Peterson Institute for International Economics.

Steve Weisman: Although Europe seems stable; there are bumps in the road on its struggling path to recovery. Jacob Kirkegaard is here with me, Steve Weisman, at the Peterson Institute for International Economics to talk about one of those bumps – Cyprus, the next country to be bailed out in the region. Jacob, what's the story with Cyprus?

Jacob Kirkegaard: Cyprus is a ricochet or an echo from the Greek debt restructuring earlier this year, which imposed such dramatic losses on the Cypriot banking system that they are facing a situation that is not very dissimilar from what we saw in Ireland in 2010. Basically the banking system, which is undercapitalized and suffering huge losses, is now bringing into question the solvency of the Cypriot government. You have other economic mismanagement in Cyprus. But it is predominantly a banking issue.

It's a tricky issue for a number of political reasons. On the one hand the euro area has been going around, since the restructuring of Greek sovereign debt, saying to investors everywhere: "Look, Greece was a special case. We're never going to do it again." But on the other hand, now you have Cyprus, where if you were to simply go ahead and recapitalize the Cypriot banking system in a manner dissimilar to what you saw in Ireland or elsewhere, then you would probably leave Cyprus in an unsustainable situation.

What I personally think is [that] you're going to have very significant bail-ins of previously protected creditors of the Cypriot banks.

Steve Weisman: By "bail-ins," you mean haircuts or restructuring?

Jacob Kirkegaard: Yes. Haircuts of bond holders, creditors, and -- interestingly enough in the case of Cyprus -- potentially also depositors.

Steve Weisman: Who are the people being asked to bail out Cyprus?

Jacob Kirkegaard: It's the usual suspects. I would expect it to generally follow the modus operandi we've seen so far, the IMF one-third, the euro area two-thirds.

Steve Weisman: What magnitude are we talking about?

Jacob Kirkegaard: It's very unclear except to say that, because Cyprus is such a tiny country, even compared to the three other small EU countries, the magnitudes of the money involved is -- I don't know if you could say it's trivial -- but it certainly in a macroeconomic sense for the euro area and the IMF, not important.

Steve Weisman: This is like a comma after the Greek situation?

Jacob Kirkegaard: In some ways, yes. I wouldn't say it's a rounding error, but it's close.

Steve Weisman: But Cyprus is a divided country with Greek and Turkish interests. Which side of the country are we talking about?

Jacob Kirkegaard: We're talking about the Greek Cypriot part, the part of Cyprus that is actually a full member of the euro area and the EU. But there is a further element to it, which is quite intriguing in many ways. One of the main capital inflows into the Cypriot banking system has come from Russia. Russia has, of course, earlier on in this crisis already extended several billion euros in loans to the Cypriot government, but has seemingly been unwilling to offer more cash and thereby bail them out rather than hand them over to the IMF.

Steve Weisman: Are they [the Russians] going to have to take the haircut?

Jacob Kirkegaard: This is, in my opinion, very likely to happen. I think that it will ultimately be politically unacceptable for the euro area if you have a situation where euro area taxpayers' money, either directly from the ESM [European Stability Mechanism] or from the euro area and the IMF to the Cypriot government and then to the Cypriot banks, essentially end up being spent to protect the money of Russian oligarchs—maybe laundered money—in the Cypriot banking system, which is essentially a largely offshore banking center for many Russians.

Steve Weisman: And a channel for corruption, you're suggesting?

Jacob Kirkegaard: I think it's fair to say that there are a lot of not particularly transparent transactions going on involving these Cypriot banks. And as I said, I would not be surprised at all to see that -- compared to the Irish bank bailout, which ended up being not particularly coercive to senior creditors, etc. and therefore was very expensive for the Irish taxpayer -- we're going to see something different in the Cypriot case. Particularly in a German election year, you cannot use taxpayers' money for the purpose of bailing out Russian oligarchs.

Steve Weisman: When do they have to decide on the bailout?

Jacob Kirkegaard: The latest we've heard comment on this is that they're going to come to an agreement in early January.

Steve Weisman: Is there some sort of deadline by which they have to roll over credit?

Jacob Kirkegaard: Yes. The understanding is that Cyprus has enough liquidity and cash on hand to last them sort of through the first quarter of next year [2013], after which it begins to become trickier.

Steve Weisman: Is there any danger that this is going to be mishandled with repercussions damaging to the European situation?

Jacob Kirkegaard: I think the worst thing that could happen is if they go ahead and actually do a full blown restructuring of Cypriot sovereign debt like what you did in Greece earlier this year. That will undermine the credibility of the euro area strategy, which is to say, "Greece is a special case and we're not going to do sovereign debt restructurings again." I think that that would

have very significant adverse effects for the euro area. Certainly given the small scale of the Cypriot problem in euro terms, it would be totally unwarranted.

Steve Weisman: But is there a danger here?

Jacob Kirkegaard: I think no. I think that despite various press reports about this, I think the likelihood of this happening is basically zero. I cannot imagine any scenario where it makes political and economic sense for the euro area to engage in a full blown sovereign debt restructuring of Cyprus. But I think that it will make a lot of sense for the euro area and the IMF – as well as for any advocate of transparency and anti-money laundering measures – to insist on a thorough and coercive bank sector restructuring in Cyprus. I would expect that -- combined with the broader IMF program reform conditionality -- to be what is holding up the negotiations right now.

Steve Weisman: The wild card finally is Russia. Do we know what the Russian leadership thinks?

Jacob Kirkegaard: No, basically, we don't. What has been going on is the Cypriot government saying to the Russians, "Look, you give us more money or we are forced to go to the troika [the IMF, the European Central Bank and the European Union] and then who knows what will happen?" And then telling the troika: "Don't impose all these harsh reforms on us, because then we're just going to get the money from the Russians." So the Cypriot government is going to be in a very tough position here, but how the Russians will react I think is anybody's guess. But my prediction would be that Russian investors in Cyprus or in the Cypriot banking system stand to lose quite a lot of money.

Steve Weisman: Thank you very much, Jacob.

Jacob Kirkegaard: My pleasure.

