



## Risky Repercussions from Cyprus

*Nicolas Véron says the discussion about forcing losses on Cyprus bank depositors could spread fears of bank runs elsewhere in Europe.*

*Transcript of interview recorded March 12, 2013. © Peterson Institute for International Economics.*

Steve Weisman: The financial travails of Cyprus, small as they are compared to the size of the European economy, are nonetheless having an impact on Europe and even potentially the rest of the world economy if they get out of hand. Nicolas Veron, a visiting fellow at the Peterson Institute for International Economics is here with me, Steve Weisman, to comment on the significance and the obstacles to the solution. First, give me a sense of the impending deadline and problems in Cyprus.

Nicolas Veron: In the ways of deadline, it is long past, because there are big problems in the Cypriot banking system, especially one or two large banks that have big holes in their balance sheets. This is largely a function of what has happened last year about the restructuring of the Greek sovereign debt because Cypriot banks have taken a lot of this Greek risk, which has materialized. Actually what happened is that the resolution of the Cypriot situation was delayed because of the general reluctance of Europeans to fix things, and also because of the elections in Cyprus last month. Now that election is past, as we speak, there are very active negotiations on how the Cypriot situation could be dealt with.

Steve Weisman: A center right government was elected. What are the main focuses of their negotiations now and what dangerous repercussions do they pose?

Nicolas Veron: There are different elements here and it's a very tangled, in many ways very toxic combination. The elements of toxicity, the most obvious one is that Cyprus is widely seen as having been a place for massive money laundering -- of course, money coming from Russia and the Ukraine and the former Soviet Union in the past decade or two. There is a perception, even though it's hard to find and definitions are fuzzy in this sort of area, but there is a perception that a lot of the deposits we're talking about are linked to activities that are not activities the EU should sponsor. But it's not the only element of toxicity. Another element is the fact that Cyprus itself is in the tricky geopolitical position.

The Cypriot people have rejected the new referendum into some form of the U.N. plan for the reunification of their island, unlike the Turkish speaking part of the population, which voted yes to this U.N. plan. There is an additional complicating factor linked to the presence of gas deposits, different forms of deposits, in the sea around Cyprus, but which itself creates possible geopolitical tensions with the likes of Lebanon and Israel next door. So it's very tangled. There is a mix of geopolitical components with Russia, with the Middle East, with Turkey, which are of course much bigger than the amounts we are talking about as far as the financial equation. And then last, but absolutely not least, this happens in the context of the German electoral cycle, where the SPD [Social Democrats] – the opposition party to Mrs. [Angela] Merkel [Chancellor of Germany] has identified Cyprus as a wedge issue on which it could campaign against Mrs. Merkel, painting her as helping the Russian oligarchs. The SPD has found it very difficult to find wedge issues in this campaign. So the things they have found, one was Cyprus, further complicates the equation.

Steve Weisman: What in the Social Democrat view in Germany is a principled position – to force Russian depositors, these oligarchs, to take big losses?

Nicolas Veron: Yes. But the problem is you cannot separate oligarchic Russian or Ukrainian depositors of Cypriot banks from the other depositors, which probably are the majority and who are Cyprus citizens or Greek depositors. There are many of them, who ironically saw that shifting their deposits from Greek banks to Cypriot banks would be a flight to safety in a previous face of the crisis.

Steve Weisman: Ironically, but stupidly.

Nicolas Veron: I wouldn't use that word necessarily. You know, they thought, here is a country which had been better managed from a macro economic standpoint and fiscal standpoint than Greece. I think that would be the case for making this judgment, and [Cyprus] speaks our [Greek] language. So it from a need of service, it looked like it made sense, even though now we know it didn't. Therefore there is a direct channel of contagion from Cyprus to Greece because of this financial interdependence: Cypriot banks having taken Greek risks and Greek economic agents having put their money in Cypriot banks.

Steve Weisman: But if these depositors and creditors are forced to take big losses in some kind of debt or asset restructuring, what's the danger?

Nicolas Veron: I would make a huge distinction between creditors—financial creditors, including senior unsecured bond holders, and other senior creditors on the one hand, and the depositors on the other hand. There is something really new if the European Union or the euro zone makes a decision, “You know what? We will impose losses on depositors.”

Steve Weisman: Are they considering that?

Nicolas Veron: Yes, they are considering that. They are on record saying they are considering that. There has been no decision. But this, by the way, you can say is stupid, saying you consider burning depositors if you haven't yet decided to do it, because this is an invitation to catch flight and bank runs.

Steve Weisman: Are we seeing that happen?

Nicolas Veron: Yes, there is. We don't have real time data, but there are anecdotes that this is indeed happening. The irony of it, of course, is that it might be the case that the fastest moving depositors who will put their money in a safe haven are exactly the shadier part of the depositor base that you would like to burn if you could.

Steve Weisman: So what is the risk of contagion blowing back on to other countries and banking systems?

Nicolas Veron: That's a very difficult question because we don't have experience. It's like -- you remember? -- Northern Rock. The governor of the Bank of England at that time said, “If we provide liquidity we will have moral hazard and therefore we shouldn't provide liquidity.” He didn't predict that there would be a bank run or a retail bank run. So we haven't seen people queuing in front of the banks in Cyprus yet, even though as I mentioned there is evidence that the flight of deposits has accelerated in recent weeks and days.

We also cannot be sure about the channels of contagion. My personal view is that we could have delayed contagion in the sense that maybe there won't be immediate effect in Greece, let alone Portugal or Spain or other countries. But there will be a pillar of trust, which is that deposits are safe in Europe, that will have been shaken. Therefore in the next crisis, in a different country, at a different time, the fact that there has been this precedent of depositors being forced to take losses will shape the behavior of agents at that moment.

Even if you assume—which I guess would be my baseline assumptions—that depositors are forced to take a loss in Cyprus, and you don't see immediate contagion in the rest of Europe, that doesn't mean it doesn't have a destabilizing effect.

It is very similar in my view to what happened when [Chancellor] Angela Merkel [of Germany] and [President] Nicolas Sarkozy [of France] in October 2010 in their famous declaration in Deauville, which said that they were envisioning Private Sector Involvement, which means losses being forced on the private sector creditors for the sovereign debt of Greece. This is now, in retrospect, seen as a turning point in the crisis, the moment when investors lost confidence in sovereign debt in the euro zone. But you couldn't see the effect immediately. So basically you shift the anchoring of expectations in a way that creates instability, but it's not something that can be observed simultaneously.

Steve Weisman: If depositors are held harmless, who will suffer the most in the restructuring or rescue in Cyprus?

Nicolas Veron: It depends entirely on the terms of this rescue or restructuring, and here we get back to the German elections. Financially the logical thing to do—at least from my perspective, given the relatively small size of the Cypriot economy and even the Cypriot banking system—would be basically to have significant, at least in proportional terms, financial assistance coming from the rest of Europe to avoid any contagion effect.

Now of course, this would be framed rightly as a bailout. This is where the political discussion becomes so dominant and why I think it's very possible that this route will not be taken given particularly the German election cycle. Why would this be the right thing to do? Precisely to strengthen and maintain the stabilization of the financial conditions that we have seen in the euro zone in the past nine months or so?

It shouldn't of course, although for perpetuation of the role of Cyprus as an alleged place for money laundering, and therefore there should be very vigorous restructuring and cleaning up of the Cypriot banking system. I believe this should not be left to the Cypriot authority. Actually there is a need for a very hands-on approach by the European Union and euro zone and what instruments should be used or created for this is an important technical debate.

I think basically the condition for any assistance, whatever form it takes, should be termination, if you will, of the current Cypriot business model, and the enormous role the banking industry has played in the Cypriot economy in the past decade. So this will be tough for the Cypriot people in any assumption because there will be innocent bystanders who had high living standards because of this business model and will lose in terms of the living standards. I don't think that can be avoided. But the question you are asking is how is the burden shared between Cypriot taxpayers and other economic agents and euro zone countries, and this remains entirely open as we speak.

Steve Weisman: Thank you, Nicolas.

Nicolas Veron: Thank you, Steve.

