Risky Repercussions from Cyprus: Another View

Jacob Funk Kirkegaard says depositors as well as bondholders might take losses in a Cyprus bank bailout—and that this would be a good thing.

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Steve Weisman: Cyprus, as previously discussed on a Peterson Perspectives interview with Nicolas Veron, continues to hang in the balance in Europe because of its banking and debt crisis. Jacob Kirkegaard of the Peterson Institute is here with me, Steve Weisman, to discuss another perspective on the Cyprus situation. Jacob, what is in the balance now with Cyprus?

Jacob Kirkegaard: The big thing in Cyprus is really the banking system. This is the root of the country's current economic malaise or the crisis. Several of these very large Cypriot banks took significant losses as part of the agreed debt restructuring. They therefore need to be recapitalized. Because they're so big compared to the overall size of the Cypriot economy, the government can't afford it and therefore the entire country needs a bailout. In that sense it's a situation not unlike the one we saw in Ireland in late 2010, where you also had a banking crisis leading to the bailout of the entire country.

Steve Weisman: Which the Irish government authorized, but there's nothing comparable here?

Jacob Kirkegaard: Part of the reason that Ireland ultimately needed a bailout is that the Irish government made the grave error of guaranteeing all the depositors and all the creditors of the Irish banks. This was back at the height of the crisis in 2008, but it ultimately proved that even with this guarantee, the losses and the loss of credibility and confidence in the Irish banks was so big, that it simply overpowered the finances of the Irish government.

Steve Weisman: Let's go to the issue of how much in the way of losses are going to be inflicted on creditors and on depositors. That's a sticking point right now. Isn't it?

Jacob Kirkegaard: Yes. The overall issue in Cyprus is that you have these very, very large banks, relative to the size of GDP, and they have very large losses. Normally you would say, "Well we need to limit these losses on the Cypriot taxpayer, so we impose these losses instead on the bond holders of these Cypriot banks."

But one of the things that is striking about the Cypriot banking system and particularly the two big banks that are in trouble —the Bank of Cyprus and Popular Bank of Cyprus—is that they actually have very few bonds issued. They haven't issued many debt securities. So even if you bail all of them in, you're still going to be left with a significant bill to be paid by the Cypriot taxpayers. That's why some policy makers have said, "Look, we should proceed and actually impose losses, or "bail-in," some of the depositors in these Cypriot banks, particularly those depositors that are above the insured maximum of €100,000 per depositor." They are potentially at risk.

A lot of this, of course, is related to the fact that the influence or the weight of the ties between Cypriot banks and Russia are very deep. There are a lot of Russian deposits in

the Cypriot banking system, even if quite a lot of those deposits have actually left the two banks that are most at risk.

But there is this general political sentiment—not least in Germany, but throughout the euro area—that it is not acceptable to be bailing out a country and thereby putting euro area taxpayers money at risk or on the line to basically protect Russian depositors in Cypriot banks, many of whom are perceived to be laundering money and thereby protecting them through taxpayers money. That's just simply not acceptable.

Steve Weisman: That may not be acceptable, but isn't the risk of imposing such losses and haircuts on these depositors, that it will cause bank runs in other parts of Europe?

Jacob Kirkegaard: I think that those risks exist. There's no doubt about that, but I think one of the striking things about Cyprus, in my opinion, is that for all the very public talk about potential bail-ins of uninsured depositors, large depositors – the head of the euro group and other senior euro area politicians have explicitly not ruled this out, they have very publicly left this as an option – yet despite that, you have actually seen no significant deposit flight from Cyprus apart from some flight of depositors in the Greek subsidiaries. It's kind of ironic. The Greek subsidiaries of the Cypriot banks where money have been taken out and presumably put back into what is not perceived to be relatively less risky Greek banks.

Steve Weisman: I'm puzzled how you could be a depositor in one of these Cyprus banks, reading the newspapers and not be pulling your money out right now.

Jacob Kirkegaard: I sit and I read the headlines and if I certainly had money and certainly if I had more than €100,000 in one of these banks, I would be asking the same question. It begs the question about what origin do these deposits come from. It is clear that if it actually really is deposits of shall we say of an odious origin-

Steve Weisman: Illicit.

Jacob Kirkegaard: Illicit, OK, illicit origin, then it may not be very easy to move them anywhere else.

Steve Weisman: Why? Another bank just wouldn't accept them?

Jacob Kirkegaard: Potentially. It may not be so easy to find a certain amount of banks outside of Cyprus that would take them. And then there is that issue also that one should remember. One of the main reasons that the linkages between Russia and Cyprus are so deep in the financial sector is not only necessarily money laundering, but it's also tax optimization. Cyprus is actually a tax haven even more so than Ireland. The corporate tax and depositor tax in Cyprus is 10 percent or less. You can have a lot of money in these banks as part of a tax optimization scheme where you might say, "Well even if I face a little bit of a bail-in, it's still worth it because compared to what I would be paying…

Steve Weisman: In taxes.

Jacob Kirkegaard: …in taxes, potentially in the process of moving of this money, it is actually higher.

Steve Weisman: So you think this is going to happen to some degree?

Jacob Kirkegaard: I don't think we will see a straight-out depositor bail-in. It's not like the euro area's going to come up and say, "Look we're going to take 10% of all Cypriot deposits over €100,000," no. But I think that there are several systemically important things that are going to happen as a result of this crisis.

First, I do think that you are going to have Russian financing as part of this Cypriot deal in some shape or form. Either it will come in the form of another bilateral loan to Cyprus, or in the form of Russian investment in these Cypriot banks, perhaps a deposit to equity swap or something like that. It could be in the form of Russian investors buying other parts of the Cypriot public sector through privatizations and things like that.

It could also—and I think this is perhaps a more interesting example—it could come in the form of a one-off depositor tax. You basically don't call it a bail-in, but call it a depositor tax or wealth tax by saying, "Look we're going to tax" – I don't know, let's just take a number – "Depositors over one million euros with a special of one or 5 percent solidarity tax." That means that it's essentially a tax measure, not a financial sector bail-in, but obviously from the perspective of the Cypriot government it has the same beneficial financial effects.

Steve Weisman: The proceeds of the tax would go for the recapitalization?

Jacob Kirkegaard: Yes, the proceeds of such a tax would go the Cypriot government, which thereby would better be able to afford the recapitalization. I think the other element that is absolutely going to happen, which also has significant systemic implications for the euro area, is that the relatively limited number of bank bonds that the Cypriot banks have issued are almost certainly going to face a bail-in. These bond holders are going to face significant losses.

That means that the bank bond bail-ins are going to be there by the established precedent or norm, in the euro area going forward. That has quite significant implications for a lot of euro area banks. Up until now, banks in the entire euro area have been issuing their bonds with an implicit government guarantee, because everyone knew that even in the case of a bank failure, the bond holders wouldn't be touched.

They are now facing potentially very significant losses, even senior unsecured bank bond holders. That again has quite a substantial longer term impact, which has to do with the broader structure of the euro area financial system. Unlike in the United States – where a lot of the credit flow to the non-financial sector comes through the corporate bond market – in the euro area, credit intermediation happens 80 percent through the banking system. As euro area banks are now being forced to deliver – and that also going forward on a permanent basis – they will no longer have the ability to issue bonds with an implicit government guarantee. I think this means that they are going to be less competitive vis-à-vis corporate bond markets in Europe.

I think, as a result of Cyprus, and as a result of the broader changes in the way banking resolution and potential liquidation of banks are done in the euro area, you're going to see a shift toward much more capital market intermediated credit to the euro area non-financial system. Cyprus may be small, but I think it will have quite significant structural effects throughout the euro area financial system.

Steve Weisman: Remarkable, thank you very much Jacob.

Jacob Kirkegaard: Pleasure.