



European Fumble in Cyprus?

Edwin M. Truman says the Europeans and the International Monetary Fund miscalculated the impact of the Cyprus bailout and must now redo the package.

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Steve Weisman: The decision in Europe to tax bank depositors in Cyprus has erupted throughout Europe with political recriminations, protests and also market chaos. This is Steve Weisman at the Peterson Institute today with Edwin Truman (Ted) to talk about whether this decision was a mistake. There will be a series of these Peterson Perspective conversations on this subject. Ted, was the decision to punish depositors necessary or a mistake?

Ted Truman: It was necessary, I think, from the standpoint of how the Europeans set up the problem. They said this is a €17 billion problem, and we need to get that to size down to €10 billion. You need €7 billion from somewhere else. They went to where the money was, which was in the banks. Then the question is when they went to the banks, did they go to the banks in the right way?

My sense is that they miscalculated. It's not strictly speaking a tax. They are essentially converting the deposits into equity. The equity may be worthless, so that's the reason why they view it as a tax, but what they forgot was that this requires political approval in Cyprus and that approval may ultimately come. They may re-jiggle the package, but I think they have not gotten out in front of the problem.

In fact, they've made it worse. They have set a precedent, even though they denied it is a precedent, but every action is a precedent, regardless of what the authorities say.

Steve Weisman: Is it a precedent to go after depositors?

Ted Truman: It's not just depositors. It's depositors that were already guaranteed by deposit insurance. I think the distinction is between the depositors who had €100,000 worth of deposits and those above that. A larger deposit you can argue is more of a wealth tax and has better income distribution aspects, so you are countervailing on one hand. The bailing in of creditors to banks is a reasonable strategy. The question is which creditors do you bail in?

Steve Weisman: But the depositors, strictly speaking, aren't creditors.

Ted Truman: Strictly speaking, they are creditors.

Steve Weisman: I see. Okay.

Ted Truman: In particular, large depositors. One of the problems is that Cyprus is different, there weren't a lot of bond holder claims on the bank and they left them off. But even though they [bondholders] are small, there is a sort of unfairness. The depositors presumably are after in line from the bond holders, so you would think they would go after the bond holders.

Steve Weisman: Why didn't they go after the bond holders?

Ted Truman: I think they weren't thinking in the fairness terms. They were thinking in de minimis terms. They said, well, if we haircut these bond holders by 10 percent, it's not going to generate enough income in terms of plugging the hole that we see.

Steve Weisman: They could have given them a bigger haircut than that.

Ted Truman: They could have, but it would not have contributed a lot. They were focusing on plugging this hole and they saw this big pot over here, which was all of these deposits.

Steve Weisman: And a lot of the depositors are foreigners.

Ted Truman: Sometimes people have argued, well, they're spreading the tax base, which is correct. The notion of having some form of private sector involvement through the banks does make some sense. I think the miscalculation is the fact that they levied so much of it on small holders and the small holders are presumably, predominantly the domestic residents and therefore the government of Cyprus is having difficulty getting this passed.

They may change the whole structure and then exempt the first €100,000 of deposits and raise a "tax" on the other, which would have to be raised, I'm told to 15 percent, 16 percent, and that probably would be a more reasonable structure, but the damage has already been done.

Steve Weisman: I was about to ask you that question. Even if they rearrange the package and pass it, aren't the repercussions permanent?

Ted Truman: I think the repercussions are permanent, both in terms of getting out in front of the Cyprus problem, because they fumbled the ball. Secondly, in terms of the precedent that they have set, even if they step back from the small depositors, that's a possibility down the road. And of course they have created a precedent in terms of the large depositors because in general, depositors in banks in these crises have not been affected.

Steve Weisman: Isn't the original sin here the private sector involvement decided back in 2010 in Greece?

Ted Truman: No, I don't think so. No. It's perfectly natural to have some private sector involvement and it is true that the Cyprus situation is particularly complicated. A large part of Cyprus's overall problem is the overbanked structure of the economy and the fact that the government of Cyprus can't support it. The notion of having some private sector involvement is sensible. I think they've gone about it in a somewhat ham handed way. That's the problem.

The other aspect of it is all these domestic political aspects of it, which may bring it down, and then geo political aspects, the relationship between Europe and Russia. I'm told that there were some conversations, but obviously they weren't the kind of conversations that got lined up Russia advance. There's this sort of curious question. Is this a Russian problem or is this a European problem?

When this Cyprus issue first came up a couple of years ago, the Europeans were happy to hand it over to Russia to inject two and a half billion dollars into Cyprus, but that proved not to be enough. There's a certain sort of turning away from, lack of recognition, not getting out in front of the problem, by the Europeans and maybe even the International Monetary Fund, in not seeking a solution to the Cyprus's problems sooner rather than later. They find themselves once again playing catch-up ball.

Steve Weisman: Thank you, Ted.

Ted Truman: You're welcome.

