

July 2013

Cyprus: A Small Country in Big Trouble

Richard N. Cooper

For *Century Weekly*

I recently visited Cyprus, a small island country in the eastern Mediterranean Sea, from which our chemical symbol Cu for copper comes, since Cyprus was once a major supplier of copper during the Bronze Age, 3000 years ago. Like Korea, it is divided. Some members of the Greek-speaking majority aspired and conspired to join Greece over 40 years ago. Predictably, that prompted Turkey to invade the island to protect the Turkish-speaking minority, in 1974. Large movements of population took place, Turkish speakers to the north, Greek speakers to the south, and the island has ever since been divided by a “green line” monitored by UN peacekeepers. The southern Republic of Cyprus joined the European Union in 2004 and adopted the euro as its currency a few years later. (The Europeans made a major mistake in not insisting that the island’s political division be settled before admitting Cyprus into the Union; it thereby lost its major leverage.)

Cyprus was once part of the Ottoman Empire, then a British protectorate or colony from 1878 to independence in 1960 – its first since pre-Roman times over 2000 years ago. It was poor in the early 20th century, but has become rich, with a per capita GDP of \$28,000 in 2010, largely on the basis of tourism to north Europeans, especially British and Russian, and by providing financial services to them and others.

But now it is in crisis. It has become the fourth, and smallest, Eurozone country (after Greece, Ireland, and Portugal) to succumb to a financial crisis and the need to be supported with funds from the International Monetary Fund (IMF) and the European Union’s new European Stabilization Mechanism (ESM). It has been placed under a rigorous program for fiscal consolidation (the European phrase for reducing budget deficits) and economic, especially financial, reform.

The Cypriots are in a state of shock, partly because of a steep economic decline from the prosperity of only a few years ago, even more because the banking system is in disarray. The withdrawal and use of bank deposits has been significantly curtailed, money can be moved out of the country only with permission (capital controls, formally prohibited by the European Union), and deposits above the guaranteed level of 100,000 euros have been partially (37.5 percent so far) confiscated through involuntary conversion into preferred stock in a bank that is technically insolvent, but is in the process of being rescued. Business firms with deposits over the guaranteed threshold have not only lost money, but also cannot function because credit is not available while the fate of the two largest banks is being sorted out.

How did this sudden change come about? Cyprus, like many other countries, was hit by the world recession of 2008-2009, especially in tourism (although that benefited somewhat in 2011 by the turmoil in Egypt). Like several other countries, it also had engaged in a period of excessive construction

in mid-decade. That declined sharply, and raised questions about future performance of many bank loans. The banking system was exceptionally large, with assets exceeding GDP by a factor of five. Unlike many large European and American banks, Cyprus' banks were not highly dependent on funds from the short-term money market, but they did have a high ratio of non-resident depositors (although not as high as in Ireland, Britain, and especially Luxembourg, among EU countries). Also, Cyprus' banks had significant operations in Greece, which were made doubtful by the Greek financial crisis from 2010; and they were especially hit by the 50 percent "haircut" on Greek sovereign debt in 2011.

In its waning years, the government of President Demetris Christofias – the only avowed communist ever to win a fair, contested presidential election – squeezed the budget but did not want to take really difficult and politically controversial actions. In particular, it eschewed closing the deeply troubled Laika (Popular) Bank, the second largest bank in Cyprus. It was left to the new government to close that bank in 2013 and consolidate it with Cyprus' largest bank, now in the process of figuring out how best to resume normal operations.

The primary budget deficit is expected to be about 2.4 percent of GDP in 2013 – not large as deficits go, but Cyprus is unable to borrow in private markets, so must depend wholly on official financing, from the IMF and the EU, a total of 10 billion euros over three years. It has pledged to convert its deficit into a primary surplus of 1.2 percent of GDP by 2016, even while providing enough support to the financial sector to get it functioning again. It will have to cut regular government expenditures, raise taxes, and sell state-owned assets worth on the order of 500 billion euros. Total bank assets are to be reduced from over 500 percent of GDP to around 350 percent. All this will put severe contractionary pressure on the economy, which is expected to decline by 12.5 percent in 2013 and 2014, with significant decline in employment.

Cyprus is a small country, but the requirement that uninsured depositors in its leading banks bear some of the cost of restructuring represents a novelty in the context of the European financial workouts, and European officials have made clear that this sets a precedent for the future – if, for example, Spanish or Italian banks should need European assistance. This prospect, of course, has predictably led to withdrawals from banks in those and other weak European economies. The capital controls introduced by Cyprus may also set a precedent for the future. All this increases the urgency for completing the European banking union, agreed in principle but stalled on details, and of introducing European-wide deposit insurance, which so far Germany has resisted.

Cyprus' future is not entirely bleak. Significant natural gas has been discovered offshore, and more is in reasonable prospect. The investments required to bring this gas to market unfortunately will take too much time to provide any immediate relief to Cypriots. But at least they can look forward to a more prosperous future.