Even though in recent years it has occupied the center stage of the European crisis, the Greek crisis is about to be surpassed by the Cypriot one. It is, of course, difficult to define such hierarchies. We would venture to say that the recent events in Cyprus will leave a deeper mark on the evolution of the European Union and will be more frequently invoked over the coming period. The Cyprus crisis is simply richer in meanings: those to do with banking and finance, but also wider, more far-reaching meanings. Of, if you will, the decisions taken of late in the Cypriot crisis define more precisely certain boundaries and milestones in the evolution of the Union. Therefore, limiting the analysis to the Cypriot banking environment and presenting its developments as being “metastatic”, is not sufficient, however instructive this approach may be. In this paper we shall attempt to reveal a few of the wider implications of the developments in Cyprus and to emphasize the idea that the situation there must also be regarded as an opportunity to apply a strategy that had already been outlined some time before, but that has been waiting for an auspicious moment ever since.

First, let’s go over the facts. Cyprus invented the off-shore industry in the 1980s, after the island had been divided in a Turkish half and a Greek half (in 1974). It is important to note that the Turkish part inherited the largest part of the industrial and agricultural base of the country. Until the ’80s, tourism had been the main income source for the locals. The off-shore industry was born as a result of an effort to create other sources of revenues. At least two factors have led to the blooming of that industry: low tax rates and high interest rates for depositors (in other words, what is known in English as a ‘tax haven’, or a ‘paradis fiscal’ in French). We might also add a tolerance for the laundering of money coming from various countries, especially from Russia and Eastern Europe. What is certain is that, as a result, the financial industry grew so much that it was eight times larger than the country’s GDP. This was, undoubtedly, a risky imbalance.

According to the analysts, the problem took root when Cypriot banks invested in Greece’s sovereign bonds. When Greece was hit by the crisis and had to restructure its debt, the price of the shares purchased by Cypriot banks plummeted dramatically, which in turn “killed” the Cypriot banking system, which was already shaken by the imbalance mentioned above. In the face of such a critical situation, Cyprus requested a bail out. Its initial request was for 17 billion Euro. The European authorities – following a push by the IMF – approved an aid package consisting of 10 billion Euro, with the caveat that this was not to be used to refinance the banks’ debts. (According to the IMF, the government would never be able to service the debt

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Farewell to the Union!

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on a full 17 bn euros rescue. The IMF backed by Berlin set a ceiling of 10 bn on what was „sustainable”, so 7 billion had to come from private investors).

In addition, the lending authorities imposed some “sanitation measures”: a second bank in Cyprus, Laiki Bank, will be split into what the specialists call “good” banks and “bad” banks. Any deposits totaling under a hundred thousand Euro (which together make up about 9 billion Euro) are to be transferred to the Bank of Cyprus. Those deposits that go over 100,000E might be maintained, depending on the value of the assets that a “bad” bank possesses. It is estimated that the owners of such deposits would incur losses of about 40%. In its turn, the Bank of Cyprus is set to go through an ample restructuring process, in order to liquidate non-performing loans. It is thus apparent that Cyprus’s banking system will suffer a severe contraction. Some experts estimate this will be of 25-30%, while others go as far as 50%.

Finally, we need to mention that, as soon as those conditions were accepted, the entire banking system in the country was blocked, so as to prevent the siphoning off of a large part of the deposited sums. This was a sort of blitzkrieg, which surprised the deposits “on the ground” and did not allow them to “take off” again. Throughout this entire storm, there was one positive aspect that was recorded. Initially, the government envisaged the taxation of deposits of under 100,000 Euro as well. In the final version, those deposits are protected from losses. They constitute the maximum upper limit recognized by the EU for insured funds.

1. Small nations with large banking sectors

James Fontanella-Khan pinpoints the cause of the problems confronting Cyprus: “Eurozone leaders declared Cyprus’s oversized banking system the cause of the country’s crisis” (Fontanella-Khan, 2013). This perspective, according to which the excessive development of the banking sector and its relationship to the economic power of the country would form the explanation of the Cypriot situation, has become the regular pattern of interpretation and understanding of the Cypriot crisis. We need, therefore, to focus upon it. It is true that the banking system of Cyprus is eight times larger than the country’s GDP. However, the informed observer might also notice other things, as well. Quentin Peel goes one step further and highlights the fact that this business model, considered as being speculative and incompatible with the European organization, is not accepted at the level of the Union. “The Cyprus’ ‘business model’ as a tax haven – what the French call so poetically a <<paradis fiscal>>, with low tax rates and high interest rates for the depositors, many from Russia, was simply not sustainable” (Peel, 2013). Should this be indeed the case, then the necessary measure to be taken is to resize the sector in question. According to Peel, that is the belief of minister Schauble, which is also shared by all of Germany. Cyprus’s banking sector – 8 times the size of its economy – had to shrink.

This approach raises a series of legitimate questions. The first one – and the most pressing – being: if that was indeed the cause of the troubles, then the cause should be tackled wherever it may be found. This statement, however, leads to the first puzzle. Luxembourg, for example, has a banking system that is not merely eight times larger than the country’s real economy, but 22 times larger. That is two-to-three times bigger than that of Cyprus. Malta’s financial services sector is eight times its gross domestic product. So the situation in
Malta, in what concerns the overall picture, is strikingly similar to the one in Cyprus. But Malta’s financial and banking services are considered fairly robust. The state of the banking systems in Slovenia and Latvia also shows clear similarities to the one in Cyprus. Therefore, if the ratio between the banking system and the real economy constitutes the problem – and this ratio is not sustainable, in either of the aforementioned states – then the shrinking of the banking sector should have been implemented in all the countries confronted with this issue.

It is true that the problems facing Cypriot banks include losses made on their holdings of Greek bonds, but that very fact is a possible symptom of an unhealthy economic situation. Today we can no longer say that the real estate bubble in the United States was the actual cause of the crisis. That bubble was merely the shape taken by an excess of speculative capital, which benefitted from the lack of certain regulatory mechanisms. Cypriot banks have indeed made a mistake. Nevertheless, should the cause of the Cypriot banks’ problems be the ratio that we have indicated, then we might expect the development of crisis situations in those other countries as well, regardless of the shape such crises would take. Any delay to act would only delay the disease, which, sooner or later, will break the surface. Thus, either the banking system volume/economic activity ratio is indeed the cause of the problems – in which case the measure to reduce the weight of the banking system must be applied wherever it is needed – or it is only a „cause” that is invoked more often than others, in order to solve other issues. For now, we can draw attention to at least one inconsistency on the part of the EU. This is not related only to the mentioned affected states, but also to the fact that the ratio in question is of 2:1 at the Union level. Consequently, the problem is affecting the entire system quite severely.

The idea of this “business model” as being unsustainable can also be brought into the debate. The comment made by Luxembourg’s Foreign Minister is telling: „I find it very hard to stomach the words „business model”. Germany has not got the right to set the business model for other countries in the EU. We mustn’t get into a situation where countries are strangled under the cover of financial technicalities” (Peel, 2013). The Luxembourg minister’s statement makes use of concrete arguments: the business model used by each country is for it to decide upon. However, when the chosen model causes problems for the whole organization (in this case, the whole European Union), the organization is entitled to intervene. The question we ask is simpler: if the (real) banking crisis of Cyprus had not occurred, would anyone have raised an alarm regarding the issues of the „business model” that is talked about these days? Probably not, even though Germany’s finance minister insists that „they have been saying it for a long time”. So, from the perspective of the specialist, as well as that of the ordinary citizen, the underlying problem is: how much of the Cyprus crisis is based on real facts and how much of it is actually a situation conjured up in order to solve other issues (that are as yet unnamed)? For if the problem really was the overgrown banking sector, it could have been solved without having to wait for a crisis to hit; and it could have been solved in all the states confronted by this sickness, not only for Cyprus.

2. Investors should now shoulder the burden

The novelty of what happened in Cyprus consists of bringing in a new bail-out philosophy, which is based on the idea that bail-outs should be paid by deposit owners and bond holders and not by tax-payers. Put it differently, investors should now shoulder the burden.
All previous bail-outs were paid by tax-payers. Why? This was done in order to calm the financial markets and to offer them a supplementary insurance that the system is solid and that the debt will be reimbursed. As Jeroen Dijsselbloem, the Dutch finance minister and President of the Eurogroup of Eurozone finance ministers, recently said, “the crisis seems to be fading out, I think we need to dare a little more” (Spiegel, 2013).

It worth mentioning this is not about Cyprus only. There is a standard response model to this type of crisis, a template. If a bank gets in trouble, the response will no longer automatically be “we’ll come and take away your problems” (Spiegel, 2013), said the President of Eurogroup. From now on, this kind of problems will be addressed with the so-called “Cypriot model”. Or, to use Jeroen Dijsselbloem’s own words, the bail-out for Cyprus will set the tone for future Eurozone bank rescues. In an interview to the Financial Times, the Dutch finance minister put it even more explicitly and commented on the crisis in Cyprus by constantly referring to the relationships between EU’s creditors and debtors. He remarked that “it is now the stated policy of the creditor countries to solve the problem of a debt overhang in the banking sector in the peripheral countries through the bail-in of bondholders and depositors” (Munchau, 2013).

The solution seems attractive and even just. If a bank is insolvent, then it should identify solutions to overcome the situation and it should not seek recapitalization with public funds. The solution put forward to save Cyprus tries to avoid the dissatisfaction of citizens with the fact that they would have to pay for mistakes they did not make. For instance, the American tax payer eventually bears the burden of the huge sums used by the American Government to recapitalize the banks confronted with the crisis. The same did the “Troika” (IMF, EU, ECB) with bail-outs for Portugal, Spain and Ireland. Why has this U-turn in the vision on the bail-out come about? The explanation given by Jeroen Dijsselbloem that the crisis seems to fading out seems unsatisfactory.

The banking system is vital to a capitalist organization. Simply, the economy and the society cannot function without this very heart of the capitalist system. What happens when a bank or more go bankrupt or they have major problems? The American experience of the last 5 or 6 years provides us with an instructive “bibliography” in this sense. One of the banks – the Lehman Brothers – was permitted to go bankrupt. If the guilt logic had been followed, many other banks in this country should have had the same fate. Nonetheless, the state has intervened and has contributed to the refunding of these banks. Was this a wrong decision to make? We can only say that nobody important in the American politics or finance has contested the opportunity of the recapitalization process of the banking system. Criticism has targeted the process of de-regulation (which has favored inefficient investments), it has targeted the easiness in allowing banks to use speculative practices, etc. Again, nobody has contested the opportunity of saving the banking system. If the heart suffers, it must be treated at any costs, because it keeps the organism alive.

As mentioned above, the recent European decision on the situation in Cyprus signals the abandonment of the solution used until now both in the EU and the US. It also indicates a new response pattern to the crisis: deposit owners also share a certain responsibility when they trust a bank with their savings. Keeping their money in a bank is an encouragement, a type of acceptance of the evolution of the respective bank, even when it this evolution is unsatisfactory. Nevertheless, judging by the measures taken, the owner seems to be guiltier than the community (in this case, the state) of the undesirable evolution of the bank. This is a very serious problem whose solutions are difficult to find and commit to.
It is already known that what is called Euro crisis is not just a crisis of the Euro. As George Soros also remarked, the Euro crisis is a triple crisis: the crisis of the currency, the banking crisis and the sovereign debt crisis. Clearly, the three are interwoven and they influence each other differently. The Euro crisis has been intensely debated by comparison with the banking crisis, which has been less discussed. From this point of view, the US have been prompter and more transparent. Bank refinancing has become a priority from the very beginning of the crisis in America and public funds have been used to this end.

We cannot fully understand the significance of the U-turn mentioned above if we don’t take into consideration the situation of the European banks and the crisis of the continental banking system. Here lies the core of the explanation of the measures taken by the EU in Cyprus. References to the crisis of the European banks have been systematically avoided and the crisis as such has been superficially tackled. When discussing Greece, for instance, the fact that French and German banks were involved in the Greek sovereign debt crisis and that a large part of the bail-outs for this country went eventually to the creditor banks was barely mentioned. While in the US this issue has been openly addressed and has become a priority for the country, in Europe the bank debts and, in general, the state of the banking system have been relegated to the shadows.

Recently, data indicating a worrying picture of the European banking crisis have been made available. The crisis in Europe is similar to the American one in terms of gravity. The problem is not that the crisis in Europe is less grave than in the US, but that is has been publicly acknowledged later than it should have been (there is a difference in timing between the European and the American crisis). Hans-Werner Sinn and Harald Hau noted that „the European Central Bank has already provided extra refinancing credit to the tune of 900 billion Euros to commercial banks in countries worst hit during the crisis, as measured by its payment system“ (Sinn & Hau, 2013). This is to say that the ECB has only offered surviving credits to banks full of toxic assets. This is the result of wrong decisions, of wrong policies – the losses have been covered by public funds.

The problem here is that the debts of the banks in countries hit by the crisis are much bigger and that they cannot be avoided anymore. The same authors showed that “the total debt of banks located in the six countries most damaged by the crisis amounts to 9.4 trillion Euros. The combined government debt of these countries stands at 3.5 trillion Euros” (Sinn & Hau, 2013). The financial help that the EU can offer to troubled countries from its “treasury” (i.e. the European Financial Stability Facility) is of 500 million Euros. This might explain the radical change in the EU’s attitude towards the banking debts. This change is partially motivated – simply put, the EU cannot sustain such financial effort needed to bail-out countries in need. If such an effort had been made, it would have equaled to a “lost decade” for Europe. The European choice, although based on solid grounds, raises some uncomfortable questions.

The first question and the most striking is this: why this change has started with Cyprus? The European banking crisis includes the Cypriot crisis, but it is hard to believe that the latter is one of the central elements of the former. The Cypriot GDP represents only 0.2% of the Eurozone (Small island, big finger. The Economist, March 23, 2013) GDP, thus ten times smaller than Greece’s GDP. Furthermore, the change discussed here is presented as a new strategy that will be applied from now on. This led Martin Wolf to say that „a consensus on the principle that creditors, not taxpayers, should pay if a bank becomes insolvent does not yet exist across the Eurozone. Does anybody imagine the German government would not rescue Deutsche Bank if it were in trouble? Of course it would.” (Wolf, 2013). Thus, we cannot talk
about proposing and using a template for the Eurozone, but for the countries confronted with similar difficulties, at best. Actually, a “re-assignment” of bank debts inside the boundaries of the countries in which those banks function is sought. Passive and guilty of its passivity during the accumulation of debts in the South, some of which were made through “cooperation” with banks from the creditor states, the Eurozone seems to suddenly appear as a knight in shining armour coming to the rescue. In reality, the Eurozone is scared by the size of debts of banks and by the size of the toxic assets. Therefore, these debts are confined to the country in which they should be paid. The majority of these debts are in the Southern countries, and thus the measure proposed to save Cyprus indicates a new level of the North/South gap and, consequently, of the tensions accompanying this divide.

In a analysis of the Euro crisis, George Soros made an important observation: “The Euro crisis had its origin in German Chancellor Angela Merkel’s decision, taken in the aftermath of Lehman Brothers’ default in September 2008, that the guarantee against further defaults should come not from the European Union, but from each country separately. And it was German procrastination that aggravated the Greek crisis and caused the contagion that turned it into an existential crisis for Europe” (Soros, 2012, p.118). In other words, the crisis has spread in Europe also because the solutions to overcome it have been transferred from a unional level to a national one. Thus, the common problems and roots of the crisis – emphasis on “common” – have been neglected and pushed in the backstage. The Euro crisis did not appear as a crisis of the Eurozone, but as “national” crises. The national dimension, explanations and roots are real but they don’t cancel the explanatory power of the idea that the single currency has been introduced in an area with very different economic performance and competitiveness. The transfer mentioned here made possible the dissemination of a quasi-official interpretation of the crisis, entirely based on profligacy policies and not on development discrepancies between member states (such an explanation would have required solid solidarity and cohesion policies). The measures to overcome the crisis are almost exclusively austerity-related. The conditions for bailing-out Cyprus have at least two meanings: first, they consolidate the idea that the roots of the crisis and the solutions are “nationally-driven”, but the recipe for treatment is European; second, they create a response pattern for small states where the volume of the financial activity is higher than that of the economy, by means of loading the burden on deposit owners’ shoulders. Both meanings absolve Brussels of any responsibility. However, overcoming the crisis means converging national and European responsibilities in order to find solutions to address both the national and the European roots of the crisis. The potential risk of tax havens raises the crucial question: where have been Brussels and the Eurogroup until now? Is this response pattern built for Cyprus only or will it address other countries confronted with a similar situation? In my view, this pattern is a signal and Cyprus is a testing grounds.

3. Where do we go next?

A solution is also assessed through the continuity it ensures. What is the next step? How things will evolve? These are the questions raised by many commentators of the measures taken in Cyprus. They say that the EU faces a decision-making problem. The decision-making process itself seems rather odd; the issue here is not necessarily that the decisions taken are good or bad. Rather they lack perspective, which is crucial for a determining the degree
of rationality of a decision that proposes ways to overcome a difficult situation. Several different approaches have been proposed. In this section, three of them will be analyzed. One may admit that the Cyprus’s ‘business model’ is unsustainable. The issue is that solving a problem has caused another, which now no one seems to attend to. What will sustain the economy of Cyprus? What will ensure the livelihood of the inhabitants of this island? In this sense, a piece in *The Economist* reads that “although the IMF talks optimistically of a fall of only 10% this time, she predicts falls of 15% this year and another 5% in 2014. This will have horrific effects. After the collapse of Laiki, unemployment is heading for 17% this year; it could exceed 25% in 2014” (The future of Cyprus, A troubled island story. *The Economist*, March 30, 2013).

At this point, Greenspan’s words come to mind. The former director of the US Treasury has launched an idea to reflect upon in times like this. Which is the most indicated action when confronted with a ‘bubble’? To react with force, to “break the bubble”, thus running the risk of contagion, of spreading the illness to the entire organism? Or to treat the problem in order to reduce it to normal dimensions and only after that take action. Medicine applies the same basic principle: the body cannot undergo surgery if it has a fever. In the case of Cyprus, the banking system was redimensioned. The problem with this intervention is that the economy has been “desertified” and the possibility to return the loan recently contracted has been reduced if not even eliminated. Apparently, this “shrinkage” will render debt-sustainability forecasts null and void” (Second time unlucky. *The Economist*, March 30, 2013).

The second approach focuses on the delay of decision-making within the EU. A decision has to prevent and it has to be made when the phenomenon targeted by the decision reaches a peak. After that, a decision only minimizes the intervention; it can generate a powerful feeling of dissatisfaction and, more importantly, it becomes inefficient. Such a decision causes more harm than good. This does not apply only to the situation in Cyprus; such shortcomings in the decision-making process are a long time suffering of the EU. On this problem of the EU, George Soros remarked: “Measures that would have worked if they had they been adopted earlier turn out to be inadequate by the time they become politically possible. This is the key to understanding the Euro crisis” (Soros, 2012, p. 126). If the measures taken in Cyprus will be extended to countries confronted with similar problems, then it is possible that the situation degenerates in a sort of “war” with the small Mediterranean island, thus confirming Christopher Pissarides’s (Cypriot receiver of the Nobel prize for economics) prediction that “the way Cyprus has been treated by its eurozone partners shows that far from the currency bloc acting as a partnership of equals, it is a disjointed group of countries where the national interests of the big nations stand higher than the interests of the whole” (Pissarides, 2013).

Finally, there is a paradox which become more and more visible and even more and more intriguing. The creditor countries are more and more dissatisfied with the effort they put on and with the reaction of the “South” that seems to reject the solutions proposed and to show no special appreciation towards the creditors. Debtors are dissatisfied, too. They contest the conditions of the bail-outs and openly admit that the single currency negatively affects their development. The paradox is this: while visible dissatisfied, none of them wish to exit the Eurozone. There is a growing tension, a visible distress in the public sphere, but for now everybody wishes to remain in the Eurozone. At this point, it seems that the Eurozone needs a moment of truth.
Does anyone think that Greece will ever pay the bail-outs received? Will the measures taken in Cyprus lead to a different result? A possible answer is that those who received bail-outs will never fully return the money. On the other hand, creditors know that their commercial surpluses are also influenced by the existence of the Union. The problem is that, confronted with such experiences, the Union is no longer a union. It is only a geographical reality comprising two distinct areas that no longer follow principles of development established at the beginning of this historical project. Instead, they seem to be circumscribed to an imperial paradigm. In the eyes of the North, the South becomes a “financial periphery”. To exit the Eurozone or even the EU is not a solution for the South. A viable solution would be the creation of a genuine banking union, with hard rules applied to everybody. Nowadays, the Union does not benefit from the initial solidarity, from the idea that together Europe will gain more. Furthermore, the Union seems to have lost optimism and trust in its own future. The visible return to nation-centric values and actions seems to be difficult to stop. Recent event have consolidated the feeling that within the EU nobody says loudly what he or she thinks. “It feels more like a loveless marriage, in which the cost of breaking up is the only thing keeping the partners together” (Just when you thought it was safe… The Economist, March 23, 2013). Cyprus is the most recent experience that deepens the gap between Northern (the creditors) and Southern member states (the debtors). Both groups are strongly dissatisfied. As Sinn and Hau (2013) noticed, “if the banking and creditor lobbies are allowed to prevail and the commission proposal passes the European Parliament without substantial revision, Europe’s tax payers and citizens will face an even bigger mountain of public debt – and a decade of economic decline”.

References

10. *** Just when you thought it was safe… The Economist, March 23, 2013.