The Politics of the Euro Area Crisis and Cyprus

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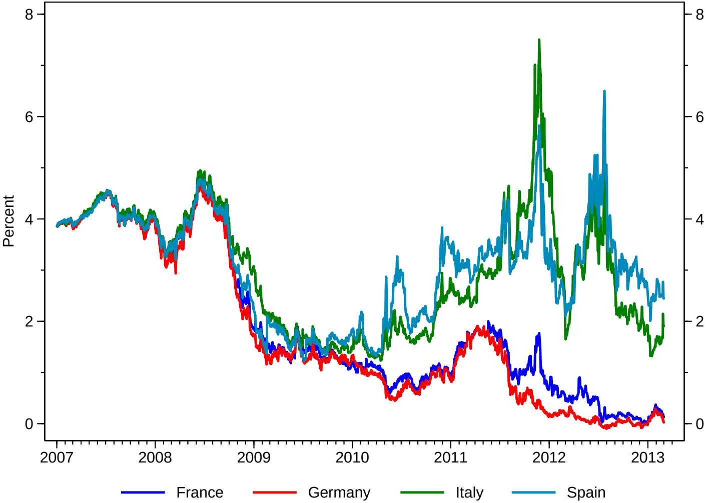
How did the euro area crisis develop?

- August 2007: A disturbance in money markets in the USA
- September 2008: The collapse of Lehman
- Caused a global banking crisis and recession in 2009
- Morphed into a sovereign debt crisis in the euro area

The disintegration of sovereign markets



- Two year government bond yields

Why is the euro project crashing to earth?

- Is the problem in Europe a "fiscal" problem, a "competitiveness" problem, a "banking" problem, etc?
- Alternatively, are these symptoms of a deeper flaw that cannot be solved with technical arguments?
- Flawed narratives can mislead policymakers.
- Dealing with symptoms while the underlying causes make the problem worse may lead to irresponsible complacency.

Crisis mismanagement

- The global crisis shed light on weaknesses in the construction of the euro area:
  - Flawed governance/decision making process
  - Incomplete design
  - Lack of a crisis management framework
- Mismanagement of the problem since 2009 has turned it into an existential threat for the euro area.
- More than half a dozen euro area member states currently under stress: Greece, Ireland, Portugal, Spain, Italy, Cyprus, Slovenia ...

Political constraints

- Europe is not a federal state—there is no single government that can design and enforce solutions for the benefit of all Europeans.
- Solutions on key issues that may involve adjusting the Treaty, require unanimous agreement by governments of the member states.
- But governments of member states must face their own electorate and some element of any solution may be unpopular to the electorate in some state.
- Elections induce some governments to postpone decisions or use a problem for local political gain.
- Constraints create potential for mismanaging the crisis.

Crisis mismanagement: Two examples

- October 18, 2010, Deauville:
  Decision to introduce credit risk in what used to be considered "safe" government debt.

- March 16, 2013, Brussels:
  Decision to introduce credit risk in what used to be considered "safe" bank deposits.

Unique and exceptional blunders?

- Why the haphazard decisions?
- One explanation is that the blunders we have repeatedly observed during the crisis reflect incompetence. If so, this could be corrected with more enlightened advisers.
- Another explanation is that these blunders are a predictable manifestation of the decision making process. If so, a correction may not be feasible.

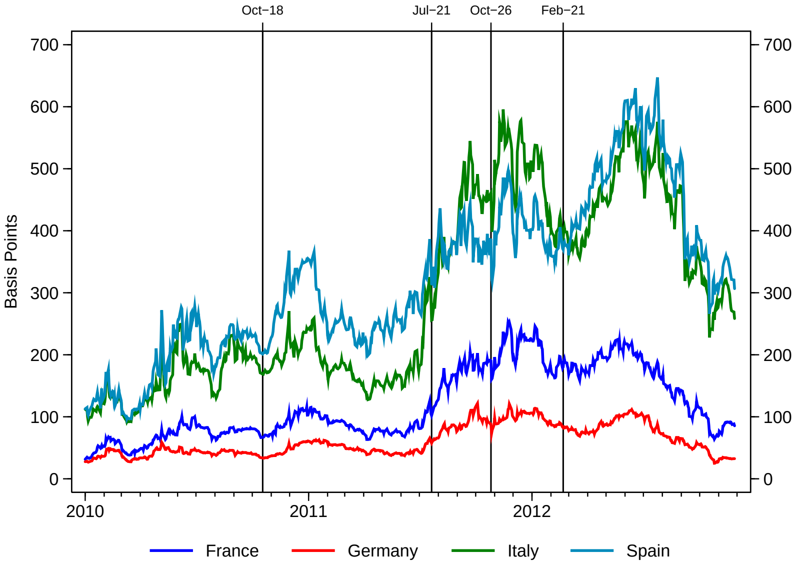
Credit risk in sovereigns

- October 18, 2010: PSI concept introduced
- July 21, 2011: PSI, up to 21% haircut on Greek debt
- October 26, 2011: PSI 50% haircut
- February 21, 2012: PSI, "53.5%" haircut (about 80%)

October 18, 2010: Deauville

- Private Sector Involvement (PSI) doctrine introduced.
- Whenever a euro area member state faced liquidity pressures (not necessarily solvency concerns), the imposition of losses on private creditors would be demanded before euro area governments agreed to provide any temporary assistance.
- Message to potential investors: Euro area sovereign debt should no longer be considered a safe asset with the implicit promise that it would be repaid in full.
- Implications:
    - Raise the cost of financing for euro area governments perceived to be relatively weak.
    - Generate adverse feedback loop between sovereigns and banks.

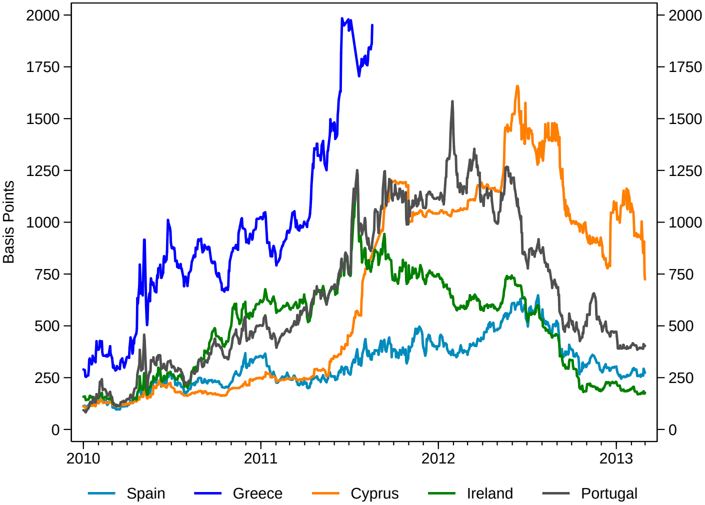
Five-year CDS on sovereigns



How did the crisis reach Cyprus?

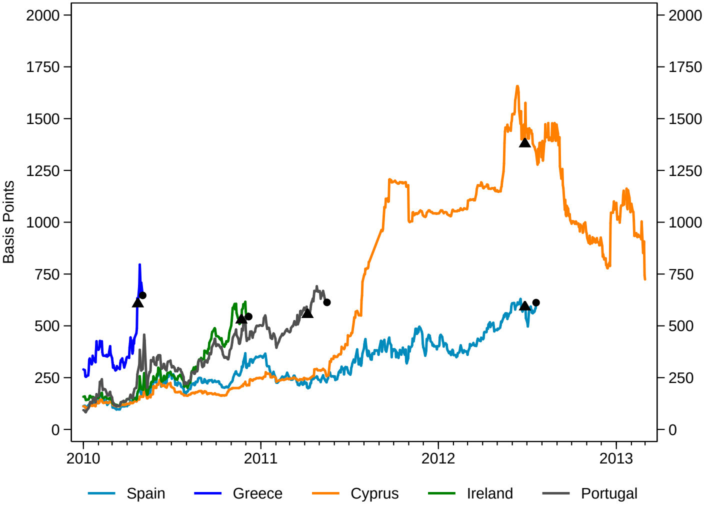
- Cyprus joined EU in 2004 and adopted euro in 2008.
- Reasons were primarily political, rather than economic.
- A large banking system and exposure to Greece made it vulnerable to bad fiscal policies.
- Coupled with a dysfunctional framework in Europe, misguided economic policies in Cyprus led to the disastrous decisions in March.
- Political considerations sealed the outcome.
  - February 2013 elections in Cyprus
  - September 2013 elections in Germany

Could you see this coming?



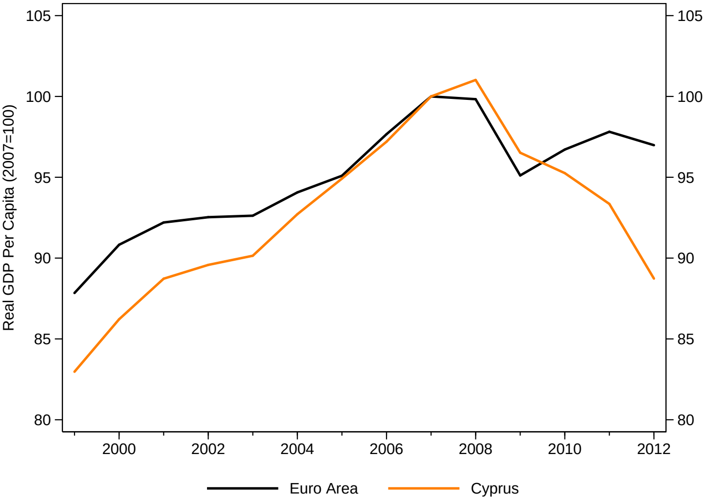
- Five-year CDS on sovereign, as of end February 2013

A government refusing to take action



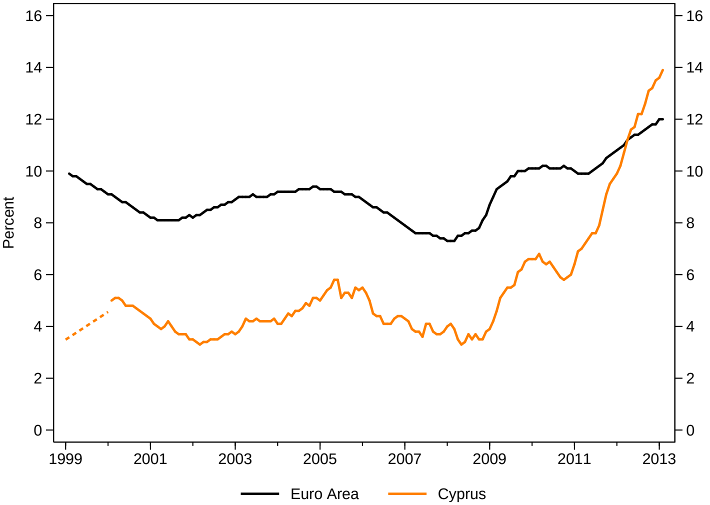
- Markers show when assistance was sought and agreed.

The economic consequences of inaction



- Real GDP per person: Cyprus vs euro area

The economic consequences of inaction



- Unemployment rate: Cyprus vs euro area

What happened?

- Cyprus joined the euro on January 1, 2008.
- The economy was in good shape.
- The government ended 2007 with a 3.5% surplus. Debt to GDP ratios projected to fall below 50% with unchanged policies.
- Solid banking system. Deposits exceeded loans. Toxic assets avoided. Risks due to real estate overheating contained by tight loan-to-value ratios.
- But the banking system was large relative to the size of the economy, which made it and the economy overall more vulnerable to fiscal mismanagement.

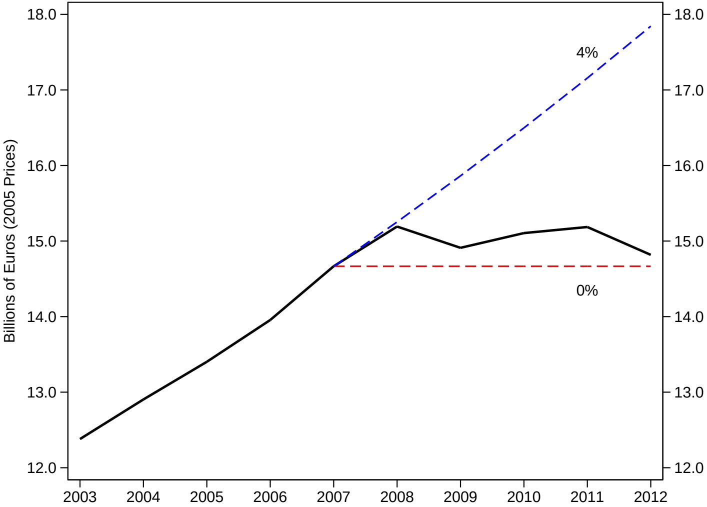
A communist government

- In February 2008, the public voted the leader of the communist party (AKEL) as President of the Republic.
- The economy was doing so well that voters focused on the political problem of the island.
- The winning argument was that the communist party could solve the occupation problem and reunify the island, something that the sitting government had failed to do.
- The crisis found Cyprus with a communist government:
  - overspending (in the name of social justice).
  - anti-business (in the name of protecting labor)
  - anti-banks and anti-capitalism (in the name of communist philosophy).

Overspending

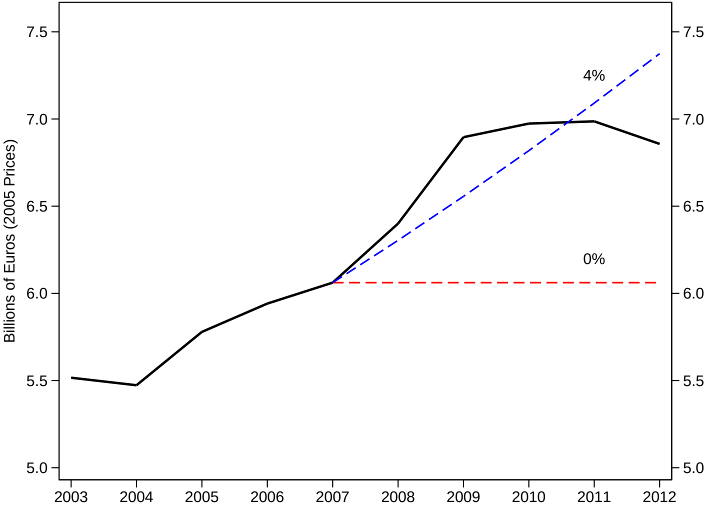
- Government started overspending immediately.
- Spending concentrated in unproductive consumption.
- While crisis reduced GDP growth and contained tax receipts, real spending increases exceeded even high pre-crisis growth rates
- Automatic spending increases, cost-of-living adjustments and increasing pension liabilities in an environment of stagnating growth made things worse.

Real GDP



18.0
17.0
16.0
15.0
14.0
13.0
12.0
Billions of Euros (2005 Prices)
4%
0%
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012

Real Government Expenditures



Concerns in 2009

- A ten percentage point reversal in the fiscal balance from 2007 to 2009 raised significant concerns as early as 2009.
- Increases in pension-related government expenditures and implicit future liabilities, put Cyprus in high risk category (European Commission 2009 Ageing report).
- However government refused to take action.
- The argument: debt to GDP is below average of the euro area so there is considerable room for more spending and bigger deficits.

Concerns in 2010

- Further deterioration of fiscal finances in the context of the sovereign crisis in the euro area led to an intensification of concerns during 2010.
- Large size of banking system and connectedness to Greece implied greater vulnerability to fiscal misteps and increased risks.
- Despite numerous warnings throughout the year, government refused to take action.

A warning from the Central Bank, 18 May 2010

"The recent dramatic events in Greece have intensified existing concerns about Cyprus ... the collapse in Greece started as a fiscal crisis, put in danger the banking sector and subsequently the whole economy. This has put fiscal problems elsewhere under the microscope. ...

Cyprus has not yet attracted close scrutiny because of its small size. In my view, this is just a matter of time ... for a number of reasons such as ... the worsening fiscal deficits and high level of public and private debt ... the very large size of the banking sector compared to GDP ...

I stress that unless there is a change in direction with meaningful fiscal consolidation, primarily on the expenditure side, the consequences for the Cypriot economy will be catastrophic."
(Letter to President Christofias)

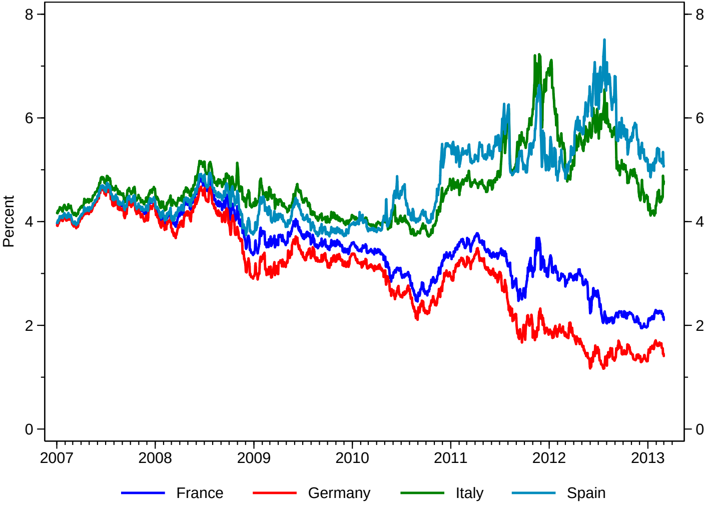
A warning from the ECB, 15 December 2010

"In light of recent market concerns about public debt sustainability, it is more important than ever that every country benefiting from the common currency takes prompt and effective steps to ensure that its public finances are on a sound footing. Experience has shown that waiting for market pressures before acting exacerbates tensions and ultimately increases the needed adjustment size. Although Cyprus' sovereign debt market has a limited size, significant concerns exist. These concerns are particularly relevant in view of the large size of the Cypriot banking system, which may produce negative feedback loops between the financial sector and public debt. ... The challenges faced by the Cypriot economy require prompt corrective action. We are confident that the Government will rapidly take the needed measures."
(Letter to President Christofias)

Anybody listening?

- Government chose to ignore warnings.
- Not heeding ECB warnings was particularly costly. Through its actions, the ECB had demonstrated its willingness to provide support and diffuse stress situations.
- By 2010, euro area sovereign markets were disintegrating.
- During 2010, the ECB had already started purchases of Greek, Irish and Portuguese debt.
- During 2011, following a similar exchange of letters with the heads of governments of Spain and Italy, and the adoption of measures by these government, the ECB started purchases of Italian and Spanish debt.

The disintegration of sovereign markets



- Ten year government bond yields

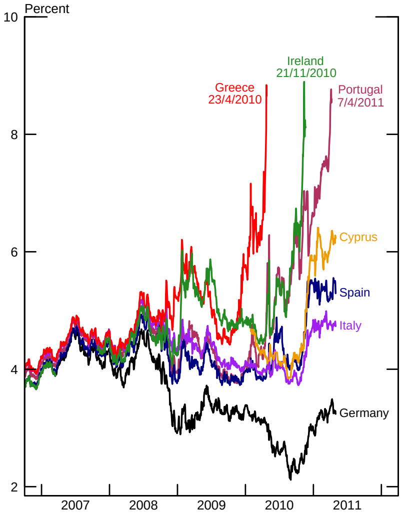
The slide in 2011

- The failure of the government to correct its widening fiscal problems and the deterioration in Greece attracted attention to Cyprus.
- Sovereign was downgraded but instead of taking consolidation measures the government imposed a bank deposit levy in April 2011, adding to pressures on banks.
- On 4 May 2011, Ministry of Finance (MoF) memo appeared in press indicating that publicly communicated deficit targets for the year were unrealistic.
- On 6 May 2011, MoF announced deficit for 2011Q1 which proved much larger than expected.

Losing market access

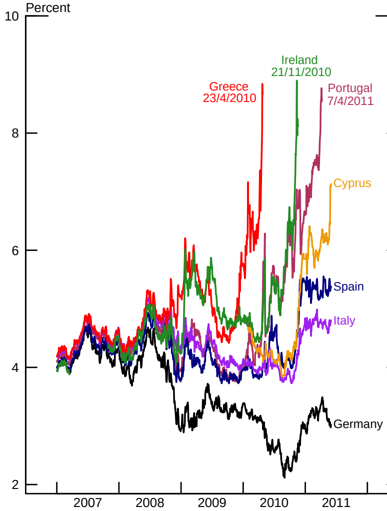
- For many months, MoF had been postponing needed long-term bond issuance to avoid disclosing elevated financing needs in advance of parliamentary elections.
- Rating agency postponed downgrading at MoF request.
- The plan succeeded, the communist party gained one seat on the 22 May 2011 parliamentary elections.
- However, attempts to tap markets after elections indicated that sovereign had lost market access.
- On 26 May 2011, MoF announced shift to domestic borrowing, admitting lost access.
- On 3 June 2011, MoF announced huge gap in public pensions, admitting unsustainability of pension plans.

Losing market access



Yields on 10-year government bonds, as of May 9, 2011

Losing market access

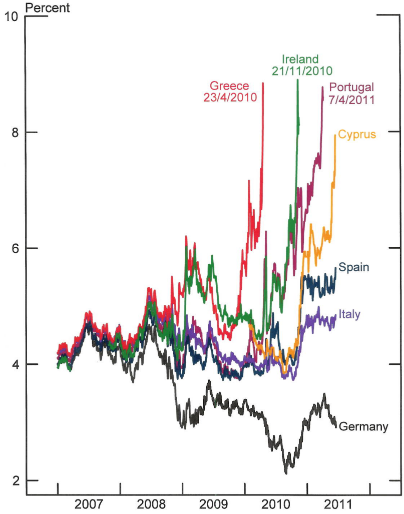


Yields on 10-year government bonds, as of May 31, 2011

A letter from the Central Bank, 17 June 2011

"The situation has deteriorated further in the past few weeks rendering a meeting extremely urgent. ...
In the meantime, I attach an updated figure ..."
(Letter to President Christofias)

An updated figure



Yields on 10-year government bonds, as of June 16, 2011

An explosive mix

- Loss of market access in May 2011
- The Iran-Syria arms-related event in July 2011
- The intensification of the euro area crisis in July 2011-October 2011

The Iran-Syria arms connection

The Iran-Syria arms connection

... stored in the sun

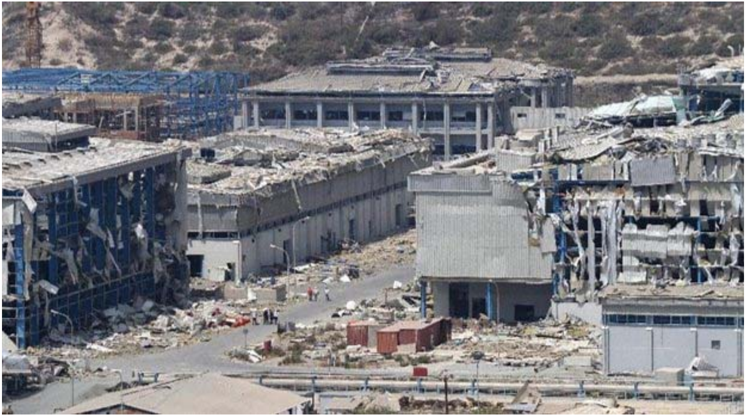
... next to the power station

11 July 2011

11 July 2011

11 July 2011

11 July 2011



11 July 2011

After the explosion

- Politics:
  - Independent investigator appointed by government found that President was personally responsible for disaster.
  - Calls for resignation of government.
  - President protected by constitution so public ignored.
  - Political instability.
- Economics:
  - Over half of island's electricity supply lost.
  - Rolling power outages.
  - Economy thrown into recession.

A letter from the Central Bank, 18 July 2011

"Accounting for all, the unfavorable global environment, the difficulties in securing international financing, the further adverse economic consequences from recent events, I believe that the economy is in a critical condition comparable to that in 1974. Consequently, to avoid the worst, including being forced to a support mechanism with all this implies for the economy and our national issue, it is imperative to adopt and quickly implement measures ..."

(Letter to President Christofias)

Communist government's response

- Warning leaked to press to dismiss it.
- Coordinate propaganda against anyone calling for action.
- Call for further increases in spending to fight the crisis.

The state of the banks

- On 15 July 2011, the European Banking Authority published new stress test results for EU banks.
- Stress test included a surcharge on sovereign debt. Test results made public holdings of sovereign debt by bank.
- The two largest Cypriot banks participated in exercise and both passed stress tests.
- System was under pressure but banks had been raising capital and had sufficient buffers to weather even possible haircuts then under discussion.

Meanwhile the euro crisis was intensifying

- July 21, 2011: PSI on Greek debt
- October 26, 2011: larger PSI and capital exercise

European Council: 21 July 2011

- EU Council decided to implement PSI on Greek debt.
- Maximum haircut of 21 percent imposed on holdings of Greek debt.
- Weathered by Cypriot banks with existing capital buffers.

European Council: 26 October 2011

- EU Council decided to abandon 21 July 2011 agreement and force bigger haircut on Greek debt ("50 percent" which eventually translated to about 80 percent in market value).
- Recapitalization exercise with elevated core-tier 1 capital requirements (9%) and mark-to-market sovereign bonds without an agreement on how capital would be provided.
- Major problems in periphery.
- Acute problem in Cyprus.

How did the government stress the banks?

- The October 26, 2011 decision regarding the Greek PSI and associated recapitalization exercise created a huge capital charge for the two largest banks.
- The hit to capital was about 25% of Cypriot GDP.
- Remarkably, the government agreed to this decision while the exposure of Cypriot banks and associated cost to them were public information.
- Banks had extra capital to cover about 15% of GDP.
- One bank needed temporary support of about 10% of GDP to reach 9% ratio. However, as sovereign had lost market access it could not raise the resources to do this.

External assessment before EU Council decisions

"The Cypriot banking system has weathered the economic difficulties well and appears to be in sound overall condition. It has benefited from reliance on deposits rather than less stable sources of financing, conservative lending practices, close attention to capital and liquidity buffers, and vigilant supervision. These factors have helped shield the banking system from the pressures that are prevalent in many other countries."

IMF
Staff Visit Preliminary Findings
February 15, 2011

External assessment after EU Council decisions

"The large banking sector, with assets totaling over 8 times GDP by the broadest measure, and with significant exposure to Greece, is a significant vulnerability. Banks face significant capital needs to reflect mark to market valuations on their sovereign bond holdings and to achieve a 9 percent core tier one capital ratio, as mandated by the European Banking Authority."

IMF
Conclusion of Article IV Consultation
29 November 2011

Russian loan

- With the economy tanking and no access to markets sovereign faced default.
- The government once again avoided seeking assistance from EU/IMF and avoided meaningful fiscal adjustments necessary to restore market access.
- Instead, government sought a bilateral loan from the Russian Federation, about 15 percent of Cypriot GDP.
- At the time the loan was made (December 2011), the aim was for the loan to meet government fiscal needs until February 2013 elections.
- Delay in corrective measures made problem worse.

Collateral eligibility as the sword of Damocles

- If banks could be assured that government debt would remain ECB eligible collateral, then the government could raise the funds through issuance of debt that banks could finance with liquidity provided by the ECB using the bonds as collateral.
- ECB eligibility requires at least one investment-grade rating of sovereign paper.
- But these rules had been waived for program countries.
- Could the rules be waived for Cyprus also?

A last chance in April 2012

- New minister of finance suggested that government adopt and implement substantial consolidation measures to avoid being forced to support mechanism.
- In meeting at ECB in mid April he committed to deliver results before the end of May.
- On 1 June 2012, the president publicly rejected the minister's consolidation plan.
- Cyprus lost its investment-grade rating on 25 June 2012.

The February 2013 election in Cyprus

- ECB did not waive rules, forcing Cyprus government to ask assistance from EU/IMF on 25 June 2012.
- Following initial troika discussions, communist government decided to avoid finalizing any MoU.
- Government desperately tried to push adjustments beyond the February 2013 elections.
- Simultaneously, it intensified its assault on the banking system as a platform for the election.

The assault on the banking system

- On 3 May 2012 the communist party effectively secured the control of the central bank.
- Government and central bank could engage in coordinated campaign against banks as part of the February 2013 presidential election campaign.
- Objective: To deflect attention from communist party's handling of the economy.
- By further damaging economy through continued delay in corrective measures, the government could ensure the problem would get bigger.

The economic consequences of inaction

- Unemployment rate: Cyprus vs euro area

The contribution of the central bank

- Removed Chairmen and CEOs from two largest banks.
- Started investigations against banks (with selective defamatory leaks to press).
- Started characterizing banking model in Cyprus as "casino banking."
- Took steps to exaggerate capital needs of banking system.
- The goal: Create image that banking system needs were greater than government's needs for financial assistance to claim that no EU/IMF assistance would have been needed except for problems with banks.

The February 2013 election in Cyprus

- The communist party lost the election.
- However, it succeeded in creating the image that banking system was so severely undercapitalized that if the government provided the capital, as was done in previous cases, then, according to standard IMF analysis, government debt could be deemed unsustainable.
- This led to discussions about bail-ins of depositors and invited disastrous decisions in March 2013.

The September 2013 election in Germany

- The delay in finalizing a program for Cyprus pushed it into the German election cycle.
- The local election dynamics in Germany became the critical determinant for conditions imposed for a loan to Cyprus.
- A reminder: The German government and the German parliament have veto power on any euro area decision.

Why do the German elections matter so much?

- The CDU (Chancellor Merkel's party) needs support from its main opposition party (SPD) to pass legislation on Europe because Merkel's junior partners oppose any pro-European legislation.
- Support of earlier programs was secured by SPD.
- Getting closer to elections, the SPD signaled a tougher stance to create political cost to Merkel.
- To build this case, German press and some German politicians started claiming that helping Cyprus is equivalent to "giving away German taxpayer money to Russian oligarchs" who have deposits in Cypriot banks.

Headlines in Germany

SPIEGEL ONLINE

11/05/2012 06:41 PM

Bailing Out Oligarchs

EU Aid for Cyprus A Political Minefield for Merkel

By Markus Dettmer and Christian Reiermann

The EU is likely to bail out the banks of tiny member state Cyprus with 10 billion euros of credit. But a secret German intelligence report reveals that the main beneficiaries of the aid would be rich Russians who have invested illegal money there. It's a big dilemma for Chancellor Angela Merkel.

5 November 2012

A solution for Merkel's government

- Any solution had to be structured so as to be an effective response to the SPD arguments and avoid political costs.
- This could be achieved if losses were imposed on depositors (preferably "Russian oligarchs").
- Ideally, for the German government, a solution should inflict permanent damage to the financial sector in Cyprus.
- Solution could be fully justified based on Cypriot authorities' description of "casino banking" in Cyprus.

The domination of local politics

“[A]nyone having their money in Cypriot banks must contribute in the Cypriot bailout. That way those responsible will contribute in it, not only the taxpayers of other countries, and that is what’s right.”

Angela Merkel, March 16, 2013 (remarks at a German election rally, quoted in eKathimerini, March 17, 2013).

The domination of local politics

"We don't like this business model and we hope it is not successful ... In the case of Cyprus we have leverage that we don't have with other tax havens."

Wolfgang Schaeuble, April 5, 2013 (Reuters).

The eurogroup blunder on March 16, 2013

- Eurogroup decided to impose haircut on all deposits, insured and uninsured, in all banks regardless of capitalization, to raise resources.
- The proposal violated fundamental principles of any known framework. For example, bank bond holders were fully protected, only depositors were targeted for a hit.
- Deposit haircut proposal rejected by parliament in Cyprus.
- Subsequent eurogroup meeting on March 25 changed program to protect insured depositors but violating other principles ensuring lasting damage to the banking system.

The eurogroup decision

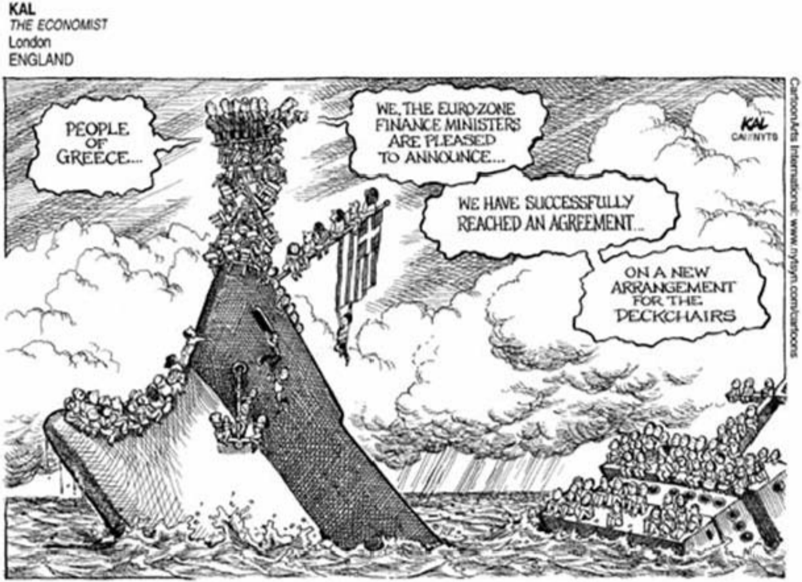
Another Deauville?

- Deauville (October 18, 2010) generated the credit risk in sovereign markets we still observe today.
- European officials keep repeating that Greece was a unique and exceptional case, never to be repeated anywhere else in the euro area.
- Similarly, European officials keep repeating that Cyprus was a unique and exceptional case, never to be repeated anywhere else in the euro area.
- March decision injected credit risk in bank deposits.
- As with Deauville, this adds stress to the periphery but the full effect will be felt over time in financing costs.

Is a solution to the euro area crisis feasible?

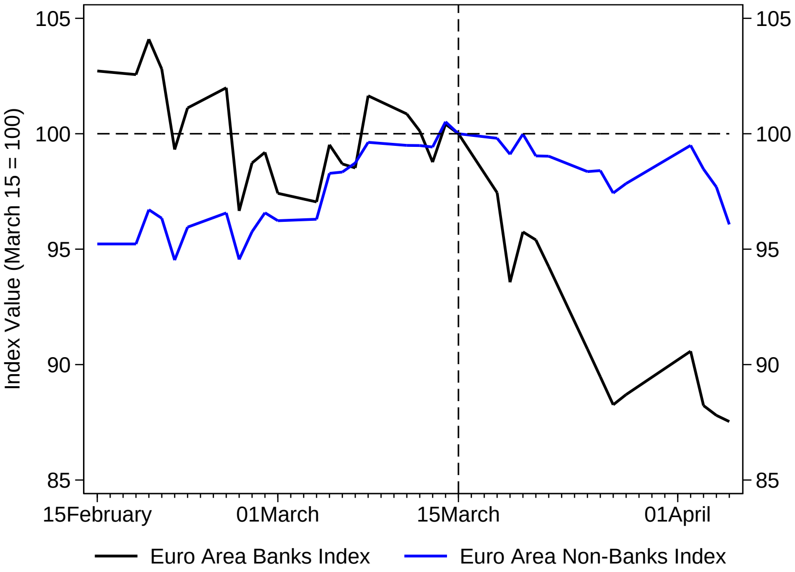
- Can a solution pass the political feasibility test?
- Not without fundamental political reform in Europe.
- Is political reform presently feasible?
- Not with the current configuration of governments.

The management of the crisis in the euro area



Additional slides

Implications for euro area banks



Implications for euro area banks