The Euro Area Crisis: Politics over Economics

Athanasios Orphanides
MIT

Nicosia, 27 August 2014
GDP per person: US vs euro area

Index: 2007Q4=100
GDP per person: US vs euro area

IMF April 2014 WEO projections. Index: 2007=100
The disintegration of the euro area economy

GDP per capita in four largest member states
GDP per person: US vs euro area

IMF April 2014 WEO projections.
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?

► The trigger for the crisis was the need to finance about 1 percentage point of euro area GDP in 2010.

► Crisis mismanagement?
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.
How could things get so bad?

- The euro was incomplete by design.
- No crisis management mechanism in place.
- The success of the euro rested on the belief or hope that if and when a crisis erupted governments would work together towards completing the project.
- This belief proved misplaced.
Why the failure?

- Every crisis generates losses.
  - Economic cost
  - Political cost

- Key question: Who pays?

- Proper crisis management minimizes the economic cost.

- This requires political leadership to advance the common good and political courage to accept political cost.

- Unfortunately, this proved infeasible in the euro area.
Why the failure?

- Europe is not a federal state—there is no government with either the incentives or the power to enforce solutions for the common good.

- Solutions require unanimous agreement by governments.

- Governments of member states bound to please their own electorate and serve local interests.

- Electoral consideration may induce a government to leverage the crisis for local political gain.
Who failed Europe?

- Key decision makers exhibited neither political leadership nor political courage.

- Rather than work towards containing total losses, politics led governments to focus on shifting losses to others.

- The result was massive destruction in some member states and a considerably higher total cost for Europe as a whole.

- European institutions could have been the last line of defense against this destructive dynamic but instead served to facilitate and enable the destruction.
Some examples of shifting losses

- Irish bank debt in 2010. Who was exposed? Who gained from forcing the Irish government to accept all losses?

- PSI concept introduction. Who benefited and who lost by injecting credit risk in euro area sovereign debt?

- Greek debt in 2010. Who was exposed? Who was protected by postponing the resolution of the crisis?

- Greek debt in 2012. Who benefited from protecting the ECB after banks in some member states unloaded their holdings to it?

- Bail-in in Cyprus in 2013. Who benefited from destroying the “business model” of the island? Who benefited from associated asset transfers?
Agreement between French and German government to introduce the Private Sector Involvement (PSI) doctrine.

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.
The disintegration of euro area sovereign markets

Yields on two-year sovereign debt
Deauville implications

- The introduction of credit risk in euro area sovereign debt raised the cost of financing for euro area governments perceived to be relatively weak.

- The first casualty was Ireland that lost access to markets within a few weeks. Portugal followed a few months later.

- The PSI doctrine also generated the adverse feedback loop between sovereigns and banks that has been driving weakness in the periphery since then.

- Although it was a blunder for the euro area as a whole, not everybody lost. By making the debt of other member states riskier, the financing costs of some member states got lower.
The Cyprus blunder

- Cyprus: 0.2% of the euro area, entered euro in 2008
- Stable currency and finances before euro entry.
- Vulnerability: Large banking system.
- Problem: Communist government was in power for five years right after euro entry: March 2008—February 2013.
- The crisis in Cyprus started with the Cypriot government. First came overspending, then the politics of the Cypriot election in February 2013.
- It ended badly as a result of the politics of the German election in September 2013.
Could one see the Cyprus crisis coming?

The delay that made Cyprus unique.

Markers show when assistance was sought and agreed.
Overspending and warnings ignored

- Communist government started overspending as soon as it took power in 2008.

- Euro area crisis made Cyprus vulnerable to unsustainable increases in public expenditures as a result of its large banking system and connectedness to Greece.

- Warnings regarding consequences of fiscal misteps and need for correction were provided to the government by the Central Bank of Cyprus, the ECB, the EC and others as early as 2009.
Overspending

Real GDP

Real Government Spending

Billions of Euros (2005 Prices)


Warnings ignored

Mr Dimitris Christofias  
President of the Republic of Cyprus
Presidential Palace  
1400 Nicosia  
Cyprus

Frankfurt, 15 December 2010

Excellency,

We are writing to you today in relation to the implementation of the ECB’s internal surveillance of competitiveness, imbalances and vulnerabilities of euro area countries. The Governing Council has discussed the outcome of this surveillance exercise and Cyprus is considered as one of the countries where the need for policy actions is particularly urgent. Especially, the implementation of strong fiscal consolidation has to be key priority for the 2011 Budget and beyond.

In light of the 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. Safeguarding market confidence in public finances and in the stability of the financial system has to be a key objective for Cyprus at the current juncture. To that end, a detailed, credible and convincing medium-term fiscal consolidation strategy, supported by an enhanced fiscal policy framework needs to be urgently announced and implemented.

This requires, above all, that the government identifies further measures in order to achieve the target deficits set for both 2011 and 2012, i.e. 4.3% and 3% of GDP respectively. According to our assessment, the measures so far specified are not sufficient. This view is shared by the European Commission which forecasts a deficit of 5.7% for both years – largely unchanged from the 2010 deficit. While some fiscal consolidation measures were announced on 9 December, these do not appear ambitious enough and rely mostly on raising additional tax revenues. In addition to these deficiencies, important concerns remain regarding the ability of the government to control public expenditures. Therefore, in addition to specifying new measures now to achieve the set target, the government needs also to specify concrete contingency plans which can be quickly implemented in case the consolidation targets are at risk. In particular, the strong growth of the public wage bill needs to be stopped and reversed. It is clearly not sustainable that public

wages grew by almost 6% in 2009, at a time when the economy contracted by almost 2%. This also creates wrong incentives for private sector wages, which have risen more than productivity, thus leading to a loss of competitiveness and higher unemployment.

Medium-term fiscal sustainability urgently requires to address the pension reform as otherwise, over time, Cyprus will be facing a very substantial increase in public pension expenditure.

Fiscal sustainability needs to be supported by robust growth. For a small open economy like Cyprus, the prospects for growth and employment are impaired by competitiveness losses accumulated when prices and unit labour costs grow much more rapidly than in the euro area as a whole. In that respect, the current wage setting mechanism, in particular the cost-of-living adjustment which covers a large part of the work force, is a serious obstacle to achieve the wage moderation required to maintain competitiveness.

We welcome the government’s announcement of plans to begin a dialogue on reforming the pension system and cost-of-living adjustment mechanism but are concerned about insufficient urgency.

The challenges faced by the Cypriot economy require prompt corrective actions. We are confident that the Government will rapidly take the needed measures. We look forward to hearing from you.

Yours faithfully,

Jean-Claude Trichet

Athanassios Orphanides

Cc: Mr Charalas G. Stavrakis, Minister of Finance, Republic of Cyprus
“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.”
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 (SMP).

During 2011, following similar letters to 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.
An “exchange of messages”

“Dear Prime Minister,

The Governing Council of the European Central Bank discussed on 4 August the situation in Italy’s government bond markets. The Governing Council considers that pressing action by the Italian authorities is essential to restore the confidence of investors. . . .

We trust that the Government will take all the appropriate actions.”

(Letter by Mario Draghi and Jean-Claude Trichet sent to Silvio Berlusconi on August 5, 2011.)
PRESS RELEASE

21 February 2013 - Details on securities holdings acquired under the Securities Markets Programme

The Governing Council of the European Central Bank (ECB) decided today to publish the Eurosystem’s holdings of securities acquired under the Securities Markets Programme (SMP). This decision is in line with the envisaged transparency stance for the Outright Monetary Transactions (OMTs) as communicated on 6 September 2012, at which time the SMP was terminated.

To this end the following table shows the breakdown of the Eurosystem’s SMP holdings as at 31 December 2012, per country of issuer, indicated at nominal value, book value and average remaining maturity.

<table>
<thead>
<tr>
<th>Issuer country</th>
<th>Outstanding amounts</th>
<th>Average remaining maturity (in years)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Nominal amount (EUR billion)</td>
<td>Book value [1] (EUR billion)</td>
</tr>
<tr>
<td>Ireland</td>
<td>14.2</td>
<td>13.6</td>
</tr>
<tr>
<td>Greece</td>
<td>33.9</td>
<td>30.8</td>
</tr>
<tr>
<td>Spain</td>
<td>44.3</td>
<td>43.7</td>
</tr>
<tr>
<td>Italy</td>
<td>102.8</td>
<td>99.0</td>
</tr>
<tr>
<td>Portugal</td>
<td>22.8</td>
<td>21.6</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>218.0</strong></td>
<td><strong>208.7</strong></td>
</tr>
</tbody>
</table>

[1] The SMP holdings are classified as held-to-maturity and consequently valued at amortised cost.
What did the ECB NOT buy?

SMP countries (ECB purchases of sovereign bonds)
- Greece
- Ireland
- Portugal
- Italy
- Spain

Program countries
- Greece
- Ireland
- Portugal
- Cyprus
- Spain
How did the crisis start in Cyprus?

- In May 2011, the government lost access to markets.
- In July 2011, an explosion destroyed the island’s largest power station. Over half of the island’s electricity was lost and economy was thrown into recession.
- The government decided to avoid dealing with fiscal problems by securing financing through a bilateral loan from Russia to last through the February 2013 election.
- In October 2011, the government created stress in the banking sector by agreeing with the Greek PSI plan that imposed 25% of GDP capital loss on banks.
- Starting in May 2012, in coordination with the bank supervisor (central bank), it run the February 2013 presidential campaign on a “blame the banks” platform.
The role of the Central Bank of Cyprus

- Started investigations against banks, providing material for selective defamatory leaks to media.

- Started describing the banking model in Cyprus as “casino banking.”

- Forced banks to book excessive accounting losses (e.g. abrupt unfavorable changes in definitions for NPLs)

- Directed analysis by PIMCO that exaggerated bank capital needs by undervaluing bank assets with unfavorable assumptions (forced liquidation valuations, massive write-offs of real estate collateral, assigning zero value to unencumbered collateral, assigning zero value to personal guarantees etc)
The February 2013 election in Cyprus

- The coordinated campaign succeeded in creating the image that the 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 set up a bad outcome in March 2013, right after the Cypriot election.

- Although communist party lost the election, the problem remained.
The delay in finalizing a program for Cyprus pushed it into the German election cycle.

How could elections in any single state matter for a program in another state?

Because each state has veto power that can be exploited whenever another euro area member state might need assistance.

EU member states not in the euro area do not face the threat that another member state would misuse its veto power in a similar manner because they are not bound together by the common currency.
Why did the German elections matter so much?

- The Chancellor’s party (CDU) has needed support from its main opposition party (SPD) to pass legislation on Europe.

- Support of earlier programs was secured by SPD.

- Getting closer to elections, the SPD signaled a tougher stance to create political cost to the government.

- This became a major issue when 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.
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.
A solution for the German 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, e.g. through a haircut of bank deposits.

- This could be “justified” using the “casino banking” description that the government and central bank had promoted during the election campaign in Cyprus.
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)
“[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 eurogroup blunder on March 16, 2013

- Eurogroup decided to impose haircut on all deposits, insured and uninsured, in all banks regardless of capitalization, to replenish capital.

- The proposal was contrary to any known framework and violated basic EU principles and was rejected by parliament in Cyprus.

- Subsequent eurogroup meeting on March 25 changed program to protect insured depositors but impose even greater damage to banking system, while violating fundamental EU principles.
Consequences?

- Much like the Deauville blunder, the solution the German government imposed on Cyprus was risky for the euro area.

- The introduction of credit risk in deposits added to pressures on banks in the periphery.

- But the strategy paid off handsomely for the German Chancellor in the September 2013 elections.
Open questions

- Role of Central Bank of Cyprus/ECB in disaster?
- Could the destruction have been avoided?
Role of ELA

- Between May 2012 and March 2013, CBC/ECB extended additional ELA (about 6 billion) to Marfin-Laiki, which was subsequently let to fail.

- The delay in resolving the situation magnified the problem leading to the haircut of deposits (about 6 billion).

- Proper provision of ELA requires two conditions:
  - The institution must be solvent.
  - Adequate collateral must be posted.

- According to Zenios (2013) these conditions for the provision of ELA appear to have been violated.

- Why did CBC/ECB violate ELA principles?
Why was the bank kept alive until March 2013?
“This was not something pleasant, but we had to sustain the bank. It was required to sustain the bank in order for the elections to take place, … ” (CBC Governor interview, 26 March 2013)

Was the bank solvent when ELA was provided?
“You can receive ELA by your National Central Bank only when you are solvent or when there is a clear perspective that the bank can become solvent again while it is recapitalized as part of an adjustment program.” (ECB Executive Board member at European Parliament Hearing, 8 May 2013)
Could the destruction have been avoided?

▶ The haircut of deposits was justified on the basis of the exaggerated estimates of bank capital produced by PIMCO, following instructions by the CB of Cyprus.

▶ Did the Central Bank of Cyprus know that the PIMCO numbers were exaggerated?

▶ According to the New York Times (25 July 2014), the CB of Cyprus not only knew that the PIMCO numbers were exaggerated but had analysis from BlackRock that could have been used to avert the haircut.

▶ The haircut could have been averted if the Central Bank of Cyprus had acted properly.

▶ The Central Bank of Cyprus kept this information secret.
Why was the BlackRock analysis kept secret?

“As to why he did not tell the new government about the BlackRock study, he said that the issue was too technical for top officials to understand and that the report was not in its complete form when crisis negotiations began in March 2013.”

A big heist?
Shifting losses: The tale of three banks

- Piraeus Bank
- Marfin-Laiki Bank
- Bank of Cyprus
## Effect of Exposure to Greek Sovereign

<table>
<thead>
<tr>
<th>Exposure</th>
<th>End 2010 CT1 Capital</th>
<th>Ratio</th>
<th>Write-off CT1 Capital</th>
<th>Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Piraeus</td>
<td>8.221</td>
<td>3.039</td>
<td>8.0</td>
<td>-1.072</td>
</tr>
<tr>
<td>Marfin-Laiki</td>
<td>3.407</td>
<td>2.015</td>
<td>7.2</td>
<td>0.312</td>
</tr>
<tr>
<td>Bank of Cyprus</td>
<td>2.407</td>
<td>2.134</td>
<td>8.1</td>
<td>0.931</td>
</tr>
</tbody>
</table>

Ratios in percent. Exposures and capital levels in billion euro. Columns (1)-(3) show data from 2011 EBA stress test. Columns (4)-(5) show an illustrative calculation of capital after a 50% write-off of the Greek sovereign exposures shown in column (1).
Outcome of March 2013 decisions

- A transfer of assets from Marfin-Laiki and Bank of Cyprus to Piraeus facilitated the recapitalization of Piraeus.

- Following the transfer of assets Marfin-Laiki and Bank of Cyprus effectively became insolvent.

- Marfin-Laiki was forcibly merged with Bank of Cyprus. As a result ELA owed by Marfin-Laiki to Eurosystem could be repaid drawing on Bank of Cyprus assets.

- Following merger, Bank of Cyprus was recapitalized by forcing losses on the equity holders, bond holders and unsecured depositors of Marfin-Laiki and Bank of Cyprus.
### Statement of Financial Position (extracted)

#### Balance Sheet (amounts in thousand euros)

<table>
<thead>
<tr>
<th>Date</th>
<th>Balance Sheet Items</th>
<th>2013 Q1</th>
<th>2013 Q2</th>
<th>2013 Q3</th>
<th>2013 Q4</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Cash and cash equivalents at the acquisition date</td>
<td>3,540,326</td>
<td>2,596,811</td>
<td>1,823,378</td>
<td>901,892</td>
</tr>
<tr>
<td></td>
<td>Inventories</td>
<td>340,533</td>
<td>332,057</td>
<td>155,899</td>
<td>150,799</td>
</tr>
<tr>
<td></td>
<td>Loans and advances to customers (net of provisions)</td>
<td>60,686,533</td>
<td>44,612,686</td>
<td>55,250,778</td>
<td>37,618,002</td>
</tr>
<tr>
<td></td>
<td>Debt securities - receivables</td>
<td>8,795,826</td>
<td>8,015,997</td>
<td>8,760,955</td>
<td>7,933,625</td>
</tr>
<tr>
<td></td>
<td>Total assets</td>
<td>64,152,918</td>
<td>53,906,853</td>
<td>65,182,440</td>
<td>55,680,827</td>
</tr>
</tbody>
</table>

#### Total Equity

<table>
<thead>
<tr>
<th>Date</th>
<th>Equity Items</th>
<th>2013 Q1</th>
<th>2013 Q2</th>
<th>2013 Q3</th>
<th>2013 Q4</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Share Capital</td>
<td>1,092,998</td>
<td>1,092,998</td>
<td>1,092,998</td>
<td>1,092,998</td>
</tr>
<tr>
<td></td>
<td>Total comprehensive income for the period, net of tax</td>
<td>3,626,385</td>
<td>85,861</td>
<td>3,660,054</td>
<td>123,607</td>
</tr>
<tr>
<td></td>
<td>Other reserves and retained earnings</td>
<td>(2,881,495)</td>
<td>(6,508,421)</td>
<td>(3,130,656)</td>
<td>(6,790,710)</td>
</tr>
<tr>
<td></td>
<td>Total equity</td>
<td>1,209,493</td>
<td>1,017,237</td>
<td>1,529,408</td>
<td>443,297</td>
</tr>
</tbody>
</table>

### Statement of Comprehensive Income (extracted)

<table>
<thead>
<tr>
<th>Date</th>
<th>Comprehensive Income Items</th>
<th>2013 Q1</th>
<th>2013 Q2</th>
<th>2013 Q3</th>
<th>2013 Q4</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Net fee and commission income</td>
<td>63,058</td>
<td>- 63,058</td>
<td>52,794</td>
<td>327</td>
</tr>
<tr>
<td></td>
<td>Other operating income</td>
<td>11,164</td>
<td>16,566</td>
<td>27,730</td>
<td>14,094</td>
</tr>
<tr>
<td></td>
<td>Net operating income</td>
<td>74,222</td>
<td>16,566</td>
<td>79,523</td>
<td>14,094</td>
</tr>
<tr>
<td></td>
<td>Total comprehensive income</td>
<td>74,222</td>
<td>16,566</td>
<td>79,523</td>
<td>14,094</td>
</tr>
</tbody>
</table>

### Other Financial Information

- **22) On the 23rd April 2013, the Second Iterative Meeting of Shareholders resolved the following:**
  - Approved the Tender Offer to purchase existing securities for cash.
  - Expected completion by 24th May 2013.

- **21) On the 13th May 2013, Piraeus Bank announced the Tender Offer to purchase existing securities for cash.**
  - This Tender Offer was approved by the Three Iterative Meeting of Shareholders.
  - Expected completion by 24th May 2013.

- **13) The Hellenic Financial Stability Fund’s (HFSF) commitment of 20 April 2012, after the relevant application submitted by the Bank to the HFSF.**
  - Additional Capital Advance of €1,900 million.
  - Increased equity to €10.63 billion.

- **12) Since there are no distributable profits or relevant amounts related to distributable reserves, according to the Distribution Act of 2013:**
  - Proposed no distribution of dividends for both 2012 and 2013.

- **31/12/2012, the associate company Evrytania S.A. Agricultural Development Company has been excluded from the consolidation since it is under idle status.**

- **Met. As a result, the financial figures and results of Piraeus Bank Egypt, its subsidiaries and associates are no longer included in the consolidation.**

- **Inventories**
  - Total value of inventories: €340,533, €332,057, €155,899, €150,799.

- **Debt securities in issue**
  - Total value: €504,131, €533,702, €504,125, €533,703.

- **Inventories property**
  - Total value: €340,533, €332,057, €155,899, €150,799.

- **Cash and balances with Central Banks**
  - Total value: €3,275,238, €3,307,503, €2,151,534, €2,091,406.

- **Other liabilities**
  - Total value: €1,058,464.
### Piraeus Bank Financial Statement: 2013Q1

<table>
<thead>
<tr>
<th></th>
<th>2012Q4</th>
<th>2013Q1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>63.022</td>
<td>78.991</td>
</tr>
<tr>
<td>Equity</td>
<td>−2.744</td>
<td>0.915</td>
</tr>
</tbody>
</table>

All entries in billion euro. Note in financial statement explains that the results include 3.414 billion euro “negative goodwill due to the acquisition of assets and liabilities of Cypriot banks’ network in Greece.”
Consequences for Cyprus

- Destruction of banking system
- Destruction of economy
- Destruction of high quality jobs
- Increase in unemployment and poverty
- Transfer of wealth away from Cyprus
GDP per person: Cyprus

IMF WEO data and projections, April 2014.
Consequences of delay in 2011

CY Gov loses market access (May 2011); Mari (July 2011); GGBs losses imposed on banks (October 2011).
Consequences of the assault of the banking sector

“If you destroy the banking sector you destroy everything”
(Former President George Vassiliou, 15 July 2012)
Consequences of delay in resolving crisis

GDP per person in Cyprus, IMF data and projections
Is a solution to the euro area crisis feasible?

- Can a solution to the euro area crisis pass the political feasibility test?
  - Unlikely without fundamental political reform in Europe.
- Is political reform presently feasible?
  - Unlikely with the current configuration of leaders and governments.
“What we have, in fact, is a crisis of the ability of the European Union’s political bodies to act. This glaring weakness of action is a much greater threat to the future of Europe than the excessive debt levels of individual euro area countries.”

“It will not be possible in the foreseeable future to change these structural shortcomings in the Treaties. But under no circumstances can they be used as an excuse not to fulfil our obligations of mutual solidarity and subsidiarity, ...”

“[W]e must work together much better than we do at present. And those who are temporarily stronger must of course help those who are weaker.”

Helmut Schmidt, October 19, 2011
Additional material
Following the decisions in March 2013, there have been attempts to rationalize the destruction of the banking system of Cyprus, e.g.:

“The Cypriot economy evolved towards a rather unbalanced business model with an inordinate weight for the financial industry.”

Fact checking?
“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
“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
Claims regarding the size of the banking system

“Cypriot banks attracted large inflows of foreign deposits. They expanded their balance sheets dramatically over recent years, both domestically and externally.”

“The problems of Cyprus built up over many years. At their origin was an oversized banking sector that thrived on attracting foreign deposits with very favourable conditions.”
Facts regarding the size of the banking system

Compare size of banking system as a multiple of GDP when Cyprus was admitted in euro area (June 2007) and when Cyprus asked for help (June 2012).

<table>
<thead>
<tr>
<th>Bank assets/GDP ratio (in percent)</th>
<th>Total</th>
<th>Domestic</th>
</tr>
</thead>
<tbody>
<tr>
<td>June 2007</td>
<td>646</td>
<td>460</td>
</tr>
<tr>
<td>June 2012</td>
<td>669</td>
<td>463</td>
</tr>
</tbody>
</table>
“The problems of Cyprus built up over many years. At their origin was an oversized banking sector that thrived on attracting foreign deposits with very favourable conditions.”

“Banks became increasingly exposed to funding vulnerabilities. They tried to attract deposits by offering very high deposit rates—on average, nearly 2 percentage points higher than the rest of the euro area.”

Example: rate for non-financial corporations, January 2013:
Euro area: 1.1%
Cyprus: 4.1%
Facts regarding deposit rates

The average for the euro area is not the relevant comparative metric for deposit rates in Cyprus because the euro area has not been functioning as a unified economy during the crisis.

A relevant comparison for Cyprus would be with Greece, an economy 10 times as large and with direct links in the financial sector. All major Greek banks have operations in Cyprus, a factor that kept deposit rates as high in Cyprus as they have been in Greece when Greek banks had funding problems.

Example: rate for non-financial corporations, January 2013:

- Greece: 4.2%
- Cyprus: 4.1%
Entries (except last column) show the number of FATF recommendation where a country is deemed as compliant, largely compliant, partially compliant or non-compliant. FATF (Financial Action Task Force) has “40+9” recommendations designed to deter criminal activity. The last column shows the percentage of recommendations that are compliant/largely compliant.
Trust in the EU and its institutions

Fraction who “tend to trust” the institution among those expressing an opinion.
The disintegration of the euro area economy

Unemployment rate in four largest member states

Germany, France, Italy, Spain
A lost generation in the making

Youth unemployment rate (age 25 and under)
The disintegration of the credit market

Lending rates to corporations
PRESS RELEASE

21 March 2013 - Governing Council decision on Emergency Liquidity Assistance requested by the Central Bank of Cyprus

The Governing Council of the European Central Bank decided to maintain the current level of Emergency Liquidity Assistance (ELA) until Monday, 25 March 2013.

Thereafter, Emergency Liquidity Assistance (ELA) could only be considered if an EU/IMF programme is in place that would ensure the solvency of the concerned banks.
“The Commission notes also that the bail-in of uninsured deposits in the two major banks constitutes a unilateral measure of the Cypriot authorities that does not form part of the MoU that was subsequently concluded.”

Olli Rehn answer to European Parliament Inquiry, 28 August 2013
The Role of European Institutions?

“He also said the pressure exerted on him by Brussels had been unprecedented. To a remark by one of the panel judges that it was ‘like a knife to the throat,’ Anastasiades said it was more like ‘a gun to the head’.”

President Anastasiades testimony to investigation committee on the catastrophe of the Cypriot economy, reported in Cyprus Mail, 28 August 2013.
The European Union Treaty: Article 2

The Union is founded on the values of respect for human dignity, freedom, democracy, equality, the rule of law and respect for human rights, including the rights of persons belonging to minorities. These values are common to the Member States in a society in which pluralism, non-discrimination, tolerance, justice, solidarity and equality between women and men prevail.
[The Union] shall combat social exclusion and discrimination, and shall promote social justice and protection, equality between women and men, solidarity between generations and protection of the rights of the child. It shall promote economic, social and territorial cohesion, and solidarity among Member States.
“The European Council reaffirms its commitment that in all circumstances the necessary measures will be taken to preserve the stability of the financial system, to support the major financial institutions, to avoid bankruptcies and to protect savers’ deposits. Inter alia, such measures aim, in conjunction with the central banks and supervisory authorities, to ensure sufficient liquidity for financial institutions, to facilitate their funding, and to provide them with capital resources so that they can continue to finance the economy properly.” (Council of the European Union, 2008, p. 2)