Abstract
The paper describes the interaction of sovereign debt, fiscal and banking crisis in the Eurozone and how the Eurozone is responding to these challenges. These events affect Cyprus in the longer term by affecting banking supervision and fiscal policy. In the shorter run, however, lessons from implementing Troika programmes in other Eurozone countries need to be learned fast, both for the Cypriot government and the Troika itself. Focusing on one particular example, I argue against the Troika recommendation that bank core tier I ratios should be raised from 8% to 10% in the midst of a severe economic crisis.

Keywords: sovereign debt, banking crisis, countercyclical capital buffers.

1. Introduction
The introduction of the euro eliminated exchange rate uncertainty within the Eurozone but at the same time removed both monetary and exchange rate independence from member countries. Given the lack of monetary policy independence, it was recognized early on that fiscal policy would become more important in stabilizing the business cycle. At the same time, the moral hazard from any country issuing debt in a more credible currency was also recognized. As Lane (2012) notes, these issues were recognized early on, and as a result the Stability and Growth Pact recommended a debt to GDP ratio lower than 60% and demanded that government deficits to GDP will be less than 3%, while inflation was also required to converge to the European average before Eurozone entry.

Unfortunately the extent government debt and deficits could affect the Eurozone was not sufficiently appreciated. Differential inflation rates added to the problem by making some countries less competitive through higher inflation rates relative to their Eurozone peers. External imbalances

† This paper was presented in the Second Annual Symposium on the Cypriot Economy organized by the School of Economics and Management at the University of Cyprus on October 13th 2012.

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between North and Southern Europe did not raise large warning flags to policy makers, and the regulatory problems arising from cross-border banking activities in the new era of financial integration were also not recognized early enough.

In this paper I will review the European Union responses to these problems and how these responses affect Cyprus.

2. Eurozone convergence and divergence

Figure 1 illustrates very tellingly the Eurozone experience in the last two decades. It plots the nominal ten year government bond interest rates (I find the levels telling and therefore did not subtract inflation to get real rates: the spread to the German rate, typically the lowest line over most of this period, gives the real spread measuring exchange rate, and sovereign (credit) risk, uncertainty).

The spreads illustrate the two tales of convergence until the breakup of the global financial crisis and divergence right after that in August 2007. Moreover, the order (from high to low spreads) of the countries in August 1993 (Greece, Portugal, Italy, Spain and Ireland) is almost the same as the order of the countries in August 2012 (Greece, Portugal, Cyprus, Slovenia, Spain, Ireland and Italy).

The convergence to a very low interest rate generated a substantial accumulation of private and government debt in many countries. Table 1 shows the large increase in debt of ‘peripheral’ countries relative to Germany. In some of these countries, it is sovereign debt that was much higher than Germany in 2010 (Italy and Greece) in others it was corporate and household debt (Spain, Portugal and Cyprus) and in some it was all types of debt (Ireland).

Given the large increase in both sovereign and total debt to GDP in the last two decades, the European Union is responding. The Fiscal Compact Treaty should become operative on January 1st 2013 and forces (once again) member states to strict fiscal policy criteria. Banking union at the Eurozone level will make bank regulation and resolution more effective.

And the European Stability Mechanism (ESM) can act to protect public debt from the cost of bank bailouts. All three moves are meant to be answers to sovereign debt and banking problems that came to the forefront in the recent crisis. All three moves are uncharted territory, however, and therefore suffer from natural time delays in a period where crisis resolution seems to be needed very fast.
FIGURE 1

Ten Year government bond rates (Jan 1993 – July 2012)
TABLE 1

*Total debt to GDP in 2010, selected European countries*

<table>
<thead>
<tr>
<th></th>
<th>Household debt</th>
<th>Corporate debt</th>
<th>Government debt</th>
<th>Total debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>61.6</td>
<td>66.5</td>
<td>81.5</td>
<td>209.6</td>
</tr>
<tr>
<td>Italy</td>
<td>45</td>
<td>80.9</td>
<td>121.1</td>
<td>247</td>
</tr>
<tr>
<td>Greece</td>
<td>60.7</td>
<td>62.9</td>
<td>165.6</td>
<td>289.2</td>
</tr>
<tr>
<td>Portugal</td>
<td>95.5</td>
<td>152.5</td>
<td>106</td>
<td>354</td>
</tr>
<tr>
<td>Ireland</td>
<td>118.9</td>
<td>222</td>
<td>109.3</td>
<td>450.2</td>
</tr>
<tr>
<td>Spain</td>
<td>85.7</td>
<td>140.7</td>
<td>70.1</td>
<td>296.5</td>
</tr>
<tr>
<td>Cyprus</td>
<td>159.2</td>
<td>144.5</td>
<td>61.5</td>
<td>365.2</td>
</tr>
</tbody>
</table>

*Source:* Eurostat.

3. Options for Cyprus

Cyprus is also suffering from similar problems as the rest of the Eurozone. The credit rating agencies have focussed on four main problems facing the Cypriot economy. They relate to banking, fiscal, competitiveness and institutional weaknesses. The February 2011 Moody’s report is the most telling about the motivation behind Cypriot sovereign debt downgrades: ‘The key drivers for today’s rating action are:

(1) Concerns that the deterioration in the Cypriot government’s fiscal metrics, relative to levels recorded prior to the financial crisis, is largely structural;

(2) The banking sector’s exposures to macroeconomic stress in Greece; and

(3) Concerns about the country’s competitiveness.’

In the long run, I think the main problems to be addressed need to be the lack of competitiveness and poor institutional structures (delays in the judicial processes, for example) in the economy.

In the short run, on the other hand, the two main problems that need to be addressed are the banking and fiscal problems. For that, it would be useful to first remind ourselves of the lessons that should have been learned from the Troika experiences of Ireland, Greece and Portugal (see Lane, 2012, for further analysis).

A speedy fiscal correction in the presence of a leveraged private sector is likely to aggravate banking sector problems making the sovereign-banking circle more vicious. Success is also more difficult in the presence of a global...
and/or European crisis. Haircuts of sovereign debts generate unintended consequences as re-issuing government debt suddenly becomes a more difficult proposition when government debt suddenly stops being ‘risk-free’. Political unanimity in implementing difficult measures becomes important, while deleveraging of both the public and private sector brings about a recession with probability one.

What are the possible options for Cyprus in the next few years? Allen and Ngai (2012) note the large negative consequences from the high unemployment rates (particularly among the young) in Spain and Greece and go so far as to propose a temporary exit from the Eurozone. I think that once exit occurs, it will be quite difficult for a country to be re-invited to join, from a political point of view. The exit will therefore have to be permanent. The question then becomes the following: ‘If a country needs to implement structural reform to become competitive in the long run, will the chances of a successful reform be higher inside, or outside, the Eurozone?’ With all the problems implied by a monetary union across states at different levels of development and the business cycle, I still think being part of a union offers stronger protection. Leaving a currency union introduces large redenomination risks (at which currency will contracts be observed and at which currency will deposit insurance work are some of the questions that will need to be addressed as the economy tries to avoid a deepening unemployment crisis). On balance, I think it would be preferable to implement the appropriate structural reforms inside the Eurozone rather than exit and devalue with the hope that these structural reforms will take place outside the Eurozone.

But there are some options that deserve more attention because they are more directly being discussed by policy makers. I will focus on one particular example that illustrates the dangers from blindly following troika’s recommendations. The troika recommends that, as part of the adjustment programme, banks’ core tier I ratios should be raised from 8% to 10%.

There are no reasons given for this recommendation but a few can be surmised. One could be that a 10% ratio will make banks more careful, but the answer to that must be that already banks know that they need to be more careful as their existence as private concerns is at stake. A second reason might be that a 10% ratio reduces the uncertainty associated with the valuation of assets on the banks’ balance sheet. But then the question arises as to the function of PIMCO: the exact valuation of the asset side of the balance sheet is what PIMCO is ascertaining. A third reason that might be offered is that a 10% ratio increases the probability that private funds might be tempted to invest in Cypriot banks. The problem with this is that
a 10% ratio might mean that no banks are left standing to accept private capital.

The role of higher capital ratios in aggravating a recession has been noted in both academic and policy circles for some time now. As Repullo and Saurina (2011) note: ‘The effect could be especially important in downturns, with banks possibly facing a ‘capital crunch’ that would further restrict their lending.’ Hanson, Kashyap and Stein (2011) also note the credit crunch and fire-sale effects that can arise when banks are collectively forced to increase capital ratios. Indeed, they note that ‘In the simplest terms, one can characterize the macroprudential approach to financial regulation as an effort to control the social costs associated with excessive balance sheet shrinkage on the part of multiple financial institutions hit with a common shock.’ (p. 5, italics in the original text). Early precursors of the credit crunch idea include Bernanke and Lown (1991) Peek and Rosengren (1995) while more recently Kashyap and Stein (2004) and Goodhart (2009) also warn about the potential business cycle amplification effects of Basel II. Repullo, Saurina and Trucharte (2010) show empirically using Spanish data how capital requirements substantially vary over the business cycle.

Indeed, in a recent speech, Michael Cors (Bank of England Financial Policy Committee) notes that one of the lessons from the crisis is that liquidity ratios and core tier I capital ratios at banks should not be constant but should have some relationship with the business cycle. In good times capital requirements should be higher and in bad times capital requirements should be lower. Of course, giving a quantitative meaning to each of the above terms (‘bad times’ or ‘higher capital requirements’) is still more of an art than science (as the Repullo and Saurina (2011) study indicates). But if it is one thing we do know right now, it is that Cyprus is entering a prolonged recessionary period and more stringent capital requirements will make the economic situation even worse.

I should note here that macro-prudential tools like a high tier I capital ratio might be needed in normal times and even a 10% rate might be low for countries with a large banking sector relative to GDP. But what policy makers are asked to provide a solution to right now, is exit from a crisis for a country that is isolated from the international capital markets since May 2011 and is called to implement a recessionary fiscal package. Crisis management is the order of the day, not crisis avoidance, and policies that prevent crises are not necessarily the same as the ones that lead a country out of an economic crisis.
4. Conclusion

The paper briefly summarizes how the Eurozone is responding to sovereign debt and banking challenges. Events at the EU level directly affect Cyprus in the longer term by affecting banking supervision and fiscal policy. In the shorter run, however, lessons from implementing Troika programmes in other Eurozone countries need to be learned fast, both for the Cypriot government and the Troika itself. Implementing the wrong economic policy choices can make the recessionary period longer, and the probability of further economic pain down the road, for both lenders and borrowers, higher.

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