

The Cyprus Debt: Perfect Crisis and a Way Forward

Stavros A. Zenios*

*Department of Accounting and Finance, University of Cyprus
and the Wharton Financial Institutions Center, University of Pennsylvania*

Abstract

The Cyprus crisis is one of the most complex in the Eurozone -although in absolute terms it is a minor crisis. An analysis of the ongoing developments from different perspectives leads to the conclusion that we are witnessing a perfect storm of a financial crisis at the confluence of sovereign debt and banking crisis together with debt overhang of business and households and a severe decline of competitiveness. As a result Cyprus has amassed a large external debt that cannot be repaid, no matter what fraction of the country's real domestic economic output is appropriated through austerity measures. Hence, fiscal austerity leads to deflationary stagnation and alone does not work. We advocate a policy response that addresses multiple dimensions of the problem with policy options of (1) austerity deleveraging, (2) structural reforms, (3) financial innovations, (4) selective privatizations and (5) debt restructuring. These options are drawn from lessons of what worked well, and what not, in crises of other countries and these lessons are summarized in lieu of conclusions. A postscript discusses the potential impact of the Eurogroup decision of March 2013 on the Cyprus crisis.

Keywords: financial crisis, debt overhang, banking crisis, competitiveness, labor cost, GDP-linked bonds, crisis management, Eurozone, Cyprus.

* Address: Department of Accounting and Finance, University of Cyprus, P.O. Box 20537, 1678 Nicosia.
E-mail: zenios.stavros@ucy.ac.cy.