Europe's Disturbing Precedent in the Cyprus Bailout

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The European economic crisis has taken different forms in different places, and Cyprus is the latest country to face the prospect of financial ruin. Overextended banks in Cyprus are teetering on the brink of failure for issuing loans they cannot repay, which has prompted the tiny Mediterranean country, a member of the European Union, to turn to Brussels for help. Late Sunday, the European Union and Cypriot president announced new terms for a bailout that would provide the infusion of cash necessary to prevent bankruptcies in Cyprus' banking sector and, more important, prevent a banking panic from spreading to the rest of Europe.

What makes this crisis different from the previous bailouts for Greece, Ireland or elsewhere are the conditions Brussels has attached for its assistance. Due to circumstances unique to Cyprus, namely the questionable origin of a large chunk of the deposits in its now-stricken banking sector and that sector's small size relative to the overall European economy, the European Union, led by Germany, has taken a harder line with the country. Cyprus has few sources of capital besides its capacity as a banking shelter, so Brussels required that the country raise part of the necessary funds from its own banking sector -- possibly by seizing money from certain bank deposits and putting it toward the bailout fund. The proposal has not yet been approved, but if enacted it would undermine a formerly sacred principle of banking in most industrial nations -- the security of deposits -- setting a new and possibly destabilizing precedent in Europe.

Cyprus' Dilemma

For years before the crisis, Cyprus promoted itself as an offshore financial center by creating a tax structure and banking rules that made depositing money in the country attractive to foreigners. As a result, Cyprus' financial sector grew to dwarf the rest of the Cypriot economy, accounting for about eight times the country's annual gross domestic product and employing a substantial portion of the nation's work force. A side effect of this strategy, however, was that if the financial sector experienced problems, the rest of the domestic economy would not be big enough to stabilize the banks without outside help.

Europe's economic crisis spawned precisely those sorts of problems for the Cypriot banking sector. This was not just a concern for Cyprus, though. Even though Cyprus' banking sector is tiny relative to the rest of Europe's, one Cypriot bank defaulting on what it owed other banks could put the whole European banking system in question, and the last thing the European Union needs now is a crisis of confidence in its banks.

The Cypriots were facing chaos if their banks failed because the insurance system was insufficient to cover the claims of depositors. For its part, the European Union could not risk the financial contagion. But Brussels could not simply bail out the entire banking system, both because of the precedent it would set and because the political support for a total bailout wasn't there. This was particularly the case for Germany, which would carry much of the financial burden and is preparing for elections in September 2013 before an electorate that is increasingly hostile to bailouts.

Even though the German public may oppose the bailouts, it benefits immensely from what those bailouts preserve. As I have pointed out many times, Germany is heavily dependent on exports and the European Union is critical to those exports as a free trade zone. Although Germany also imports a great deal from the rest of the bloc, a break in the free trade zone would be catastrophic for the German economy. If all imports were cut along with exports, Germany would still be devastated because what it produces and exports and what it imports are very different things. Germany could not absorb all its production and would experience massive unemployment.

Currently, Germany's unemployment rate is below 6 percent while Spain's is above 25 percent. An exploding financial crisis would cut into consumption, which would particularly hurt an export-dependent country like Germany. Berlin's posture through much of the European economic crisis has been to pretend it is about to stop providing assistance to other countries, but the fact is that doing so would inflict pain on Germany, too. Germany will make its threats and its voters will be upset, but in the end, the country would not be enjoying high employment if the crisis got out of hand. So the German game is to constantly threaten to let someone sink, while in the end doing whatever has to be done.

Cyprus was a place where Germany could show its willingness to get tough but didn't carry any of the risks that would arise in pushing a country such as Spain too hard, for example. Cyprus' economy was small enough and its problems unique enough that the rest of Europe could dismiss any measures taken against the country as a one-off. Here was a case where the German position appears enormously more powerful than usual. And in isolation, this is true -- if we ignore the question of what conclusion the rest of Europe, and the world, draws from the treatment of Cyprus.

A Firmer Line

Under German guidance, the European Union made an extraordinary demand on the Cypriots. It demanded that a tax be placed on deposits in the country's two largest banks. The tax would be about 10 percent and would, under the initial terms, be applied to all accounts, regardless of their size. This was an unprecedented solution. Since the global financial crisis of the 1920s, all advanced industrial countries -- and many others -- had been operating on a fundamental principle that deposits in banks were utterly secure. They were not regarded as bonds paying certain interest, whose value would disappear if the bank failed. Deposits were regarded as riskless placements of money, with the risk covered by deposit insurance for smaller deposits, but in practical terms, guaranteed by the national wealth.

This guarantee meant that individual savings would be safe and that working capital parked by corporations in a bank was safe as well. The alternative was not only uncertainty, but also people hoarding cash and preventing it from entering the financial system. It was necessary to have a secure place to put money so that it was available for lending. The runs on banks in the 1920s and 1930s drove home the need for total security for deposits.

Brussels demanded that the bailout for Cypriot banks be partly paid for by depositors in those banks. That demand essentially violated the social contract on the sanctity of bank deposits and did so in a country that was a member of the European Union -- one of the world's major economic blocs. Proponents of the measure pointed out that many of the depositors were not Cypriot nationals but rather foreigners, many of whom were Russian. Moreover, it was suggested that the only reason for a Russian to be putting money in a Cypriot bank was to get it out of Russia, and the only motive for that had to be nefarious. It followed that the confiscation was not targeted against ordinary people but against shady Russians.

There is no question that there are shady Russians putting money into Cyprus. But ordinary Cypriots had their money in the same banks and so did many Cypriot and foreign companies, including European companies, who were doing business in Cyprus and need money for payroll and so on. The proposal might look like an attempt to seize Russian money, but it would pinch the bank accounts of all Cypriots as well as a sizable amount of legitimate Russian money. Confiscating 10 percent of all deposits could devastate individuals and the overall economy and likely would prompt companies operating in Cyprus to move their cash elsewhere. The measure would have been devastating and the Cypriot parliament rejected it.

Another deal, the one currently up for approval, tried to mitigate the problem but still broke the social contract. Accounts smaller than 100,000 euros (about $128,000) would not be touched. However, accounts larger than 100,000 euros would be taxed at an uncertain rate, currently estimated at 20 percent, while bondholders would lose up to 40 percent. These numbers will likely shift again, but assuming they are close to the final figures, depositors putting money into banks beyond this amount are at risk depending on the financial condition of the bank.

The impact on Cyprus is more than Russian mafia money being taxed. All corporations doing business in Cyprus could have 20 percent of their operating cash seized. Regardless of precisely how the Cypriot banking system is restructured, the fact is that the European Union demanded that Cyprus seize portions of bank accounts from large depositors. From a business' perspective, 100,000 euros is not all that much when you are running a supermarket or a car dealership or a construction company, but this arbitrary level could easily be raised in the future and the mere existence of the measure will make attracting investment more difficult.

A New Precedent

The more significant development was the fact that the European Union has now made it official policy, under certain circumstances, to encourage member states to seize depositors' assets to pay for the stabilization of financial institutions. To put it simply, if you are a business, the safety of your money in a bank depends on the bank's financial condition and the political considerations of the European Union. What had been a haven -- no risk and minimal returns -- now has minimal returns and unknown risks. Brussels' emphasis that this was mostly Russian money is not assuring, either. More than just Russian money stands to be taken for the bailout fund if the new policy is approved. Moreover, the point of the global banking system is that money is safe wherever it is deposited. Europe has other money centers, like Luxembourg, where the financial system outstrips gross domestic product. There are no problems there right now, but as we have learned, the European Union is an uncertain place. If Russian deposits can be seized in Nicosia, why not American deposits in Luxembourg?

This was why it was so important to emphasize the potentially criminal nature of the Russian deposits and to downplay the effect on ordinary law-abiding Cypriots. Brussels has worked very hard to make the Cyprus case seem unique and non-replicable: Cyprus is small and its banking system attracted criminals, so the principle that deposits in banks are secure doesn't necessarily apply there. Another way to look at it is that an EU member, like some other members of the bloc, could not guarantee the solvency of its banks so Brussels forced the country to seize deposits in order to receive help stabilizing the system. Viewed that way, the European Union has established a new option for itself in dealing with depositors in troubled banks, and that principle now applies to all of Europe, particularly to those countries with financial institutions potentially facing similar problems.

The question, of course, is whether foreign depositors in European banks will accept that Cyprus was one of a kind. If they decide that it isn't obvious, then foreign corporations -- and even European corporations -- could start pulling at least part of their cash out of European banks and putting it elsewhere. They can minimize the amount of cash on hand in Europe by shifting to non-European banks and transferring as needed. Those withdrawals, if they occur, could create a massive liquidity crisis in Europe. At the very least, every reasonable CFO will now assume that the risk in Europe has risen and that an eye needs to be kept on the financial health of institutions where they have deposits. In Europe, depositing money in a bank is no longer a no-brainer.

Now we must ask ourselves why the Germans would have created this risk. One answer is that they were confident they could convince depositors that Cyprus was one of a kind and not to be repeated. The other answer was that they had no choice. The first explanation was undermined March 25, when Eurogroup President Jeroen Dijsselbloem said that the model used in Cyprus could be used in future bank bailouts. Locked in by an electorate that does not fully understand Germany's vulnerability, the German government decided it had to take a hard line on Cyprus regardless of risk. Or Germany may be preparing a new strategy for the management of the European financial crisis. The banking system in Europe is too big to salvage if it comes to a serious crisis. Any solution will involve the loss of depositors' money. Contemplating that concept could lead to a run on banks that would trigger the crisis Europe fears. Solving a crisis and guaranteeing depositors may be seen as having impossible consequences. Setting the precedent in Cyprus has the advantage of not appearing to be a precedent.

It's not clear what the Germans or the EU negotiators are thinking, and all these theories are speculative. What is certain is that an EU country, facing a crisis in its financial system, is now weighing whether to pay for that crisis by seizing depositors' money. And with that, the Europeans have broken a barrier that has been in place since the 1930s. They didn't do that casually and they didn't do that because they wanted to. But they did it.

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