

Media comment

Cyprus bailout sets poor precedent - Azad Zangana, European Economist, Schroders

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"After months of negotiations, an agreement has been reached on a bailout for Cyprus and, in particular, Cypriot banks. Cyprus will receive €10 billion of European funds, but is controversially being forced to fund €5.8 billion from Cypriot banks. It appears that latter amount will come directly from depositors. Accounts holding over €100,000 will be forced to pay a 9.9% levy, while those holding less will pay 6.75% - making a mockery of the newly agreed €100,000 European-wide deposit guarantees scheme.

"Despite EU officials stating that Cyprus is a special case, the move sets a dangerous precedent for future bailouts of member states with problem banks. The move will obviously spark outrage in Cyprus, and exacerbate the distrust already present between the public and banks. However, the bigger danger for international investors is the potential spread of fears to other countries, particularly Spain which is yet to complete its banking bailout.

"Cypriot banks were badly hurt by the crisis in Greece owing to their large exposures to Greek government bonds, which were restructured twice last year. According to the Bank of Cyprus, the country's banks held €68 billion in deposits from individuals and countries at the end of January. €43 billion was classed as being domestic residents; €5 billion was from other eurozone countries, while almost €21 billion came from the rest of the world. The suspicion is that as much as €25 billion is owned by Cypriot-based Russian companies, using the banking system as an off shore tax haven. This is part of the reason for the reluctance of eurozone partners to bailout the Cypriot banking system without some hit to domestic creditors (which includes those Russian companies).

"In addition to the depositor tax (or hair-cut), junior bank bond holders are facing losses, while taxes on capital income and corporation tax have also been increased (the latter rising from 10% to 12.5%). However, senior bank bond holders and sovereign bond holders have remained unscathed.

"The Cypriot crisis is more complex than elsewhere in peripheral Europe, not because of the size of the Cypriot economy (less than 0.5% of eurozone GDP), but because of the Russian involvement, and the recently-discovered 7 trillion cubic feet of natural gas reserves. Once natural gas extraction is underway, Cyprus will be energy independent, and have enough left over to pay for the recapitalisation of its banks. However, there was a risk that if a European deal could not be reached, then Cyprus could enter negotiations with external countries - namely Russia - that would be happy to accept future gas revenues in payment. For Europe, not only is it important to secure one of its member states, but also the significant reserves of natural gas.

"European equity markets have understandably reacted badly to the news from the EU summit. The exact parameters of the depositor tax/hair-cut is yet to be confirmed, with President Nicos Anastasiades still requiring a majority vote in parliament.

"The European Central Bank (ECB) is in support of the deal, and must feel more confident about its ability to minimise contagion effects. The other notable outcome from the summit was the extension of loan

maturities for Portugal and Ireland, which have recently had success in raising funding through the bond market. The extension of loans is reward for the pair's efforts in meeting its key austerity targets, and should help them trigger the ECB's outright monetary transactions (OMT) programme later this year, which in turn is likely to bring down the yield on their government bonds."

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