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Virginie Maisonneuve's Global Insight March 2013

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In this month's Global Insight, Virginie Maisonneuve discusses the implications of the Cyprus bailout. She argues that investors should prepare for short-term volatility but that the long-term recovery should not be derailed.

Cyprus: taxing the tax havens?

The decision, after months of negotiations, to fund €5.8 billion of the Cyprus bailout from a tax on depositors has met a strong reaction in Cyprus and by declines across equity markets.

To tax savers is unprecedented and undermines the newly agreed €100,000 Europe-wide deposit guarantees scheme, while exacerbating the distrust between the public and financial sector. Although this is not our base case scenario, one of the biggest dangers is the potential spread of fear to other countries that are facing bailouts (most noticeably Spain) which could undermine the region's banking sector, especially in the weaker countries, and result in higher bond yields in peripheral Europe.

No game changer

The Cyprus bailout should not, though, be a game changer. It is yet another twist and turn in the Eurozone crisis and will thus create short-term volatility. But markets are becoming increasingly resilient to unpredictability in the Eurozone.

Cyprus is an exceptional situation, which lends itself to exceptional measures. First, it has a very large banking sector at around 7-8 times GDP and the bailout is one of the largest in global financial history at 56% of GDP. Second, the Russian involvement complicates the situation: Europe is reluctant to bailout a banking sector where an estimated €25 billion is owned by Russian companies using the banking system as an offshore tax haven. At the same time, no deal at all risks Cyprus turning to external countries for help – potentially in return for important gas revenues.

Re-structuring debt

This should limit the read-across to other countries facing bailout and prevent any lasting contagion. Furthermore, so long as the ECB continues to fund banks across peripheral Europe, an EU-wide credit freeze is unlikely. The immediate reaction among investors and the media has been to focus on the tax on banks deposits. Certainly, it is far from a perfect solution and if the hit to deposits under €100,000 does go through, it will be a bitter pill for Cypriots to swallow. But this overlooks the fact that the bailout is a decisive move to restructure unsustainable levels of banking debt: a necessary move to return growth to the region.

Stay underweight peripheral Europe

In the short term, prepare for bouts of volatility. If the bailout programme is rejected by the Cypriot parliament, as looks likely at the time of writing, this could prolong the uncertainty. If and when a deal is closed, a deposit run in Cyprus is probable, but the ECB is likely to be ready with a generous liquidity backstop to cushion the impact.

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European financials have performed very well and over the last six to nine months valuations have converged. These developments may trigger some pull back and result in a divergence in share price performance in favour of quality financials, and we recommend staying underweight in peripheral Europe.

In the long term, pushing ahead with structural reform and achieving the right balance between austerity and measures that promote growth are what will be important, and we continue to see progress in this area.

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