OBSERVATION

TD Economics

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CYPRUS: TRAVAILS SHOULD LEAD TO BENIGN IMPACT ON REST OF EUROPE

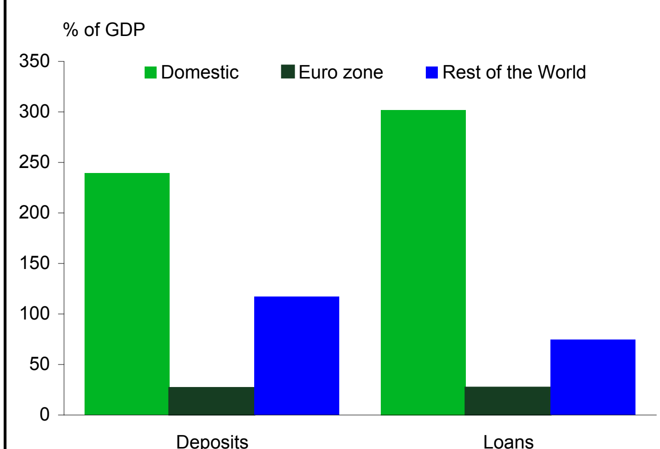
Highlights

- After a week of intense negotiations, euro zone finance ministers reached agreement last night with Cypriot authorities on the key elements of a macroeconomic adjustment program.
- The program will provide €10 billion in financial support for the sovereign in quarterly installments, over a period of three years.
- Cyprus' second-largest bank will be liquidated, and depositors over the €100K insurance limit will take losses.
- Outside of Cyprus, the main risk is that depositors in other euro zone countries could withdraw their deposits from banks that are perceived to be weak. As long as this does not trigger a massive capital outflow in that country, the systemic consequences of Cyprus' crisis should remain minimal.

Over the last 10 days, Cyprus has been making headlines with its repeated attempts to secure a bail-out program from the European Union and the International Monetary Fund. The country had originally requested financial assistance in June of last year, after a deepening recession and losses caused by their exposure to Greek assets had crippled Cypriot banks. As a precondition to a bail-out, the troika – the EU, the IMF, and the European Central Bank – asked Cyprus' central bank to commission an independent assessment of domestic banks' recapitalization needs. Although official figures were scheduled to be released after the formalized bail-out was signed, preliminary estimates suggested a €6-billion capital gap under a baseline scenario, which would rise to €8.9-billion under severe stress conditions.

Providing Cyprus with a bail-out to fund those recapitalization needs and the sovereign's fiscal deficits for the duration of a typical 3-year adjustment program would have driven the debt-to-GDP ratio to around 180%, making it unsustainable under IMF standards. Consequently, both the IMF and the EU demanded that Cypriot authorities come up with an alternative plan to restructure their banks. Given the very low levels of equity and debt on Cypriot banks' balance sheets, there were very few alternatives but to impose losses on deposit accounts. On March 16th, the troika and Cypriot authorities agreed on a plan to extract a levy on all deposits, even those under €100 thousand that are protected by a euro

CYPRUS BANKING



Source: Cyprus Central Bank, TD Economics

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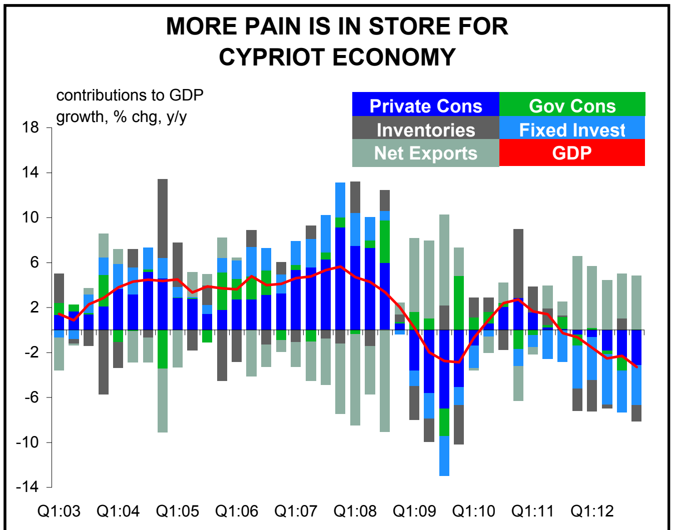


Source: Haver, TD Economics.

zone wide deposit insurance scheme. The plan elicited a public backlash and was defeated in the Cypriot parliament.

After a week of intense negotiations, euro zone finance ministers reached agreement last night with Cypriot authorities on the key elements of a macroeconomic adjustment program, which should be signed in early April following approval from some euro zone national parliaments. The program will provide €10 billion in financial support for the sovereign in quarterly installments, over a period of three years.

Cypriot banks will be restructured

As part of the plan, Cyprus' second-largest bank, Laiki, will be wound-down immediately. Equity shareholders, bondholders and depositors with account balances over €100 thousand will bear the losses in full. The bank's remaining bad loans will be transferred to a "bad" bank and will be run down over time. Laiki's depositors with accounts below €100 thousand will be transferred to Bank of Cyprus, the country's largest lender, together with Laiki's performing loans.

In addition, Bank of Cyprus will also assume responsibility for €9 billion in emergency liquidity assistance (ELA) that had been granted to Laiki by Cyprus' central bank.

The Bank of Cyprus will be recapitalised through a conversion into equity of both uninsured deposits – above €100 thousand – and bonds, targeting a capital ratio of 9% by the end of the program. To this end, uninsured deposits will remain frozen until recapitalization has been effected.

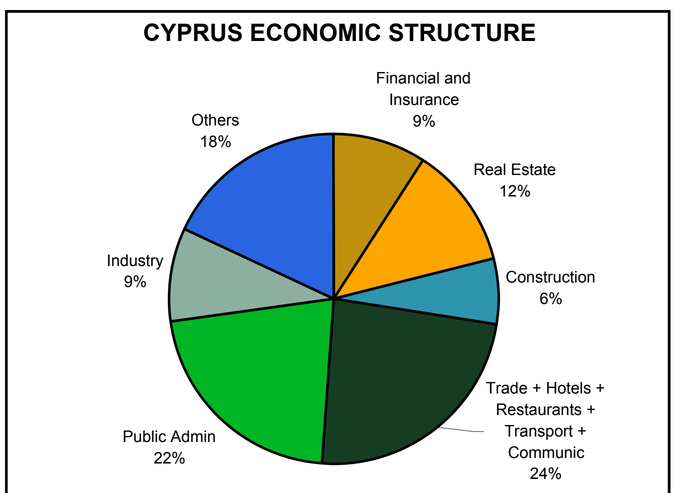
Euro zone finance ministers have also urged the immediate implementation of an agreement between Cyprus and Greece to deal with the Greek branches of the Cypriot banks. Greece's Piraeus Bank announced on Friday it will buy both Laiki's and Bank of Cyprus' Greek operations, after both governments provide €1.5-billion in fresh capital.

Within the conditions of the adjustment program, Cypriot authorities have reaffirmed their commitment to step up efforts in the areas of fiscal consolidation, structural reforms, and privatization. They have also agreed to an independent evaluation of the implementation of the anti-money laundering framework in Cypriot financial institutions. Any problems in the implementation of the framework will be corrected as part of the program conditionality.

Implications for Cyprus

Cyprus is one of the smallest euro zone members, with an economy of €17.9-billion and a population of under 900 thousand people. The country has run current account deficits in 30 of the last 33 years at an annual average of 5.7% of GDP. Its fiscal accounts have also registered persistent imbalances, with average annual deficits of around 3.2% over the last 18 years. This means that, structurally, both the public and private sector rely on external savings to conduct their domestic economic activities.

In recent years, low corporate taxes, lax regulatory oversight, and accession to euro zone membership contributed to the development of an off-shore financial centre, which grew to 8 times the country's GDP. This channeled plenty of foreign capital to finance Cyprus' domestic and external imbalances. The severe losses on deposits accounts, coupled with capital restrictions and much tighter regulatory oversight under a troika program, will dramatically reduce financial activity in Cyprus. And, with it, the entire



Source: Haver, TD Economics

economy will suffer.

Prior to the recent debacle, the European Commission forecast Cypriot GDP would contract 3.5% and 1.3% this year and next, after a 2.4% contraction in 2012. Over the coming months, the fiscal adjustment and structural reforms attached to the bail-out program, in combination with extremely tight credit conditions for the private sector, will make this forecast look optimistic.

Furthermore, given that Cyprus does not control its foreign exchange rate, it is barred from devaluating its currency to try to stem its competitiveness. Therefore, if the country is to remain within the euro zone, all the adjustment will have to come via domestic deflation. But, for small countries that rely heavily on imported goods, inflation tends to be very sticky, because the country has no control or influence over the prices of its imports. Consequently, deflation has to be achieved via unit labor costs reduction, which under current circumstances will prove further contractionary in Cyprus. The unemployment rate is already at 14.7%, and the prospect of at least two more years of economic recession will severely damage private consumption and business investments.

All in all, even if the bank restructuring process is implemented swiftly and efficiently, economic conditions in Cyprus will be extremely difficult for a number of years. And, it is within the realm of possibility that at some point the country could bow out of the euro zone.

Implications outside of Cyprus

Cyprus represents less than 0.2% of euro zone GDP, therefore, the direct impact on euro zone GDP growth of a severe recession in Cyprus will be negligible. In terms of financial contagion, foreign exposure to Cyprus is limited to a few countries – e.g. Russia, the U.K., and the Netherlands. And, although significant with respect to Cyprus' economy, it is minor relative to the size of its foreign counterparts. Hence, the direct repercussions on global financial markets from the losses imposed on Cyprus assets are minimal.

Perhaps the more serious impact of Cyprus' crisis would stem from the message conveyed to uninsured depositors across the euro zone, that if a bank is too-big-to-save, then they are at risk of taking the losses. In the coming weeks, financial market participants, as well as central bankers and regulators will be closely monitoring whether this threat leads to deposit withdrawals across the likes of Portugal, Spain, and Italy.

Bottom Line

The ink has not dried yet on the deal signed by Cyprus and its international lenders and one can already feel the pain of the adjustment to come, even under the assumption of smooth implementation of the bank restructuring process. In any case, there are countless details still to be finalized, which create room for errors and negative outcomes. The situation for Cyprus was dramatic before last night's deal, it remains dramatic today, and it will still be very difficult a few years down the road. Outside of Cyprus, the main risk is that depositors in other euro zone countries could withdraw their deposits from those banks that are perceived to be weak. As long as deposits move from one bank to another within the same jurisdiction and this does not trigger a massive capital outflow out of that country, the systemic consequences of Cyprus' crisis should remain minimal. We believe this benign outcome is the most likely one.

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