Cyprus's Bank Crisis: A Risky Precedent is Set

Anyone who's been following the news must be aware of the absolute chaos that's currently unfolding in Cyprus, and in Europe at large. The truth is this: both Cyprus's beleaguered banks and its government need bailing out, and European leaders are quickly losing their taste for bailouts. But Cyprus is a tiny country, as is its economy. Why is everybody so focused on a nation of 1.1 million that represents a meager 0.2 percent of the EU's GDP?

It's largely because of the precedent that's been set with the original bailout plan, which has since been rejected by the Cypriot parliament. The original plan was to impose a one-time bank deposit tax on depositors themselves in order to raise the 5.8 billion euros necessary to satisfy what were largely (according to ECB ministers, intransigent) German demands. That was to go on top of the 10 billion that the 'troika'—the IMF, the ECB, and the European Commission—are prepared to shell out in order to rescue the tiny island nation. Deposits of up to 100,000 euros would have been taxed at a rate of 6.75% and those over 100,000 would have been taxed at a rate of 9.9%. For the first time, guaranteed deposits—that is, deposits of up to 100,000 euros—would not have been guaranteed at all. The last-minute amendment to not impose the tax on deposits of less than 20,000 euros came too late, and the bailout was still rejected.

The message sent, despite the plan's rejection, is that savers are not safe and insured bank deposits are no longer sacrosanct to Europe's finance ministers. On the one hand, Spain's finance minister went so far as to say that Spanish savings accounts were 'sacred.'[1] On the other hand, mentioning it at all reflects the anxiety depositors in his country and others, notably Italy, must be feeling. The fact that the deposit insurance plan was ignored by those who drafted the bailout severely undermines the credibility of any other deposit insurance plan in the Eurozone. Anyone that's holding euros in a bank should be getting nervous, if not yet panicking.

The government of Cyprus broke the news of the bailout—and its contemporaneous terms—to people in a way that was, to put it politely, sly. They announced the news on Friday evening after banks had shut, and planned to close banks for at least a few days the following week; as of this writing, banks in Cyprus are still on 'holiday' and people have been lining up at ATMs to withdraw their cash. At present, there's a 200 euro withdrawal limit imposed by banks, and electronic transfers have been suspended[2]; the one tiny silver lining is that the ATMs are indeed still being refilled. There has been no bank run yet—but then again, the banks haven't been open to allow one to happen. A bank run in Cyprus is by no means out of the question.

Currently, Cyrpus's finance minister is in Moscow in an attempt to wheedle cash out of the Russian government to help save the nation and its banks, as well as wealthy Russian depositors.

[1] http://www.ft.com/intl/cms/s/0/eeff4c98-9080-11e2-862b-00144feabdc0.html#axzz2Nt1iU8M1
[2] http://www.forbes.com/sites/abrambrown/2013/03/19/the-meltdown-on-cyprus-a-faq-guide-to-the-latest-european-financial-crisis/

Moscow certainly has some interest in this, and seems to have strong influence in Cyprus's parliament[3]; this is because large amounts of Russian cash were parked in Cypriot banks as either a tax haven or as a form of money laundering. A third to a half of bank accounts in Cyprus are of Russian origin, amounting to some 24 billion euros—5 billion more than the entire nation's GDP last year.[4] Cyprus's appeal to Russia for help—whichever form it might come in—dramatically raises the stakes for saving the nation. Any plan that does not satisfy Eurozone demands will lead to a full banking meltdown on the island and a possible exit from the euro. Over the past several years Cypriot banks have created loans totaling 8 times the nation's GDP; many of these institutions do seem too big to save, and if they toppled many depositors could stand to lose everything.

A run on a bank or, worse, a systemic run on an entire region or nation's banks, can destroy an economy and leave a lasting scar on a nation's psyche. In a recent paper titled "Europe Risks a Bank Run," the Financial Times' normally sober Wolfgang Munchau cites Sir Mervyn King, head of the Bank of England in saying that while it isn't rational to *start* a bank run, it's rational to *join* one once it's already in progress, even though you know it will destroy the bank.[5] A bank run today would likely look very different from the ones witnessed in the Great Depression, which comprised huge lines of people swarming banks to claim their cash; with the ubiquity of ATMs and the availability of online transfers, a bank run today could happen much quicker than one might imagine possible. Certainly, there are controls banks and nations can enact to delay such runs once they've begun: bank 'holidays', imposing withdrawal limits, suspending electronic transfers—but to do so would be to temporarily cripple an economy and only delay the inevitable.

To prevent bank runs like the ones that happened during the Great Depression, the United States created the Federal Deposit Insurance Corporation, guaranteeing deposits up to $100,000, and many nations followed suit. If these insurance plans are circumvented by bailout plans however, as the original Cyprus plan was intended to do, depositors would be remiss to not withdraw all their money and stuff it under the mattress. The fundamental point of a bank for a depositor is to have a safe place to put your money; if you stand to lose any of it at all, much less ten percent, there's no reason to keep your money there.

European finance ministers—including Spain's—have been quick to note that Cyprus's case is unique, and will not apply to any future bailouts. If Cyprus's situation were unique, however, why wouldn't the troika simply have forked over the cash? Why did they have to set such a dangerous precedent, and leave depositors biting their nails across the continent? Was this simply mismanagement, or intentional?

Financial systems are certainly more complicated and, arguably, prevent more harm than those in previous eras; the lessons of previous eras, however, need not be ruled out. Spain has defaulted on its external debt thirteen times in the past five hundred years. France reneged on its debt four times in the 18th century alone. Greece has spent more than half of its independent existence in default. There is

[3] http://www.ft.com/intl/cms/s/0/eeff4c98-9080-11e2-862b-00144feabdc0.html#axzz2Nt1iU8M1
[4] http://www.bbc.co.uk/news/business-21831943
[5] http://www.ft.com/intl/cms/s/0/b501c302-8cea-11e2-aed2-00144feabdc0.html#axzz2Nt1iU8M1

no Latin American country with fewer than three defaults on its record. The United States only avoided default in 1933 by confiscating its citizens gold, and during the Civil War by disallowing convertibility. Is today so different that a fourteenth default for Spain is out of the question? Indeed, is it out of the question for any country?

The botched bailout of Cyprus represents a match thrown close to the European financial powder-keg—one of many matches, with more likely to come. Greece stands to run out of money by July, and Spain and Italy are in precarious positions; indeed, the current situation has pushed up Italian and Spanish bond yields as markets react to the newly set precedent of asking depositors to pay for banks' and governments' mismanagement of funds.[6]

Although there's no sign of panic on the continent yet, the position that tiny Cyprus has put the Eurozone in proves that holding Euros is not the best idea for the moment. Hard assets—goods with intrinsic value—are always a reliable hedge against economic calamity. Hard assets are not nearly as subject to the whims of currency or equities markets, or as exposed to speculation as commodities can be. In times of economic uncertainty, which Europe is certainly experiencing, money is safest when it's invested in things that can be seen, felt, and used—things that can weather the economic storm until a return to normalcy, whenever that may be.

[6] http://www.reuters.com/article/2013/03/18/markets-bonds-euro-idUSL6N0CA24T20130318