FINANCIAL CONTAGION RELOADED: THE CASE OF CYPRUS

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Abstract

In the present case study, our main objective is to bring to the forefront the main factors that led to the double-dip recession of the Cypriot economy. We analyze determinants such as "tax haven" status, interlinks with the Greek economy, spillovers originating in the Euro Area as a whole (through the debt crisis) and Greece in particular. In spite of the fiscal reform of 2002 and the new fiscal system in force since the 1st of January 2003, Cyprus continued to be a "tax haven". Its high investment attractiveness spurred the "Cyp-Rus" relations, boosted an outsized banking sector (representing 800% of Cyprus GDP in 2010-2011) and generated an unsustainable proportion between the real and the "virtual" economy. Besides, the public sector became larger than required by such a small economy, its share in the total yearly value added being close to one quarter. Taking into consideration all these factors, we conclude that the „W"-shaped recession of the Cypriot economy is a *sui generis* one and the questioning of its "fiscal paradise" status is even more acute than in the case of countries such as Luxembourg or Liechtenstein.

Keywords: *Cyprus, financial contagion, tax haven, Cyp-Rus, Cyprus-Greece, recession, euro zone, debt crisis*

JEL classification: E22, E32, E44, E66, F21, F33, F34, F44, F62, G01, G11, G15, G21, H81

Introduction

Cyprus, a member of the euro zone since 2008 and a high income non-OECD economy (according to the World Bank classification), recorded a robust economic growth during 1975-2008. The insular country is considered "unique" in the EU, taking into account several cumulative evidences: its geostrategic position (at the intersection of three continents), its status of "tax haven", its division in two parts (one Greek, the other Turkish) since 1974, the UN peacekeeping force and the British military presences on the island. As demonstrated in our analysis, "unique" in the euro zone are as well the Cypriot crisis and the "bail-in" rescue package.

The reason for having chosen the present topic is, on the one hand, its actuality, and, on the other hand, the absence from the literature of a comprehensive analysis of the determinants that led to the Cyprus crisis. The existing papers examine either its tax haven status (Maftei, 2013) or the deep relationship with Russia through the capital flows (Pelto *et al.*, 2004), or the EU accession (Tocci, 2004) or institutional aspects (for instance its banking sector, Stephanou, 2011, or the territorial partition between Greece and Turkey, Tocci, 2004).

Drawing on data provided by institutions such as Eurostat, International Monetary Fund (IMF) and European Commission and experts' opinions, we analyze in our case study Cyprus main macroeconomic indicators and explain the key factors that led to the double-dip recession of the Cypriot economy.

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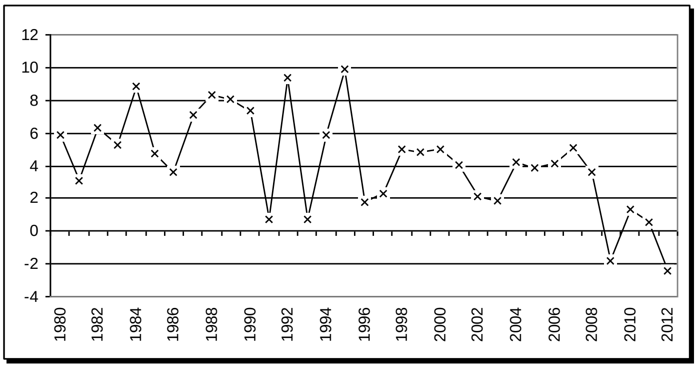
1. The „W"-shaped recession of the Cypriot economy mirrored by macroeconomic indicators

Before it became a member of the euro zone in January 2008, the Republic of Cyprus presented "impeccable credentials" (The Economist, 2012). In 2007, it ran a budget surplus of 3.5% of GDP and a government debt of 59% of GDP (IMF, 2013).

In 2009, as a direct consequence of the global financial and economic crisis (spread through channels such as decline in external demand, investment decrease, increasing difficulty in accessing credit for the already highly indebted private sector), the Cypriot economy slipped into its first recession in 35 years.

After two years of modest growth, the economy entered a double-dip recession in 2012 (Chart 1), having as source the spillovers originating in the euro zone as a whole and Greece in particular.[1]

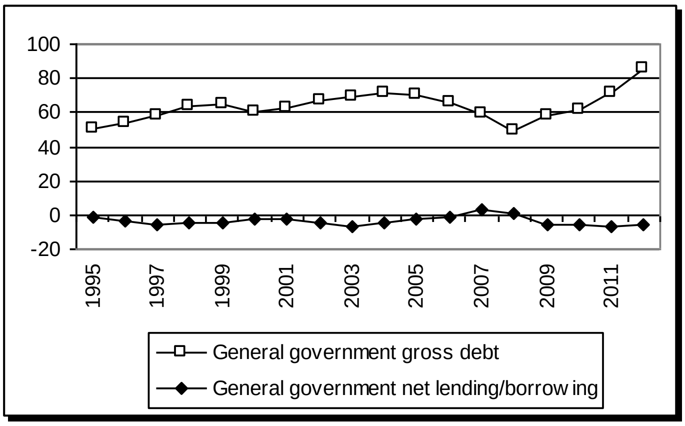
Chart 1: Cyprus GDP real growth rates during 1980-2012 (in %)



Source: IMF (2013).

Starting with 2009, the general government balance was negative, and the government gross debt deepened. At the level of 2012, the IMF data indicated a fiscal deficit of 5% of GDP and a public debt of over 86% of GDP (Chart 2).

Chart 2: Cyprus – General government balance and public debt during 1995-2012 (% of PIB)

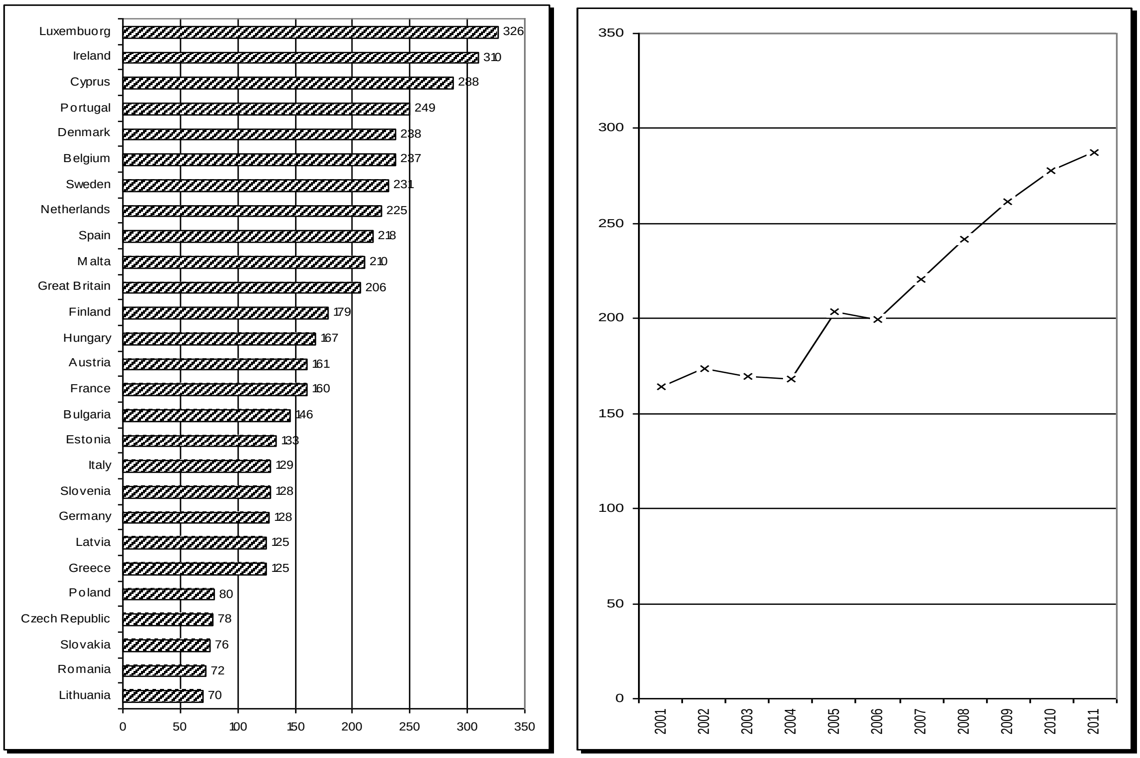


Source: IMF (2013).

[1] For the distinction between *contagion, spillover, monsoonal effects*, please consult Masson (1998) and subsequent research papers. Intensive research in the "contagion" area was successively stimulated and revitalized by the Latin American debt crisis (1982), the Mexican crisis (1994), the Asian financial crisis (1997-1998), the Russian financial crisis (1998), the Brazilian one (1998-1999) and more recently the global financial and economic crisis.

At the same time, the private sector debt (including here the households and companies from the non-financial sector) continued its ascending trend and is close to 300% of GDP – the third highest in the EU (The Economist, 2013; Eurostat, 2012) (Chart 3).

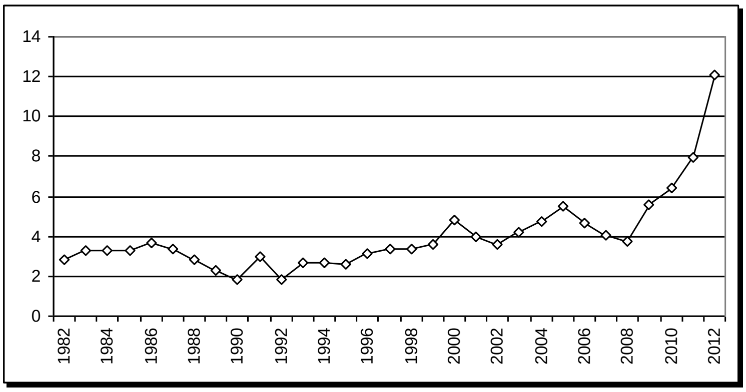
Chart 3: Private sector debt in the EU countries in 2011 and in Cyprus during 2001-2011 (% of GDP)



Source: Eurostat (2012).

The recession brought as a direct consequence a sharp increase of the unemployment rate in Cyprus, which surpassed in 2012 the level of 12% - higher than the euro zone and EU-27 averages (European Commission, 2013) (Chart 4).

Chart 4: Unemployment rate in Cyprus during 1982-2012 (% of the active population)



Source: IMF (2013).

These macroeconomic indicators alone do not explain *why* Cyprus entered the double-dip recession in 2012, which forced the authorities to resort to the burdening "bail-in" package. Factors such as the status of Cyprus as a "low tax haven" (Maftei, 2013, p. 44) and its attractiveness for the Russian capital, its banks exposure to sovereign Greek debt, the spillover effects of the global financial and economic crisis as well as of the euro zone debt crisis on the Cypriot economy are just several determinants of its actual economic situation.

2. Main "acts" of the Cyprus "drama"

Year 2011 may be considered decisive for the Cypriot economic situation, due to a complex of factors. It was the first time after the EU accession when its internal weaknesses became visible, as the economic downturn of 2009 had been considered mainly a direct consequence of the global financial and economic crisis. The Cypriot banks exposure to sovereign Greek debt proved to be too high and the pace of the structural and fiscal reforms too slow. The austerity measures adopted in 2011 were not the solution to the crisis and the protests against the austerity intensified. More than that, in July 11, 2011, the Vassilikos power plant (the largest one in Cyprus) was extensively damaged by a blast at the Cyprus Naval Base. Besides the restoration costs (estimated at Euro 300-350 million), a direct effect was the increase of the energy prices, already situated at levels above the EU average (Cyprus Mail, 2012).

The rating agencies Moody's, Fitch and Standard&Poor's played again their role by the means of downgrading government bond ratings and banks credit ratings. In September 2011, the Cyprus access to the international bond market was practically blocked by prohibitive bond yields (Financial Times 2011).

The moment that prefigured Cyprus' "fate" was the euro zone Summit of 26-27 October 2011 in Brussels, when it was decided that the Greece debt would be reduced by circa Euro 100 billion, by the means of a "voluntary" 50% haircut in the nominal value of the Greek bonds. This decision had successive repercussions on the Cypriot banking sector. At the level of 2011, Laiki Bank (Cyprus Popular Bank) lost Euro 2.5 billion (Reuters, 2013d), and the Bank of Cyprus over Euro 1 billion (The New York Times 2012), as a consequence of the financial contagion transmitted through the channel of the Greek bonds (EUObserver 2012). In the Annual Report of 2011, the Central Bank of Cyprus emphasized that "Cypriot banks with operations in Greece are particularly exposed to credit risk due to the adverse economic conditions and the increased uncertainty that exists."

In December 2011, Cyprus managed to obtain a loan from the Russian Federation, amounting to Euro 2.5 billion, with a five year maturity and an interest rate of 4.5%. Cyprus has been for a long time an offshore centre preferred by the Russian "big business" (Reuters, 2013c). It is worth underlining that, in spite of the fiscal reform of 2002 and the new fiscal system in force since the 1st of January 2003 – considered necessary for the EU membership of 1st of May 2004 –, Cyprus continued to be a "tax haven". Among the factors that guaranteed this position were: low levels of income taxes and VAT and the absence of a rigorous capital control. At the same time, the foreign investors outside the EU (especially from the Russian Federation) were attracted by the possibility of acquiring Cypriot citizenship (therefore EU status), which stimulated the "Cyp-Rus" relationship (Pelto *et al.*, 2004).

Table 1: VAT levels in Cyprus since the adoption of the VAT legislation in 1992

Date/period	Standard rate	Reduced rate 1	Reduced rate 2
01/07/1992 - 30/09/1993	5%	---	---
01/10/1993 - 30/06/2000	8%	---	---
01/07/2000 - 30/06/2002	10%	5%	---
01/07/2002 - 31/12/2002	13%	5%	---
01/01/2003 - 31/07/2005	15%	5%	---
01/08/2005 - 29/02/2012	15%	5%	8%

Date/period	Standard rate	Reduced rate 1	Reduced rate 2
01/03/2012 - 13/01/2013	17%	5%	8%
14/01/2013 - 12/01/2014	18%	5%	8%
Starting with 13/01/2014	19%	5%	9%

Source: http://www.mof.gov.cy/mof/vat/VAT.nsf/DMLrates_en/DMLrates_en?OpenDocument.

Its high investment attractiveness boosted an outsized banking sector (with assets representing 800% of Cyprus GDP in 2010-2011) and generated an unsustainable proportion between the real and the "virtual" economy. Cyprus and other EU countries, like Luxembourg, Malta, Ireland, Great Britain, Denmark, France and Netherlands record also a value of bank assets as a percentage of GDP higher than the EU average of 370%. Outside the EU, "tax havens" like Switzerland and Liechtenstein register as well high bank assets-to-GDP ratios (European Banking Federation, 2012). Nevertheless, most of them have a highly diversified national economy and are export-oriented. For instance, in Liechtenstein, although the financial sector contributes to 27% to the GDP and generates more than one third of the state revenue, the manufacturing industry is the largest sector (Liechtenstein Bankers Association, 2012). Financial services contribution to the overall economy (measured by gross value added) is close to 27% in Liechtenstein – similar to Luxembourg – and much higher than in countries like Switzerland, UK, Ireland. Of the 17 banks licensed in Liechtenstein, seven are subsidiaries of solid Swiss and Austrian institutions (Liechtenstein Bankers Association, 2012).

In Cyprus, the largest shares of the total gross value added in 2011 (at basic prices) were held by the following sectors: Distributive trades, transport, accommodation and food services (23%), Public administration, defence, education, human health and social work activities (22%), Real estate activities (almost 12%), Financial and insurance activities (9%) and Construction (8%) (Eurostat, 2013). This structure underscores not only the low contribution of the financial sector to the output, but also another weakness, given by an oversized public sector.

Moreover, there are two other key factors that distinguish Cyprus from other countries with large banking systems. As indicated by Stephanou (2011), domestically-owned credit institutions (both cooperatives and commercial banks) play an important role in Cyprus. Besides, even though the biggest domestically-owned banks in Cyprus are small in absolute terms, their large size as a proportion of GDP sets them apart from those of other countries. The three biggest banks (Bank of Cyprus, Laiki, and Hellenic Bank) controlled 56% of domestic deposits and 48% of domestic loans as of March 2011 and expanded their operations abroad, particularly in Greece (Stephanou, 2011).

In June 25, 2012, a week before his country assumed the rotating six-month presidency of the Council of the European Union, the Cypriot president announced the intention of resorting to international financial assistance. At that time, the government estimated the financial need at Euro 3-4 billion, while the EU experts had already advanced the amount of Euro 10 billion.

Without any access to the international capital markets, Cyprus had been searching a second loan from the Russian government, in order to recapitalise Laiki Bank, its second-largest bank after big losses caused by Greece's debt restructuring in March 2012 (The Economist, 2012).

In November 2012, the Cypriot authorities declared that the necessary amount to avoid collapse was at least Euro 17 billion, out of which 6.1 billion was required for the payment of the due external debts, and the rest for the banks recapitalisation (RiaNovosti 2013).

One month later, it was outlined a draft memorandum of understanding between the Cypriot authorities and the troika of international lenders, made out of the European Central Bank, the European Commission and the IMF. The hard conditions attached to this memorandum (new austerity measures and taxes increase) hindered the reach of any agreement. As a consequence, the government was forced to resort to a loan amounting to Euro 250 million from the pension funds of the state-owned companies, in order to be able to pay the holidays wages of the civil servants (Spiegel International 2012a and 2012b, EUObserver 2012, RiaNovosti 2013).

Exactly nine months after the announcement made by the Cypriot authorities regarding the financial aid needed, on the 25th of March 2013, the finance ministers of euro zone member countries reached an agreement with the Cypriot authorities on the key elements necessary for a future macroeconomic adjustment programme (Eurogroup Statement on Cyprus, 2013).

This agreement (considered as "Plan B"), was concluded a week after the rejection by the Cypriot parliament of the initial proposal ("Plan A", supposing a levy of 6.75% on deposits of less than 100,000 euros – the ceiling for European Union guaranteed deposits – and 9.9% on deposits above 100,000 euros, Bloomberg, 2013). Even the "Plan B" is considered "harsher" than the initial one (as it involves the shut down of Laiki Bank, the move of the guaranteed deposits from this bank to the Bank of Cyprus, while uninsured deposits face major losses), the Parliament could not vote against it, as this implies the restructuring of the banking sector, for which there is a legal framework already adopted. Anyway, this solution was based on the principle "take it or leave it", as the European Central Bank had informed on its decision to cancel all forms of financing for Cyprus in the absence of an agreement until the 25th of March 2013.

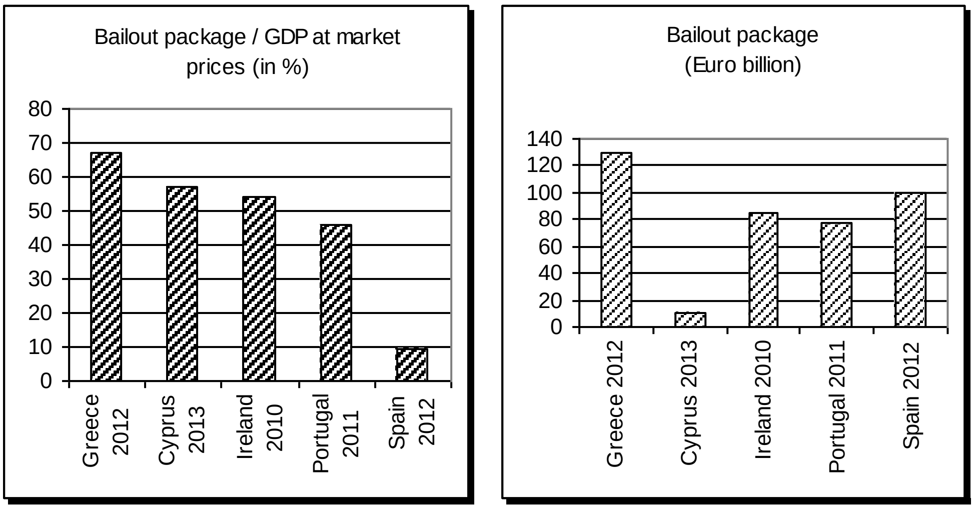
Besides these two plans, the experts envisaged another one, having as main players Russia and Cyprus. Apparently, Cyprus is only a small insular country in the Mediterranean, but, in reality, its geostrategical position and resources are eyed by major players on the international stage. According to this scenario, the Russian banks would have taken over the Cypriot credit institutions, Gazprom would have assumed control over the newly discovered gas resources located offshore Cyprus (estimated at Euro 400 billion), and the Euro would have been replaced by the Russian Ruble. Nonetheless, this "Plan C" would have tensioned the relations between the Russian Federation and the EU and also would have had a negative impact on the Euro, with a share of 40% in Russia's foreign exchange reserves. At the same time, the Cypriot Orthodox Church would have supported Cyprus' exit from the euro zone, but probably not the costly alliance with Russia. This is a strong institution at national level and holds almost one third of the Hellenic Bank shares, the third "big bank" after Bank of Cyprus and former Laiki. One might conclude that, like in a chess game, Cyprus was sacrificed in order for Russia to obtain a better position. Besides, Latvia, as a future member of the euro zone, might replace Cyprus as an attractive destination for the Russian investors (Süddeutsche Zeitung, 2013b; Der Spiegel, 2013).

The agreement according to the "Plan B" is known as a "bail-in", as the shareholders and bondholders in banks are forced to bear the costs of the restructuring first, followed by uninsured depositors (Reuters, 2013a).

Jeroen Dijsselbloem, Dutch minister of finance, president of the Eurogroup and president of the Board of Governors of the European Stability Mechanism, asserted that this solution chosen for Cyprus should be considered "a model for the rest of the euro zone". Nevertheless, market reactions were negative, and many EU heads of government infirmed the "Dijsselbloem model".

Even if it has the lowest value among the countries that have already resorted to external financial aid (Greece, Ireland, Portugal, Cyprus and Spain – GIPCS), the "bail-in" package represents circa 57% of its GDP (Euro 10 billion / Euro 17.5 billion), as compared to bailout packages of approximately: 67% for Greece, 54% for Ireland, almost 46% for Portugal and 9.5% for Spain (Chart 5). Taking into consideration this amount, we estimate that the general government gross debt will reach 146-160% of GDP at the level of 2013. According to the troika of international lenders, Cyprus will have to diminish this percentage to 100% of GDP until 2020 (Financial Times, 2013, Süddeutsche Zeitung, 2013a).

Chart 5: Bailout/"bail-in" packages for Cyprus, Greece, Ireland, Portugal and Spain (% of nominal GDP and Euro billion, respectively)



Sources: Eurostat 2012a and 2012b.

After the Cyprus "bank earthquake", against the background of "capital flight" (even in the presence of strong rules on capital flows – Reuters, 2013b) and the loss of the statute of "tax haven", of increasing unemployment rate and of higher risks of credit default, the European Commission presents a discouraging economic outlook for Cyprus: GDP decreases in real terms of 3.5% in 2013 and 1.3% in 2014 and gross fixed capital formation reductions of 23.7% in 2013 and 11.6% in 2014. Moreover, in April 2013 it changed the previous forecasts to GDP declines of 8.7% and 3.9%, respectively. Other experts predicts GDP drops of 15% in 2013, 15% in 2014 and 5% in 2015, generating a cumulative four-year decline in GDP of 33% and surpassing the six-year decline of Greece of circa 24%. Besides, a possible "labour exodus" could hurt the economy even more than the "capital flight" (The Economist, 2013).

Conclusions

In the present paper, we underscored the main factors that led to the actual crisis of the Cypriot economy and the burdensome "bail-in" package.

In 2009, the Cypriot economy slipped into its first recession in 35 years. The economic downturn of 2009 had been considered mainly a direct consequence of the global financial and economic crisis and only in 2011 Cyprus' economic weaknesses became visible, for the first time after its EU accession. Among these weaknesses can be mentioned the following.

First, its status of "tax haven" boosted an outsized banking sector (with assets representing 800% of Cyprus GDP in 2010-2011) and generated an unsustainable proportion between the real and the "virtual" economy. In contrast to other "tax havens", like Switzerland and Liechtenstein, the Cypriot economy is not enough diversified. Moreover, a small number of domestically-owned credit institutions play an important role in Cyprus and they expanded their operations abroad, particularly in Greece.

Second, the Cypriot banks exposure to sovereign Greek debt proved to be too high. The financial contagion transmitted through the channel of the Greek bonds and the associated losses had successive repercussions on the Cypriot banking sector and on the Cypriot economy as a whole. Third, the austerity measures adopted in 2011 were not the appropriate solution to the crisis and the protests against the austerity intensified. Fourth, the oversized public sector chose a slow pace of the structural and fiscal reforms. In the near future, a possible "labour exodus" could hurt the economy even more than the "capital flight". As a consequence, the „W"-shaped recession of the Cypriot economy is a *sui generis* one and the questioning of its "tax haven" status is even more acute than in the case of countries such as Liechtenstein.

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