The Cypriot economy is adapting to major shocks. Substantial private wealth has been lost and Cypriot firms have lost, or lost access to, working capital over €100,000 at two SIFIs (systemically important financial institutions). Capital controls have hampered the conduct of business. The loss of confidence in the banking system is an additional concern. All this on top of the contractionary measures in November’s draft MoU. The current climate makes more austerity measures likely, further constraining consumption and investment. The overall impact on GDP growth will be very severe.

While the current crisis is largely due to inaction in Cyprus over the past several years, the magnitude of the burden that Cyprus has been called upon to bear by the euro area bail-in has been made unnecessarily and unfairly greater by a number of actions and decisions taken outside Cyprus.

A successful bail-in must come as a surprise and be implemented quickly and effectively. The Cyprus bail-in was not. This option was discussed by European officials for several weeks prior to its execution and, as a result, €6bn in deposits left Cyprus between January and March 15th, including €3.4bn (largely held by foreigners) in the first two weeks of March. The resulting lower deposit base cost Cyprus at least €1bn (assumed haircut of 20%). The responsibility for this flight lies squarely with policy actors outside Cyprus, adding to the Cypriot taxpayer and depositor cost. Even if the bail-in was the best available option for the Cypriot economy, discussion of this policy prior to implementation increased the bill for Cypriots.

In addition, the bail-in was implemented without careful preparation. Its form was changed drastically within a week, away from a general one, to one concentrated on the most troubled banks (Laiki and the Bank of Cyprus or BOC) and uninsured depositors. Moreover, there was no clear understanding of how a bail-in was to be implemented. No distinction was made between long-term deposits earning high returns and money sitting in current accounts, such as firms‘ working capital. This amounted to a significant loss of working capital for businesses and a severe blow to economic activity. The troubled banks had few bond-holders and were systemic, holding the vast majority of deposits in Cyprus. Merging the ‘good’ Laiki with the BOC and resolving the ‘bad’ Laiki proved time-consuming and costly to the conduct of business. An alternative, longer-term, downsizing of the banking system away from publicity and without bank-runs was a credible (given the government’s commitment) alternative that would not have produced such a deep recession. This was an option the Eurozone did not consider. The current front-loaded policy path will lead to heightened unemployment and a much deeper recession.

Another feature of the current solution was that deposits at the branches of Laiki and BOC in Greece were spared from a haircut to prevent contagion. These deposits amounted to €15bn (€26bn in Laiki and the BOC in Cyprus), which suggests that roughly €3bn could have come from depositors in Greece - branches in Greece were in any case more problematic than those in Cyprus in terms of NPLs. The wish of the ECB and the Commission to avoid contagion to Greece was also evident in their insistence that Cyprus should sell its Greek branches. This insistence reduced the bargaining power that Cyprus had, giving the purchaser (the Bank of Piraeus) a better deal. But the handful of Cypriot depositors and taxpayers cannot afford to offer their Eurozone partners insurance that costs them dearly.
After all, Cyprus was not offered any ‘compensation’ during the PSI programme for Greece and has already contributed 25% of its GDP (€4.5bn) through this initiative. The heavy burden placed on Cyprus by the restructuring of Greek debt was not taken into consideration when it was Cyprus’ turn to seek help.

It goes without saying that Cyprus needs to implement the MoU in a timely manner and fix long-standing structural problems. But this will not suffice as recent events have crippled the economy. Based on the arguments above, Cyprus can make a reasonable case for support from the EU. Moreover, by resolving the moral hazard issue, this bail-in precedent makes a Banking Union more likely and, in that case, Cyprus would deserve its retroactive implementation. Such measures would give the economy of Cyprus a fighting chance.