Print Close

Cyprus Bailout Plan Breaks Cardinal Rule of Financial Crises

By Matt Egan

Published March 19, 2013 | FOXBusiness

By threatening to snatch a chunk of insured bank deposits, Cyprus and its European overseers appear to have broken a cardinal rule of financial crises: don't give jittery depositors a reason to yank their cash from banks.

It's true that given the relatively massive size of the Cypriot banking system, which serves as a tax and money-laundering haven for Russians, there are few good ways to finance the tiny island nation's 17 billion euro bailout request.

Still, the proposed levy on deposits in the Cyprus bailout threatened to set a negative precedent and represented the polar opposite reaction from the 2008 meltdown when governments raced to stand behind accounts.

"It's a terrible idea," said Jack Goldstone, a senior fellow at George Mason University. "I think the worst thing you can do is raise doubt about the security of savings in one place. It's just going to make people worry about other places."

Forced upon Cyprus by leaders in Europe, the deposit tax proposal has thrown the eurozone back beneath a cloud of uncertainty by sparking ATM shortages in Cyprus and eroding political support for a rescue that is needed to keep the country's banking system from collapsing.

On Tuesday, the Cypriot parliament rejected the tax on deposits as a condition of the bailout.

"It was like hanging a sign on the door that said -- 'Your money is no longer safe here,'" Art Cashin, director of floor operations at UBS (UBS), said in a note to clients. "It was the perfect setup to start a run on the banking system and a bull market in mattresses."

'08 Lessons Forgotten?

The proposed deposit levy also stands in stark contrast with the 2008 decision by the U.S. to guarantee money-market funds and raise federal deposit insurance to $250,000 from $100,000.

Even German Chancellor Angela Merkel knows how scary a bank run can be.

Faced with rising withdrawal levels after a 2008 bailout, Merkel reassured anxious Germans that "their funds are secure" and raised the country's deposit insurance to 100,000 euros from 20,000.

The U.K. also faced the threat of bank runs during the '08 crisis as Britons feared the safety of the money in their failing banks.

"There were massive queues outside going around the block several times," said Jan Randolph, director of sovereign risk at IHS Global Insight.

Eventually, the U.K. government quelled the crisis by guaranteeing savings up to 50,000 pounds.

Randolph said the idea is to make sure "small savers feel their small pot of gold is always sacrosanct."

Cyprus Bailout Chaos

But the eurozone flipped this principle on its head over the weekend by demanding Cyprus raise 5.8 billion euros for its proposed bailout by imposing a levy on bank deposits.

Attempting to avoid punishing wealthy foreigners, Cyprus initially proposed a levy on all deposits, not just high-end ones. Cyprus also pledged to give depositors a cut of future natural gas revenue.

In response, there were ATM shortages over the weekend and Cyprus was forced to extend a scheduled bank holiday through Thursday as lawmakers debated and eventually rejected a proposal that would have protected depositors with less than 20,000 euros.

“The Pooh-Bahs meeting in Brussels…grossly miscalculated the response of the Cypriot general public,” Edwin Truman, senior fellow at the Peterson Institute for International Economics, said in an email.

“It is a coercive negotiation to say the cash you had in the bank on Friday might not be there on Monday,” said Goldstone.

Why Cyprus is Different

Fearing bank runs could spread to Greece and Spain, eurozone leaders promised the Cyprus deposit haircut won’t be repeated elsewhere.

While clearly unpopular, the decision to go after Cypriot deposits reflects the fact that there were few other ways to come up with the money needed to recapitalize the tiny island country’s banks.

“The biggest asset they’ve got is those deposits. You could put a good argument down that Cyprus is a special case,” said Randolph.

Cam Harvey, a professor at Duke University, notes that the 17 billion euro bailout request for Cyprus, which has gross domestic product of just 18 billion euros, would be the equivalent of a $15 trillion bailout of the U.S.

The $700 billion TARP program is “a drop in the bucket compared to the mess that Cyprus is in,” Harvey said.

Harvey also points out that it was far easier for the U.S. and Germany to guarantee bank deposits in 2008.

Cyprus deposits represent nearly 400% of GDP, compared with just 58.5% for the U.S. Put another way, if the U.S. had the same relative size of deposits as Cyprus, it would need to insure about $60 trillion.

Randolph said while there is some truth to the “instinctive reaction in the West” expressing dismay about punishing “the poor, small saver,” he is “less anguished.”

After all, the Cypriot banking system swelled because depositors were lured by high interest rates and lax money-laundering standards. An estimated $31 billion in deposits are held by Russian residents and corporations.

“Quite frankly, the people who put their savings in high interest rate bank accounts should recognize that high interest represents higher risk. The regulators in Cyprus and Russia should have highlighted that to their own residents,” said Randolph.

‘Over the Cliff’

Still, the decision to treat Cyprus as a special case marks an about-face from recent efforts to further integrate the eurozone banking system all under a single regulator.

“It’s a step backwards,” said Goldstone.

It also represents another attempt by eurozone leaders to attempt to buy time for economic growth by kicking the proverbial can down the road.

“The Cyprus crisis is one more example of Europe (and the IMF it would seem) living in never-never land and hoping the problem would go away rather than their getting ahead of the issue,” said Truman, a former Treasury official.

While Cyprus voted down the current bailout terms on Tuesday, the country's lawmakers may have little choice but to eventually accept amended conditions.

"If they reject it outright then the banks will simply collapse and the ECB will have to withdraw its liquidity support for the Cypriot banks," said Randolph. "The sovereign would default because it's got no means to support itself."

Randolph predicted Cypriot GDP would plummet 6% to 7% and unemployment could spike above 20%.

"You'd have this huge sucking sound in the Cypriot economy as credit is withdrawn. If you don't accept, you're basically over the cliff," he said.