JOHNS HOPKINS
SCHOOL of ADVANCED
INTERNATIONAL STUDIES

Bologna Institute for Policy Research
Via B. Andreatta, 3 - Bologna (Italy)
+39 051 292 7811 www.bipr.eu

Date: April 1st, 2019
Speaker: Michael Sarris, Former Minister of Finance, Cyprus
Chair: Arntraud Hartmann, Steven Muller Professor, Johns Hopkins University SAIS Europe, Bologna, Italy

The Eurozone Crisis and its Aftermath: The Case of Cyprus

During the eurozone crisis, Cyprus was used to test a new "bail-in" method for re-capitalizing banks. As Minister of Finance of Cyprus, Michael Sarris helped prepare the entry of Cyprus into the euro currency union, serving until the change in government in March 2008. In March 2013, he was called back again as Minister of Finance to negotiate Cyprus's request for a financial bailout needed for the country' serious, at the time, funding needs. European leaders were, of course, aware that they had not created a perfect monetary union. One of its most serious shortcomings was the absence of an agreed mechanism for crisis management. However, there was just enough spirit of solidarity and collaboration between members to muddle through and prevent a collapse of the monetary union.

Cyprus joined the European Union in 2004 and the eurozone at the beginning of 2008. Sarris notes that unfortunately, he and his colleagues in the EU did not fully recognize at the time the complexities and possible dangers of adopting a single currency in which the country does not have a central bank that can act in an emergency as a lender of last resort to the sovereign. Moreover, countries that run into difficulties due to loss of competitiveness can adjust their exchange rate to make their exports more attractive and their imports less attractive. However, when you join a monetary union, you can no longer use the exchange rate to address these and other imbalances either in the real or financial sectors. In Cyprus, bank deposits increased from €20 billion in 2000 to €72 billion by 2010, mainly from Russian depositors. This led to a tremendous increase in lending – primarily in construction – resulting in a real estate boom.

Sarris explains that countries with large foreign currency deposits typically restrict loans based on the foreign currency, as these deposits can come in and out very quickly. As Finance Minister, Sarris informally suggested to the European Central Bank (ECB) that Cyprus be allowed to implement reserve requirements for non-Cypriot deposits, but the ECB did not agree. Furthermore, public finances deteriorated rapidly as Cyprus went from having a budget surplus of 3.5% of GDP in 2007 to a budget deficit of 6% in 2012 – nearly a 10% turnaround. At the same time, the debt-to-GDP ratio increased from 48% *in 2008* to 84% by 2013. Sarris notes that Cyprus had several opportunities to ask for support, but the government at the time for a variety of reasons refused to ask for help until mid-2012.

By early March of 2013, the newly elected Cyprus government facing bankruptcy had to complete urgently an agreement with its European partners and begun negotiations with the European Commission, ECB, and the International Monetary Fund (IMF). The proposal put forth by the IMF and the German government, supported by many member states suggested that the two banks causing the trouble to be re-capitalized through their own funds, depositors and shareholders. Cyprus vigorously opposed the bail-in proposal and was supported by the Commission and ECB, who also feared that this would create a dangerous precedent. In the end, the parties came to a compromise and agreed that Cyprus would take deposits across the board from all banks, at 6.75% up until €100,000 and at 9.9% above €100,000. However, the Cypriot parliament, in an act of defiance, rejected the compromise. In the end, one Cypriot bank was closed, and the another had half of its deposits wiped out and replaced by shares. The idea of this solution was to protect the taxpayer by taking money from the depositors. Depositors would additionally be more cautious in the future, knowing that they will lose their deposits if the bank runs into trouble. However, Sarris points out that another important factor in this decision was that Cyprus was a small, non-systemic country, so it could be used as a test ground without impacting other countries.

The Cypriot economy has since recovered – it is growing at about 4%, unemployment has come down from 15% to 7%, and the government is now running a primary surplus. Sarris notes that it is too early to tell whether the approach taken was the correct one; however, there is additional recognition today that there were some problems with how the eurozone was set up: the ECB is increasingly becoming a lender of last resort, and there are some moves in the direction of a federal budget – although Sarris notes that with the rise of nationalist sentiments, there is little appetite in Europe right now for an "ever-closer Europe."