

The Cyprus Depositor Haircut

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In August 2005 a Helios Airways airplane crashed killing 121 passengers plus air crew and leaving 33 orphans. Each orphan received about €1mn in compensation which carers mainly placed in bank accounts for when the children grew older. The Cyprus bailout means most of their money is now gone.

Hotels in Cyprus during winter took large advance payments from foreign travel agencies for bulk bookings of rooms over the coming summer. The money they received has now all but been forfeited to the government but they are legally obliged still to provide the accommodation and food services the travel agencies purchased. Losses will be huge.

An amount equivalent to 60% of GDP has been taken from all business and individual depositors in the two biggest banks in Cyprus accounting for over 60% of the banking system. All accounts bar a select few have lost all amounts above €100,000 at the now closed down Laiki Bank, and 60% of amounts over €100,000 at the larger Bank of Cyprus have gone. So if you had €500,000 on deposit at Laiki, or €50mn, you now have €100,000. Families have lost their life savings, potential home buyers have lost funds from their previous house sale, businesses have lost the funds they were going to use for expansion. How did this happen?

These money confiscations are the result of Cyprus's €23bn bailout agreement reached with the Troika of the European Commission, European Central Bank and IMF on April 2 – the first time ever that depositors in a bank have been “bailed in” on a large scale. It is not something which was forced upon depositors in either of the two Greek bailouts or the Portuguese or Irish bailouts. It has shattered Cypriot confidence in any concept of “solidarity” in the Eurozone, was made necessary by poor bank and central bank governance in Cyprus, and it is probably the model to be used for all future bailouts in Europe and other countries.

I was in Cyprus from the evening of Saturday 4 to the morning of Thursday 9 May, saw in Easter Sunday and celebration of the Rising of Christ after midnight on Saturday, and partook of the copious meat eating people engage in after 50 days of avoiding animal-based food products. I spent Sunday in the beautiful valley village of Palaichori which supplied about 90% of New Zealand's Cypriot migrants, crossed briefly into the buffer zone in Nicosia between the Greek Cypriot part of Cyprus and the 37% of the country seized by Turkey in their 1974 invasion, and spoke with many senior government and business community figures.

These included the former Finance Minister who negotiated the bailout deal with the Troika, senior representatives of the Ministry of Finance and Central Bank of Cyprus, people from the Cyprus Investment Promotion Agency, Union of Cyprus Municipalities, and the Cyprus Chamber of Commerce and Industry. All experiences and visits were wonderfully arranged by New Zealand's Honorary Consul in Cyprus Tony Christodoulou who with his wife Mickey were excellent hosts. The weather was hot, the people friendly (90% speak English), and if you are heading to Europe and want a relaxed hot weather holiday Cyprus is a great place to go with good food, great service, and wonderful beaches – though I did not have time to see any of them.

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Here is the story of how Cyprus got itself into its current situation as best as I have been able to discern during two working days of interviews. A full dissection of the collapse and the factors causing it will eventually emerge one imagines and the book will make for fascinating reading.

Basic Facts

Cyprus has a population of about one million people, makes up 0.2% of the Eurozone GDP (NZ is 0.2% of global GDP). It's income per capita is nearly the same as New Zealand's.

[http://en.wikipedia.org/wiki/List_of_countries_by_GDP_\(PPP\)_per_capita](http://en.wikipedia.org/wiki/List_of_countries_by_GDP_(PPP)_per_capita)

NZ scores equal first least corrupt country in the world. Cyprus comes in at 29th.

<http://www.transparency.org/cpi2012/results>

NZ scores 4th global ranking for economic freedom, Cyprus 41st.

<http://www.heritage.org/index/ranking>

Cyprus is a modern economy, but one with some slight corruption problems, some protected sectors, a bloated public sector common to Europe, and very strong unions favoured by the sometimes communist leadership – just voted out this year.

Cyprus entered the EU in 2004 and joined the Euro in 2008. Hit by the global financial crisis the Cyprus economy shrank 3% from pre-GFC to the end of 2009 (NZ shrank 3.8%) but returned to growth of 2.1% during 2010 (NZ 1.8%). Some 10% of GDP comes from tourism, 9.2% from financial services, the agriculture and manufacturing bases are small, most food is imported, and the people are highly educated. So far so good.

Precursors to the Collapse

Cyprus has long been an international business centre but from 2003 as tax laws were equalised across different groups and made compatible with the EU, and exchange controls lifted Cyprus began accepting foreign currency deposits. Banks had to place some 70% of such deposits in secure assets such as the central bank or government bonds. However, in 2008 when Cyprus adopted the Euro these foreign currency deposits largely became local currency deposits for which only 30% needed to be placed in secure assets. Finding themselves with extra liquidity banks lent it out on top of money they had already been lending heavily into the domestic economy and offshore – largely into Greece.

They sought out high yielding assets also in some other Eastern European countries in some cases opening branches because the interest rates they were paying for funds back in Cyprus were lifted 1% - 2% in order to compete with Russian and Greek banks which had entered the market. The Cyprus banks chased risk.

As a tax haven Cyprus offering interest rates up to 2% above rates elsewhere in Europe and with a 10% corporate tax rate Cyprus became home to the accounts of tens of thousands of holding companies, and was a recipient of an estimated €32bn of deposits from Russians. Much of this money from Russia was placed only on short-term deposit because it was used by Russian companies and state enterprises for handling accounts in other parts of the world and the role of Russian oligarchs appears over-rated. Cyprus banks were borrowing short and lending long.

With nominal GDP of just under €18bn Cypriot bank assets amounted last year to some 7.5 times GDP. In contrast the NZ ratio is about 1.5 times. Ireland was eight times. Iceland (non-Eurozone) 16 times. Banking was huge compared with the size of the economy.

In their search for yield and use of funds flowing in from offshore the two largest Cypriot banks built up very large exposures to the Greece economy and in particular to Greek government bonds. Risk was not diversified.

The onset of the financial crisis in 2008 caused a downturn in the Cyprus economy which naturally generated impaired assets for Cyprus banks both domestically and offshore. Losses started building whether recorded in accounts as such or not. The economy improved as noted to 2.1% growth in 2010 generating some optimism and increased willingness to take extra risks in order to offset weakness in direct

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lending to businesses and households predominantly in Cyprus and Greece. So the two large Cyprus banks started more aggressively trading high yielding Greek government bonds which at one point saw a 30% contribution to profit for one of the two banks. In fact between December 2009 and mid-2010 the Bank of Cyprus lifted its holdings of Greek government bonds from €100mn to near €2.5bn. Risk was more aggressively chased to offset other losses.

Early in 2010 Greece revealed its fiscal position to be a lot worse than previously admitted and its bond markets collapsed. This directly caused huge losses for the two biggest banks in Cyprus – Laiki Bank and the Bank of Cyprus. Together these two banks account for two-thirds of Cyprus's banking system. Cyprus has a very undiversified banking system with excess concentration of assets in just two institutions.

One bank attempted to hide its near €2bn in losses by shifting its Greek bond holdings from its trading account to its “hold to maturity” account in order to avoid having to write down their value. Bank directors and the regulatory authorities did not know the depth of losses.

As the Greek economy continued to deteriorate over 2011 along with much of the rest of Europe Cyprus's economy weakened anew with shrinkage of 0.6% over full year 2011. One important incident contributed to this weakness – 0.8% GDP shrinkage in the September quarter of 2011 following the Mari Incident. In July 2011 ammunition seized from freighters destined for Syria and stored in 98 containers for two and a half years blew up and severely damaged the plant responsible for half of Cyprus's electricity generation. The cost was estimated at between €1 – 3bn or up to 17% of GDP which clearly strained government tax receipts while boosting expenses. Bank lending books deteriorated anew.

Then in December 2011 the much noted “haircut” or Private Sector Involvement (PSI) was applied to holders of Greek government bonds in a second bailout. Holders had to write down the value of their Greek bonds by about 75%. This haircut generated extra losses for Cyprus's banks.

Laiki Bank (the second largest after Bank of Cyprus with the two together accounting for over 60% of the system, Laiki 16%) lost €4.1bn in 2011 including €2.5bn from the Greek haircut making hefty Greek bond holdings worth little.

Adding losses for other banks from the haircut brings a cut cost to Cyprus banks of €4.1bn or almost 25% of GDP for such a small economy. Simple bad lending including financing a construction boom up to 3 – 4 years ago (prices have fallen since then) appears to account for the rest of the losses adding another €4bn or so including losses from €11.8bn lent in the depressionary Greece economy. Revealing its unviable state the government was eventually forced to take an 84% stake costing €1.8bn in Laiki Bank in June 2012.

The central bank oversaw a boom in the size of the banking sector, dependence of banks on short-term funding, hefty investment in an undiversified range of assets, and poor bank asset monitoring and reporting procedures. The Central Bank of Cyprus failed to properly oversee the country's banking sector and allowed the situation to develop through their inaction.

Request For Participation in The Greek Bailout

More generally, the losses for the two big banks come the end of 2011 were too much for the Cypriot government to cover given debt increases from 2008 – 11 and ongoing budget deficits. At the end of 2008 the ratio of government debt to GDP was 49%. By end 2012 it was 86%.

The Mari incident and revealed losses on Greek bonds meant investors lost faith in the ability of the Cyprus government to fund itself and from December 2011 the international markets were essentially closed off to Cyprus. That meant funds had to be found from special sources to cover maturing debt and the ongoing budget deficit.

In early-2012 the Cyprus government began talking with the Troika partners (European Commission, European Central Bank, IMF) about the huge impact debt restructuring in Greece was having on Cyprus and asking for some aid to Cypriot banks to be included in the allocation of the Greek package funds. Had

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the Troika recognised the magnitude of losses sheeted home to Cyprus banks as a result of Greek debt restructuring (over 25% of GDP versus a few decimal points in most other Eurozone economies), and had a special compensatory package been advanced, the situation in Cyprus now would be less bad. Unfortunately all progress on discussions ceased when fresh elections were called in Greece for May 2012. The special problem for Cyprus caused by the Greek debt restructuring was not corrected.

The Official Cyprus Bailout Request

Cyprus managed to secure a loan of €2.5bn from Russia in December 2011 but continuing deterioration in the economy, worsening losses on Greek bonds and from lending in Greece meant Cyprus went to its European partners seeking a €10bn bailout in June 2012. The negotiations commenced, the economic and bank loss situations became worse, and the communist-led ruling party in Cyprus could not or would not reach agreement with the troika. Quick action on a Cyprus bailout to try and stem the deterioration was not taken.

Following election of a new Cyprus government in February this year negotiations resumed in earnest. On March 15 a deal was announced involving a €10bn contribution from the Troika and a €7bn contribution from Cyprus. The Cyprus contribution was to partly come from a 6.75% levy on all deposits at Laiki and Bank of Cyprus and 9.9% levy on deposits over €100,000.

The levy announcement reverberated through European society and financial markets as it implied that the national deposit guarantees on the first €100,000 in each individual's bank accounts did not hold. Concern surged over what the impact would be in banking systems and economies outside Cyprus. Inside Cyprus it was seen right from the announcement that people would try to take their funds out of banks. In fact while outflows from Cyprus appear to have been minimal during 2011 and 2012, from January flows lifted and by one estimate some €6bn left the country in the two weeks ahead of March 15.

In order to stop runs on the banks when they were scheduled to reopen on Tuesday 19 after a Monday holiday the banks were kept shut. They stayed shut for two weeks during which time the ATMs emptied out very quickly. Cyprus became a cash-only and barter economy because of the unworkable haircut proposal for all deposits.

The Cypriot Parliament rejected the deal a few days after it was announced and the Cypriots quickly went to Russia asking for another €5bn. They did not get it.

Faced with a threat from the European Central Bank to withdraw all provision of liquidity to Cypriot banks the Cyprus government signed up to the following deal because not signing would have meant collapse of the two banks. That would have meant the Cypriot government was liable for up to €15bn of payouts to depositors with amounts less than €100,000. No money existed for such payments and with no ability to print money the Cypriot government would have had to declare bankruptcy and risk being kicked out of the Eurozone if not the EU. Access to global financing markets could have been denied for many years. So a new deal was signed on April 2.

The Details

The April 2 agreed bailout package of €23bn (Greece was €240bn) is this.

- The Eurozone's bailout fund (The European Stability Mechanism of €500bn established in September 2012) will contribute €9b.
- The IMF will contribute €1bn. These two amounts will cover bank recapitalisation of €2.5bn, maturing government debt of €4.1bn, and three years of budget deficits adding to €3.4bn. It is expected that Cyprus will regain offshore funding ability within three years.
- Cyprus will find the other €13bn itself (lifted from €7bn in March) through the following means.
 1. All depositor money in Laiki Bank above €100,000 will be forfeited or "bailed in". Laiki Bank will be closed down with all deposits under €100,000 folded into the Bank of Cyprus and all deposit amounts over €100,000 put into a "bad bank".

2. All deposits in the Bank of Cyprus above €100,000 will have 60% bailed in (converted to Bank of Cyprus stock). The final bail-in percentage is expected to be known by September. A maximum €10.6bn will come from these two bail-ins. This equals almost 60% of GDP. The NZ equivalent would be \$120bn.
3. The corporate tax rate will rise from 10% to 12.5% and capital gains tax double to 30% - expected to raise €600mn.
4. Gold reserves will be sold - €400mn.
5. Domestic holders of Cyprus government debt will be automatically rolled over into new debt - €1bn.
6. Privatisation of state assets - €1.4bn.
7. Reduced interest rate and longer maturity on an earlier Russian loan of €2.5bn – save €100mn.

As a result of this package it is forecast that the Cyprus economy after shrinking 3.3% in 2012 and 0.6% in 2011 will shrink 8.7% this year and 3.9% in 2014 before growing 1.1% in 2015. That is about 17% shrinkage over a four year period. The government is forecast to run a deficit equal to 6% of GDP this year, 7.9% in 2014, 5.7% in 2015, and 2.5% in 2016. The ratio of public debt to GDP is forecast to rise from 86% at the end of 2012 to 109% at the end of this year, 123% in 2014, and 126% in 2015 before easing to 122% in 2016. The unemployment rate is forecast to rise from 14.2% in March to 15.5% year end and 16.9% at the end of 2014.

However capital controls are in place limiting withdrawals of funds to €300 a day and capital controls limit money transfers out of the currency in electronic and cash form. No-one knows how depositors will behave once the capital controls are lifted. The risk is that banks lose their depositor bases and this is one factor which leads many people to predict that the Bank of Cyprus will follow Laiki into closure. No-one has an economic model which tells us how the disappearance of business funds to finance expansion, trading inventories etc. will impact the economy. There is no model reliably telling us how the loss of so much household wealth will affect people's willingness to spend, consumer and business confidence generally, and willingness of young people in particular to stay in the country.

The clear risk is that the forecasts for 8.7% GDP shrinkage this year and 3.9% next year are wildly optimistic.

Some Key Issues of Contention

- Jump in Cyprus Bailout Contribution

One area of angst has been the jump in the size of the contribution required from Cyprus for any bailout from around €7bn last year to now €13bn. There is a view that had a deal been agreed last year there would have been no haircut and that is quite possible. However history has shown many times that initial estimates of the extent of bank lending losses are usually much too low, and the Greek economy has performed far worse than expected resulting in even more new losses for the large quantity of loans which Cyprus banks have there. Thus had an early bailout been agreed, there would probably still be need for another.

- Should Parliament Have Accepted The First Package?

There is debate over whether it would have been better to have followed through on the original March 15 package which involved a low % haircut across all deposits, calling it a levy as a means of trying to avoid saying that it violated the European banking system guarantee for the first €100,000 for each depositor. But such a move effectively invalidating the deposit guarantee scheme would have led to massive shifts in depositors funds in the rest of Europe away from perceived risky countries toward those perceived as having far less chance of bank problems. In the end even the Troika recognised the levy proposal for funds under €100,000 to be unviable.

- Special Haircut Exclusions

There is discontent that the Troika prevented the inclusion of foreign banks operating in Cyprus in any bail-in and the accounts of Cypriot banks operating in Greece. These exclusions may have been driven by concern over the impact on the Greek economy.

- Cyprus Treated Differently

There is extreme discontent in Cyprus that they have been treated so differently from other countries which have been bailed out. This discontent often manifests itself as high criticism of the Germans with use of terms such as hegemonic, and criticism that the Germans cared more about domestic politics ahead of the general election there late this year rather than doing good for a Eurozone member caught out significantly by Greece's collapse. Media commentary shows popular presentation of Cyprus outside the country as having benefitted from years of laundering Russian money. Data supporting such a view have not appeared.

- Early Rejected Haircut Alternatives

Early during the negotiations the idea of taking perhaps half the over €2bn in interest payments on bank deposits was considered. But it became clear that this would not raise enough funds quickly enough. Another proposal was that the state pension funds should be used to help recapitalise the banks. But few Cypriots had any interest in taking away people's pensions.

- Time Wasted

It is felt in some quarters that the €2.5bn advanced by Russia in December 2011 was wasted, as it were, in that the Cypriot government did not use the time bought to undertake economic reforms which would greatly improve their debt servicing ability. The communist-led government was however not capable of such reforms. The loan made things worse.

- Russians Abandoned Cyprus

Cyprus has always had a close relationship with Russia and there are questions as to why Russia did not contribute the €5bn sought in March to sooth the haircut pain. But there appear to be a number of reasons why the Russians baulked. One may be the deterioration in the situation and lack of action following the first loan. Second may be a diminution of President Putin's power in Russia limiting his ability to ride over widespread concerns amongst Russian people that the loan was aimed essentially at bailing out the oligarchs and rich Russians whom people believe have squirreled their potentially ill-gotten money in Cyprus. Third, Russia values its relationship with the EU and the EU had made it clear that they felt Russia was interfering in family matters.

- Divergent Opinions On What Is "Fair"

Regarding attitudes toward the bail-ins for Laiki and Bank of Cyprus depositors, the feeling amongst some is that it penalises largely those with wealth and not the poor, that the bulk of the money affected comes from offshore, that some of that money was dodgy, and that the taxpayer could not have handled the bailout burden anyway – so there was no alternative. Yet others say that a 6.75% levy on all depositors would have been the fairest thing to do, spreading a small amount of pain across many people rather than concentrating it amongst a far smaller number – perhaps 10% of depositors though figures enumerating the under and over €100,000 was not found.

- Veto Not Used For Greek haircut

There is a view that had Cyprus used its power of veto to stop the second Greek bailout or had threatened to use the veto unless they were included then things would be a lot better. Sounds reasonable. Why did the Cypriot government not use this power to protect its people?

What are some key risks going forward?

1. The economy performs worse than expected so the deficit is worse than projected, the financing requirement rises, and a second bailout package will be needed.
2. Asset sales do not raise the budgeted €1.4bn – just as Greece's asset sales programme has failed. In fact the government negotiated a two year extension of the sales deadline preferring presumably not to alienate vested groups opposed to asset sales. Such opposition could scuttle all sales. The state agencies affected are already trying to subvert the process by seeking to raise €1.4bn in debt from offshore lenders.
3. Some recapitalisation of the third bank in Cyprus, Hellenic Bank (the Church's bank) plus co-operative banks will be needed and their requirements could render the €10bn Troika bailout contribution inadequate.

4. The public may never regain confidence in Cyprus banks and as capital controls are lifted the banks may lose their deposit bases thus initiating a new credit crunch and banking system collapse.
5. Financial services account for 9.1% of GDP and 5.2% of employment. The collapse in Cyprus as an international financial (though not business) centre risks a sharp cut in not just bank staff numbers but employment at many holding companies etc.
6. Tourism contributes 10% of GDP and could fall sharply as Germans stay away fearing opprobrium, Russians stay away out of disgust at loss of compatriots' money and accusations of money being laundered, and foreigners generally stay away due to uncertainty regarding use of money, service availability, cuts in Cyprus Airways flights, and tough economic times back home. However the experience of Kiwis continuing to flock to Fiji after coups – especially to take advantage of discounts – suggests tourism may remain strong.
7. Businesses banked predominantly with Laiki Bank and the Bank of Cyprus. Their funds for expansion have disappeared. Business investment could all but collapse. No-one has an economic model to easily simulate the impact of businesses losing their liquid assets, or of households losing their large accounts.
8. The government has deliberately favoured public sector employment by concentrating package pain in the private sector while public service job numbers will be cut just 4,500 over the next three years. Government expenses as a proportion of GDP may rise while the tax base declines, risking a substantial deficit blowout.
9. Cyprus has a well-educated young population. Many may leave the country as unemployment rises.

Is there upside? Some, given that huge gas reserves have been discovered and there is talk of a large processing plant being built. But this will take capital and time and won't fill the economic gap for the next three years. There has been some firm interest in distressed assets coming out of the likes of the United States as investment companies there seek yield and disbursement of cash piles courtesy of Fed. money printing. There is rising interest in health tourism, joint research and development projects, renewable energy developments, plus the shipping sector is doing quite well. There is some interest from China, but it is mainly on the residential property purchase side and buying residency. Foreigners cannot buy citizenship – something quite misrepresented in the media. That is, Chinese cannot invest and acquire EU passports. Even with residency people will still need visas to travel to France for instance as Cyprus is not part of the Schengen Area of free movement.

Why Does Cyprus Matter?

1. Without a bailout package the government would have had no choice other than to default on its debt and would probably be forced out of the Eurozone, thus opening up potential exit for other countries. This would produce huge uncertainty regarding all future Euro-denominated transactions and a flow of funds out of most Eurozone countries into Germany and the other wealthier northern Eurozone members. Collapse of Cypriot banks would have ripple effects through other countries' banking systems. Thus the signalling effect of a Cyprus collapse is what mattered and that comes regardless of the tiny size of its economy.
2. The initially proposed "haircut" on bank deposits included even those under €100,000 guaranteed in the Eurozone scheme. This led to huge concern regarding deposits in banks of other indebted Eurozone countries and risked producing huge capital flight up north and out of Euros into other currencies thus worsening banking ability to lend and fund economic activity. The first proposed Cyprus bailout of March 15 opened up the possibility of Europe's bank deposit insurance schemes being worthless.
3. It appears to show that size matters. Far bigger Greece was spared extra downward pressure from inclusion of deposits in Greek branches of Cypriot banks in the haircut – even though Greece lied about its fiscal accounts over an extended period of time. More than that the Cyprus banks were forced to sell immediately the banks they owned in Greece at what many consider a fire sale price.
4. It is considered that in any future bailouts involving bank recapitalisations, depositors in banks with amounts above €100,000 will suffer haircuts. Bank risk is perceived to have increased.

5. Had Cyprus not agreed to an inequitable haircut procedure the deposit guarantee scheme would have proved worthless because the Cypriot government does not have enough funds to pay people their €100,000 in the event of collapse of Cypriot banks – a bill which could top €20bn. National deposit guarantee schemes are not as safe as people may think and their existence acts against the interests of those who deposit large amounts in banks.
6. The Cyprus banking sector and government finances collapsed less than four years after joining the Eurozone - before which extensive examination was undertaken of the Cyprus economy to gauge its worthiness for entry. Those assessments failed to spot the structural weakness of the banking sector. Therefore, have glaring weaknesses also been missed in other recent entrants to the Eurozone?
7. It shows that even after the depths of the global financial crisis central bank supervision of financial institutions is still lacking. (NZ had its own version of this with some finance companies blowing up because of post-2008 activities – though they were not under the RBNZ’s supervisory umbrella. Now they are.)
8. It shows that stress tests do not fully capture bank risks as those undertaken in Cyprus late in 2011 did not produce capital base growth recommendations remotely approaching the amounts eventually needed.
9. It shows that governance in banks, governments, and regulatory authorities is of vital importance. Boards must contain members who ask questions and demand answers. Members must be appointed on merit, rotated out, and not rotated in because of family relationships. Board members and senior bank managers should not be the same people to which banks are advancing money. Finance Ministers must focus on finances first and the sustainability of debt structures etc. before politics. There must be a good relationship between the central bank Governor and the President or Prime Minister.
10. It serves as a warning that following the problems in Ireland and Iceland (not in the Eurozone), countries with high ratios of bank lending to GDP have a tendency to get into trouble and the government cannot bail out the banks. People are asking which other countries look like those three.
11. Cyprus shows that solidarity in the Eurozone let alone the European Union is weak. There is little concept of shared pain, and people in Cyprus feel not just abandoned, but punished because their economy followed an economic path different from much larger economies.

How Does NZ Compare With Cyprus?

Well thankfully.

- The ratio of NZ bank assets to GDP in New Zealand is only around 1.5 rather than Cyprus’s 7.5 times.
- NZ banks have minimal exposure to offshore governments and businesses whereas large proportions of Cypriot bank assets were offshore, as were their depositors. Risk of capital flight is therefore substantial. The Cypriot banks had very poor funding bases.
- NZ banks are backed by large Australian banks by and large.
- Supervision of NZ’s banking system by the Reserve Bank of New Zealand has been stringent since our own 1980s banking crisis. Supervision in many foreign economies has been woeful.

My Conclusions

Cyprus had a reasonable economic structure though bloated public sector with excessive protection for certain groups ahead of the GFC and its own crisis, but these were not the cause of the crisis. The crisis was because of huge bank exposure to Greece. These huge exposures developed because of poor bank management structures and poor central bank supervision. It is up to others to discern why these governance failures occurred and how to correct them – quickly.

Cyprus had a wealth-destroying bailout forced upon it by its Eurozone partners because bailout fatigue has set in amongst northern country citizens and from here on in those most closely associated with the country of a government needing aid will pay more of the bill. Bail-ins will now be the norm.

In three years' time Cyprus will likely be coming out of its slump as its non-bank economic structure looks acceptable and development of gas reserves has huge potential. But between now and then it risks a depression as bad as Greece's own.

The dishevelled inner city I saw while there was due primarily the collapse of an earlier debt-funded commercial property boom leaving empty buildings and sites. In three years it is likely to look much worse and apparently has become so in just the past four weeks.

For the moment the concept of shared pain within Cyprus is strong and charitable activity is growing rapidly, centred around food distribution. But the downturn has barely started and businesses have only just commenced layoffs. The government is encouraging businesses to keep people and to keep their benefits. But this is simply not possible given the loss of monetary assets, collapsed confidence, and falling revenue. The unemployment rate risks going much higher than the official forecast of a peak near 17% in 2014.

This paper is written by Tony Alexander, Chief Economist at the Bank of New Zealand and is one of a range of releases including the following.

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Most of these publications plus research into impediments to NZ's economic growth are available on this website. www.tonyalexander.co.nz

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