Weekly Geopolitical Report

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The Crisis in Cyprus

Over the weekend of March 16, Cyprus announced it was taxing deposits in order to recapitalize its banking system. The proposal, which levied a tax of 9.9% for deposits under €100k and 12.5% for amounts over that level, caused a severe political backlash. The Cypriot legislature would not approve the measure. In the days following, a banking holiday was put in place to prevent banking runs. The Troika (the EU, the IMF and ECB), who approve bailouts for the Eurozone, negotiated into late Sunday, March 24, before reaching a deal.

The agreement causes Cyprus to wind up its second largest bank, Bank Popular. The bank will be split into a "good" and "bad" bank. The former will be absorbed into the Bank of Cyprus, the nation's largest bank. It will also get all the deposits under €100k. The bad bank will get all the bad assets (mostly Greek bonds) along with the deposits over €100k. The bad bank will use the deposits, reportedly around 40%, to absorb the bad loans. In return, the Troika will loan Cyprus €10 bn.

This bailout is unique in that this is the first time depositors have been hit to address a bad bank. Although this was common practice through the Great Depression, the adoption of widespread deposit insurance has mostly ended the practice in advanced economies. The decision to take this step is fraught with risk, and could trigger bank runs across the Eurozone.

In this report, we will provide a brief history of Cyprus. This information will give the context for the background of the current crisis. We will examine the current crisis in more detail and discuss the impact on the Eurozone. As always, we will examine the potential effects on the financial and commodity markets from the Cyprus problem.

A History of Cyprus

The island of Cyprus is important geopolitically.

(Source: Wikipedia)

As the star on the map shows, controlling Cyprus gives a power a base to project power across the Levant into the coastal regions of Egypt and Anatolia. Like Syria, Cyprus has been at the crossroads of empires. It appears that Greeks were the first recorded settlers as far back as 1400 BC. From this period to the Renaissance, the island has been under the control of Egypt, Persia, Assyria, Rome and Arab powers.

In the 15th century, the island was controlled by Venice. Venetians ruled over Greek serfs. In 1570, the Ottoman Empire launched an invasion. Nicosia, the capital, fell on September 9, 1570, after a siege. The Turks massacred the survivors, killing an estimated 20k people. By August of the following year, the Ottomans controlled the entire island. The Venetians that remained were sent back to Italy and the Greek Cypriots remained.

In its early stages, the Ottoman Empire mostly ruled with a "light touch." A high degree of cultural and religious autonomy was allowed in most of the area controlled by the empire. As long as taxes were paid and the nations didn't threaten the sovereign power of the empire, the Ottomans generally didn't interfere in the daily lives of its subjects. The Cypriot Orthodox Church essentially ruled the island; bishops were both religious and civil leaders.

However, as time passed and the Ottoman Empire began to fray, the light touch became less so. Taxes increased and colonial rule became inept. The Cypriots increasingly opposed Ottoman rule and wanted to join with their ethnic and religious compatriots in Greece. This desire to unify with Greece was known as "enosis."

By the 1800s, the Ottoman Empire was struggling to hold its territory from encroachment of the Russian and French empires. The Ottomans offered Cyprus to the British in 1833, 1841 and 1845. The British took control in 1878. The Ottomans formally held the territory but the administration of the island went to Britain.

The British wanted Cyprus to project power into the Levant. It established naval bases on the island. During this period, known as the "Great Game," the British and Russian empires were constantly trying to prevent the other from gaining territory from Afghanistan to the Mediterranean. By holding Cyprus, the British Navy could impede the Russians from projecting power from the Dardanelles if the Russians were able to oust the Ottomans from the Black Sea.

The British ruled the island by preventing the majority Greek Cypriots from gaining control. As was typical of the period, colonial powers tended to side with minority groups. Greek Cypriots represent about 75% of the population, with Turkish Cypriots comprising most of the remainder. The two groups are divided by both ethnicity and religion. The former are Greek and Orthodox; the latter are Turkic and Muslim. The British created colonial councils that overrepresented the Turks.

With the outbreak of WWI, the British revoked the arrangement with the Ottoman Empire (which was allied with Germany and the Austrian Empires) and took full control of the island. They raised taxes to pay for the defense of the island which were resented. Interestingly enough, at the outbreak of the war, Britain offered Cyprus to Greece but the Greek government declined the offer, fearing it would drag neutral Greece into the war.

During this period, the goal of enosis remained. The Greek Cypriots still wanted to join with Greece; needless to say, the Turkish Cypriots were fine with British rule and had no interest in enosis.

The Cypriots were enthusiastic supporters of the allies in World War II, especially after Germans invaded Greece in 1940. The island suffered little physical damage during the war but 30k Cypriots joined the Allied military. Both Anthony Eden, Britain's

foreign secretary, and Winston Churchill, the prime minister, offered vague promises that Cypriot "issues" would be resolved after the war. The Greek Cypriots read these promises to mean enosis; the British had less expansive plans.

After the war, the Greek Cypriots increasingly agitated for enosis. An insurgency developed and the Cypriot leadership petitioned the U.N. for independence. Of course, since the U.K. is a permanent member of the Security Council, the U.N. was not going to be able to make much difference. By 1958, the violence had escalated, not only between the British and the Cypriots but between the Greek and Turkish Cypriots.

In 1960, Britain granted Cyprus independence. The Turkish Cypriots went along because they received strong minority protections in the new constitution. The Greek Cypriots were disappointed that enosis was not achieved but were happy about independence. The British were allowed to keep two military bases on the island.

The Cypriot government became unworkable. The minority rights granted to the Turkish Cypriots were seen by the Greek Cypriots as an impediment to progress. The Turkish Cypriots were fearful of bending the constitution for fear they would end up part of Greece. By 1963, violence between the two groups escalated to the point of civil conflict. The following year, the U.N. sent a peace keeping force to the island, creating a de facto partition. The peacekeeping force remains to this day. During this period, Turkey threatened military action to protect the Turkish Cypriots. Strong action by the Johnson administration prevented a hot war from developing. In 1967, a military junta took control of Greece; this junta was rather belligerent about Cyprus. They supported insurgent groups in Cyprus that wanted to oust the government.

In 1974, a coup ousted long-time Cypriot President (and Archbishop) Makarios III. The officers who established the junta planned to merge Cyprus with Greece. To protect Turkish Cypriots, Turkey invaded the island in 1974, establishing the Turkish Republic of Cyprus on the northern third of the island (note the map below). Turkey is the only nation in the world that recognizes this political entity. The rest of the world views northern Cyprus as occupied. The island remains divided to date.

The history of Cyprus to the mid-1970s can be summarized as follows:

- the majority of the islanders would prefer to either be Greek or be closely aligned;
- because of the misrule of the Ottomans to the inability to co-exist with the Greek Cypriots, Turkey is not well regarded by non-Turkish Cypriots;
- the island has enjoyed only short periods of independence throughout its history and so it tends to rely on outsiders.

Recent History
Because the island is divided, Cyprus has been in a sort of "twilight zone" as a nation. It can't join either Greece or Turkey because significant parts of both populations would oppose the move. In fact, it might just prompt a war between Greece and Turkey as both nations view Cyprus as their territory. Thus, it remains in what seems to be a temporary situation, divided with no clear prospects for unification. When the U.N. inserted peace keeping forces on this island, we doubt they expected them to be in place for nearly half a century.

The island has few natural resources. Tourism is an important industry but the divided nature of the island has tended to dampen that sector. Because of its uncertain political situation (and opposition to Turkey), Cyprus decided to join Europe. It became a member of the EU in 2004 and the Eurozone in 2008 despite concerns that the island should not be allowed into either until the sovereignty issue was resolved. However, Greek pressure to accept Cyprus was strong enough to overcome these objections.

The Background of the Crisis
In the early 1990s, as the Soviet Union began to break apart, fortunes were being made by Russian oligarchs who gained control of former state owned enterprises. Fearful that capricious officials would confiscate their riches, these oligarchs began to look for offshore venues to hold their savings. One country they moved funds to was Cyprus, where there were lax financial rules. As a result, Cyprus became a venue for Russian capital flight.

In the 1990s, it is estimated that €300 bn traversed through the island's banking system. By 2010, bank assets peaked at €170 bn. In January, assets were at a hefty €126 bn, nearly seven times the country's GDP. EU officials worried that Cyprus was becoming a location for money laundering for Russian criminal groups.

The Cyprus economy became dangerously dependent on the financial sector. It represents about 21% of Cyprus's GDP, while retailing (tied to tourism) is 23%. Manufacturing only represents 15%, which means that a banking crisis would seriously weaken the economy.

Cypriot banks, flooded with deposits, were faced with the dilemma of trying to find assets to generate income to pay these depositors. Due to their close ties to Greece, Cypriot banks heavily invested in Greek sovereign bonds. When the Troika forced the private sector to restructure Greek debt in 2012, it impaired Cypriot bank assets. As concerns rose, Cyprus was able to delay insolvency through a €2.5 bn loan from Russia.

The Crisis
Last year, the Troika began talks with Cyprus about its banking system. Both the Troika and Cyprus wanted to recapitalize Cypriot banks without creating a crisis. And, the amounts in question were fairly small—only €15 bn. However, official lenders did not want to fully loan the money, fearing the new debt, though small in absolute terms, would push Cypriot total debt to unsustainable levels. Thus, the Troika wanted to limit the lending to €10 bn. Cyprus would have to come up with the other €5 bn.

Earlier this year, EU officials approached Russian officials to see if they would be willing to buy Bank Popular. If the EU could find a buyer for the bank, the recapitalization would not be a major

problem. However, the Russians had no interest.

As conditions deteriorated, the Troika and Cyprus struggled to find a resolution. Complicating the issue were conflicting goals of Cyprus and the Troika. The former wanted to save its banking system, fearing that if it lost that sector the economy would be doomed to a massive contraction. On the other hand, the Germans, especially Chancellor Merkel who is facing elections in September, did not want to use German taxpayer funds to bail out depositors believed to be Russians of questionable legal standing. Shrinking the Cypriot banking system was another German goal; Merkel feared that outsized financial systems were prone to instability, essentially socializing the risk and privatizing the profits (the U.S. "too big to fail" problem).

The first attempt at a deal was the aforementioned deposit tax. The Troika was not comfortable with this proposal because it taxed small depositors who should have been protected by deposit insurance. But Cyprus did not want large depositors to bear all the cost of the recapitalization, fearing they would flee to other venues, effectively collapsing the Cypriot financial industry.

Small depositors were furious and the Troika was not supportive of this plan. The ECB quietly let the Cypriot government know that it would stop lending to Cypriot banks under its Emergency Lending Program by Monday, March 25. Without this lifeline, Cyprus was doomed.

Cypriot officials scrambled. Cypriot President Nicos Anastasiades tried to sway the Troika to easier terms. At the same time, Finance Minister Michalis Sarris was dispatched to Moscow to see if he could sway Russian support. It appears the Cyprus government was hoping that it could create an alternative bailout scheme to get better terms from the Europeans. Although Russian President Putin derided the Troika bailout plan, Russia had no real interest in bailing out Cyprus. After all, some of that Russian money in Cyprus banks was likely garnered in less than legal fashion; using Russian taxpayer money to bail out "criminals" would be difficult to justify. In addition, Putin would have an incentive to create an element of risk for Russian capital flight by causing issues with its destination.

In the end, a compromise of sorts was reached. As noted above, the largest and most vulnerable bank, Bank Popular, was divided. Deposits under €100 were spared but larger deposits will be used to wind up the "bad" bank. Although media reports suggest that only 40% of these large deposits will be at risk, in reality, that is probably conservative.

Ramifications

There are several important ramifications from this bailout program.

The Cypriot economy is in very serious trouble. The collapse of the banking system will likely lead to years of economic contraction. The lack of a manufacturing base means that tourism may become the island's most important industry. There are potentially massive natural gas reserves offshore, but ownership is in dispute as the Turkish Cypriot Republic also claims these fields and Turkey has threatened to intervene militarily to uphold these claims. Even if these claims can be resolved, it will be years before these assets are developed.

Penalizing depositors to recapitalize banks is a very dangerous precedent. The reason modern banking systems offer deposit insurance is because most households are

unable to determine the safety of banks (my maternal grandfather carried wads of money everywhere because he didn't trust banks—he had taken deposit losses during the Great Depression). When depositors are treated as lenders to a bank, rumors of losses can trigger bank runs, which usually end up harming the insolvent and solvent alike. This occurs because of the inability of normal depositors to evaluate the safety of their bank. To resolve this issue, governments have implemented deposit insurance schemes. This has not been effective in preventing bank insolvencies but it has prevented bank runs. The Cyprus bailout program undermines this faith. The next sovereign crisis in the Eurozone could also include deposit flight; if Italy, for example, develops problems, the example of Cyprus may encourage large depositors to move their funds, creating a bank run. We expect Cyprus to implement capital controls to slow withdrawals. Capital controls will only exacerbate the next crisis.

Up to now, Germany has talked very tough but has always given in at the time of resolution. This is because Germany benefits greatly from the Eurozone. The Eurozone created a free trade zone that allows the more productive German economy to export to its less productive neighbors. If the Eurozone breaks up, Germany will face the problem of a rapidly appreciating currency. For example, the Greek economy probably cannot survive in the Eurozone without a debt restructuring of sovereign holders. Pushing Greece outside the Eurozone would seem to be a reasonable decision compared to recapitalizing the ECB, which may result from a debt restructuring. However, the Merkel government allowed Greece to stay in the Eurozone, at least for now. Germany does not want to create the precedent of a Eurozone exit. In the case of Cyprus, Germany took a very hard line and maintained it. This is probably due to a number of factors. First, Cyprus is small; Germany is probably gambling that there will be no banking contagion. Second, Germany is holding elections in September and, because of how the bailouts have been framed for German voters (hard working Germans bailing out spendthrift southerners), Merkel could risk losing votes if she went easy on Cyprus. Third, Germany likely wants to put an element of uncertainty to other nations teetering on insolvency that terms can be harsh and getting one's house in order is prudent. Accepting help needs to appear to be an unattractive option.

At root, it is unlikely that German policy has changed. Cyprus is being made an example because of its small size. EU officials are taking great pains to characterize Cyprus as an unusual case. However, it is possible that Germany is moving in another direction and is going to take a much harder line on troubled nations going forward. Again, this is probably not the case; such a stance would end the EU project and return Europe to its prewar condition of a Germany too strong for Europe but not strong enough to dominate Europe. More likely, Cyprus is simply an example of what harsh outcomes await monetary "sinners."

Perhaps the most puzzling factor from this crisis was the behavior of Russia. Cyprus would be an attractive asset for the Putin regime. Not only could the island replace Syria as a regional ally, it is probably safer; Syria was always vulnerable to other nations in the region. In addition, the Russians could exploit the natural gas resources. So, why were the Russians reluctant to bail out Cyprus and gain control? It isn't completely clear. We doubt that Putin worried about a U.S. reaction. The Obama administration has been running an "offshore rebalancing"

policy and is allowing other nations to take the lead on regional matters. U.S. officials have been mostly silent on the Cyprus situation. It is possible Russia would rather avoid a direct confrontation with Turkey. Turkey has a modern military and the Russian military is suspect. However, Turkey and Russia have generally favorable relations and it may have been possible to build a workable arrangement. It is also possible that Russia isn't prepared to face down Germany and the EU. Germany is an important trading partner with Russia and harming that relationship over Cyprus probably wasn't worth the effort. It would appear that Cyprus thought it could use Russia as a "stalking horse." That plan, as noted above, went nowhere.

It is still too early to know what "Pandora's box" Germany and the Troika have opened by hitting depositors. That won't be known until the next crisis hits. But the chances that a bank run develops are higher than it was before Cyprus; it may turn out that the unwillingness to funnel €15 bn to Cyprus was penny wise, pound foolish.

In terms of markets, the euro will likely remain under pressure as Eurozone depositors look for safe places to keep cash. This should also support U.S. Treasuries. In fact, U.S. financial assets may benefit from this new level of uncertainty.

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