The View from Europe
By David Jessop

Cyprus, debt and the Caribbean

In the last few days the Government of Cyprus has begun to implement the measures demanded of it by the European Union, the European Central Bank and the International Monetary Fund (IMF).

In return for providing €10 billion (US$13 billion) in support, a sum small by international standards, Europe has taken steps down a route that may set a precedent for Slovenia and others in the Eurozone such as Italy and Spain, if they are unable to resolve their long term economic problems.

The accord requires the Cypriot Government to take around 40 per cent of depositors' holdings from anyone with over €100,000 (US$128,000) in the two largest Cypriot banks. It will also break up the Cyprus Popular Bank, the island's second largest, and has resulted for the first time in countries using the Euro in severe restrictions being placed on withdrawals, transfers and the use of credit cards.

The message emerging, as this is being written, is that there will be a new order of priority of who has to bail out European banks and by extension EU nations in any future financial crisis. Oversimplified, it is firstly stock holders in troubled institutions, secondly holders of bonds, and thirdly depositors in troubled banks. Put another way, in future it will not be the European taxpayer who will suffer: it will be those with stocks, bonds or large deposits in troubled European banks who will effectively be funding the bailout of another EU state.

Although European politicians have denied the universal applicability of this approach now being taken in Cyprus, it is a theme that has run through recent European discussions in the drafting of new European laws on banking and reflects a much tougher approach to debt by the Board of the IMF.

Europe, as is now well known, rowed back from its initial politically destabilising and possibly insurrection-inducing proposal to seize money from all Cypriot bank account holders, a proposal that set aside the EU's deposit guarantee scheme which repays up to €0.1m in any failed bank. Instead, it has now imposed an approach that will have the effect of wiping out the operating capital of many small businesses in Cyprus, while receiving a tax on what little part may be left of the dubious money that flowed into the country from Russia, to make use of Cyprus' lightly regulated offshore tax status within the Eurozone.

In this latter respect, Cyprus' situation is argued to have been unique. Russian funds made up the vast majority of deposits in Cypriot Banks and were there, at best, to avoid tax or the coercive business practices in that country or, at worst, to launder the proceeds of politically-protected Russian organised crime. According to ratings agencies such funds were estimated to be around US$31billion, dwarfing the Cypriot economy, although since the crisis began, reports suggest a significant part of this money has managed to find exit routes from Cyprus even while the banks have been closed.

The Caribbean is of course not Cyprus, but there are worrying signs that the indebtedness of an increasing number of Caribbean nations is now reaching crisis proportions; albeit, it is important to stress this, without any suggestion of draconian solutions of the kind now being imposed in Europe.

As has been widely reported the US credit rating agency, Moody's Investor Services has warned that Grenada's default on its US and Eastern Caribbean dollar bonds has heightened the risk of its distress touching other member countries in the Eastern Caribbean Currency Union (ECCU).

Grenada's default, according to the agency, has 'systemic implications for the ECCU through two channels – financial and institutional'. It warned too that the island's default will elevate short-term financing costs for other countries that issue EC dollar denominated bonds and treasury bills on the ECCU's Regional Government Securities Market.

At the same time the World Bank has suspended disbursements to Grenada after defaults in February. Taiwan too continues to press US courts to enforce a 2007 judgement against Grenada to repay US$32m that is owed.

To put this in a broader perspective, it is part of a worrying picture emerging in the Eastern Caribbean. St Kitts-Nevis defaulted on its debt in 2011. Antigua restructured its debt in 2010 subsequently reaching loan arrangements with the IMF with embedded conditionality and structural reform requirements. Beyond this all six ECCU members, which also include St Vincent, St Lucia and Dominica, rely on emergency IMF credit facilities to finance reconstruction. Despite this, and worryingly, Government debt in the ECCU averaged 94 per cent of GDP last year, putting it as Moody's stated 'on par with distressed Euro area sovereigns'.

Views in the region differ, however, as to the systemic dangers of Eastern Caribbean indebtedness and on regional indebtedness more generally. Some experts suggest in private an impending major crisis because of the interconnected nature of regional and sub-regional institutions with Governments, while others suggest that sovereign debt issues can be contained within the nations concerned.

Notwithstanding, there are general messages for the Caribbean in what is happening in Europe.

The first is that those institutions and nations providing support will become more closely engaged in ensuring the rigour of application of the future economic policies of the countries concerned. This is not just because they are seeking orthodoxy but because they recognise that if future defaults occur, their political capital is at risk with their own voters who are fast losing patience with any country engaging in special pleading or not able to manage its own finances. This view now prevails in the multilateral institutions and bodies such as the G20.

The second is that there can be a danger if governments turn to non-traditional sources for financing or to new ways to stimulate economic growth. In Cyprus' case it was to seek Russian money. In the Caribbean's, it may be to loans or short term measures that have uncertain geo-political implications or in the selling of economic citizenship; schemes that carry with them long-term reputational risk that may come to haunt the citizens of the nation concerned.

And thirdly, solutions involving multilateral institutions will now undoubtedly result in the imposition of the new IMF orthodoxy. This arises out of pressure from both developed and the advanced developing nation members of its Board to reduce risk and introduce globally consistent solutions in any future bail outs that may occur.

David Jessop is the Director of the Caribbean Council and can be contacted at
david.jessop@caribbean-council.org
Previous columns can be found at www.caribbean-council.org
March 28th, 2013