Cyprus poses danger for euro zone stability

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Leading European Union (EU) officials have issued warnings over the threat posed by the financial crisis gripping Cyprus for the euro zone as a whole.

Amid long-running discussions over the terms of a bailout for the island, Klaus Regling, the head of the European Stability Mechanism (ESM), the EU's bailout fund, told *Le Figaro*, "We require a rapid decision" over a support package for Nicosia. Cyprus was "system-relevant", he said, and could trigger a renewed outbreak of the euro crisis.

Regling spoke just prior to Sunday's presidential election, which saw the conservative right-wing candidate Nikos Anastasiades defeat Stavros Malas who was supported by the AKEL (Progressive Workers Party) of outgoing President Demetris Kristofias.

Kristofias's popularity had steadily declined due to his implementation of austerity measures that have seen a deepening economic slowdown and rising unemployment, and his alleged failure to deal with an explosion at a military base in 2011 that killed 13 people and destroyed much of the country's power infrastructure. Anastasiades won 57.5 percent of the vote.

The cost of a bailout is expected to be around €17 billion (US$22 billion), almost equivalent to the country's GDP—a sum made all the more staggering by the fact that the island has a population of just over 1 million. But the assets controlled by Cypriot banks are much greater, approaching 10 times that of annual output.

Without an agreement in the next few weeks, Cyprus faces state bankruptcy. Reports suggest that by the end of March the government will run out of money. On June 3, a four-year government bond is due to be repaid totalling €1.4 billion—8 percent of GDP. Credit rating agency Standard & Poor's has stated that Cyprus faces a "material and rising risk" of default.

An economic collapse is exacerbating the situation. Last Friday, the EU downgraded its expectations for the Cypriot economy in 2013, stating that instead of contracting by 1.7 percent, it would shrink by 3.5 percent. Unemployment has risen to more than 14 percent.

Concerns over the broader impact on the euro zone are being driven by the deteriorating economic outlook across the continent. Economic output in the euro zone is set to contract again this year, and predictions suggest it will grow only marginally in 2014. The instability on international finance markets means that a default or even a debt restructuring in Cyprus could trigger a renewed global financial crisis.

The bailout being discussed in the EU will impose the full burden of the crisis on working people. Although €10 billion of the estimated €17 billion is required by the banks, it will be added to the balance sheet of the government since no agreement has yet been reached on whether direct recapitalisation of banks can take place. This would see public debt increase to 140 percent of GDP, which is widely seen as unsustainable.

Jörg Asmussen, one of Germany's board members on the European Central Bank (ECB), insisted that a bailout programme would only be agreed under strict conditions. "In order to ensure debt sustainability, we will need to have far-reaching privatisation", Asmussen commented.

Anastasiades is committed to implementing such measures. In January, he received the backing of German Chancellor Angela Merkel during a visit to Cyprus. He has proposed cutting wages in the public sector and implementing pension reforms as part of broader austerity measures. After his victory was confirmed on Sunday evening, he stated on national television that Cyprus would "work together as quickly as possible with its European colleagues" to finalise terms for the bailout.

Cyprus initially applied for aid from the EU, ECB

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and International Monetary Fund last June. The delay in agreeing final terms on a bailout package is in large part due to geopolitical considerations. Cyprus has become in recent years a base for a significant number of Russian-owned businesses that have taken advantage of low corporation tax rates of 10 percent. Over €22 billion in bank deposits from Russian account holders are located in Cypriot banks and Cyprus is one of the largest sources of Foreign Direct Investment (FDI) for Russia.

EU politicians have accused Cyprus of being a base for money-laundering and irregular financial activities. They have pushed Nicosia to permit an “independent” investigation into its finance sector, which would be aimed at increasing the EU’s presence in an area where Russian banks and firms have been expanding their influence.

EU officials have made clear their intent to make Russia assume some of the burden of a bailout for Nicosia, and are working to prevent an EU support programme strengthening the position of Russian investors on the island. One proposal being circulated would see the amount of bailout money from the EU reduced while investors with large deposits in Cypriot banks would be forced to make a contribution to the bailout costs.

This would in practice mainly impact Russian investors. But concerns have nonetheless been raised that establishing a precedent that sees investors contributing to the bailout of banks could set off panic in other “peripheral” economies, with the potential to provoke an exit of capital and a bank run. As a leaked EU Commission document containing the proposal warned, “The risks associated with this option are significant.”

A further possibility would see corporation tax increased to 12.5 percent, and the period of repayments for a €2.5 billion loan that Cyprus received from Russia in 2011 lengthened.

There are other powerful economic considerations behind the attempts by the EU to strengthen its position in Cyprus at Russia’s expense. The discovery of natural gas reserves off the coast at the end of 2011 by US drilling firm Noble Energy has opened up the prospect of lucrative investment opportunities. The area explored, which is only a portion of the seabed that Cyprus is claiming as its territorial water, has been estimated at between 140 billion and 240 billion cubic metres.

In the run-up to the presidential election, the outgoing government agreed new drilling contracts with French firm Total and a consortium including Italy’s Eni. Noble Energy is due to report the results of its second stage of drilling in October, at which point it is expected to be able to give a more accurate evaluation of the quality and quantity of gas supplies in the region.

In the bailout discussions, Eurogroup chair and Dutch finance minister, Jeroen Dijsselbloem, indicated that a possible deal could be agreed that would include provisions that a portion of future revenues would be paid in to a special account to repay the bailout loans.

Another means by which the position of European firms could be strengthened will be through privatisations that will be part of any bailout. At present, the management of Cyprus’s potential oil and gas resources within its exclusive economic zone is conducted by a government funded entity.

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