The Political Economy Aspects of the Cyprus Bail-in Plan: Challenges for EU Financial Crisis Management[1]

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Abstract

The paper examines the political economy aspects of the bail-in plan during the Cyprus economic crisis and its implications for the EU financial crisis management framework. The analysis explores the interplay between macroeconomic conditions and political dynamics, focusing on the bail-in plan's implementation as part of the Economic Adjustment Programme of the years 2013–2016. Methodologically, the analysis draws on a political economy framework, combining insights from both orthodox and heterodox perspectives. The research findings show that the bail-in plan embodies a neoclassical rationale, emphasising individual responsibility and moral hazard concerns. In terms of applied policy, the Cyprus bail-in plan marks a paradigm shift in crisis resolution strategies, challenging conventional EU bailout policies.

Keywords: Cyprus economic crisis; bail-in plan; economic adjustment programme, political economy; moral hazard

Introduction

The 2004 accession of the Republic of Cyprus (Cyprus) to the European Union (EU) had a positive impact on the Cypriot economy and advanced its financial sector. However, the 2007 global financial crisis (GFC) and its international and European fallout, along with local political changes, shook the stability of the country's economic trajectory. In the period 2008–2016, the Cypriot economy faced a serious financial crisis. The Cyprus economic crisis (CEC) began in 2008, a year of significant policy changes due to Cyprus' entry into the Eurozone and the political shift with the rise of AKEL in government; 2008 was also the last year of fiscal surplus and public debt

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reduction. In 2009, the Cypriot economy experienced its first negative GDP growth in a period of 35 years.[4] The Cypriot Economic Adjustment Programme (EAP)[5] was implemented on Troika's conditionalities between 2013 and 2016.[6] In essence, the EAP was a bailout programme which, in the case of the Cypriot economy, could be much more accurately described as a bail-in plan. The Cypriot economy exited the EAP in March 2016.

Was the Cypriot bail-in plan an unbiased economic policy in European macroeconomic financial crisis management, implemented with the objective to stabilise the banking sector and restore financial confidence? Or, was it a politically and ideologically burdened decision with broader political economy implications? To respond to these research inquiries, this analysis explores the political economy aspects of the bail-in plan implemented in Cyprus. We examine the macroeconomic conditions and political dynamics surrounding the CEC, focusing on the implementation of the bail-in plan as part of the broader EAP.

The Cypriot bail-in plan challenged the conventional rescue policies of the Troika, bringing neoclassical rhetoric and policy into European macroeconomic financial crisis management. In this context, the bail-in plan is an example of financial crisis resolution based on an individualistic perspective, with the aim to financially punish individual depositors and shareholders by shifting macroeconomic and financial responsibilities to them. The plan reflects the principles of individual responsibility of creditor countries and private depositors and stakeholders, blaming them for their predicaments, and aiming to avoid moral hazard and further reckless behaviour.[7] Thus, it is important to assess the plan as a paradigm shift that transformed the European framework of macroeconomic financial crisis management.

Methodologically, the paper draws on a specific political economy framework, combining macroeconomics and politics, to provide a thorough analysis of the bail-in plan. In tackling this subject, we have striven to sidestep personal ideological preju-

4 Monica Iulia Oehler-Sincai, 'Financial Contagion Reloaded: The Case of Cyprus' (2013), available at https://mpra.ub.uni-muenchen.de/48214/ (last accessed 13.03.2025) 48214 7.

5 European Commission, *The Economic Adjustment Programme for Cyprus* (2013), available at https://ec.europa.eu/economy_finance/publications/occasional_paper/2013/pdf/ocp149_en.pdf (last accessed 13.03.2025).

6 The term 'Troika' refers to a group consisting of three international organisations: the European Commission (EC), the European Central Bank (ECB), and the International Monetary Fund (IMF).

7 Paul De Grauwe, 'The New Bail-in Doctrine: A Recipe for Banking Crises and Depression in the Eurozone', *Centre for European Policy Studies* (2013), available at http://aei.pitt.edu/41609/ (last accessed 10.03.2025) 1, 3.

dices and dogmatism. Our approach does not adhere strictly to the analytical framework of a single orthodox or heterodox school of thought. The research arguably follows an eclectic analytical framework in terms of the selected literature, which draws from both orthodox and heterodox schools of thought. Our research effort empowers the examination of the political economy aspects of the Cyprus bail-in plan, from which students and scholars from various academic fields such as politics, economics and finance could benefit. Finally, the political economy analysis presented here includes theoretical critique and policy recommendations.

The literature on the CEC and the bail-in plan explores theoretical underpinnings, systemic risks, policy responses, and socio-economic impacts. The introduction of the bail-in principle in Cyprus marked a pivotal shift in European financial governance, laying the groundwork for the EU's banking union framework. Proponents highlighted the bail-in's ability to reduce taxpayer burden by holding stakeholders accountable for bank solvency, but critics underscored its selective application and systemic risks, as well as its resulting erosion of trust in financial stability and European solidarity. Alexander[8] identified legal ambiguities and market risks in the bail-in framework, while Avgouleas and Goodhart[9] highlighted its limited effectiveness in regions like Cyprus that have a high number of non-performing loans (NPLs). Clerides[10] and Orphanides[11] traced the crisis to post-Euro regulatory failures and delayed reforms, and Pashourtidou and Savva[12] quantified its adverse macroeconomic effects. Christou,

[8] Kern Alexander, 'Bail-in: A Regulatory Critique', *Butterworths Journal of International Banking and Financial Law* (2017) 31(1), available at https://doi.org/10.5167/uzh-149193 (last accessed 05.02.2025), 28–29.

[9] Emilios Avgouleas and Charles Goodhart, 'An Anatomy of Bank Bail-Ins – Why the Eurozone Needs a Fiscal Backstop for the Banking Sector' (2016) 2 *European Economy – Banks, Regulation, and the Real Sector* 75 available at https://european-economy.eu/leading-articles/an-anatomy-of-bank-bail-ins-why-the-eurozone-needs-a-fiscal-backstop-for-the-banking-sector/ (last accessed 10.03.2025).

[10] Sofronis Clerides, 'The Collapse of the Cypriot Banking System : A Bird's Eye View' (2014) 8 *Cyprus Economic Policy Review*, available at https://www.econstor.eu/bitstream/10419/97787/1/IMFS_WP_79.pdf (last accessed 10.03.2025) 3.

[11] Athanasios Orphanides, 'What Happened in Cyprus? The Economic Consequences of the Last Communist Government in Europe' (2014) 79 *IMFS Working Paper Series*, Institute for Monetary and Financial Stability, Goethe University, available at https://www.econstor.eu/bitstream/10419/97787/1/IMFS_WP_79.pdf (last accessed 10.03.2025).

[12] Nicoletta Pashourtidou & Christos S Savva, 'Effects of Bail-in on Macroeconomic Indicators : The Case of Cyprus' (2013), available at https://www.ucy.ac.cy/erc2/wp-content/uploads/sites/125/2023/08/DOP_09_2013.pdf (last accessed 10.03.2025).

Ioannou & Shekeris[13] noted the EAP's fiscal achievements, but emphasised persistent recession and unresolved banking risks, while Hardouvelis[14] and Theophanous[15] advocated for diversified growth models and structural reforms to ensure long-term recovery.

From a political economy perspective, Lütz, Hilgers & Schneider[16] explored how Cyprus leveraged Troika commitments to enforce domestic reforms, while Katsourides[17] and Karatsioli[18] examined shifts in political attitudes and identities during the crisis. Charalambous[19] investigated changes in political trust, participation, and party dynamics, linking them to broader societal transformations. In the international sphere, Aspriadis, Papaioannou, and Samaras[20] analysed how German political discourse shaped Cyprus' post-crisis image, reframing it from a victim of Turkish imperialism to an abuser of the Eurozone, using rhetoric, blame-shifting, and strategic communication. Comparative analyses provide additional insights. Papadimitriou and Pegasiou[21] contrasted Cyprus' adjustment programme with Ireland's, highlighting negotiation dynamics and policy learning, while Philippon and Salord[22] reviewed

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13 Odysseas Christou, Christina Ioannou & Anthos I Shekeris, 'Social Cohesion and the State in Times of Austerity, Cyprus' (2013), available at https://opendata.uni-halle.de/bitstream/1981185920/109966/31/787602582.pdf (last accessed 18.02.2025) 2.

14 Gikas A Hardouvelis, 'Overcoming the Crisis in Cyprus', *Cyprus: Five years in the Eurozone* (Eurobank Research 2014) available at https://www.eurobank.gr/Uploads/Reports/20January2014Q.pdf (last accessed 05.03.2025).

15 Andreas Theophanous, 'Cyprus in Search of a New Economic Paradigm' (2018) 30 *Cyprus Review* 213.

16 Susanne Lütz, Sven Hilgers & Sebastian Schneider, 'Games Borrower Governments Play: The Implementation of Economic Adjustment Programmes in Cyprus and Portugal' (2019) 42 *West European Politics*, available at https://doi.org/10.1080/01402382.2019.1583482 (last accessed 13.03.2025) 1.

17 Yiannos Katsourides, "Circumstantial and Utilitarian Euroscepticism: Bailed-in Cyprus during and after the Eurozone Crisis' *South European Society and Politics* (2020) available at https://doi.org/10.1080/13608746.2020.1776480 (last accessed 05.03.2025) 1.

18 Barbara Karatsioli, 'Cyprus in Europe: (In)-Dependence and In-Debtedness' (2014) 26 *Cyprus Review* 15.

19 Giorgos Charalambous, *Political Culture and Behaviour in the Republic of Cyprus during the Crisis.* (Peace Research Institute Oslo (PRIO) 2014).

20 Neofytos Aspriadis, Aristeidis Papaioannou & Athanassios N Samaras, 'Games of (de)Legitimization and Images of Collective Subjects at the Management of a Financial Crisis: The Cyprus Memorandum in the German Political Discourse' (2017) 29(1) *Cyprus Review* 19.

21 Dimitris Papadimitriou & Adonis Pegasiou, 'From Bail-out to Bail-in: Explaining the Variegated Responses to the International Financial Aid Requests of Ireland and Cyprus' *New Political Economy* (2023) 28 available at https://doi.org/10.1080/13563467.2023.2215706 (last accessed 12.03.2025), 971.

22 Thomas Philippon & Aude Salord, 'Bail-Ins and Bank Resolution in Europe: A Progress Report' (2017) available at https://cepr.org/system/files/publication-files/60176-geneva_special_4_bail_ins_and_

the implementation of the European banking resolution framework, citing Cyprus as a case of successful bail-in application despite lingering challenges like high NPLs. Floyd[23] integrated economic crises into securitisation theory, using Cyprus to explore the intersection of security and economic governance. The 2013 crisis also forced Cyprus to reassess its economic model. Theodore and Theodore[24], as well as Apostolides, highlighted the socio-economic consequences of the crisis, while Sapir et al.[25] stressed the importance of structural reforms and financial stability for recovery. The analysis of this paper is further supported by the original documents of the Memorandum of Understanding (Law N. 4173: Financial Support Facility Agreement)[26], the Economic Adjustment Programme for Cyprus[27], and the Cyprus Memorandum of Economic and Financial Policies and Technical Memorandum of Understanding.[28]

The structure of the paper is as follows: Section 2 presents the macroeconomic fundamentals and political developments in Cyprus from its entry to the Eurozone and the 2007 GFC to the formulation of the EAP in 2013. Section 3 analyses the EAP, focusing on the bailout programme's bail-in plan. Section 4 explores the political economy underpinnings of the bail-in plan. Section 5 concludes with the overall key remarks of the study.

The Macroeconomics and Politics of the Cyprus Economic Crisis

Cyprus joined the Eurozone in 2008, which was the same year the Eurozone found itself at the centre of the GFC.[29] With the outbreak of the GFC in 2007, which was trig-

bank_resolution_in_europe.pdf (last accessed 10.03.2025).

23 Rita Floyd, 'Evidence of Securitisation in the Economic Sector of Security in Europe? Russia's Economic Blackmail of Ukraine and the EU's Conditional Bailout of Cyprus' (2019) 28 *European Security*, available at https://doi.org/10.1080/09662839.2019.1604509 (last accessed 10.03.2025) 173.

24 John Theodore & Jonathan Theodore, *Cyprus and the Financial Crisis: The Controversial Bailout and What It Means for the Eurozone* (London: Palgrave Macmillan, 2016).

25 André Sapir & al., 'The Troika and financial assistance in the euro area: successes and failures' (2014) *Directorate General for Internal Policies Economic Governance Support Unit (Egov)* available at https://www.bruegel.org/sites/default/files/wp-content/uploads/imported/publications/20140219AT-T79633EN_01.pdf (last accessed 13.03.2025), 1.

26 Official Gazette of the Cypriot Government, Law N. 4173 Financial Support Facility Agreement 2013 available at https://www.cylaw.org/nomoi/arith/2013_3_001.pdf (last accessed 10.03.2025), 1.

27 European Commission (no 5).

28 IMF, 'Cyprus' Memorandum of Economic and Financial Policies and Technical Memoranum of Understanding' (2013), available at https://www.imf.org/external/np/loi/2013/cyp/082913.pdf> (last accesed 10.12. 2024).

29 Karatsioli (no 18) 15, 23.

gered by the subprime crisis of the United States and transmitted to Europe, the pace of economic growth and the direction of economic policy in Cyprus changed. Thus, the collapse of the Cypriot banking system and subsequent economic downturn must be seen in the light of the GFC and the macroeconomic and political environment in the Eurozone during this period.

In macroeconomic terms, since 2007, Cyprus' primary fiscal surplus started to decline and turned to primary deficit in the following years. This had a negative impact on general government debt as a percentage of GDP. The share of investment in GDP fell sharply, undermining future living standards by forcing resources to be diverted towards consumption instead of investment in construction, machinery, and equipment.[30]

Table 1 presents key macroeconomic figures for Cyprus, covering the period from the country's accession to the EU in 2004 to 2013, the year in which the Cypriot Parliament ratified the EAP. This timeframe is critical as it encompasses Cyprus' accession to the EU and a period of steady economic growth. However, this growth was marked by the accumulation of significant internal and external imbalances that ultimately led to financial turmoil.[31] Persistent fiscal deficits increased public debt from 45.1% of GDP in 2008 to 79.7% by the end of 2012. Tax revenue decreased from 44.8% of GDP in 2007 to 40% in 2012 and total government expenditure increased from 41.3% of GDP in 2007 to 46.3% of GDP in 2012. Coupled with key macroeconomic measures, the sum of public sector wages and total social transfers reached 30.9% of GDP in 2012, in contrast to 26.8% of GDP in 2008, exposing a loose fiscal policy.

Table 1. Cyprus Macroeconomics 2004–2013

Year	Real GDP Growth (%)	Fiscal Balance (% of GDP)	Public Debt (% of GDP)	Tax Revenue (% of GDP)	Total Government Expenditure (% of GDP)	Public Sector Wages (% of GDP)	Total Social Transfers (% of GDP)
2004	5	-3.7	64.7	38.3	42.4	15.0	12.2
2005	4.9	-2.2	62.8	40.7	43.1	14.9	12.9
2006	4.7	-1.0	58.7	41.4	42.6	14.9	12.4

[30] Hardouvelis (no 14) 4–5.

[31] Tasos Anastassatos, Ioannis Gkionis & Platon Monokrousos, 'Cyprus at a Turning Point' (2013) 8 *Eurobank Ergasias S.A.* 1 available at https://www.eurobank.gr/Uploads/Reports/EconomyMarketsJuly13.pdf (last accessed 10.03.2025), 2–3; Hardouvelis (no 14) 2.

2007	5.1	3.2	53.5	44.8	41.3	14.6	11.7
2008	3.6	0.9	45.1	43.1	42.1	14.6	12.2
2009	-2	-5.4	53.8	40.1	46.2	16.2	13.5
2010	2.6	-4.7	56.3	40.9	46.2	15.8	14.4
2011	0.4	-5.7	65.7	39.7	46.0	16.0	14.6
2012	-3.4	-5.6	79.7	40.0	46.3	15.8	15.1
2013	-6.6	-5.1	102.6	38.3	42.4	15.0	12.2

Source: Table constructed by the authors with data from the IMF, The World Bank, and the Cypriot Statistical Service.

The years 2011 and 2012 were critical for the CEC mainly due to the turmoil in the international financial markets combined with the financial developments in the Greek economy. Let us explain it chronologically. In May 2011, market confidence in Cyprus declined and Fitch[32] issued its first downgrade of the country, signalling the deepening of the crisis.[33] The international financial markets became risk averse for the Cypriot economy. Up to September 2011, the Cypriot economy's access to the international bond market had been practically prohibited.[34] The Eurozone Summit held in Brussels in October 2011 resulted in a cut to the nominal value of Greek bonds by 50%, which entailed huge losses for the Cypriot banking sector as it was highly exposed to Greek debt. In fact, the Greek fiscal crisis was transmitted to Cyprus through the channel of Greek bonds. At the same time, the debate about the exit of the Greek economy from the Eurozone (Grexit) stretched the Member States in the European periphery. As a result, bank lending from the Eurozone, including emergency liquidity assistance (ELA) increased sharply. Essentially, the CEC was triggered by the Greek crisis as 45% of the total assets of Cypriot banks were linked to Greek banks. The impact of the Greek crisis on the Cypriot banking system was manifested in loans to the Greek private sector and investments in Greek government bonds.[35]

[32] Fitch Ratings is a global credit rating agency assessing the creditworthiness of entities such as corporations, sovereign nations, and financial products.

[33] Kate Phylaktis, 'The Cyprus Debacle: Implications for the European Banking Union' (2016) *European Banking Union: Prospects and Challenges* 1, 3.

[34] Oehler-Sincai (no 4) 4–5.

[35] Mathieu Pigasse, *In Praise of Abnormality (in Greek)* (Stereoma Publications, 2015) 36; Vassilis T Rapanos & Georgia Kaplanoglou, 'Governance, Growth and the Recent Economic Crisis: The Case of Greece and Cyprus' (2014) 8 *Cyprus Economic Policy Review* available at https://www.ucy.ac.cy/erc2/wp-content/uploads/sites/125/2023/08/CyEPR_Vol8_No1_A1_06_2014.pdf (last accessed 10.02.2025) 3, 8.

In April 2012, the private sector involvement (PSI) mechanism for Greece implemented a 53.5% reduction in the nominal value of Greek government bonds held by private investors. These investors participated in the debt restructuring process at a rate of 96.9%, with bonds valued at €199 billion. The debt restructuring involved exchanging these bonds for new Greek government-issued bonds, PSI payment notes from the European Financial Stability Facility (EFSF), detachable GDP-linked securities from the Greek government, and PSI accrued interest notes.[36] This turn of events proved catastrophic for both the banking sector and the broader economy, yet the Cypriot political system dismissed early warnings from credit agencies regarding a potential downgrade.[37] Indeed, the two major banks in Cyprus, Bank of Cyprus and Laiki Bank, had invested an amount equivalent to almost their entire capital, approximately one third of the country's GDP, in Greek government bonds. When the PSI agreement was signed, these banks incurred losses of around 80% on their bond holdings, or a loss of about €4.5 billion, which essentially wiped out their capital base.[38]

In this context, the spreads calculated from the yields of Cyprus' 10-year government bonds increased in comparison to those of Germany and hindered access to the international capital markets.[39] In response, fiscal authorities in Cyprus sought alternative sources of funding, for example, a €2.5 billion loan from the Russian Federation.[40] In May 2012, the Cypriot Parliament approved the allocation of €1.8 billion for the recapitalisation of Laiki Bank, compelled by the bank's failure to secure sufficient capital from the market, to prevent its bankruptcy and the subsequent State obligation to cover over €7 billion in insured deposits. The eventual resolution of Laiki Bank highlighted its insolvency, a situation that was ostensibly recognised by the authorities despite the bank continuing to receive ELA funding.[41] During that

[36] Bank of Greece, *Report on the Recapitalisation and Restructuring on the Greek Banking Sector* (2012), available at https://www.bankofgreece.gr/Publications/Report_on_the_recapitalisation_and_restructuring.pdf (last accessed 12.02.2025), 12.

[37] Panicos Demetriades, *A Diary of the Euro Crisis in Cyprus* (Cham, Switzerland: Palgrave Macmillan, 2017) 3.

[38] Theophanous (no 15) 219.

[39] Germany's 10-year government bonds serve as a benchmark for Eurozone sovereign debt due to their low-risk status and strong credit rating. As a result, the spread between Cyprus' bond yields and Germany's reflects investor confidence and the perceived credit risk of Cyprus in comparison to a stable reference point.

[40] Hardouvelis (no 14) 6.

[41] Stavros Zenios, 'Self-Fulfilling Prophecies in the Cyprus Crisis: ELA, PIMKO and Delays', in Alexander Michaelides and Athanasios Orphanides (eds), *The Cyprus Bail-in, Policy Lessons from the Cyprus Eco-*

time, worries about a potential Grexit reached their zenith, casting Cyprus as another frontrunner for a possible exit from the Eurozone. From July to December 2012, during its EU Presidency, Cyprus encountered severe obstacles in accessing international borrowing markets, highlighting the urgent need for substantial steps to stabilise its economy.[42]

By the end of 2012, total bank assets reached 640% of GDP, twice the Eurozone average, and had previously peaked at over 800% of GDP in 2010. Despite similar fiscal and competitiveness deficits and like other crisis-hit economies, Cyprus' predicament was primarily a banking crisis. The country saw a remarkable expansion of the real estate bubble, especially between 2006 and 2008. However, the onset of the GFC burst this bubble, adversely affecting the economic landscape and triggering a serious banking crisis.[43] This susceptibility in the financial sector escalated into a systemic risk with the dual impact of the GFC and the Greek PSI.[44] The Cypriot banking sector's downturn not only caused significant losses to bank balance sheets but also precipitated a rapid deterioration in public finances. In response to these financial challenges, Cyprus applied for financial assistance from the Troika in June 2012—the same day Fitch announced its downgrade.[45]

Turning to politics, the presidential elections held in February 2008 were the first after the country's accession to the EU and the rejection of the Annan Plan.[46] For the first time in its history, AKEL, the communist party, chose to present its own presidential candidate. This decision eventually led to the election of Demetris Christofias—the first communist President in an EU Member State. In line with his campaign promises, the new President and his government consistently increased social transfers, wasting public funds and relying excessively on short-term borrowing. Additionally, the country demonstrated excessive financial solidarity towards Greece by acquiring a disproportionate amount of Greek government bonds, a move that was not aligned with its national financial interests. This action, coupled with a notable

nomic Crisis (London: Imperial College Press, 2016) 11–13.

42 Hardouvelis (no 14) 6–7.

43 Clerides (no 10) 4–5.

44 Gikas A Hardouvelis and Ioannis Gkionis, 'A Decade Long Economic Crisis: Cyprus versus Greece' (2016) 10 *Cyprus Economic Policy Review* 3, 12–13.

45 Pashourtidou and Savva (no 12) 9.

46 The Annan Plan was a 2004 UN proposal to reunite Cyprus that was put to referendum in both communities. It secured Turkish Cypriot approval but failed due to Greek Cypriot rejection.

delay in seeking international financial assistance, further complicated its financial situation.[47]

When the country asked for a bailout agreement in June 2012, the Troika harboured doubts about the Cypriot political system's ability to effectively manage an adjustment programme. The Cypriot government was criticised for its lack of recognition of the severity of the economic downturn, engaging in rampant public expenditure, relying heavily on short-term borrowing, and experiencing significant delays in negotiating a bailout deal.[48] Additionally, the politico-economic image of Cyprus across the EU, particularly in terms of German public opinion, was marred by perceptions of a fundamentally flawed political system that mishandled the crisis and facilitated money-laundering activities.[49] The Troika designed a Cypriot EAP aimed at 'frontloaded banking sector restructuring', 'a frontloaded and expenditure-based fiscal adjustment', and 'front-loaded fiscal consolidation measures',[50] to guarantee the swift and effective implementation of the reforms. This strategy, characterised by immediate fiscal consolidation and structural reforms, was deemed a fitting neoclassical remedy for the enduring economic imbalances plaguing Cyprus. Consequently, the possibility of adopting an alternative strategy focused on growth, driven by an interventionist state fiscal policy, was deemed untenable.[51]

The then Eurogroup President, Jeroen Dijsselbloem, said of Christofias: '[W]e had no intention to conclude an agreement with a President which would be replaced in a while'.[52] In the 2013 presidential elections, the Troika pressed for a bailout agreement, previously requested by the Cypriot government, but the Eurogroup strategically delayed action until the presidential elections of February of that year that would usher in a new administration. By dismissing the possibility of further negotiations with the AKEL government, the Eurogroup exacerbated the situation.[53]

The 2013 presidential elections marked the first time in history where the economic crisis overshadowed the longstanding discussions on the Cyprus problem.

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[47] A Apostolides, 'Beware of German Gifts near Elections: How Cyprus Got Here and Why It Is Currently More out than in the Eurozone' (2013) 8(3) *Capital Markets Law Journal* 300–318, 314.

[48] ibid; Sapir & al. (no 25) 50.

[49] Aspriadis, Papaioannou & Samaras (no 20) 19, 36; Sofia Iordanidou & Athanassios N Samaras, 'Financial Crisis in the Cyprus Republic' (2014) 21 *Javnost* 63, 71.

[50] European Commission (no 5).

[51] Andreas Charalambous, 'The Cyprus Adjustment Programme – Necessity or Wrong Medicine' (2015) 9 *Cyprus Economic Policy Review* 21, 32.

[52] Jeroen Dijsselbloem, *The Euro Crisis* (Kerkyra-Economia Publishing, 2018) 104.

[53] Pigasse (no 35) 42.

Each presidential candidate focused on their strategies to address and resolve the financial crisis.[54] Eventually, Nicos Anastasiades, representing the centre-right (DISY) party, secured victory in the presidential elections' second round. Shortly after, in March 2013, his government secured a bailout agreement during the Eurogroup meeting, which notably introduced the controversial bail-in plan. In imposing this bail-in plan, the ECB starkly warned that the ELA facility for Laiki Bank would cease on 25 March 2013, precipitating the bank's collapse, which would force Cyprus to compensate all insured depositors, risking State default. However, on 13 March, the Cypriot House of Representatives dismissed the initial bailout plan, facing the inevitable withdrawal of ELA for Laiki Bank. Following this parliamentary rejection of all proposed versions of the levy on 19 March, the escalating financial pressures on Laiki Bank, alongside the anticipated withdrawal of ELA funds, Cyprus was forced to prioritise the adoption of bank resolution procedures and inevitable capital controls. Subsequently, on 25 March 2013, an agreement was reached on a rescue programme aimed at averting the imminent threat of sovereign default.[55]

Even after the presidential change in 2013 and the signing of the Memorandum of Understanding (MoU), this scepticism towards the Cypriot government's ability to foster confidence among its creditors and broader society resulted in only a moderate level of programme implementation success.[56] The handling of the Cypriot crisis was considerably hampered by fervent political debates that centred on the political system's inability to effectively tackle the crisis and the Central Bank of Cyprus failure to adequately supervise financial institutions. This pronounced political discord brought to light divergent perspectives regarding the origin of the crisis, oscillating between interpretations of it as a banking versus a fiscal crisis. In contrast to Greece, Ireland, and Portugal, who all managed to secure rescue packages within 50 days of requesting assistance, Cyprus required 271 days to reach a final agreement, a delay that underscores the significant complications brought about by these political disagreements.[57]

On 25 March 2013, the Troika announced an agreement to provide financial assistance of €10 billion to Cyprus until the first quarter of 2016. Initially, the Troika estimated Cyprus' needs at around €17 billion, with the basic condition that these

[54] Iordanidou & Samaras (no 49) 63, 68.
[55] Theodore & Theodore (no 24) 76.
[56] Lütz, Hilgers & Schneider (no 16) 1, 3.
[57] Stavros A Zenios, 'The Cyprus Debt: Perfect Crisis and a Way Forward' (2013) 7(1) *Cyprus Economic Policy Review* 3–4.

funds would not be used to recapitalise Laiki Bank or Bank of Cyprus. Ultimately, Cyprus utilised €6.3 billion from the European Stability Mechanism (ESM)[58] and €1 billion from the IMF,[59] and the bail-in amounted to €9.4 billion—as a percentage of the total bailout, it was more than half of the total funds disbursed.

The Economic Adjustment Programme

On 30 April 2013, the Cyprus House of Representatives approved the Troika proposal ratifying the MoU and the EAP, which was based on the belief that the crisis was caused by poor fiscal governance and a lack of competitiveness. The country was obliged to implement short- and medium-term financial, fiscal, and structural measures. The EAP aimed:

> to restore the soundness of the Cypriot banking sector and rebuild depositors' and market confidence by thoroughly restructuring and downsizing financial institutions […]; to continue the on-going process of fiscal consolidation […] and to implement structural reforms to support competitiveness and sustainable and balanced growth.[60]

The EAP strove to rectify the financial, fiscal, and structural disparities, incorporating a comprehensive financial package totalling €11 billion.[61] The EAP incorporated extensive reforms across the above domains through an overhaul of the banking sector, which included the merger of Laiki Bank with the Bank of Cyprus, and the transfer of Cypriot bank branches in Greece to Piraeus Bank. The EAP also included liquidity support from the Eurozone, reopening of banks, enhanced anti-money-laundering measures, and fiscal consolidation efforts targeting 7.25% of GDP from 2013 to 2015. Other integral components of the initiative included structural reforms such as wage and pension adjustments, budgetary frameworks, debt management legislation, and privatisation.[62] Overall, the securitisation of Cyprus' crisis through the EU's conditional bailout highlighted critical macroeconomic adjustments, governance re-

[58] The European Stability Mechanism (ESM) was established in 2012. It was created as a permanent crisis resolution mechanism for Eurozone countries, replacing temporary structures like the European Financial Stability Facility (EFSF).

[59] Stella Schaefer-Brown, 'Cyprus: Laiki Bank and Bank of Cyprus Restructuring, 2013' (2024) 6 *Journal of Financial Crises* 123, 126.

[60] European Commission (no 5) 39.

[61] Christou, Ioannou & Shekeris (no 13) 2.

[62] Anastassatos, Gkionis & Monokrousos (no 31) 7–8.

forms, structural measures, and capital controls, reshaping financial institutions and redefining policy frameworks amid Eurozone instability.[63]

Pursuant to the MoU,[64] the nation committed to enacting a series of short- and medium-term measures relating to revenue and expenditure:

a) **Revenue measures**: Ensuring additional revenue from property taxation, increasing the statutory corporate income tax rate to 12.5%, increasing the tax rate on interest income to 30%, increasing the bank levy on deposits raised by Cyprus banks and credit institutions, reforming the tax system by June 2013, with a view to raising additional revenue, and increasing fees for public services by at least 17% of the current values.[65]
b) **Expenditure measures**: Controlling healthcare expenditure, reducing the expenditure on various housing schemes, further streamlining the Easter allowance to pensioners by limiting benefits, implementing a scaled reduction in emoluments of public and broader public sector pensioners and employees, and structurally reforming as of the budget year 2014 the educational system.[66]

According to the MoU:

> [E]nhancing the efficiency of public spending and the budgetary process, implementing further reforms in the pension system to mitigate the anticipated surge in pension spending, implementing measures to curb the growth of healthcare expenditure, boosting tax revenues by enhancing tax compliance and collection, revamping the public administration to enhance its functionality and cost-effectiveness, revising the overall benefit structure to ensure an efficient allocation of resources and strike a balance between welfare assistance and encouraging employment, as well as formulating a program to enhance the efficiency of state-owned and semi-public enterprises, along with commencing a privatization initiative.[67]

Additionally, the MoU stipulated a broader set of responsibilities for Cyprus to address. These obligations encompassed a variety of areas, aimed at further stabilising and reforming the country's economic infrastructure. Key mandates included:

63 Floyd (no 23) 173.
64 Law N. 4173 Financial Support Facility Agreement 2013 1.
65 ibid 254.
66 ibid 255.
67 ibid 257.

> [R]eforming the wage indexation system to ensure a sustainable enhancement in economic competitiveness, aligning wage formation more closely with productivity changes. Moreover, Cyprus was directed to orchestrate a comprehensive overhaul of public assistance aimed at striking a suitable equilibrium between public support and incentives for employment, directing income assistance towards the most vulnerable, reinforcing activation policies, and mitigating the fiscal implications of escalating unemployment. Additionally, the mandate encompassed measures to alleviate adverse effects on competitiveness and employment by tethering alterations in the minimum wage to economic conditions.[68]

The MoU also entailed measures concerning goods and services. These market initiatives encompassed:

> [R]emoving unjustified obstacles, improving the quality and reducing the cost related to regulated professional services, reinvigoration of the competitiveness of tourism sector, improving administrative regulations pertaining to the real estate sector, and capitalizing on the exploitation of domestic offshore natural gas resources.[69]

In financial terms, Cyprus needed a €17 billion financial package for its fiscal and monetary system support. However, the Troika limited their financing to €10 billion, concerned about the large debt relative to Cyprus' economy, as this amount was more than half the country's GDP. Specifically, IMF rules on sustainable debt levels meant that a programme over 50% of Cyprus's GDP could violate debt sustainability criteria.[70] The Eurogroup's decision on bailout terms for Cyprus was heavily influenced by a PIMCO study.[71] Using an adverse scenario, PIMCO estimated a requirement of €8.867 billion for bank recapitalisation. Combined with Cyprus' existing public debt, this led to a total debt level of 130% of GDP.

A resolution aligned with IMF principles was reached at the Eurogroup meeting, involving the closure of Laiki Bank and the recapitalisation of the Bank of Cyprus. The plan introduced a comprehensive bail-in extending beyond stakeholders to include deposits exceeding €100,000, aimed at rescuing Cyprus' financial sector.[72] The

68 ibid 267.
69 ibid 270.
70 Apostolides (no 47) 300–301.
71 Michalis Sarris, 'Cyprus in the Eurozone' in Alexander Michaelides and Athanasios Orphanides (eds), *The Cyprus Bail-in, Policy Lessons from the Cyprus Economic Crisis* (Imperial College Press 2016) 21–22.
72 Dijsselbloem (no 52) 112.

bail-in plan was a precondition for an MoU to facilitate the bailout of the Cypriot economy and reached the amount of €9.4 billion. The plan recapitalised the two major banks of the country 'through the full dilution of equity and bond holdings and conversion of 37.5 percent of uninsured deposits into preferred shares'.[73] The initial proposal, which included a levy on deposits up to €100,000, ignited widespread protests and strong parliamentary opposition in Cyprus, leading even the ruling DISY party to withhold support. Following intense backlash and bank closures, negotiations revised the bail-in to affect accounts over €100,000.

Summing up, the bail-in plan in Cyprus was part of a policy strategy to stabilise the country's banking sector. The bail-in was stipulated by the Troika in the MoU with Cyprus, 'establishing a comprehensive framework for the recovery and resolution of credit institutions, drawing, inter alia, on the relevant proposal of the European Commission'[74] exerting considerable influence on European regulatory proposals for future bank recapitalisation strategies.

The Political Economy Aspects of the Bail-in Plan

The EAP for Cyprus introduced an unprecedented bail-in plan to reconstruct the banking system—a move that not only aimed to secure resilience in the Cyprus economy but also boldly redefined the contours of European banking regulation. In characterising the bail-in's principles, Dijsselbloem suggested that if a bank faced difficulties, the resolution should begin with shareholders and bondholders, and if necessary, extend to uninsured deposit holders to partake in the bank's recapitalisation.[75] As mentioned, the EAP was accompanied by a banking sector restructuring plan and a bail-in plan in order to recapitalise the banks. The aim was 'to build the foundation for sustainable growth over the long run'.[76] Markedly, the bail-in plan dominated the EAP, setting its contribution to disbursed capital at over 50% and had a significant impact in shaping European regulations for future strategies in bank recapitalisation, thereby serving as a pioneering model for crisis resolution techniques.[77]

73 IMF (no 28)19.

74 ibid 30.

75 Business Insider, 'DIJSSELBOOM: Eurogroup President Spooks Markets By Saying Cyprus Deal Is A New Template' (2013), available at https://www.businessinsider.com/dijsselbloem-cyprus-deal-is-a-template-2013-3 (last accessed 13.01.2025), 1.

76 European Commission (no 5) 114.

77 CAE Goodhart, 'Lessons for Monetary Policy from the Euro-Area Crisis' *Journal of Macroeconomics* (2014) 39 available at http://dx.doi.org/10.1016/j.jmacro.2013.08.014 (last accessed 23.02.2025), 378,

The European response to the CEC took a neoclassical approach, distinctly based on the perceived fiscal imprudence and competitiveness issues of each nation. This approach led northern EU countries to provide financial aid under stringent conditions aimed at addressing moral hazard concerns.[78] Furthermore, it underscored the belief that debtor nations should bear the primary responsibility for their predicaments, without imposing additional burden on the taxpayers of other countries.[79] In this framework, the Troika fully adopted the idea of financially punishing Cyprus due to the 'corrupting influence of "oligarch" money' and the reckless banking and depositor behaviour.[80]

The implementation of this neoclassical bail-in plan—placing the financial weight of the crisis on the depositors and small businesses with working capital in their bank deposits— raised questions about its alignment with social solidarity principles. The imposition of the bail-in, following Parliament's initial resistance and the Troika's subsequent threats, led to an agreement that placed significant burden on uninsured depositors, putting the country in a position of dealing with uncontrolled bankruptcy.[81] The restructuring drastically reduced deposits, eroding a significant portion of the populace's wealth and disadvantaging small local enterprises. Favouring individual responsibility, the plan compromised the Cypriot welfare regime, undermining people's trust in a social safety net.[82] In this framework, the bail-in plan implicated shareholders, creditors, and depositors in bearing the financial repercussions of banking failures, thereby redistributing the economic impact of such downturns across a broader spectrum of stakeholders.[83] It signalled to depositors that in instances of bank failure requiring recapitalisation, they might need to assume a part of the financial load. This policy aimed to diminish government liability associated with bank rescues and mitigate the fiscal risks emanating from banking sector distress, thereby sharing the losses more equitably among individuals and reducing potential costs to the public finance system.[84]

382.

78 Kathleen Lynch & Manolis Kalaitzake, 'Affective and Calculative Solidarity: The Impact of Individualism and Neoliberal Capitalism' (2018) 23 *European Journal of Social Theory* 1, 4.

79 De Grauwe (no 7) 3.

80 Theodore & Theodore (no 24) 99, 131; Papadimitriou and Pegasiou (no 21) 971, 981.

81 Lütz, Hilgers & Schneider (no 16) 11; Sapir & al. (no 25) 51.

82 Lynch and Kalaitzake (no 78) 2.

83 Avgouleas and Goodhart (no 9).

84 Jessica Cariboni & al, 'Reducing and Sharing the Burden of Bank Failures' (2016) 2015 *OECD Journal: Financial Market Trends* 29, 47.

At the core of the bail-in plan is the strategic intent to circumvent the moral hazard associated with 'too-big-to-fail' financial institutions.[85] This is a response to traditional bank bailouts that have been critiqued for fostering moral hazard issues, undermining market discipline, and placing undue stress on public finances.[86] Originating from neoclassical economic theory and the insurance sector, the term 'moral hazard' refers to the increased risk-taking behaviour that insured parties might exhibit when shielded from the full consequences of their actions, thereby engendering adverse incentives.[87] By adopting the neoclassical approach of the bail-in plan, the objective was to alleviate moral hazard concerns and prevent additional burden on taxpayers, optimising the country's financial and institutional structure towards greater efficiency and accountability. The implementation of bail-in mechanisms serves as a fundamental tool for governments to bolster bank capital reserves without resorting to taxpayer funds, thus directly addressing the moral hazard dilemma.[88] Specifically, the ECB's interpretation of moral hazard aligns with the neoclassical view, emphasising economic rationality and advocating for risk-sharing practices that serve the broader public interest.[89] Accordingly, the bail-in narrative mandates that shareholders, creditors, and depositors bear the financial repercussions of bank failures, aligning their interests with the overall health of the financial system.[90] This rationale underpins the bail-in's objective to mitigate moral hazard and ensure that the financial burden of risky investment behaviours does not fall upon taxpayers.[91] The Cypriot EAP facilitated the recapitalisation of the two largest banks through the comprehensive dilution of existing equity and bond holdings, alongside the conversion of a portion of uninsured deposits into preferred shares.[92] Within the neoclassical paradigm, the bail-in plan is lauded for its equity and efficiency, significantly shrinking Cyprus'

[85] Alexander, (no 8).

[86] Avgouleas and Goodhart (no 9) 76.

[87] Martha T McCluskey, 'Efficiency and Social Citizenship: Challenging the Neoliberal Attack on the Welfare State' (2003) 78 *Indiana Law Journal* 783, 807.

[88] Lorenzo Pandolfi, *Bail-in vs. Bailout: A False Dilemma?* (2018) 499 WORKING PAPER, CSEF-Centre for Studies in Economics and Finance DEPARTMENT OF ECONOMICS – UNIVERSITY OF NAPLES 31.

[89] Laura Pierret, 'The Political Use of the Term "Moral Hazard": Evidence from Policymakers of the Eurozone' (2019) 78/2019 *Political Research Papers*, DEPARTMENT OF EUROPEAN POLITICAL AND GOVERNANCE STUDIES, College d' Europe available at https://aei.pitt.edu/102477/1/wp78_pierret.pdf (last accessed 10.03.2025) 27.

[90] Avgouleas and Goodhart (no 9) 81.

[91] Alexander (no 8) 29.

[92] IMF (no 28) 152.

oversized banking sector and reinstating market discipline within the industry.[93] This intervention was designed to safeguard market integrity and fiscal stability.

The decision to employ a bail-in plan for Cyprus' financial predicament was primarily political. European lenders, particularly under the influence of Germany within the Troika, criticised Cyprus' governance, accusing it of corruption and inefficiency. These allegations suggested Cyprus was unworthy of financial aid, especially given concerns over policies that seemingly facilitated money-laundering through the banking sector and foreign direct investment.[94] The presence of substantial deposits from Russian oligarchs in Cypriot banks further politicised the bail-in plan, with claims that rescuing these banks would also benefit Russia's elite.[95] Ironically, while ostensibly designed to reduce moral hazard, the plan effectively heightened systemic risk across the Eurozone. This policy raised concerns about the potential for future bail-ins to trigger bank runs in other financially distressed Eurozone countries, exacerbated by a lack of shared responsibility among EU Member States.[96]

Steered by a European mandate, the plan effectively marginalised the Cypriot government and its citizenry, rendering them virtually voiceless in the formulation and enactment of critical financial policies. This imposition of decisions from external actors inflicted profound harm on the foundational trust between the Cypriot people and both their own governmental institutions and broader European authorities, with the painstaking process of rebuilding confidence only commencing in the protracted aftermath of the financial upheaval.[97] Additionally, the Troika's calculated manipulation of the ECB's ELA mechanism to apply coercive leverage not only exhibited a severe insensitivity to democratic norms but also actively circumvented established legislative protocols and the essential practice of engaging public opinion, thereby eroding the core tenets of democracy within Cyprus.[98] Charalambous

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[93] Yiannis Kitromilides, 'The Cyprus "bail-in" Blunder: A Template for Europe?' (2013) available at https://www.opendemocracy.net/en/can-europe-make- it/cyprus-bail-in-blunder-template-for-europe/ (last accessed 01.05.2023).

[94] Frederic Florian Hans-joachim Fiedler, 'Saving Cyprus from Its "Financial Crisis" in 2013 by the Troika: A Necessary Action Under the Right Terms and Conditions?' (2019) 7 *Journal of Global Economics* 1, 3; Kitromilides (no 93) 2; Markos Vogiatzoglou, 'Cyprus' Explosion: Financial Crisis and Anti-Austerity Mobilization' in D della Porta & al (eds), *Late Neoliberalism and its Discontents in the Economic Crisis* (Cham: Palgrave Macmillan, 2016) 2.

[95] Katsourides (no 17) 1, 8; Kitromilides (no 93) 1; Orphanides (no 11) 20.

[96] De Grauwe (no 7) 3.

[97] Theodore & Theodore (no 24) 142; Katsourides (no 17) 9.

[98] Nicole Scicluna & Stefan Auer, 'From the Rule of Law to the Rule of Rules: Technocracy and the Crisis of EU Governance' (2019) 42 *West European Politics* 1420, 1432.

underscores how the Cypriot economic crisis triggered profound shifts in political culture and public behaviour.[99] Specifically, it led to a notable decline in trust toward political institutions, particularly political parties, which were seen as complicit in the financial turmoil. Concurrently, citizens increasingly turned to alternative forms of civic engagement, bypassing traditional party structures to participate in grassroots movements and civil society organisations. This transformation highlights a dual dynamic—while established political channels suffered, new participatory forms of democracy emerged, reflecting public frustration with traditional governance and a search for alternative solutions to the economic and social challenges brought by the crisis. To build on this analysis, Efthyvoulou and Yildirim highlight how public opinion and trust play a critical role in shaping political and economic outcomes during crises, noting that declining trust in political institutions can deepen economic instability.[100] In Cyprus, this erosion of trust heightened public discontent, with citizens blaming political elites for the financial turmoil, further complicating efforts to implement necessary reforms. Overall, the bail-in plan not only questioned the integrity of the EU's financial governance frameworks but also sparked a broader dialogue on sovereignty and democratic accountability within Member States, casting a long shadow on the collective European project and its commitment to upholding democratic values and processes.

The pattern set by the bail-in plan is expected to influence future bailout strategies internationally, with an anticipatory clause that depositors in banks requiring rescue may incur losses, particularly for deposits surpassing the €100,000 mark.[101] This approach has been enshrined in the Basel III framework, aiming to instil a more cautious investment ethos among financial and credit institutions to avert the risk of widespread financial turmoil.[102] The evolution of this strategy into a structured policy led to the establishment of the EU Bank Recovery and Resolution Directive (BRRD) in 2015, embedding the bail-in mechanism within a formalised legal structure. This directive outlines procedures for bank recapitalisation through the conversion of

[99] Charalambous (no 19).
[100] Georgios Efthyvoulou & Canan Yildirim, 'Market Power in CEE Banking Sectors and the Impact of the Global Financial Crisis' (2014) 40 *Journal of Banking and Finance* 11.
[101] De Grauwe (no 7) 1.
[102] Fiedler (no 94) 16.

debt into equity in the event of potential failures, marking a significant shift in handling financial crises.[103]

The bail-in narrative, connected to the earlier discussion of its neoclassical foundations, underscores the multifaceted impact of such financial interventions, blending economic principles with political realities and highlighting the profound effects on the societal fabric of Cyprus. Indeed, the execution of the bail-in plan in Cyprus was marked by disarray, serving as a cautionary tale on the pitfalls of crisis management. This tumultuous implementation inflicted considerable harm on market confidence and investor sentiment, highlighting the challenges in navigating such fiscal interventions.[104]

The CEC was fundamentally driven not by the actions of individual depositors but by broader systemic issues, notably the exploitative profit motives targeting the most vulnerable sectors of society.[105] While designed as a remedy, the bail-in plan profoundly shocked the banking sector, challenging the foundational trust and confidence of depositors in the stability of their banks—a sentiment critical to the functioning of the financial system. The stability of deposits and the broader banking system hinge on the confidence of the depositing public, a principle that underscores the importance of robust mechanisms, such as the European Central Bank's role as the lender of last resort and the necessity of a strong deposit guarantee scheme to ensure the security of depositors' savings in Cyprus.[106]

Instead of a Conclusion

By researching the political economy aspects of the Cypriot bail-in plan, which was a part of the bailout programme implemented by the Troika, we conclude with four key remarks. First, the Cypriot bail-in plan represented a fundamental shift in the approach to financial crises within the EU crisis management framework. Shifting the responsibility for financial stabilisation to private depositors and stakeholders, the plan exemplified a neoclassical economic logic that emphasised individual responsibility, the avoidance of moral hazard, and risk sharing, bringing with it implications of financial 'punishment'. This marked a significant departure from previous bailout

[103] Jannic Alexander Cutura, 'Debt Holder Monitoring and Implicit Guarantees: Did the BRRD Improve Market Discipline?' (2018) 232, SAFE Working Paper, Center for Financial Studies and Goethe University 1.

[104] Philippon and Salord (no 22) 36.

[105] Karatsioli (no 18) 18.

[106] Kitromilides (no 93) 3.

programmes, positioning the Cypriot EAP as a precedent for future crisis resolution frameworks within the EU. Second, the implementation of the bail-in plan underscored the complex interplay between financial policies and political sovereignty. The coercive nature of the Troika's intervention, juxtaposed initially against the vehement opposition from the Cypriot Parliament and populace, highlighted the contentious nature of supranational oversight. This tension between national sovereignty and EU-level governance illuminated the challenges inherent in reconciling domestic political imperatives with broader economic stability objectives within the Eurozone. Third, the bail-in plan had socio-economic implications, exacerbating inequalities and eroding public trust in financial institutions. The redistribution of financial crisis costs to private stakeholders and depositors not only challenged social solidarity principles but also raised concerns about the long-term viability and fairness of such crisis resolution strategies. As a fourth and final remark, this study proposes the need for enhanced democratic accountability and transparency in decision-making processes related to financial crisis management. Cyprus' experience brought to the fore the imperative for legitimising EU governance structures to ensure that policy interventions, instead of punitive, are both effective and reflective of the collective interests of EU Member States and citizens.

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