

The Cyprus Bail-In: Policy Lessons from the Cyprus Economic Crisis

ALEXANDER MICHAELIDES AND ATHANASIOS ORPHANIDES (EDITORS)
Imperial College Press (London, 2016), xiii + 350pp.
ISBN: 978-1-78326-875-7 (hdbk)

This new and timely book is the outcome of a conference held only two months after the Cyprus bail-in, on the topic ‘*Cyprus: Five Years in the Eurozone*’ in Nicosia, Cyprus in May 2013, organized by the Tassos Papadopoulos Centre for Studies. It is one of the first – if not the very first – volumes to deal collectively with the complex issues of the Cyprus bail-in, from a variety of angles. It offers high-level analysis from distinguished economists, both academics and policy experts who have had key roles in Cypriot, Greek or EU public affairs. As clearly stated in the prologue of the book, the editors’ objective is to ‘draw lessons from the [Cypriot] crisis’ that could, among other things, ‘provide guidance’ in dealing with crises, both before (by preventing them) and after they erupt (by managing them) (p. ix).

The book offers a three-dimensional analysis of the Cyprus bail-in. First, why Cyprus got into a crisis and the bail-in; second, how Cyprus got out of its financial crisis; and third, how the Cypriot crisis and bail-in relate to the wider institutional issues of the Eurozone.

The first part (‘Cyprus in Crisis: What Happened in Cyprus?’), with key contributions from former Finance Minister Michalis Sarris, former Central Bank of Cyprus director Athanasios Orphanides and former non-executive directors Alexander Michaelides and Stavros Zenios, as well as from younger academic Costas Xiouros, offers a narrative about the Cypriot crisis. Sarris discusses Cyprus’ Euro membership since 2008, which called *inter alia* for sound national economic policy choices. Unfortunately, these failed to materialise and, added to the erroneous crisis management on behalf of the European institutions, soon led to a bust. Sound public finances, fiscal adjustment and structural reforms are essential for Cyprus’ recovery and to its continuing membership in the Euro area. As Sarris correctly points out further, at the same time the Euro area should address its own issues, including better states’ surveillance and better governance, so as to prevent from future crises happening. Zenios and Xiouros discuss more in-depth the banking sector issues that led to the bail-in, particularly the mishandling of the Cyprus Popular Bank (Laiki)’s Emergency

Liquidity Assistance (ELA), the erroneous estimates of the capital needs of the Cypriot banking system by PIMCO and the catastrophic delays in signing a Memorandum of Understanding (MoU) with European institutions. As Zenios remarks, the catastrophic delays were caused by political expediency, with enormous costs for the Cypriot economy. Xiouros delves into the mishandling of the Laiki ELA as well as into the details of the Cyprus bail-in package, including the legality of Cypriot systemic banks' resolution or restructuring. He argues, convincingly enough, that the bail-in was contrary to the principles of legality and fairness, through the unfair treatment of uninsured depositors in haircuts as well as through the wealth destruction and transfer by fire sale of Cypriot banks' branches in Greece.

Orphanides and Michaelides discuss the macroeconomic factors that led to the Cyprus crisis. Michaelides analyses the macroeconomic imbalances (fiscal, banking, housing and external) that became more pronounced after Cyprus joined the EU and Euro. As Michaelides argues, the steady growth that Cyprus enjoyed over the years led to 'overconfidence' and was 'misinterpreted as evidence of local competence by an unsophisticated political system that failed to become sophisticated and competent sufficiently quickly after EU and Eurozone entry' (p.159). The catastrophic delays in reaching an MoU agreement after the country lost access to international markets are emphasized by the two authors as an example of both such incompetence and of political expediency. Orphanides, like Michaelides, shows how the 'last communist government of Europe' (2008-2013) defied all warnings – from national and EU institutions alike – and through reckless behaviour led the country to the bail-in. Orphanides uses a detailed sequence of events to highlight such governance deficiencies, like the government's inaction to correct fiscal imbalances while still manageable, its handling of the Greek Private Sector Involvement (PSI) negotiations despite Cypriot banks' large exposure to the Greek debt and – most importantly – of the MoU negotiations to avoid any short-term political cost. Economic populism generated painful outcomes for Cyprus.

The second part ('Overcoming a Crisis') looks at the aftermath of the Cypriot crisis, with three key contributions from former Finance Minister of Greece Gikas Hardouvelis, University of Cyprus Economics Professor Sofronis Clerides and the Central Bank of Ireland Member of the Commission Alan Ahearne. Clerides and Hardouvelis discuss in length the post-crisis lessons for Cyprus. Implementing reforms, in the banking and public sectors alike, overcoming short-term risks, including resolving the growing size of non-performing loans (NPLS), taking ownership of the fiscal adjustment programme as well as restoring trust and designing a growth model for Cyprus are all prerequisites for the country's future success. Social consensus is also essential, as Hardouvelis points out, while affirming Cyprus' position in the Eurozone should be clarified as a geostrategic choice (p.268). Virtuous behaviour is

rewarded, as the Irish example tells us, according to Ahearne. The latter illustrates how the Irish government took ownership of its adjustment program and managed to implement it. Its strong commitment was rewarded by the troika, in the form of bank recapitalizations with Irish Central Bank bonds with longer maturities, or by revisiting programme conditions.

Finally, the third and last part of the volume ('The Future of the Euro Area') looks at the topic from the Euro perspective. Yannis Ioannides, former consultant to various US, EU and Greek institutions, and European Central Bank (ECB) advisor Michael Haliassos discuss about the institutional deficiencies of the Eurozone. As both show, the growing asymmetries between the Euro members, with divisions between the North and the South, creditors and debtors, and large versus small states, have only exacerbated such deficiencies. Ioannides, performing a comparative study of the Eurozone and the US federal examples, shows how country size influences macroeconomic policy-making in the Eurozone and creates democratic deficit. Without a true fiscal union, the Eurozone cannot function as efficiently as the US fiscal one. The Cyprus bail-in is a prominent example, according to Haliassos, since it was part of 'a consistent strategy of the North to avoid moral hazard' (p.311), both in the South and in the Eurozone in general. Instead of austerity, he proposes that the weaker Euro countries, like Cyprus or Greece, should give emphasis on export-led growth through a combination of business-friendly reforms and attracting investment funding. Instead of widening the North and South divide and thus questioning the viability of the European project, the EU should develop policies that will help the weaker countries to recover and prosper. Lastly, former ECB Board Member Lorenzo Bini Smaghi shows how the crisis exposed all the institutional flaws of the Eurozone architecture. Separating monetary from fiscal policies in the Union especially during the crisis questioned the sustainability of fiscal policies. As Bini Smaghi remarks, true cooperation between monetary and other policymakers is required. However, this vacuum was solved largely through ad hoc solutions like the troika (IMF/EC/ECB), which was charged to monitor and negotiate the adjustment programmes in the EU. The ECB's single primary mandate, price stability, restricted it from other engagements on account of retaining its institutional independence. Nevertheless, as the crisis forcefully showed, ECB's engagement is essential for the Euro's survival.

Overall, the volume is a significant contribution to the limited literature on the Cypriot crisis and the events that led to and followed the 2013 bail-in. It offers expert insights from distinguished economists and policy makers coming from six different countries (Cyprus, Greece, Italy, Germany, Ireland and the USA). As such, it has a clearly international outlook and approach to the Cypriot crisis, while effectively situating it within the Eurozone context. Given its orientation, this edited volume

proves to be an essential reading not merely for a Cypriot audience, but an international one. While some additional chapters from other crisis-hit states in the Eurozone, like Greece or Portugal, are lacking and would be valuable from a comparative perspective, the volume does justice to the causes and the effects of the crisis. It avoids a biased or partisan view of the facts and the politics of the Cypriot crisis. Thus, it opens avenues for exploration for everyone interested to know in depth about the topic, both in a national and in an international context. It therefore achieves its main aim, to provide lessons and guidance about crisis management, risk prevention and recovery. Both economists and senior policymakers worldwide will benefit greatly from this book.

ANNA TSIFTSOGLU