

2015

# Disparity in the Responses to the European Financial Crisis: Cyprus and the State of Bail-In Policy

Kelly Hess  
*Portland State University*

Follow this and additional works at: <https://pdxscholar.library.pdx.edu/honorstheses>

Let us know how access to this document benefits you.

---

## Recommended Citation

Hess, Kelly, "Disparity in the Responses to the European Financial Crisis: Cyprus and the State of Bail-In Policy" (2015). *University Honors Theses*. Paper 176.  
<https://doi.org/10.15760/honors.157>

This Thesis is brought to you for free and open access. It has been accepted for inclusion in University Honors Theses by an authorized administrator of PDXScholar. Please contact us if we can make this document more accessible: [pdxscholar@pdx.edu](mailto:pdxscholar@pdx.edu).

Disparity in the Responses to the European Financial Crisis:

Cyprus and the State of Bail-In Policy

by

Kelly Hess

An undergraduate honors thesis submitted in partial fulfillment of the

requirements for the degree of

Bachelor of Arts

in

University Honors

and

Political Science

Thesis Adviser

Professor David Wolf

Portland State University

2015

The end of the first decade of the new millennium was marred by a sudden and precipitous economic collapse, the likes of which had not been seen in nearly a century. This was not a localized affair but a globally-linked recession that touched nearly every nation in the developed world. The Eurozone, which had only just made its first tenuous steps towards monetary union, was among the hardest hit by the disaster. The focus of the Eurozone's distress were the "PIIGS" states—Portugal, Italy, Ireland, Greece, and Spain. In response to a combination of poor capital controls and irresponsible investing, the European Central Bank (ECB) and the International Monetary Fund (IMF) were forced to hand down billions of euros in the form of numerous bailouts to help stabilize these states' financial institutions. The PIIGS states, however, were not the only Eurozone members to suffer from the financial collapse: Cyprus, who joined the European Union in 2004 and the Eurozone in 2008, experienced similar fiscal turmoil. The ECB, however, did not respond to Cyprus with the same set of financial and monetary restructural requirements it did in response to the rest of its irresponsible children. It punished the island nation for its close ties with Russia by instituting an unprecedented bail-in policy that to this day risks the economic stability of Europe. While this study gives a brief analysis of the factors that led to the financial collapse within several of the PIIGS states<sup>1</sup> and the ECB's response to each case, my main purpose is to demonstrate how the ECB's disproportionate punishment of Cyprus has

---

<sup>1</sup> Since Italy has yet to receive a bailout from the ECB, it will not be examined in this paper.

risked leading the Eurozone down a dangerous financial path from which it may not be able to recover.

## **Background**

Although the global housing bubble had already peaked by 2006, the current global financial crisis began in earnest in early fall 2008 with the collapse of key financial institutions such as Lehman Brothers and Bear Stearns, due to the effects of drastic overleveraging of capital in risky subprime mortgage loans. These rapid failures spread like a contagion throughout international financial markets. Although far from being the first financial crisis of its kind in recent memory—Reinhart and Rogoff identify 18 separate financial crises since the Second World War with similar financial circumstances<sup>2</sup>—it has resulted in the deepest global recession since the Great Depression.<sup>3</sup>

The PIIGS states faced a problem heretofore unseen in modern finance: since they had all become members of Eurozone, they had ceded sovereign control of their own fiscal policies to the European Union, making them less able to respond to shifts within their respective economies. Notably, they lack the ability to devalue their own currency, thus losing one of the most potent tools of a state to directly affect interest,

---

<sup>2</sup> (Reinhart and Rogoff 2008)

<sup>3</sup> (Davis 2008)

and by extension investment, rates.<sup>4</sup> This lack of fiscal self-determination makes them an interesting area of study, particularly in light of the changes brought to the European Stability Mechanism (ESM) caused by “the Cypriot problem”. Because of Cyprus’s failures and fiscal mismanagements, and perhaps due to its close relationship with Russia, the depositors of Cyprus’s primary banks were forced by the ECB to take significant “haircuts,” that is, losing nearly 10% of their deposited Euros. This was the price Cyprus paid in order to receive a loan to recapitalize their financial institutions—in stark contrast to the taxpayer-funded bailouts received by the rest of the PIIGS states. This change in fiscal response mechanism is one that risks the very foundation of the Eurozone by further reducing faith of potential investors in Eurozone markets.

## Spain

In order to understand the raw deal given to Cyprus, we must first look to the other primary recipients of aid from the ECB. Upon reflection, the difficult measures enforced in these countries will seem even-handed when compared to the treatment that Cyprus received. As Spain is the fourth largest economy in the Eurozone, the prospect of a Spanish economic failure would pose catastrophic consequences to not only the Euro, but to the survival of the European Union itself.<sup>5</sup> Spain’s sudden state of affairs came as something of a shock in the grand scheme of the Eurozone crisis. For the

---

<sup>4</sup> (The PIIGS that won't fly 2010)

<sup>5</sup> (The Euro Crisis: How to save Spain 2012)

better part of the first decade of the 21st century, the country seemed to be handling its finances responsibly, ensuring that its debt to GDP ratio remained at acceptable levels. Between 2007 and 2009 however, the Spanish deficit rose to over 11% its GDP while its total national debt was resting at 70% of GDP.<sup>6</sup> According to the International Monetary Fund (IMF), Spain's woes were caused at least in part by a permanent loss of revenue due to the international financial crisis: "The persistence of deficits reflects permanent revenue losses, primarily from a steep decline in potential GDP during the crisis, but also due to the impact of lower asset prices and financial sector profits".<sup>7</sup> The problems did not start with just these economic indicators, however. Like the other states most affected by the financial crisis, excessive optimism in the housing market, combined with subprime mortgage lending, caused strain on Spain's financial institutions.<sup>8</sup>

In June of 2012, Spain formally requested the aid from the European Union to recapitalize its ailing financial sector, receiving over €100 billion from the ECB.<sup>9</sup> In exchange, Spain was required to undergo austerity measures including cutting the deficit by €65 billion over three years<sup>10</sup> in order to bring its financial sector back under control.<sup>11</sup> In January of 2014, Spain successfully completed the structural readjustment

---

<sup>6</sup> (Debt Crisis: The Spanish Problem 2010)

<sup>7</sup> (Fiscal Affairs Department of the International Monetary Fund 2010)

<sup>8</sup> (Frayer 2014)

<sup>9</sup> (On being propped up 2013)

<sup>10</sup> (Roman and Winning 2012)

<sup>11</sup> (Geitner, Kulish and Minder 2012)

requirements imposed by the ECB, including the merger of 38 financial institutions and major reforms to the house lending market<sup>12</sup>—although unemployment rates remain at nearly one quarter of the labor force.<sup>13</sup> While still not back to pre-crash levels, Spain is well on its way to recovery through the program set out by the ECB.

## **Ireland**

Prior to 2002, Ireland had what seemed to be one of the relatively healthiest economies within the Eurozone, with nearly full employment levels at a 4% nominal unemployment rate.<sup>14</sup> Like the United States, however, it focused entirely too much on the housing sector and its related industries. While the Irish financial sector appeared as profitable as ever, its true status was masked by an over-reliance on speculative investments and aggressive construction. The government was likewise overly trusting of what we now know to be a bubble in housing prices, with more than 16% of the tax base of the country stemming directly from stamp duties, Value-Added Taxes (VAT), and capital gains taxes based on land.<sup>15</sup> When the bubble burst, not only were the banks hamstrung, but the government found itself bereft of a great percentage of expected revenues deriving from the aforementioned taxes.

---

<sup>12</sup> (On being propped up 2013)

<sup>13</sup> (Román 2015)

<sup>14</sup> (The European Commission 2012)

<sup>15</sup> Ibid.

When the housing market crashed in 2008, the Irish government decided to cover the full cost of the debts of the affected banks as well as that of recapitalizing them; along with the tax shortfall experienced as a result of the same crash, these measures caused the government to be unable to effectively service their foreign debt stocks, shutting them out of the international debt market. In November of 2010, Ireland was forced to receive an €85 billion bailout and imposed structural readjustment or risk intentional neglect from the ECB. The specifics of these reforms are beyond the scope of this paper, but include elements such as mergers of financial institutions, lowering of the minimum wage, steep cut backs to government programs, and harsh restrictions on how and to whom banks can lend money.<sup>1617</sup>

Although one of the countries hardest hit by the recession, Ireland is now on the path to recovery since its exit from its bailout program in late 2013.<sup>18</sup> Recapitalization of the banks has been successfully concluded, the nation has been meeting every benchmark for reducing the budget deficit to acceptable levels, and efforts are underway to reform the labor market across the board after the collapse of the regulatory, financial, and housing markets.<sup>19</sup>

---

<sup>16</sup> (German Federal Ministry of Finance 2013)

<sup>17</sup> (Castle 2015)

<sup>18</sup> (Ireland's bail-out exit 2013)

<sup>19</sup> Ibid.



## Portugal

Unlike Ireland, at the onset of the economic crisis Portugal was in the midst of political as well as economic turmoil.<sup>20</sup> In 2009, Prime Minister José Sócrates's controlling grasp of the Assembly of the Republic was loosened when his socialist party lost ground to smaller fringe parties on both the left and the right. Although still maintaining a plurality of the assembly, the socialists seemed to be headed into a forced coalition with radical fringe parties. This outcome would have threatened their political existence from the ensuing backlash: allying with left-fringe parties like the Left Block could have induced far more radical reforms than Sócrates's socialist party would allow—including sweeping rounds of nationalization and a withdraw from NATO—making an alliance with the conservative People's Party more likely (though still unpalatable) in order to retain the support of business owners.<sup>21</sup> This coalition did not come to pass however, leading to an impasse in the assembly that prevented it from passing a budget until well into late 2010. Portugal's political troubles continued on. Sócrates was forced to resign in 2011 following continued poor economic performance that made the state the third in the Eurozone to request aid from The European Commission, the European Central Bank, and the International Monetary Fund—collectively known as the “Troika”.<sup>22</sup>

---

<sup>20</sup> (Erlanger and Minder 2010)

<sup>21</sup> (Socratic method 2009)

<sup>22</sup> (Lewis, Macdonald and Kowsmann 2011)

Portugal's troubles began long before the rest of the other PIIGS states—reaching as far back as the turn of the millennium and the creation of the Eurozone itself. For the past decade, Portugal had been in an economic slump: Its real GDP per capita raised less than half the rate of the Euro area average and almost two thirds less than their trading partners in the Eurozone from 2000-2007, making it the poorest state in the Eurozone.<sup>23</sup> Unemployment markers were likewise abysmal, doubling within the same time span as there were marked increases in employment in Spain and France.<sup>24</sup> During this period Portugal's economy shifted towards services and other non-tradable sectors, drastically affecting its current account balance by winnowing out Portuguese exports and making them more dependent on imports. Within a single decade, Portugal's foreign-owned debt skyrocketed to € 165 billion—more than its entire GDP. When it became clear that Portugal would be unable to service its debt, it was forced to seek relief from the IMF and the Troika.

On April 6th of 2011, caretaker Prime Minister Sócrates officially announced that his government would be seeking a bailout of €78 billion in order to help get a handle on its current account balance issues, as well as its 9.1% deficit. The deal, which was to be executed over the course of three years, would carry an interest rate less than half the going market rate for a similar long-term loan. In return, Portugal was tasked with reaching certain benchmarks regarding its budget deficit each year: 5.9% of GDP by the

---

<sup>23</sup> (Reis 2013)

<sup>24</sup> Ibid.

end of 2011, 4.5% by the end of 2012, and 3% by the end of 2013. In addition, Portugal was asked to find at least €5.5 billion by selling off government assets and drastically cutting government expenditures.<sup>25</sup> The government attempted to accomplish this through a series of increasingly difficult austerity budgets that have created deep political and social unrest within the state.<sup>26 27 28</sup> Following the budget posted in October of 2014, thousands of protesters clogged the streets of Lisbon and Porto in order to express their frustration with increased austerity measures that further reduced wages and social services in the midst of rampant unemployment and economic recession.<sup>29</sup>

On May 17<sup>th</sup> 2014, Portugal officially exited its three-year bailout program, although its recovery had not been nearly as successful as had been hoped for during initial deliberations.<sup>30</sup> Sovereign debt remains nearly a third higher than the state's GDP, output has fallen nearly six percent, and unemployment had reached a staggering 17.6%<sup>31</sup>—a number that would surely have been higher were it not for the brain drain

---

<sup>25</sup> (Kowsmann, Portugal Bailout Plan Detailed 2011)

<sup>26</sup> (Wise, Portugal Announces More Austerity Measures 2011)

<sup>27</sup> (Kowsmann, Portugal Unveils Toughest Austerity Budget Yet 2013)

<sup>28</sup> (Austerity in Portugal 2012)

<sup>29</sup> (Al Jazeera and agencies 2013)

<sup>30</sup> (Wise, Portugal exits bailout without safety net of credit line 2014)

<sup>31</sup> (Portugal's bail-out: Final Call 2014)

caused by the educated youth leaving the state for better prospects abroad.<sup>32</sup> Not everything was bleak, however: the trade imbalance that was a major source of Portugal's economic slump leading into the financial crisis had turned around into a net positive. Although the bailout was not nearly as successful as the Portuguese and the rest of the Eurozone had hoped it would be, this is only the first step in the process to recovery.

## Greece

When speaking of the Eurozone crisis, it is difficult to overstate the impact that Greece's banking and governmental disingenuity had on not only its own economy, but also on those of the other PIIGS states. The public sector was the greatest contributor to the crisis by far: in the first half of the 2000s, government wages rose by more than 50% while at the same time the government was taking on tremendous debts in order to finance the Athens Olympics.<sup>33</sup> In addition to this, in October of 2009 it became clear that Greece had been intentionally misleading the European community as to the state of its current account: its deficit exceeded 13% of GDP—dramatically more than the 3% target for Eurozone members—and its sovereign debt topped 115% of the state's GDP.<sup>34</sup>

---

<sup>32</sup> (Wise, The educated unemployed bid farewell to Portugal and austerity 2013)

<sup>33</sup> (Eurozone crisis explained 2012)

<sup>34</sup> (Europe's sovereign-debt crisis: Acropolis Now 2010)

By August of 2011, the S&P had downgraded Greece's credit rating from A to CC. Greece was described by the ratings organization as "Currently vulnerable and dependent on favorable business, financial and economic conditions to meet financial commitments,"<sup>35</sup> indicating a significant probability of default.

Upon Greece's first major credit downgrading in 2010, Eurozone members gave Greece its first major bailout of €110 billion<sup>36</sup> (€80 billion from the Eurozone and €30 billion from the IMF)<sup>37</sup>, with the expectation that steep austerity measures would follow. By requiring such steep measures, the Troika sent a message to other Eurozone members to avoid the failures of Greece, an intent that was directly echoed by the German Chancellor:

Noting that Greece is going to have to make deep and painful cuts to public sector pay and benefits while raising taxes sharply, Mrs. Merkel said those harsh terms would deter other Eurozone countries from getting into similar pickles. Other heavily indebted governments would 'see that Greece's path, with the IMF's strict terms, is not easy, so they will do everything to avoid that for themselves,' Mrs. Merkel said.<sup>38</sup>

---

<sup>35</sup> (Standard and Poor's Rating Service 2015)

<sup>36</sup> (Magnay, et al. 2010)

<sup>37</sup> (Europe agrees a "shock and awe" bail-out for Greece 2010)

<sup>38</sup> Ibid.

Over the next several years, Greece passed a series of austerity budgets that were met with everything from outrage to riots to suicidal protests.<sup>39 40</sup> In 2012, the Troika felt that a second “economic adjustment program” was needed in Greece, giving the state an additional €130 billion.<sup>41</sup> The austerity requirements that came as the price for this loan caused some to call the situation experienced by the Greek people a “humanitarian crisis” due to the personal sacrifices imposed by the state.<sup>42</sup> In early 2015, the terms of this agreement was revised in order to bring some relief to Greece, but recovery is still a long way off.<sup>43</sup> Despite this unusual series of bailouts, perhaps the most controversial move by the ECB was the 2011 decision to entirely write off half of all of Greece’s foreign-owned debt, directly causing the spread of the financial crisis to Cyprus—one of the primary holders of Greek debt and our primary subject for the remainder of this study.<sup>44</sup>

## The Cypriot Case

---

<sup>39</sup> (Weeks and Bensasson 2010)

<sup>40</sup> (Kitsantonis and Donadio, Greek Parliament Passes Austerity Plan After Riots Rage 2012)

<sup>41</sup> (The European Commission 2015)

<sup>42</sup> (Kanter and Kitsantonis 2015)

<sup>43</sup> *Ibid.*

<sup>44</sup> (Higgins and Alderman, Europeans planted seeds of crisis in Cyprus 2013)

As part of its EU accession and adoption of the Euro, Cyprus was forced to meet financial convergence criteria that included that rapid liberalization of its fiscal policy and financial industries.<sup>45</sup> Perhaps due in part to this sudden expansion of the financial sector, within three years of adopting the Euro the top Cypriot banks soon found themselves in possession of assets over 8 times the GDP of the small island nation.<sup>46</sup> Prior to their accession, Cyprus had maintained a cozy relationship with Russian financiers, who made judicious use of the state in Cayman island-like tax evasion and money laundering ventures.<sup>47</sup> This only increased with further liberalization, making the lion's share of the banks' assets international depositors. In addition to these factors, Cyprus's historical and economic ties to Greece led them to take on major shares of Greek bonds. When the financial crisis tanked Greece's economy, borrowing costs in Cyprus skyrocketed; When Greek foreign debt was partially forgiven, the Cypriot economy crumbled.<sup>48</sup>

In 2011, the Cypriot national deficit rose to 7.4% GDP, more than twice the acceptable amount provided for by the regulations of the European Union.<sup>49</sup> As a direct result, the ECB imposed sudden capital control and closed the two largest banks of Cyprus for two weeks. These actions caused domestic economic output to fall by over

---

<sup>45</sup> (Georgiou 2013)

<sup>46</sup> (Milne 2013)

<sup>47</sup> (Eurozone confident on Cyprus bailout 2013)

<sup>48</sup> (Georgiou 2013)

<sup>49</sup> Ibid.

5%,<sup>50</sup> forcing the Cypriot parliament to approach the ECB for more substantive action towards financial stabilization<sup>51</sup>. On March 25 2013, Cyprus and the ECB agreed upon an initial €10 billion bailout package that differed significantly from those received by the PIIGS states. The agreement placed the onus of recapitalization on the depositors of the Cypriot banks—as opposed to the taxpayers, who would have provided for it through a general fund. Though initially categorically rejected by newly-elected Cypriot President Anastasiades,<sup>52</sup> Cyprus was eventually forced to come to terms with the reality that depositors were going to have to take a 10% “haircut” on their accounts over €100,000, unprecedented in modern finance.<sup>53</sup> Indeed, the deal is better described as a “bail-in” in order to reflect the responsibility that is being placed upon individual depositors as opposed to the taxpayers at large.

Why, when under similar financial duress, was Cyprus treated so differently than the PIIGS states? This monumental agreement was reached in light of years of fiscal mismanagement of the Cypriot banks, both at the private and national levels. When financial indicators began to sour in 2011, the European Banking Authority (EBA)—the regulatory arm of the EU’s financial sector—informed the Cypriot government that their national banks should begin to create a “buffer” of around 9% of their tier 1 capital ratio

---

<sup>50</sup> (Cyprus one year on: Injured Island 2014)

<sup>51</sup> (Zenios 2014)

<sup>52</sup> (Eurozone confident on Cyprus bailout 2013)

<sup>53</sup> (Barker 2013)



(the ratio of a banks' equity capital and it's risk-weighted assets<sup>54</sup>) by July 2012. The ECB's forgiving of Greek foreign-owned debt would make this goal an impossibility: none of the previously-successful banks came close to reaching this goal, some missing it by nearly one quarter of a billion dollars.<sup>55</sup> Had they managed to successfully create this buffer, the impact on depositors would have been significantly lessened.

In addition to their financial mismanagements, the primary Cypriot banks held a reputation as dealing in seedier and far more salacious business that may have led to their disproportionate punishment by the rest of the European community: they had the appearance of having a money-laundering relationship with Russian arms-dealers in Syria.<sup>56</sup> Even though the illegal nature of their dealing with Russia is questionable,<sup>57</sup> their cozy financial relationship with the country did nothing to help the new member's standing.<sup>58</sup> In the end, the most likely reason for the ECB's punishment of Cyprus is that the majority of these financial mishandlings were conducted *prior* to their induction to the Eurozone in 2008 – in effect bringing billions of euros of toxic assets into the Eurozone at a critically bad moment.

---

<sup>54</sup> (Investopedia 2015)

<sup>55</sup> (Zenios 2014)

<sup>56</sup> (Matthews 2013)

<sup>57</sup> Although, it appears circumstantially damning. Even the business arm of Russia Today is unable to deny the strong and questionable financial connection between the two states. See (RT Business 2013).

<sup>58</sup> (Higgins, Cyprus Bank's Bailout Hands Ownership to Russian Plutocrats 2013)

## The Bail-In

The bail-in is a revolutionary economic tool that I believe will negatively affect the future economic stability of the Eurozone states. The bail-in itself consists of two primary actions: it divides insured domestic accounts from the affected national banks containing under €100,000 into newly-created financial institutions, and it forces the remaining accounts with over €100,000 to take a scaling 6.75-9.9% haircut to pay down the debt.<sup>59</sup> This deal so revolutionized Eurozone economics that the directive empowering the ECB to take this action was passed almost exactly a year *after* talks with Cyprus were concluded.<sup>60</sup> Prior to the Cypriot case, the Troika did not have the power to allocate and divide the assets of financial institutions directly in this manner. This has the particularly troublesome effect that certain exclusions and protections given to future cases were not applied to the Cypriot crisis (e.g. accrued pension funds and other benefits).<sup>61</sup>

ECB president Mario Draghi, with the support of Germany and other important players in the Eurozone, has lauded the bail-in response as the future model for the EU in dealing with financial crises.<sup>62</sup> Although the policy will officially go into effect in 2018,

---

<sup>59</sup> (Birnbaum and Schneider 2013)

<sup>60</sup> (The European Parliament and the Council of the European Union 2014)

<sup>61</sup> (Zenios 2014)

<sup>62</sup> (Steen 2013)

Draghi has been pushing for region-wide adoption as soon as 2015.<sup>63</sup> However, this pan-continental application of bail-in policy is among the most real threats to the stability of the Eurozone. As it stands, the European Union is a collective of loosely aligned states within a geographic region that share several broad values—democratic representation, capitalism, etc.—but differ on many of the nuances. Among the 28 member states of the EU, nearly one third elected not to enter the Eurozone—most notably, perhaps, the United Kingdom. Since lessened sovereignty in the form of delegated monetary policy came part and parcel with the adoption of the Euro, many nations elected not to join. Even though the Eurozone ceded control of their monetary policy to the Troika, the member nations retain control over their fiscal policy—the separation of which can be particularly detrimental to the application of structural debt management solutions.<sup>64</sup> If you add investor, and even *depositor*, uncertainty to every fluctuation in the market, capital flight and runs on the bank will become crippling and increasingly frequent concerns.

The bail-in has not saved Cyprus. After nearly three years, unemployment remains at record highs, domestic income is swiftly eroding, and over half of all loans in the country are in a state of default.<sup>65</sup> The Eurozone, while recovering, is doing so at an

---

<sup>63</sup> Ibid.

<sup>64</sup> (Togo 2007)

<sup>65</sup> (Guzzo 2014)

all-too-slow pace. In an Op-ed piece for the New York Times, Paul Krugman looks at the relative recoveries of the United States and the Eurozone:

America has yet to achieve a full recovery from the effects of the 2008 financial crisis. Still, it seems fair to say that we've made up much, though by no means all, of the lost ground. But you can't say the same about the eurozone, where real G.D.P. per capita is still lower than it was in 2007, and 10 percent or more below where it was supposed to be by now. This is worse than Europe's track record during the 1930s.<sup>66</sup>

It is clear that recovery is taking too long, a problem that the bail-in would not seem to remedy if the Cypriot experience is taken as an auger.

## **Options: Iceland's Example and the state of the Eurozone**

Where, then, can we look to find a stronger solution to difficulties such as the one experienced in Cyprus? In Iceland, an island that was among the worst and first hit by the 2008 financial crisis, under circumstances shockingly similar to those of Cyprus. "No other developed country endured a systemic collapse in its banking sector on the scale that occurred in Iceland or, indeed, rarely in the history of finance" said Sigurjonsson and Mixa in their 2011 report "Learning from the 'Worst Behaved.'" When Iceland's three main banks, Glitnir, Landsbanki, and Kaupthing, became insolvent, they held assets worth over 10 times the GDP of the small island nation.<sup>67</sup> It seems evident that Iceland's insolvency stems from four primary sources: rapid privatization of the

---

<sup>66</sup> (Krugman, That Old-Time Economics 2015)

<sup>67</sup> (Milne 2013)

state's financial institutions from 1992-2003 (although general liberalization of foreign exchange and fiscal policy began at a much earlier date), inexperience and incompetence of banking executives caused by nepotism, financial compensation models that encouraged risky investments, and the overleveraging of investments abroad in the form of loans, primarily to England and Scotland.<sup>68</sup>

Here is where Iceland's response diverges from Cyprus: to combat the freefall of their financial sector, the Icelandic government—in direct opposition to the dominant austerity policies of other nations— seized direct control of their banks, separated domestic and foreign depositors, and used a \$5 billion loan from the IMF and other Nordic states to deal with their shortfall and begin direct reinvestment back into the market.<sup>69</sup> The results have been astounding:

Few countries blew up more spectacularly than Iceland in the 2008 financial crisis [...]. Since then, Iceland has turned in a pretty impressive performance. It has repaid International Monetary Fund rescue loans ahead of schedule. Growth this year [2012] will be about 2.5 percent, better than most developed economies. Unemployment has fallen by half. In February, Fitch Ratings restored the country's investment-grade status, approvingly citing its "unorthodox crisis policy response."<sup>70</sup>

The parallels between Iceland and Cyprus here are stunning: two island nations, both vying for inclusion in the EU, allowed their primary financial institutions to amass

---

<sup>68</sup> (Sigurjonsson and Mixa 2011)

<sup>69</sup> (Hart-Landsberg 2013)

<sup>70</sup> (The Editors of Bloomberg 2012)

tremendous amounts of capital—several times in excess of their country’s GDP—in the form of questionable foreign investment and debt acquisition, causing their catastrophic economic collapses. Even their financial responses were similar: in both cases, the depositors of the financial institutions were shuffled around into new banks, leaving one set of depositors to bear the brunt of recapitalization. Where Iceland and Cyprus have primarily differed comes as a result their relationships with the EU. Whereas Iceland has recently halted its once-promising EU accession talks,<sup>71</sup> by the start of the financial collapse Cyprus had already been accepted as a member of both the EU and Eurozone itself.<sup>72</sup> Since Cyprus relies on the EU and the European Central Bank (ECB) for monetary policy, the country was unable to take the unilateral—and controversial—actions that benefited Iceland so well. Where Iceland protected its national depositors by directly transferring their assets to new banks—Arion Bank for Kaupthing, Landsbankinn for Landsbanki, and Islandsbanki for Glitnir—leaving foreign depositors and creditors to take the brunt of their recapitalization efforts,<sup>73</sup> Cyprus was forced by the ECB to adopt a more radical “bail-in” policy.<sup>74</sup>

Would Iceland’s example work for the Eurozone? Perhaps in some cases, but it would not solve the structural deficiencies shown by the ECB’s response to the economic crisis. Monetary policy cannot be used as a blunt weapon, ignoring the

---

<sup>71</sup> (The Associated Press 2013)

<sup>72</sup> (Georgiou 2013)

<sup>73</sup> (Milne 2013)

<sup>74</sup> (Jenkins, Jr. 2013)

specific qualities of each state's circumstance in its implementation, nor can it be fully divested from fiscal policy. In light of this, there are two potential paths that the Eurozone can pursue in the future: the current path, where nations are bound by the ECB's monetary policy; or, the path of political union. Neither option is perfect. The current path allows for the maintenance of the status quo, where the Eurozone member states can claim to their people to remain sovereign entities—while in fact being hamstrung in their ability to react fully to financial mishaps through the coordination of all available political tools. The path of political union is by far the more radical, due to its total subsuming of national sovereignty to the EU, but may be the most lasting option for the success of the Euro that can be offered. By unifying fiscal and monetary policy, thereby tearing down the last of the borders that separate the states of the Eurozone, it can be possible to make targeted changes to the financial landscape to provide for the best possible outcomes.

The Eurozone is unlikely to collapse anytime soon—the costs, both political and economic, associated with such a move are impossible to fully calculate—but that does not mean that the system is living up to its true potential. Cyprus is merely a symptom of greater unease within the union. Unless these various nations, divided by millennia of cultural differences and united only by shared geographic and economic goals, are able to come together and work as one body—with each nation being treated fairly and as equal partners—then the monetary union they have created will fail, even as it limps through the coming years.

## Bibliography

Al Jazeera and agencies. 2013. "Thousands rally against Portuguese austerity." *Aljazeera*.

October 19. <http://www.aljazeera.com/news/europe/2013/10/thousands-protest-austerity-cuts-portugal-2013101916551667232.html>.

"Austerity in Portugal." *The Economist*. Oct 18 2012.

<http://www.economist.com/news/europe/21564902-yet-another-austerity-budget-raises-concerns-about-future-growth>.

Barker, Alex. 2013. "Cyprus Bailout Trauma Clouds EU Bank Bail-in Plans." *Financial*

*Times*, May 12.

Birnbaum, Michael, and Howard Schneider. 2013. "Markets drop amid euro-crisis fears over Cyprus bailout." *The Washington Post*. March 18.

[http://www.washingtonpost.com/world/europe/cyprus-bailout-raises-euro-crisis-fears/2013/03/18/f93540cc-8fc8-11e2-9173-7f87cda73b49\\_story.html](http://www.washingtonpost.com/world/europe/cyprus-bailout-raises-euro-crisis-fears/2013/03/18/f93540cc-8fc8-11e2-9173-7f87cda73b49_story.html).

Castle, Stephen. 2015. "E.C.B. Threatened to End Funding Unless Ireland Took Bailout, Letters Show." *The New York Times*, November 6: B6.

"Cuts and more cuts: Athens passes 2013 budget." *Russia Today*. November 12 2012.

<http://rt.com/news/greece-government-austerity-budget-439/>.

"Cyprus Crisis to Hit European Banks Hard." *Financial Times*. April 4 2013.

<http://www.ft.com/intl/cms/s/0/a03d8e30-9d4b-11e2-88e9-00144feabdc0.html?siteedition=intl#axzz2nEQqcbeU>.



"Cyprus one year on: Injured Island." *The Economist*. May 8 2014.

<http://www.economist.com/news/finance-and-economics/21598649-bail-out-working-bail-isnt-injured-island>.

Davis, E. Phillip. 2008. "The Evolution of the Financial Crisis of 2007-8." *National Institute Economic Review* 206, NO. 5 5-12.

*Debt Crisis: The Spanish Problem*. May 17 2010.

[http://www.economist.com/blogs/freeexchange/2010/05/debt\\_crisis\\_7](http://www.economist.com/blogs/freeexchange/2010/05/debt_crisis_7).

Erlanger, Steven, and Raphael Minder. 2010. "As Ireland Nears Bailout, Portugal Waits in Wings." *The New York Times*. November 18.

[http://www.nytimes.com/2010/11/19/world/europe/19lisbon.html?pagewanted=all&\\_r=0](http://www.nytimes.com/2010/11/19/world/europe/19lisbon.html?pagewanted=all&_r=0).

"Europe agrees a "shock and awe" bail-out for Greece." *The Economist*. May 2 2010.

[http://www.economist.com/blogs/charlemagne/2010/05/eu\\_rescue\\_greece](http://www.economist.com/blogs/charlemagne/2010/05/eu_rescue_greece).

"Europe's sovereign-debt crisis: Acropolis Now." *The Economist*. April 29 2010.

<http://www.economist.com/node/16009099>.

"Eurozone confident on Cyprus bailout." *BBC News: Business*. March 4 2013.

<http://www.bbc.com/news/business-21655475>.

"Eurozone crisis explained." *BBC News: Business*. November 27 2012.

<http://www.bbc.com/news/business-13798000>.

Fiscal Affairs Department of the International Monetary Fund. 2010. *Fiscal Monitor: Navigating the Fiscal Challenges Ahead*. IMF Fiscal Monitor Series.

- Frayner, Lauren. 2014. "Spain exits bailout program; second Eurozone country to do so." *Los Angeles Times*. January 23. <http://www.latimes.com/world/worldnow/la-fg-wn-spain-exits-international-bailout-20140123,0,1905023.story#axzz2xlebb6OX>.
- Geitner, Paul, Nicholas Kulish, and Raphael Minder. 2012. "Spain to Accept Rescue From Europe for Its Ailing Banks." *The New York Times*, June 9: A1.
- Georgiou, George C. 2013. "Cyprus's Financial Crisis and the Threat to the Euro." *Mediterranean Quarterly*, Volume 24, NO. 3 56-73.
- German Federal Ministry of Finance. 2013. "Reforms in the eurozone: examples." *Federal Ministry of Finance*. February 25.  
[http://www.bundesfinanzministerium.de/Content/EN/Standardartikel/Topics/Europe/Articles/Stabilising\\_the\\_euro/Figures\\_Facts/2012-11-29-reforms-in-the-eurozone-examples.html#doc290354bodyText3](http://www.bundesfinanzministerium.de/Content/EN/Standardartikel/Topics/Europe/Articles/Stabilising_the_euro/Figures_Facts/2012-11-29-reforms-in-the-eurozone-examples.html#doc290354bodyText3).
- Guzzo, Vincenzo. 2014. *The Prospects for the Cypriot Economy in 2015*. IMF Report, IMF.  
<http://www.imf.org/external/country/CYP/rr/2015/020615.pdf>.
- Hart-Landsberg, Martin. 2013. "Lessons from Iceland: Capitalism, Crisis, and Resistance." *Monthly Review* 65 (5).
- Higgins, Andrew. 2013. "Cyprus Bank's Bailout Hands Ownership to Russian Plutocrats." *The New York Times*. August 21.  
<http://www.nytimes.com/2013/08/22/world/europe/russians-still-ride-high-in-cyprus-after-bailout.html>.
- Higgins, Andrew, and Liz Alderman. 2013. "Europeans planted seeds of crisis in Cyprus." *The New York Times*. March 26.

- <http://www.nytimes.com/2013/03/27/world/europe/europeans-planted-seeds-of-crisis-in-cyprus.html?pagewanted=all>.
- Investopedia. 2015. "Tier 1 Capital Ratio." *Investopedia*.  
<http://www.investopedia.com/terms/t/tier-1-capital-ratio.asp>.
- "Ireland's bail-out exit." *The Economist*. December 15 2013.  
<http://www.economist.com/blogs/freeexchange/2013/12/irish-bailout-exit>.
- Jenkins, Jr., Holoman Jenkins. 2013. "Cyprus Bailout Revisited." *The Wall Street Journal*, May 7.
- Kanter, James, and Niki Kitsantonis. 2015. "After Bailout Plan Approval, Greece Faces a Balancing Act." *The New York Times*. February 24.  
<http://www.nytimes.com/2015/02/25/business/european-lenders-to-review-greece-overhaul-plan.html>.
- Kitsantonis, Niki. 2013. "Greece Approves New Austerity Measures." *The New York Times*. July 17. [http://www.nytimes.com/2013/07/18/world/europe/greece-approves-new-austerity-measures.html?\\_r=0](http://www.nytimes.com/2013/07/18/world/europe/greece-approves-new-austerity-measures.html?_r=0).
- Kitsantonis, Niki, and Rachel Donadio. 2012. "Greek Parliament Passes Austerity Plan After Riots Rage." *The New York Times*. February 12.  
[http://www.nytimes.com/2012/02/13/world/europe/greeks-pessimistic-in-anti-austerity-protests.html?pagewanted=all&\\_r=0](http://www.nytimes.com/2012/02/13/world/europe/greeks-pessimistic-in-anti-austerity-protests.html?pagewanted=all&_r=0).
- Kowsmann, Patricia. 2011. "Portugal Bailout Plan Detailed." *The Wall Street Journal*. May 5.

- <http://online.wsj.com/news/articles/SB10001424052748703937104576302883922114642>.
- . 2013. "Portugal Unveils Toughest Austerity Budget Yet." *The Wall Street Journal*. October 15.
- <http://online.wsj.com/news/articles/SB10001424052702304106704579137861552035466>.
- Krugman, Paul. 2010. "MisIMFormation?" *The New York Times*. May 15.
- <http://krugman.blogs.nytimes.com/2010/05/15/misimformation/>.
- . 2015. "That Old-Time Economics." *The New York Times*. April 17.
- <http://www.nytimes.com/2015/04/17/opinion/paul-krugman-that-old-time-economics.html?ref=topics>.
- Lewis, Jeffery T, Alex Macdonald, and Patricia Kowsmann. 2011. "World News: Portugal Says it Needs No Bailout." *The Wall Street Journal*, March 11: A.11.
- <http://www.nytimes.com/2011/01/12/business/global/12euro.html>.
- Magnay, Diana, Erin McLaughlin, Bharati Naik, and Mary Retiniotis. 2010. "Greece accepts bailout package." *CNN Money*. May 2.
- [http://money.cnn.com/2010/05/02/news/international/greece\\_bailout/](http://money.cnn.com/2010/05/02/news/international/greece_bailout/).
- Maltezou, Renee, and Harry Papachristou. 2011. "Greece adopts austerity bill amid protests." *Reuters*. October 20. <http://www.reuters.com/article/2011/10/20/us-greece-idUSTRE79H1FI20111020>.
- Matthews, Dylan. 2013. "Everything you need to know about the Cyprus bailout." *The Washington Post*. March 18.

- <http://www.washingtonpost.com/blogs/wonkblog/wp/2013/03/18/everything-you-need-to-know-about-the-cyprus-bailout-in-one-faq-2/>.
- Milne, Richard. 2013. "Iceland Lessons for Cyprus." *Financial Times*. March 21.  
<http://www.ft.com/intl/cms/s/0/f56de290-9244-11e2-a6f4-00144feabdc0.html#axzz2nEQqcbeU>.
- "On being propped up." *The Economist*. May 25 2013.  
<http://www.economist.com/news/europe/21578394-spains-pain-likely-continue-despite-some-promising-reforms-unless-new-sources-growth>.
- "Portugal's bail-out: Final Call." *The Economist*. March 22 2014.  
<http://www.economist.com/news/finance-and-economics/21599371-portugals-economy-better-shape-it-vulnerable-any-turbulence-final>.
- Reinhart, Carmen M, and Kenneth F Rogoff. 2008. "Is the 2007 U.S. Sub-Prime Financial Crisis So Different? An International Historical Comparison." *American Economic Review* 98, NO. 2 339-344.
- Reis, Ricardo. 2013. *The Portuguese Slump and Crash and the Euro*. Washington, D.C.: Brookings Papers on Economic Activity.
- Román, David. 2015. "Spanish Unemployment Unchanged in the Fourth Quarter." *The Wall Street Journal*. January 22. <http://www.wsj.com/articles/spanish-unemployment-unchanged-in-december-1421923618>.
- Roman, David, and Nicholas Winning. 2012. "Madrid Austerity Plan Boosted to \$80 Billion." *Wall Street Journal Business*. July 12.

- <http://www.wsj.com/articles/SB100014240527023039195045775202134201792>  
48.
- RT Business. 2013. "\$30bn in Russian money sent to Cyprus in 2 decades - study." *Russia Today*. June 18. <http://rt.com/business/russia-cyprus-money-transfer-877/>.
- Sigurjonsson, Throstur Olaf, and Mar Wolfgang Mixa. 2011. "Learning from the "Worst Behaved": Iceland's Financial Crisis and the Nordic Comparison." *Thunderbird International Review* 53, NO. 2 209-223.
- Smith, Helena. 2012. "Anger in Athens as Greek austerity measures passed." *The Guardian*. November 7.  
<http://www.theguardian.com/world/2012/nov/07/greece-austerity-protests-violence>.
- "Socratic method." *The Economist*. October 1 2009.  
<http://www.economist.com/node/14560974>.
- Standard and Poor's Rating Service. 2015. *Credit Ratings Definitions & FAQs*.  
<http://www.standardandpoors.com/ratings/definitions-and-faqs/en/us>.
- Steen, Michael. 2013. "ECB Draws Bail-in Lessons from Cyprus." *Financial Times*. April 4.  
<http://www.ft.com/intl/cms/s/0/a1db98e6-9d4a-11e2-88e9-00144feabdc0.html#axzz2nEQqcbeU>.
- The Associated Press. 2013. "Iceland's next prime minister halts EU membership talks." *The Guardian*. May 22.  
<http://www.theguardian.com/world/2013/may/22/iceland-eu>.

The Editors of Bloomberg. 2012. "Fighting Recession the Icelandic Way." *BloombergView*.  
September 26. <http://www.bloombergview.com/articles/2012-09-26/is-remedy-for-next-crisis-buried-in-iceland-view-correct->.

"The Euro Crisis: How to save Spain." *The Economist*. June 2 2012.  
<http://www.economist.com/node/21556238>.

The European Commission. 2015. "Financial Assistance to Greece." *The European Commission*. March 12.  
[http://ec.europa.eu/economy\\_finance/assistance\\_eu\\_ms/greek\\_loan\\_facility/index\\_en.htm](http://ec.europa.eu/economy_finance/assistance_eu_ms/greek_loan_facility/index_en.htm).

—. 2012. *Ireland's economic crisis: how did it happen and what is being done about it?*  
The European Commission. [http://ec.europa.eu/ireland/key-eu-policy-areas/economy/irelands-economic-crisis/index\\_en.htm](http://ec.europa.eu/ireland/key-eu-policy-areas/economy/irelands-economic-crisis/index_en.htm).

The European Parliament and the Council of the European Union. 2014. "Directive 2014/59/EU of the European Parliament and of the Council." *Official Journal of the European Union*. May 15.

"The PIIGS that won't fly." *The Economist*. May 18 2010.  
<http://www.economist.com/node/15838029>.

Togo, Eriko. 2007. "Coordinating Public Debt Management with Fiscal and Monetary Policies: An Analytical Framework." *The World Bank Banking and Debt Management Department*.

Wearden, Graeme. 2011. "Greek parliament passes bill enabling new package of austerity measures." *The Guardian*. June 30.

<http://www.theguardian.com/business/2011/jun/30/greek-parliament-passes-enabling-bill-austerity-measures>.

Weeks, Natalie, and Marc Bensasson. 2010. "Greek Parliament Approves 2011 Budget, \$18 Billion Deficit-Reduction Plan." *Bloomberg News*. December 23.

<http://www.bloomberg.com/news/2010-12-22/greek-parliament-approves-2011-budget-18-billion-deficit-reduction-plan.html>.

Wise, Peter. 2011. "Portugal Announces More Austerity Measures." *Financial Times*.

October 13. <http://www.ft.com/intl/cms/s/0/d66e3552-f5dd-11e0-bcc2-00144feab49a.html>.

—. 2014. "Portugal exits bailout without safety net of credit line." *Financial Times*. May 4.

<http://www.ft.com/cms/s/0/2009bb08-d3a5-11e3-b0be-00144feabdc0.html#axzz3aBWdGfID>.

—. 2013. "The educated unemployed bid farewell to Portugal and austerity." *Financial*

*Times*. April 25. <http://www.ft.com/intl/cms/s/0/971817a6-a68f-11e2-885b-00144feabdc0.html#axzz2xexhV6sW>.

Zenios, Stavros A. 2014. "Fairness and reflexivity in the Cyprus bail-in." *Working Paper*

#14-04 23.