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Sacrificing Cyprus

Truths and half-truths about Europe's gambit

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- Even by European standards, this month's Cyprus crisis has been a barely forgivable fiasco. While it is true that several factors rendered depositor haircuts more likely than in other countries, clumsy implementation has ushered in two new uncertainties and revived an old one. The new ones concern Europe's template for banking sector resolution and the application of capital controls. The old one is EMU exit.
- This note highlights several presumptions which have arisen over the past two weeks, and scores them on a scale of truth, half-truth and falsehood. There are indeed some right conclusions to draw from this experience, but also a few wrong ones.
- 1. Europe has launched a new bank resolution regime: half true
- 2. There is another Cyprus in the region: false
- 3. Capital controls in Cyprus create a two-tier euro: true
- 4. Deposit flight from the periphery will be significant: half true
- 5. Cyprus will leave EMU: false
- 6. Cyprus' EMU exit would be more manageable than any other country's: true
- 7. Markets deserve a risk premium: true

See page 6 for analyst certification and important disclosures.

Even by European standards, this month's Cyprus crisis has been a barely forgivable fiasco. While it is true that three factors rendered depositor haircuts more likely than in other countries[1] – a highly-indebted sovereign, insolvent banks and few bank bondholders – clumsy implementation has ushered in two new uncertainties and revived an old one. The new ones concern Europe's template for banking sector resolution and the application of capital controls. The old one is EMU exit. This note highlights several presumptions which have arisen over the past two weeks, and scores them on a scale of truth, half-truth and falsehood. There are indeed some right conclusions to draw from this experience, but also a few wrong ones.

1. Europe has launched a new bank resolution regime (half true)

The Cypriot decision to bail in senior debt holders and uninsured depositors has no precedent within the Euro area, although such an event has occurred in the EU (Denmark). Iceland as well haircut senior bondholders, and the US impaired uninsured depositors.[2] Thus Cyprus appears to have set a precedent for banking sector resolution justifying a higher risk premium on senior debt and potentially deposit flight from weak banking systems (see point 7 below). This perspective is half-true. Indeed Europe has pursued banking sector resolution to an unprecedented degree up the capital structure, but this approach was scheduled to take effect in 2015 when the EU's Resolution and Recovery Directive (RRD), the region-wide guidelines for banking sector restructuring, comes into effect (see *Fast Forward to an RRD World*, Roberto Henriques, March 25, 2013).

Thus when Eurogroup President Dijsselbloem speaks of Cyprus as a template, this episode will be in that the authorities are willing to consider all parts of the capital structure – equities, subordinated debt, senior debt, uninsured deposits – during the resolution process. But in contrast to the original Cyprus proposal which would have bailed in insured and uninsured depositors while bypassing senior bondholders, the final agreement respects the order of subordination and complies with a regime due to take effect in two years' time. Clearly this early implementation is a surprise, but the approach to Cyprus is not watershed, especially considering that there were too few subordinated or senior bondholders to bail in (only €1.7bn of bank debt).

2. There is another Cyprus in the region (false)

Given that Europe appears to be road testing its 2015 resolution framework, it is natural for investors and hedgers to look for another country which combines Cyprus' vulnerabilities: outsized banking sector, over-indebted sovereign and insolvent banks. That combination is scarce three years into the sovereign crisis, as highlighted in table 1. Luxembourg's banking sector is 21 times the country's GDP but lacks the asset quality issues which wrecked banking sectors in Spain, Ireland, Greece and Cyprus, since its activities do not fund real estate nor peripheral sovereigns to the same degree. Malta is potentially more similar, though its financial sector is less than half the size of Cyprus' in nominal terms.

Slovenia has little in common with the top three in the table – its banking sector is the second-smallest in Europe, equal to only 140% of GDP. The country may require a troika programme, but given a much smaller financial sector and a different bank liability structure, the likelihood of a depositor bail in, much less capital controls, look small (see *Slovenia: Not as threatening as feared*, Salford and Bowe, March 28, 2013). Forthcoming J.P. Morgan research will address the issue of how Europe will likely manage outsized but safer financial sectors such as Luxembourg.

Table 1: Sovereign credit quality and banking sector comparisons

Country	2012 GDP, € bn	Banking sector assets, € bn	Banking sector assets/GDP	Sovereign debt/GDP
Luxembourg	44	960	2170%	21%
Malta	7	53	786%	73%
Cyprus	18	126	708%	93%
Ireland	163	1151	706%	122%
Eurozone	9489	32824	346%	96%
France	2030	8532	420%	93%
Netherlands	601	2460	409%	74%
Spain	1048	3510	335%	96%
Portugal	165	552	333%	124%
Austria	310	962	310%	75%
Germany	2645	8110	307%	81%
Finland	194	573	295%	56%
Belgium	379	1077	284%	101%
Italy	1565	4194	268%	128%
Greece	194	435	224%	176%
Slovenia	36	51	141%	60%
Estonia	17	19	113%	11%
Slovakia	72	60	83%	52%

Source: J.P. Morgan

[1] See *Cyprus: the sleeping mini-crisis*, Kedran Panageas, February 5, 2013.

[2] For example, when IndyMac failed in 2008, the FDIC only reimbursed 50% of deposits over the insured limit.

3. Capital controls in Cyprus create a two-tier euro (true)

Europe has undeniably crossed a Rubicon by imposing capital controls in Cyprus, such as those limiting cash withdrawals to €300 per day, requiring savings accounts to be held to maturity and imposing documentation requirements for imports. Of course investors and corporates operate regularly in countries with capital controls, but imposing capital controls within a currency union has no modern precedent. Hence the discussion of a two-tier euro – or Cypriot euro – since cash in Cyprus lacks the fungibility of cash elsewhere in the region.

Several aspects of this new regime should trouble investors and corporates deeply. First, these controls are national rather than institution-specific, so even holding cash in a high-quality bank is no guarantee of currency convertibility if a country faces Cyprus' fate in future. Relatedly, fear of capital controls, like fear of banking sector insolvency, can prompt a self-fulfilling bank run in third countries, or at least permanently-higher funding rates to compensate for convertibility risk. The subsequent tightening of financial conditions risks undoing the benefits of the ECB's OMT, which had driven sovereign and other credit spreads materially tighter over the past nine months.

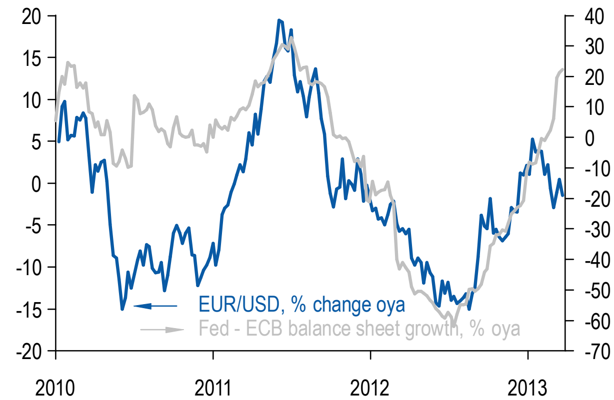
But before reaching for the gold bars, an important caveat applies: capital controls imposed on a domestic(ish) currency like the euro are easier to unwind than Iceland-like capital controls on foreign currency. Recall that capital controls in Iceland, and indeed in most countries, are imposed during a financial/balance of payments crisis to preserve hard currency for funding imports and honouring debt service. Such policies are necessary because the country has access to no other borrowing window than the IMF (or a generous, bilateral sponsor). Cyprus will have access to euros through the ECB's ELA facility as banking sector resolution is completed in coming months, thus reducing the need for indefinite capital controls typical in balance of payments crises.

4. Deposit flight from the periphery will be significant (half true)

Elsewhere in Europe, the scope for deposit flight is critical to the EUR/USD view since outflows will worsen Target 2 imbalances, increase peripheral banks' dependence on the ECB, potentially prompt a third LTRO, and thus weaken the currency through a larger ECB balance sheet. Note that the relative pace of ECB versus Fed balance sheet growth has explained about 50% of EUR/USD's moves over the past three years, though the currency is now about 5% cheap to what recent balance sheet moves imply (chart 1).

Chart 1: EUR/USD is about 5% too weak given the pace of Fed versus ECB balance sheet growth this year

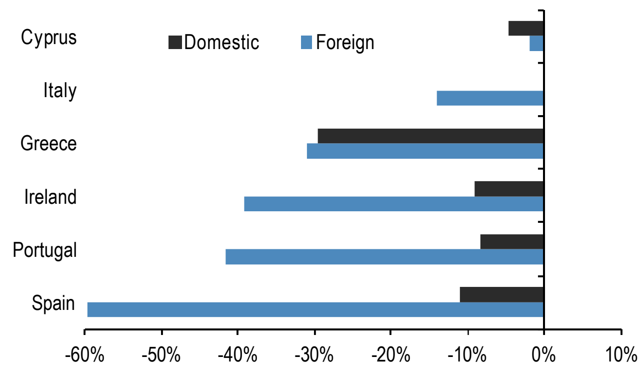
Growth in ECB versus Fed balance sheet year-on-year versus EUR/USD change year-on-year



Source: J.P. Morgan

Chart 2: Foreigners have reduced deposits in the periphery by 60% in Spain and 14% in Italy during the EMU crisis

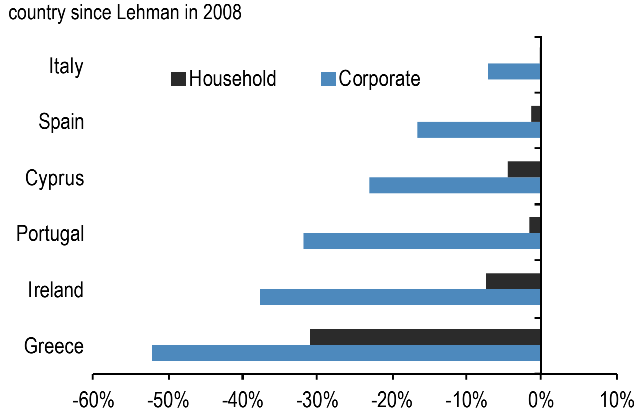
Percentage change in deposit holdings for by foreigners and domestics in each country since Lehman in 2008



Source: J.P. Morgan *Flows and Liquidity*, March 22, 2013

Chart 3: Corporate outflows account for most of this shift

Percentage change in deposit holdings for households and corporates in each country since Lehman in 2008



Source: J.P. Morgan *Flows and Liquidity*, March 22, 2013

The deposit flight argument seems obvious, though the degree is debatable in view of how much has already occurred. Recall that Cyprus isn't Europe's first convertibility scare: the original one occurred in May 2012 when Greek elections threatened to bring to power Syriza, a group whose economic policy aims like declaring a debt moratorium would have probably resulted in the country's expulsion from EMU.[3] That event, combined with the previous two years of recurring sovereign stress, have promoted significant deposit flight already from peripheral to core banks. Foreign deposit holders have reduced their balances by 60% in Spain, 40% in Portugal and Ireland, 30% in Greece and 15% in Italy (chart 2).

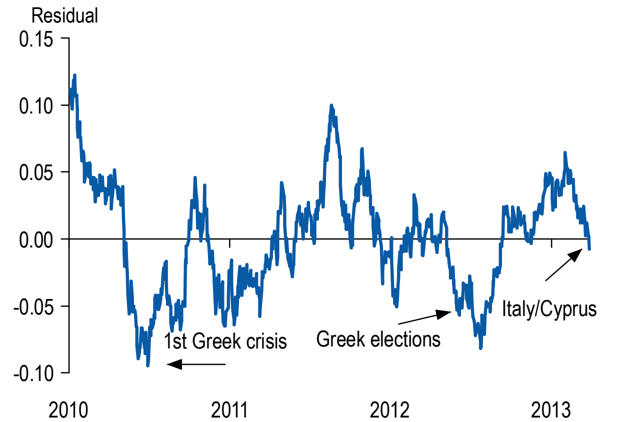
Most of this outflow has been corporate-driven: their deposits are down by 50% in Greece, 40% in Ireland, 30% in Portugal, 17% in Spain but only 7% in Italy. So while the novelty of capital controls in Europe would normally justify a rethink on cash management policy, last year's Greek EMU exit scare may have already triggered much of this shift. The figures to watch for tracking deposit flight will be monthly reports from national central banks, as well as banks' demand for weekly funding reported each Tuesday by the ECB.

5. Cyprus will leave EMU (false)

Over the past two weeks Cyprus' possible EMU exit has been mentioned by at least one parliamentarian, a cabinet minister and numerous external commentators. As with Greece, the argument is standard and one-sided: restructuring the Cypriot economy is too difficult without stimulus from a weaker exchange rate, so better to exit the single currency.

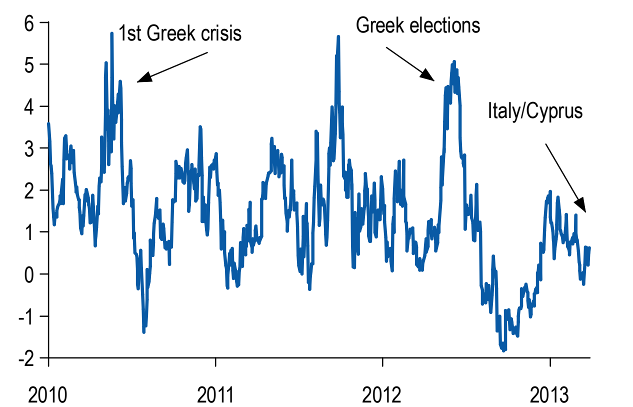
Rarely mentioned in these tense times are the costs: high/hyper-inflation due to massive currency deprecation; high interest rates due to inflation; corporate/household defaults on euro-denominated debt; breakdown of the payments system due to uncertainties over contract settlement; and loss of trade privileges due to EU exit as well (see *Answers to 10 common questions on EMU breakup*, Normand, December 7, 2011). And if Cyprus had any ambitions to remain focussed on offshore banking, albeit on a smaller scale, the decade of financial market instability from introducing a new currency would put paid to that idea. So while Cyprus, like some other peripheral countries, will continue to openly discuss and even threaten EMU exit, it is not obvious that reinventing one's economy is easier by courting a convertibility crisis. If economic restructuring is inevitable, at least remaining in EMU

Chart 5: The euro carries no risk premium, but the OMT should keep any undershoot much smaller than in 2010 and 2012
Risk premium in EUR/USD measured as difference between actual and predicted EUR/USD value from regressing spot on cyclical variables such as Euro-US rate spreads, peripheral spreads to Germany and equity volatility. A negative value represents euro undervaluation versus cyclical fundamentals.



Source: J.P. Morgan

Chart 6: The options market reflects a modest risk premium
EUR/USD vol risk premium measured as difference between 3-mo implied and realised volatility



Source: J.P. Morgan

guarantees low, long-term financing and probably eventual debt forgiveness.

6. Cyprus' EMU exit would be more manageable than any other country's (true)

Should policymakers' perception of the cost–benefit for EMU exit shift, however, Cyprus' exit would be easier to manage than any other country's. Cyprus' small size is one factor limiting contagion: the economy is 15% the size of Greece, which is itself only 2% of Euro area GDP. Also helpful is the OMT, which did not exist when Greece's EMU exit first surfaced in November 2011 (through a referendum on membership proposed by Germany and France), and during the May 2012 election. More subtle is

[3] It would have been daft for Europe to allow Greece access to ECB funding if the government had declared a debt moratorium, and expulsion from the European system of central banks is tantamount to EMU expulsion.

the notion that no other country would probably be interested in following Cyprus' lead, since its economic model is perceived as both unique and unappealing due to a focus on a loosely-regulated and outsized banking sector.

7. Markets deserve a risk premium (true)

In any market, policy uncertainty and regime change typically justify a risk premium. In sovereign and in bank credit markets, this premium is obvious in spread widening since the original Cyprus bail-in was announced on March 16. In currencies, this risk premium would appear in two places: the euro's cheapening versus what cyclical conditions would justify in a fair value model (chart 5), and in a rise in implied versus realised volatility (chart 6).

During the first Greek crisis in May 2010 the euro undershot by 10% relative to cyclical conditions at that time, and during Greek elections in May 2012 the currency undershot by 5%. The combination of Italian and Cypriot events in February and March 2013 have eliminated the euro's January overvaluation, when the currency spiked to the high 1.30s on a presumption that LTRO funds would be repaid rapidly, driving European rates higher. The currency has dropped to fair value, but carries no risk premium for contagion. The message is similar in options markets: the 1% premium for 3-mo implied versus realised volatility is far less than the 5% premium witnessed during previous crises.

While there is no evidence that EUR/USD is undershooting or options markets overshooting as is typical in a crisis, this isn't a typical crisis now that ECB repos can contain banking funding stress while the OMT can address sovereign funding stress. Hence our reluctance to extrapolate recent events into systemic deleveraging, or to forecast significant euro weakness.

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