THE EUROZONE CRISIS: MORE THAN *MONEY TROUBLES.* A DIFFERENT APPROACH TO THE CYPRUS DEFAULT

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ABSTRACT:
WE HAVE BEEN ACCUSTOMED, AT LEAST FOR THE LAST FEW YEARS, TO PORTRAY THE ECONOMIC CRISIS WITHIN THE EUROPEAN UNION MOSTLY AS "MONEY TROUBLES" (MONEY LAUNDERING, BANK INSOLVENCY, BAD INVESTMENTS, SOVEREIGN DEBT, ETC.). VERY RARELY WE CONSIDERED LOOKING FOR POTENTIAL CAUSES OF DEFAULT, ELSEWHERE, MEANING INCOMPLETE BUT DESPERATELY NEEDED POLITICAL INTEGRATION WITHIN THE EUROPEAN UNION, AMBIGUOUS POLITICAL DECISIONS AT EU LEVEL, INSUFFICIENTLY ADDRESSED CONFLICTING CULTURES, AND MAYBE PROMOTING ALL THE WRONG STANDARDS OF FINANCIAL GOVERNANCE OR THE ABSENCE OF THE RIGHT FINANCIAL INSTRUMENT TO MAKE THE PROMISE BELIEVABLE – THE PROMISE TO RESCUE THE LEGITIMACY OF EU. IN CYPRUS CASE, - THE SMALL MEDITERRANEAN COUNTRY FACES FORMIDABLE ECONOMIC AND FINANCIAL PROBLEMS -, A MORE PARTICULAR CASE, THIS PAPER TRIES TO EXPOSE OTHER ISSUES RESPONSIBLE FOR THE PRESENT ECONOMIC ENTRENCHMENT, SOME OF WHICH ARE NOT EXCLUSIVELY RELATED TO MEASURING MONEY MISMANAGEMENT OR INDIFFERENCE TO ACCOUNTABILITY. FURTHERMORE, HOW THE OUTCOME OF ALL THIS GREAT ENGAGEMENT TO SAVE THE APPEARANCES FOR THE ENTIRE EUROPEAN LANDSCAPE WILL TURN OUT IS YET TO BE DETERMINED.

KEY WORDS: CYPRUS; CRISIS; CULTURE; EUROPEAN UNION; RUSSIA.

The Cyprus economic crisis was with a few exceptions a sample of "*I saw it coming!*" situation, after all, the island's economy was always thought to be a shaky deal and with a predisposition for disaster. With a population of a little over 1 million people, Cyprus is the eurozone's third-smallest economy, with a gross domestic product of $23,5

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billion in 2012, or only about 0,2 percent of the Eurozone economy. Its main industry is tourism and banking. The financial crisis this time had been expected because banks in Cyprus had a large amount of bonds issued by the Greek government. They suffered badly because of Greece's sovereign debt crisis and plummeted into a deep recession. On average, the total assets of banks in each EU member country are about 3.5 times the size of GDP. But the corresponding figure for Cypriot banks is about seven times the size of GDP. The latest European financial drama sets also a few sad records to be remembered: a damaging attempt to raid the small nation's insured deposits[2] - an approach contrary to past European settlements, which relied more on taxpayer funds, also a truly scary scenario of what could resemble a situation of a first Eurozone member declaring its own national bankruptcy and last but not least, the inability of European leaders to come up with "a better solution than that reached last week"[3] has become a regular episode from a "déjà-vu" series.

More or less, apart from the technical financial problems, the big picture sets the question of whether the process of *Europeanizing* Cyprus really came into shape. The current state of affairs shows that the process was not developed in a satisfactory manner for any of the parties involved. The European Union brought the conflict inside the union by admitting Cyprus (a non-European entity) into its institutions and now it has a responsibility to make sure the Cypriots, as European citizens are secure. It is the whole island that has joined the European Union in 2004, even though it is formally represented by the Republic of Cyprus, the government in control in the south. That means that Turkish

[2] That was probably the first element of surprise. For the global stock markets that plummeted on announcement of the terms of the first attempted deal between the Cypriot authorities and its lenders on 15 March, the fact that small depositors had been targeted first was a surprising rewriting of the rules of capitalist prudence. The initial decision to *tax* the insured deposits was an incredible violation of the spirit, if not the letter, of a 2009 EU Directive, establishing that all bank deposits below €100,000 should carry an insurance guarantee. Furthermore, the new deal calls for a levy on uninsured deposits over €100,000 in the country's second biggest bank, Laiki, which will be restructured. The country's largest bank, Bank of Cyprus, will take over Laiki's prime assets, and deposits over €100,000 at Bank of Cyprus will be frozen for the time being and used to resolve Laiki's debts and increase the capital of Bank of Cyprus. Uri Dadush, „Cautious optimism from Cyprus", *The National Interest,* April 2nd, 2013, accessed May 17th, 2013, http://nationalinterest.org/commentary/cautious-optimism-cyprus-8295

[3] There have been a lot of mixed feelings about the evolution and consequences of the Cyprus bailout. Surprise, shock, astonishment, panic over deposit guarantees, fear of bank runs in Cyprus and other countries subject to Troika mandates, and uncertainty about the uncertainties of wealth from now on both ensued and augmented the pain of finding an eligible solution. «Once again, leaders have demonstrated their inability to balance the interests of the currency union „haves" with those of the „have nots"». Sven Böll, Christian Reiermann, Michael Sauga, Christoph Schult, Anne Seith and Daniel Steinvorth, „Lessons from Cyprus: Euro Crisis Poses Grave Dangers to EU Unity", *Spiegel Online,* March 25th, 2013, accessed May 3rd, 2013, http://www.spiegel.de/international/germany/cyprus-bailout-highlights-deep-mistrust-in-europe-and-euro-zone-a-890745.html

people living in the north are entitled to claim the benefits of membership, even though that may involve going through the Republic of Cyprus. The membership of Cyprus in the European Union allows Northerners to break out of the isolation, but it also recognizes them as Cypriots and as Europeans, too. Apart from that, we have to agree that EU has failed to enforce upon the small island, Europe's standards of financial governance. There where the European Union has been unsuccessful, the Russians have managed to grasp the "lost" opportunity. Therefore, Russian money became fuel for the catastrophe, but was not itself the cause. Bank insolvency and money laundering are not two faces of the same coin, implying that are not inextricably convergent or related. Reflecting a different perspective on the matter, the Cyprus crisis could possibly be referred to as a result of conflict between distinctive political cultures: European, Greek Cypriot and Russian.

REFERENCES IN THE PAST

For a better understanding of the background of this crisis, one should have a close look to some facts historically related, starting with the fact that the Republic of Cyprus (Greek Cyprus) is a distinct political culture from mainland Greece. The Hellenic Republic, if we may say so, has roots both of Greek and Balkan origin, whereas The Republic of Cyprus, besides the Greek background has also Levantine influences. For a quarter of a century, Greece has been the "black sheep" of the European family, but it cannot be blamed for not seeking in a genuine and unselfish manner a European identity and vocation. The leaders of the Hellenic nation have been truly preoccupied with finding a solution and behaving as responsible Europeans, throughout the whole crisis situation. This most desired implication was ultimately due to the fact that the Greek politicians have accepted that their country's crisis was the consequence of its own fiscal profligacy.

Unlike their Greek fellows, the Greek Cypriots were a little too confident about their place within the European civilization and quite sure of what European partnership meant for them[4]. In embracing their European citizenship, the Cypriots forgot to exchange their Levantine business model and practices for European standards. Maintaining both practices was a better option for them, on the spot, but a much tricky one, on the long run.

[4] *Until the very last moment, Greek Cypriots* – from people in the streets to the presidential figure – expected and bet it on a full bailout from Brussels and Frankfurt as being rightfully theirs. *No other Eurozone government approached the Troika (European Commission, European Central Bank, IMF) with such nonchalant self-confidence and indifference to accountability*. E. Wayne Merry, "The Cyprus-Crisis Culture Clash", *The National Interest*, April 8th, 2013, accessed May 14th, 2013, http://nationalinterest.org/commentary/the-cyprus-crisis-culture-clash-8321.

Miming the European way of doing business, while keeping and encouraging what the Germans call a "casino economy" has been the favorite game of manipulation played successfully by the small state, up till now.

But what really brought this catastrophic situation upon the island republic in the eastern Mediterranean, as economically significant as the German city-state of Bremen? Two events, before the critical year of 1974, were responsible for the transformation of Greek Cyprus from a chill out island into a fiscal paradise, a booming international financial hideaway. The first one refers to the expulsion of foreign communities from Egypt[5] by President Gamal Abdel Nasser and dates back in the year 1956, and the second has to do with the Lebanese civil wars. Both events have marked the end of an era in which Alexandria and Beirut were the dominators of the regional financial landscape. Which other candidate was more eligible to take the stand? Between Athens and Nicosia (along with Limassol and Larnaca), the last one was the winner. Although both were considered as provincial, Nicosia presented itself as the better offer with an attractive combination of British commercial law and Levantine enforcement.

In July 1974 a chain of events resulted in Turkey invading Cyprus under the pretext that it was a peace operation to bring back peace and stability to the island. The outcome of this invasion has been enormous and still impacts the island and its inhabitants today, just as it also impacts Turkey and the wider global powers, too. Thousands of Greek-Cypriots had been driven away from homes in the northern part of the island by the Turkish army, which remains in control of northern Cyprus to this day. The northern Cyprus self-determination is recognized only by Turkey.

The disruption caused by the 1974 division of the island into Greek and Turkish sectors reduced the Greek south to a haven for offshore business, "a kind of Dubai in miniature". Cyprus provided a lot of special treatment: easy available financial services and also an ideal legal environment for shell companies, flag-of-convenience shipping,

[5] Most Egyptian Jews were thought to have left the country after the Suez Crisis in 1956, when former President Gamal Abdel Nasser expelled Jews deemed disloyal. Earlier this year, "Yousef bin Gaon, the head of the Jewish community in Alexandria, condemned statements made by Essam al-Erian, vice president of the Freedom and Justice Party, in which he accused the regime of former President Gamal Abdel Nasser of expelling Egyptian Jews from Egypt. Bin Gaon claimed that Nasser only expelled some Jews who had other nationalities and who were proven to have not been loyal to Egypt. Erian sparked controversy at the end of last year, when he issued a call for the Egyptian Jews who live in Israel to return to Egypt". „Head of Alex Jewish community: Nasser did not expel Egyptian Jews", *Egypt Independent*, January 7th, 2013, accessed May 22nd, 2013, http://www.egyptindependent.com/news/head-alex-jewish-community-nasser-did-not-expel-egyptian-jews.

weapons and narcotics trafficking, and tolerance of Soviet bloc espionage. In the same sense, Cyprus was particularly not preoccupied with British and American activities conducted from the two British Sovereign Base Areas on the island[6].

Becoming aware of this favorable situation, after the collapse of the Soviet Union, Russians started depositing their money in Cypriot banks. It is said that about one-third of the banks' deposits is owned by Russian companies and wealthy people. It is also suspected that the banks are used by Russians for money laundering and tax evasion. "It is unlikely that Cyprus, with a GDP of around US $ 23 billion can manage to make such large investments in Russia unless those investments were financed through illicit assets from Russia. The recorded – direct investment – positions merely reflect the round-tripping of prior illicit deposits from Russia into Cyprus"[7].

THE BANKING SYSTEM – HOW THINGS STAND

There are no more doubts about how stupidly big the Cyprus' banking system was. Latest data shows that the Cypriot banking sector's assets revolve around 146.2 billion euros – or about 820 % of the GDP – making it one of the biggest risks to the island's economy[8]. To create an even greater sense of vulnerability, it has been reported also an extremely high level of private sector loans[9]. Filled with Russian money, the inflated Cypriot banking system absorbed huge quantities of Greek debt and when it was written down in early 2012, it turned into a catastrophic loss for the small island. And, on top of that, Germany already raised eye browses when scathing about Cyprus' role as a magnet for Russian offshore funds, which are labeled as having dubious provenance.

The Reuters Agency has come into possession of a list of documents[10] showing that a significant proportion of companies transferring money from the two agonizing banks of the Mediterranean island were Russians and East Europeans[11].

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[6] E. Wayne Merry, "The Cyprus-Crisis Culture Clash", The National Interest, April 8th, 2013, accessed May 14th, 2013, http://nationalinterest.org/commentary/the-cyprus-crisis-culture-clash-8321.

[7] Dev Kar and Sarah Freitas, "Russia: Illicit Financial Flows and the Role of the Underground Economy" (report), *Global Financial Integrity & Ford Foundation*, February 2013.

[8] Other sources say in January 2013 „there were some €126.4 billion ($162.6 billion) worth of assets on the books of Cypriot banks. That's nearly seven times the size of the the country's GDP as a whole". Matt Phillips, „Cyprus' absurdly large, dodgy banking system, in three simple charts", *Quartz,* March 25th, 2013, accessed May 15th, 2013, http://qz.com/66794/cyprus-absurdly-large-dodgy-banking-system-in-three-simple-charts/.

[9] Data shows this loans worth around 48.5 billion euros (270 % of the economy).

[10] „Prepared in April by private sector lenders Bank of Cyprus and Laiki Bank, and passed to lawmakers by the island's central bank, the documents list 5,323 transactions, most previously undisclosed. They detail transfers of 100,000 euros or more from Bank of Cyprus and Laiki Bank in the two weeks before Cyprus

But, surprisingly enough, the size of the Cypriot banking sector is not unique and it was not considered that much of a problem until last year, when the European Union set up tools to monitor such imbalances. As a matter of fact, when Cyprus was examined as to whether it met the criteria to join the European Union in 2003 or not, the European Commission reported “no problems” with the banking sector, simply because it was not a criterion for membership. “Neither did the European Central Bank mention that anything was wrong with Cypriot banks or their business model - based on funding from deposits, almost half of which are from non-residents - when it evaluated whether Cyprus was fit to join the euro zone in a 2007 report”[12].

The first sign of things gone wrong became visible just last year, most precisely in May 2012, in a report prepared by the Commission – under the newly agreed procedure to detect macroeconomic imbalances – which indicated that the size and business model of the Cypriot banking sector might become a problem in the foreseeable future. Unfortunately, the indications in the report proved to be real and caused great distress to both Cyprus and the Eurozone.

The financial meltdown of Cyprus’ banking system appears to have been postponed thanks to a last-minute rescue deal struck on March 25 by the country and its international lenders – the European Union, the European Central Bank and the International Monetary Fund (more commonly known as the Troika). The new deal calls for a levy on uninsured

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closed its banks on March 16 as it desperately negotiated an international rescue”. Michael McIntyre, professor of law and a tax expert at Wayne State University in the United States confirms that „this list verifies the well-founded Cyprus' reputation as an offshore economy used as a conduit for people, particularly Russians, to hold large sums of money, often to avoid paying tax and without too much scrutiny”, in Stephen Grey and Michele Kambas and Douglas Busvine, “Insight: Bank documents portray Cyprus as Russia's favorite haven”, *Reuters*, May 15th, 2013, accessed May 17th, 2013, http://www.reuters.com/article/2013/05/16/us-cyprus-outflows-insight-idUSBRE94E0BN20130516.

[11] “Reuters analyzed 129 companies that each transferred 5 million euros or more over the two-week period, collectively accounting for 1.9 billion euros. Of those companies, 95 could be traced. Out of that group, 34 have links to Russia and five have links to Ukraine and two to Kazakhstan. The remainders comprise companies from Cyprus and other countries including tax havens such as the Cayman Islands, the British Virgin Islands and the Dutch Antilles. By value, more than half the transactions were made in dollars”. Stephen Grey and Michele Kambas and Douglas Busvine, “Insight: Bank documents portray Cyprus as Russia's favorite haven”, *Reuters*, May 15th, 2013, accessed May 17th, 2013, http://www.reuters.com/article/2013/05/16/us-cyprus-outflows-insight-idUSBRE94E0BN20130516.

[12] „In a report published almost a year ago, the first public mention of the threat that Cypriot banks might pose to the financial stability of the island, the European Commission said Cyprus ranked only fourth in the euro area. Luxembourg has a banking sector 24 times the size of its economy, Ireland eight times and tiny Malta 7.8 times bigger than its GDP. A senior EU official said that the European Commission told the Cypriot government in a telephone call already in November 2011 that it should reduce the size of the banking sector, but that advice was ignored”, in Jan Strupczewski, „Does size matter? Cypriot bank sector problem went overlooked”, *Reuters*, March 21st, 2013, accessed May 11th, 2013, http://www.reuters.com/article/2013/03/21/us-eurozone-cyprus-banking-size-idUSBRE92K0YK20130321

deposits over €100,000 in the country's second biggest bank, Laiki, which will be restructured. The country's largest bank, Bank of Cyprus, will take over Laiki's prime assets, and deposits over €100,000 at Bank of Cyprus will be frozen for the time being and used to resolve Laiki's debts and increase the capital of Bank of Cyprus.

THE RUSSIA-CYPRUS *FATAL* FINANCIAL ATTRACTION

It doesn't take too much of an effort to clearly see why Cyprus financial system exerted such a big attraction to Russian more or less covert finances. The attraction goes way back to Soviet times, when it was said that Nicosia meant for its region (especially the Soviet one), what Vienna did for the Central Europe. The assets that made Cyprus so popular among Russians (particularly the Russian oligarchs) were mainly its proximity, the lifestyle and Orthodox Christian religious rituals both people shared. There were also the climate and the beaches. But, make no mistake - the financial boom in Cyprus was already in place and thriving before Russia even had its first oligarch.

The Russian financial activity in Cyprus could be referred to as two types of money laundering: one type was more open and observable and the other, not so overt. The more visible type of money laundering implicated the employment of offshore banking services in order to obtain the necessary financial aid which was not available back at home[13]. The second type truly involved money laundering by Russian oligarchs….and so many others (Ukrainians, Arabs, Israelis, etc.). Actually, the so-called "Russian capital" in Cyprus, was in fact "Russophone", meaning that the funds came from a various range of countries, such as Ukraine, Bulgaria, Georgia, Serbia, Armenia and others, all having a common denominator in being former members of the Soviet bloc. Nevertheless, in time, Russian capital became the largest component of foreign funds in Cyprus and the Laiki Bank managed a large share of the Russian money flow. The second-largest bank on the island was famous for the flexibility of its services and, particularly, for removing the assets of Slobodan Milosevic and his family from Serbia to Cyprus. But putting the blame entirely on Russian and foreign money invading the Cypriot banks will be a false statement to make. The blame should be shared equally among irresponsible investment decisions by major banks (Laiki being the leader), numerous failures of financial governance in Nicosia

[13] One could initiate a whole debate on whether this type of activity should really be addressed as money laundering. The fact is that it depends on your definition. The respective financial services were very much legal in Cyprus, at the time, whereas Moscow officially sanctioned it.

and by European decision-making, the downgrading of Greek sovereign debt, so putting everything in one sentence: the general failure of Greek Cypriots bankers and authorities.

Once the crisis unfolded, from the development of negotiations procedures emerged two critical conflicts of political culture: European versus Cypriot (mainly Greek Cypriot) and European versus Russian. There were also two main reasons for which the Troika has initially delayed confronting the problem, even though the storm was unsurprisingly and rapidly approaching. One reason had to do with the general situation in the Eurozone, especially in Spain, which was everything but stabile. The other one, it anticipated a change of government in Nicosia, meaning the election of the centrist Nicos Anastasiades gave the green light for seriously launching the Cypriot financial bailout.

It is a well-known and agreed fact that the European political culture is, at least in this story, of largely German influence and therefore, we need to think about money as inherently evil and consider debt as deeply immoral. So, Russian expectations that their interests on issues such as the Cyprus bailout will be “taken into account” by the German counter-part were very much overrated. Both the German political class and the media chose instead to portray Russia as the “scapegoat” for the Cyprus financial conundrum. But who could blame them for such an exaggeration? After all, Germany faces an election year that announces a lot of trouble and controversy for Chancellor Merkel’s party. Keeping it honest until the end, there were a few German voices from the media that acknowledged the failed attempts made by the European institutions in struggling for the right solution to deal with the agony of a Eurozone member. We should have heard more about the Cypriot banks’ fatal decision to take on big chunks of Greek sovereign debt, about the Troika’s imposed cut on Greek bonds back in 2011, which made the Cyprus crisis a cruel certainty. And nobody talks about why the separate Russian bank on the island remained solvent despite having processed large amounts of offshore funds also?

As I was stating in the beginning of this paper, the crucial mistakes where made firstly by accepting Cyprus as an EU member without resolving its division problem, and secondly by turning a blind eye to the fact that the island’s banking system – by then suffocated with illicit offshore money – did not even remotely meet the standards of European financial law. On top of everything, the European leaders learned hardly any lesson from this terrible chain of unfortunate decisions. Thus, no later than the year 2007, a totally unprepared, unreformed and unaware Cyprus was welcomed into the Eurozone.

Maybe these were the reasons for which the Troika felt like playing the old game of redemption. Giving the incredible mistakes made in the past, the European leadership felt the need to impose a certain "moral hazard" to the case, and along with it, the same actors, couldn't resist the temptation of punishing Cyprus for its prodigal fraternization with Russia. The European and especially German portrayal of the crisis was made with the intention of presenting the "Cyprus problem" as a convenient lesson to be learned for those in danger of doing too much business with Russia.

CONCLUSIONS

As Greek Cypriots go through a hard time accepting and enduring the current set of harsh rules imposed by the EU leaders, media leaks from Nicosia have indicated massive withdrawals from foreign accounts in the final days of Cypriot banks (especially Laiki Bank)[14]. Still, there were some exceptions that chose to share the Cypriot illusion that a European bailout was guaranteed and to whom the presumed European "solidarity" will be the cause for considerable damage. For those less fortunate the losses will be far more difficult to measure, while for the true oligarchs the lack of transparency will ease somehow the brunt of misfortune.

As things now stand, Cyprus' political deciders has to face a great deal of economic distress and most likely a lot of public resentment due to increased deprivation caused by implementing Troika's draconic measures. What greater opportunity for the Russian oligarchs to return? They could most probably benefit from local hostility towards European and/or German leadership (perceived as a new type of colonialism). What normally today seems like a crusade against Russian intrusion in European affairs, tomorrow, with a little patience, opportunism and a small sample of "solidarity", Moscow could turn the tables to its advantage. If Cyprus' nightmare would, one day, become reality, the Greek part of the island could grow more Russocentric and create serious implications for both Turkey and Europe. The European and Russian attitudes, both bear the stigma of their own delusions. The European club, heavily influenced by Germany is determined to tell the story of the Eurozone saga in moralistic terms. Trapped in a movie of

[14] „As debts threatened to overwhelm Cyprus early this year, money began to flow out of the country in fluctuating amounts. In January 1.7 billion euros left the island and a further 900 million in February, according to Central Bank of Cyprus figures. The run accelerated in March as Cyprus found it had few friends among international institutions suffering bail-out fatigue. Many of the biggest transfers were by firms linked to Russia". Stephen Grey and Michele Kambas and Douglas Busvine, "Insight: Bank documents portray Cyprus as Russia's favorite haven", *Reuters*, May 15th, 2013, accessed May 17th, 2013, http://www.reuters.com/article/2013/05/16/us-cyprus-outflows-insight-idUSBRE94E0BN20130516.

its own, Russia permanently sees the internal affairs and policies of the European Union as some sort of conspiracies aimed to threaten its national security.

Cyprus, without the Russian money, could very well face another bank crisis. Moreover, the probability of a levy on bank deposits to be used again in the future as a means of solving a financial crisis creates already a strange vibe among all members of the Eurozone. The fear of a seemingly run on deposits happening in other countries sets the stage for one big controversy. The present crisis exposed the economic vulnerability coming from excessive dependence on the financial industry. The given situation gives birth to an unbearable need to create a joint European framework for better supervision of banks and for direct injection of capital into banks treading troubled waters.

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