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Banking in Cyprus: A Crisis Made in the Eurozone

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Cypriot banking: A crisis made in the Eurozone

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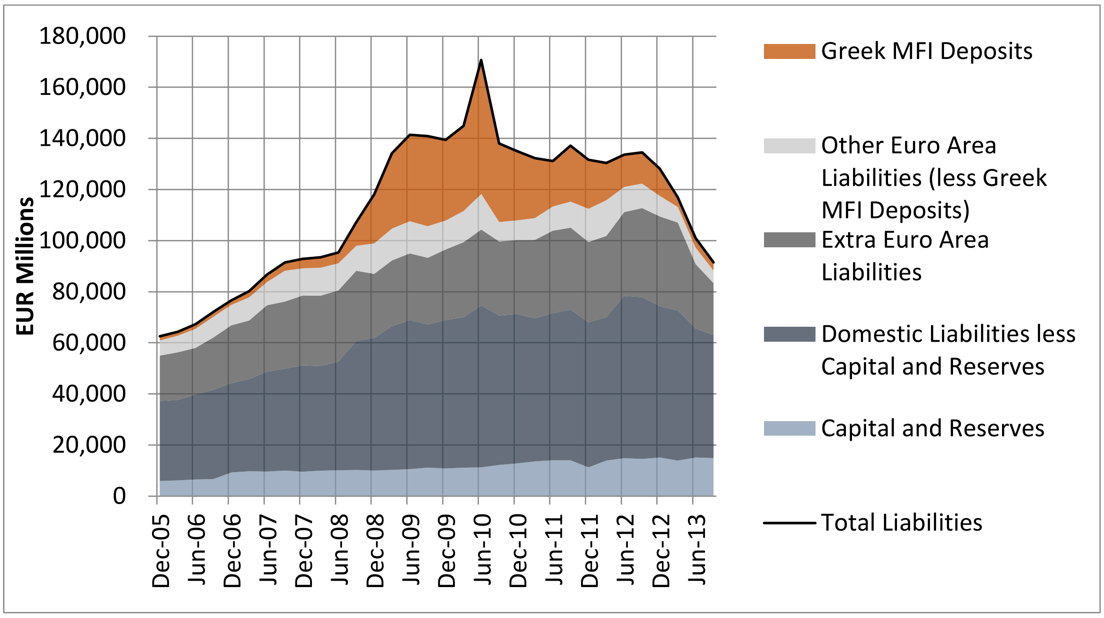
Entry into the euro, followed shortly by the Eurozone debt crisis and subsequently by the problematic management of the banking crisis by the EU, has had profound and detrimental effects on the Cypriot banking system. This brief note highlights how adoption of the euro and the Eurozone crisis jointly formed the critical backdrop to the Cypriot crisis.

Banking crises typically appear first as liquidity crises. Figures 1 and 2 below provide an overview of Cypriot bank liabilities between Dec 2005 and September 2013 (cumulative and non-cumulative respectively). The period can be divided into a sustained boom before 2008; an extraordinary boom after Cyprus joined the euro in 2008 and the global financial crisis erupted; and an equally pronounced bust as the global financial crisis mutated into the Eurozone sovereign debt crisis - a bust which became extraordinarily acute in 2012.

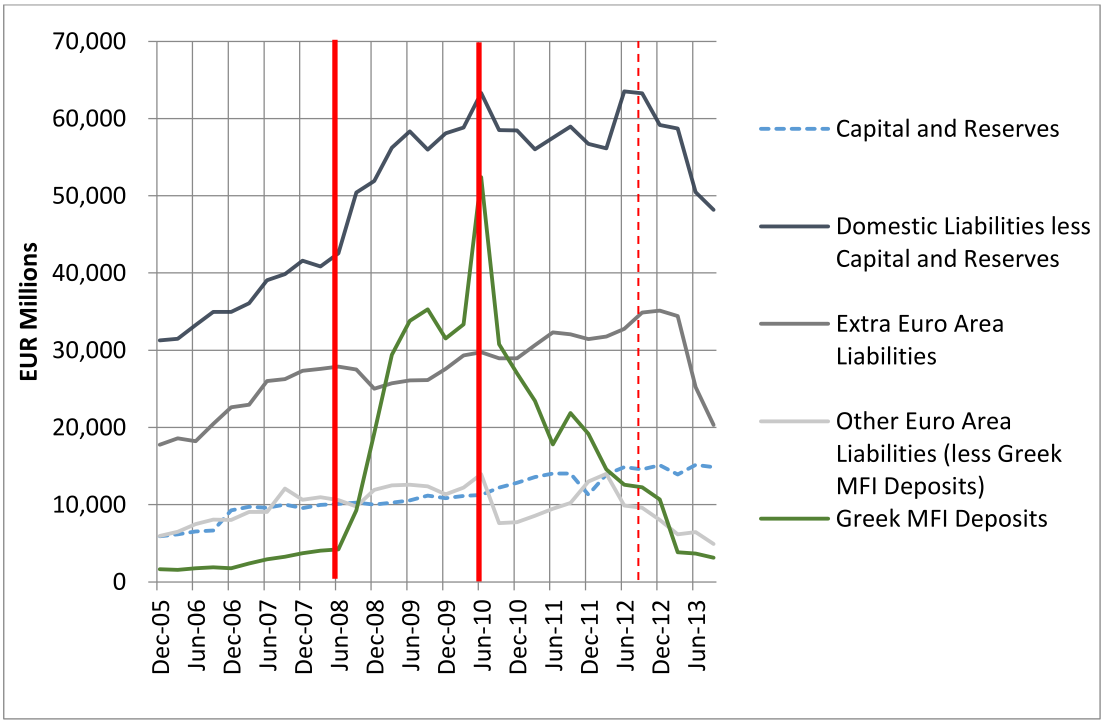
Analysis of the Cypriot crisis involves three main groups of bank clients: Greek banks (known as MFIs), domestic clients and clients from outside the Eurozone. The Cypriot banking disaster, however, was made in the Eurozone, and in particular made through close links with Greece: in the run up to the crisis only ‘other Eurozone clients’ - in other words, Greek MFIs – exhibited any significant change of behaviour. This point is apparent in both figures and forms the focus of this note.

Figure 1. Cypriot Bank Liabilities - cumulative (Dec 2005 – Sept 2013)



Source: Constructed by the author using Central Bank of Cyprus and ECB data.

Figure 2. Cypriot Bank liabilities - non cumulative (Dec2005-Sept2013)



Source: Constructed by the author using Central Bank of Cyprus and ECB data.

Cypriot banking embraced offshore banking in the 1990s.[1] This appears to have allowed for steady growth of bank balance sheets prior to 2008. During this time it appears that own capital and a net inflow from outside the Eurozone (liabilities > assets) funded a positive net asset position in domestic and other euro area balances. In other words, the sustained growth of domestic bank credit to (often for residential housing) was probably fuelled to some extent by offshore liabilities. These developments, however, pale into insignificance in light of the turmoil beginning in 2008.

The combination of euro entry and the global financial crisis going into full swing in 2008 dramatically disturbed this pattern. The combination exposed Cypriot banks to extraordinary financial flows, not directly related to underlying economic activity, as the mechanisms of the Eurozone mediated the global financial crisis. These fresh financial flows laid the ground for the Cypriot banking crisis. Starting in the second half of 2008 banks in the core of the Eurozone fled from assets affected by the first wave of the crisis, most notably US residential mortgage bonds. Believing all Eurozone assets to have similar risk profiles, and buttressed by rating agencies and capital rules, banks of the core dramatically increased their holdings of southern European sovereign debt and bank liabilities. [2]

The banks of the core did not invest directly in Cyprus but they did invest in Greece. A knock on effect of this development was the corresponding increase of holdings of Cypriot bank liabilities by Greek banks, as is shown in Figure 3. Huge inflows to Cypriot banks from Greek MFIs were largely matched by increases in Cypriot bank loans to Greek MFIs and holdings of Greek securities, above all Greek government bonds. Although it is easy to castigate in hindsight, this matching of flows was not criticised by most official observers at the time. Both the IMF (2009) [3] and ECB stress tests in 2010 & 2011, for instance, gave Cypriot banks a (relatively) clean bill of health. [4] Between 2008 and 2010 Greek bank deposits held by Cypriot banks rose faster than Cypriot bank lending to Greek banks and holdings of Greek securities. This excess liquidity most likely leaked into the domestic banking system further fuelling a domestic credit bubble in Cyprus. The explosive growth of domestic credit was further facilitated by the new liabilities being accounted in euro – a global currency – and hence requiring lower reserves by the Cypriot central bank.

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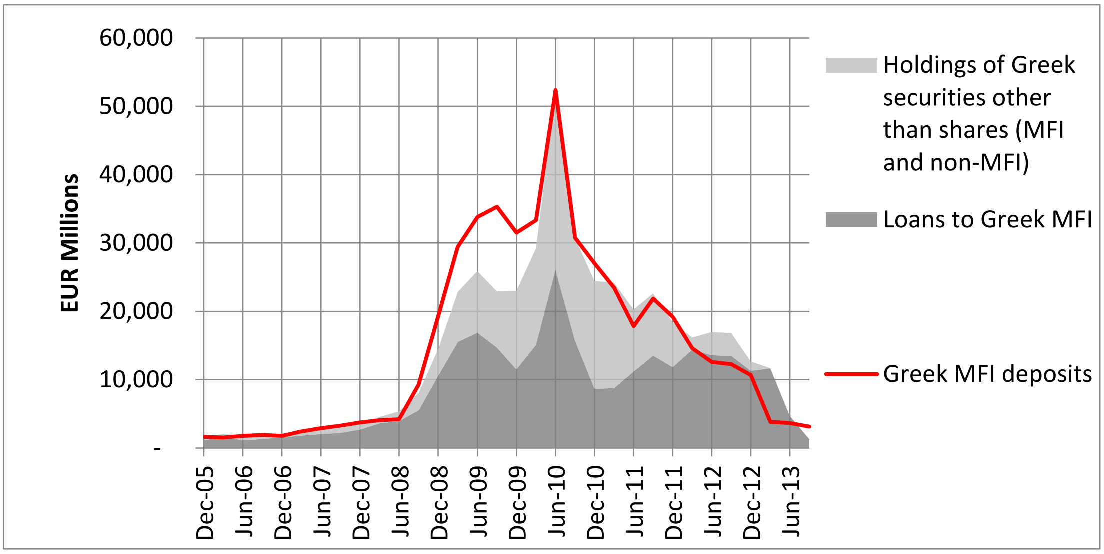
[1]From the late 1990s according to one source http://www.forbes.com/sites/jayadkisson/2013/03/25/cyprus-and-the-death-of-an-offshore-haven/
[2]See *Crisis in the Eurozone*, 2012, Lapavitsas et al.
[3]http://www.imf.org/external/pubs/cat/longres.aspx?sk=23381.0
[4]http://online.wsj.com/news/articles/SB10001424127887323501004578386762342123182

Figure 3. Greek MFI loans, deposits and holdings of Greek securities by Cypriot banks (12/05-09/13).



Source: Constructed by the author using Central Bank of Cyprus and ECB data.

By the middle of 2010 the financial crisis had also become a 'Crisis in the Eurozone'. Greek banks were in trouble and the inflow of liquidity turned to a rapid outflow. Then in late 2011 a plan was announced to impose a significant haircut on Greek sovereign debt. In September 2011 Cypriot banks held roughly 9bnEUR worth of Greek securities (excluding shares), mostly government bonds. By March 2012 these holdings were valued at less than 2bn EUR and Cypriot banks were reported to have taken losses of over 4bnEUR on Greek Government Bonds.[5] This was the trigger for an intensification of the Cypriot bank crisis as other groups began to withdraw liquidity. Greek MFI deposits also fled during this period, falling faster than loans and securities holdings as Figure 3 shows.[6]

In short, entry into the euro has been a disaster for Cypriot banking. Most directly it exposed Cyprus to huge and damaging financial flows which were a direct result of the way in which the global financial crisis manifested itself in the Eurozone. Whatever other problems Cypriot banking might have stored for itself over two decades of offshore activities, it is these flows which formed the backdrop to the lethal Cypriot banking crisis of 2013. Only after the losses on Greek government bonds (bought with deposits, by then long gone, from Greek banks) that the crisis proper broke out in Cyprus. For further analysis of the crisis it would become necessary to focus analysis of Cypriot bank activities in relation to domestic and extra-Eurozone clients, rather than simply to the rest of the Eurozone.

[5]http://online.wsj.com/news/articles/SB10001424127887323501004578386762342123182

[6]'Other Euro Area liabilities were dominated by non-MFI Greek deposits, they fall in June 2010, again after the Greek sovereign default (Figure 2).