The Cyprus Eurocrisis: The Beginning of the End of the Eurozone?

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The Cyprus crisis is essentially a Eurozone crisis which threatens the very foundations of the European Union (EU). This small island economy, only 0.2 per cent of the Eurozone, is proving to be 'systemic' at the political, social and economic level. The Cyprus crisis is a manifestation of a deep crisis of democracy and equality in EU institutions, which subordinates the democratic will of the people to finance interests. More significantly, it is threatening the European integration project itself as it is only the beginning of a process.

In the early hours of Saturday, 16 March 2013, the Eurogroup resolved that the only way for Cyprus to receive its promised banking rescue was to impose a hair-cut tax on deposits including guaranteed deposits (i.e. under €100,000). This was an unprecedented confiscation of 6.75 per cent of deposits under €100,000 and 9.9 per cent for those with over €100,000. It amounted to shock therapy-type liquidation of the banking and financial services of a small island state economy with a banking sector that was (and is no more) 8 times larger than the country's GDP.

The Cyprus Crisis: A Chronicle of Eurocrisis Foretold

The Eurogroup decision has already destroyed the finance sector; eventually, there will be an exodus of foreign, most notably Russian companies and deposits from Cyprus, despite the capital controls and emergency measures introduced. The Republic of Cyprus (RoC) is no longer an isolated island: it may prove to be deeply 'systemic,' triggering a domino effect for the periphery of the EU.

Cyprus, with its complex social and political history, has to be located within its turbulent regional context: it is the border zone of the EU with the Middle East and North Africa. The significant discovery of hydrocarbons off the southern coast of Cyprus and regional wars over the Middle East, the civil war in Syria as proxy war between Israel/West versus Iran and the repercussions for Lebanon, the Arab revolts and the recent Obama-brokered apology of the Israeli Prime Minister to Ankara for the Mavi Marmara massacre, an attempt to mend the regional rivalry between Turkey and Israel – all these recent developments have a significant part to play in the future of the conflict zones in the Middle East.

With the transformations in the political and economic architecture of the globe, the roles of global, regional and national forces in the area, its frontiers and fault-lines are also being transformed. Declining U.S. hegemony increases regional rivalries and redefines the fault-lines in regional geopolitical, energy and security contests.

In the regional power games which are articulated within the context of Eurozone politics, the leaders of the Eurogroup seemed to have grossly underestimated and miscalculated some crucial factors.

Firstly, legal implications aside, the decision over the haircut of the guaranteed deposits was met with severe indignation by the Cypriot people and was condemned across the globe; it was simply politically and socially unacceptable, and accordingly unanimously rejected, causing a shockwave. It remains unclear whose initiative this was between the Cypriot authorities, the Troika or Germany. The fact remains that *all parties* agreed in the end.

Secondly, the decision has not only permanently damaged the country's economy, but was also a huge blow to the confidence in international banking in the EU as a whole, unfolding a long crisis with no-one knows what end-result: international investors can no longer trust EU banks. The small economy of Cyprus has not only joined the southern European 'PIGS.' It was unfortunately selected as the 'guinea pig' for a sick experiment of the new 'bail-in proposals' contained in the relevant draft Directive.[1] The draft directive provides:

"The bail-in tool whereby the bank would be recapitalised with shareholders wiped out or diluted, and creditors would have their claims reduced or converted to shares. … To this end, banks would be required to have a minimum percentage of their total liabilities in the shape of instruments eligible for bail-in. If triggered, they would be written down in a pre-defined order in terms of seniority of claims in order for the institution to regain viability."

This was essentially a *shock therapy treatment* that left everyone stunned. As the *Economist* remarked:

"The biggest question Cypriots are asking is perhaps the hardest of all to answer: why are they having to resolve all this in a single weekend? After all, Cyprus asked for a bail-out last June. And a country can hardly change its business model and restructure its two biggest banks in just two days. It will be a long time before Cypriots forgive this week's blunders of the Eurogroup and of their own parliament and government."

Perhaps we can now understand what the recent smears accusing Cyprus of being a money laundering country were about. They were preparing the ground for the 'treatment' to come. The fact that the driving force were Dutch and German political leaders is quite remarkable: Germany has an estimated €50 to €60-billion ($65-billion to $78-billion (U.S.)) stemming from illegal activities such as blackmail, drugs or arms trading, while the European Commission has launched an infringement procedure in response to Germany's reticence and non-pursuit of money-laundering that might enable the funding of terrorist activities.[2] Interestingly, Russian investors bank with German and Dutch banks such as *Rabobank*, *Deutsche Bank*, *ABN AMRO Bank* etc.; so targeting Russian investors in Cyprus makes a lot of sense.

Third, as the Troika's decision, a sword of Damocles, hangs over Cyprus, either scenario *within the current Eurozone/EU regime* will prove to be nightmarish. However, for the 'EU partners' it may well prove to be the beginning of a meltdown of the Eurozone, deeply wounding the EU integration project. The so-called 'optimistic scenario,' i.e. under duress a 'new deal,' as a desperate damage limitation exercise to avoid bankruptcy would mean that the Republic of Cyprus would be transformed into a protectorate of unending economic and social austerity. The Eurogroup proposal has essentially dissolved the country's offshore banking industry. Cypriot banks hold €68-billion in deposits, including €38-billion in accounts of more than €100,000 – enormous sums for an island of 1.1 million people. It is estimated that the decision on Saturday, despite its rejection by the Cypriot Parliament, has slashed the Cypriot GDP by up to a quarter; unemployment is expected to rise to 20 per cent (currently it already stands at 15 per cent and 57 per cent for under 25s). We are talking about an economic and social crisis reaching proportions as high as those that resulted from the Turkish invasion in 1974, which left the county and people divided by a barbed wire with 34 per cent of its territory under the control of Ankara.[3] The so-called 'pessimistic scenario' is that Cyprus will be forced out of the Eurozone; a new Cypriot pound would be massively devalued and living standards would drop dramatically over night. But in the long run (i.e. in the next five years) the country might well bounce back, as happened with Iceland.

Unaccountable Bankers

In the case of Cyprus, at the heart of the establishment was the banking system, particularly the two big banks that are closing now or being restructured as per the second Eurogroup decision following the Cypriot Parliamentary rejection of what was on the table: Laiki Popular Bank is already wound up; deposits of the Bank of Cyprus will receive a haircut of over 40 per cent. The pro-EU Greek-Cypriot economic and political elites, who were fully committed to EU integration, benefited from the network of business and services around the two major banks – professionals such as lawyers, accountants, financial and insurance consultants as well as politicians and media tycoons were all in their pay roll. EU accession in 2004 did little if anything to make the bankers accountable; on the contrary, the so-called institutional 'independence' of the Central Bank, that made the Governor of the CB accountable to the ECB rather than having any democratic accountability to the people who would be immediately affected, has made the bankers more unaccountable. A large part of profits of the years 2004 to 2008 were invested in the financial sector where rates of return on capital were increased. In 2009, three billion Euros were given to the banks to boost liquidity in response to the crisis. Instead of fixing the long-term problems of the sector and providing the Cypriot economy with its badly needed liquidity, they chose to take high risk investment in Greek Bonds in the secondary market. During the crisis years, private banks invested heavily in Greek bonds with speculative intent and following bad advice from the Cypriot Central Bank.[4] As a result, the RoC banks were downgraded by international markets.

Cyprus entered the Eurozone in 2008, four years after accession. Private consumption was the growth engine of the Cypriot economy during the recovery years 2004-2008, although the average real wage did not increase. This apparent contradiction was resolved through plentiful lending to workers' households. Consumer spending and residential investments were fuelled by loans to workers, although the purchasing power of their wages remained constant. Therefore, at the end of this period (2008), profitability was high after five years of constant wages and income redistribution, workers' households were highly indebted, private consumption was approximately 20 per cent higher than in 2004, residential investment and banking profitability were at historical highs, and the current account deficit was unsustainable. The recovery and boom of the years 2004-2008 achieved its exploding profits and financial euphoria at the cost of a historically high current account deficit and the high debt burden of households. These are the reasons that the RoC economy is now in a process of adjustment with falling real wages and domestic demand, slow growth and exploding unemployment, decreasing imports and a current account deficit.

It is a paradoxical fact that it was during the time when AKEL was in Government that the first austerity measures were introduced: a pre-agreement was forced on Demetris Christofias. The agreement was reached between the Cypriot government and the Troika as regards the terms of the bailout agreement and the measures introduced, even while the Memorandum of Understanding was still being negotiated. The terms included salary cuts and pay freezes in the public sector, an increase in the retirement age, and an increase of the working hours of teachers as well as a number of other measures.

Many experts and scholars repeatedly warned at the time that the most serious threat to economic growth derived from the exposure of the two larger banks to the Greek crisis – the only way out was public ownership and control of these banks. Now this is forced on the RoC for reasons related to the IMF, ECB and German agendas. But the options have significantly shrunk: unless there is systemic transformation within the EU, if Cyprus has any hope for equitable recovery and growth it has to depart from the TROIKA-driven austerity programmes, risking being forced out of the Eurozone.

The Return of the Social Question to Politics

Contrary to the prevailing media coverage about Cyprus, there is a vibrant civic and political culture which cannot be ignored by the elites. From 1 March, the right-wing leader of DISY (Democratic Rally), Nicos Anastasiades took office, carrying a fresh mandate that in any other EU country would be tantamount to the 'right' to bulldoze through Parliament the deal he agreed in the Eurogroup.

Not in Cyprus; the deal was seen for what it was – not only illegal but also socially unjust, forcing small earners to pay for the Bank haircut. However, the decision heavily damaged the economy of the country as it amounted to a forcible liquidation of the financial and banking sector by shock therapy. Anastasiades' authority has been badly wounded as a result of submitting to (if not actively encouraging) Eurogroup instructions, but also for his obstinate address to the nation that the package had to be approved, come what may. No one believed him, not even the MPs of the party he presides over responded to his call.

It is questionable whether he will recover any of his lost authority. He no longer commands a steadfast Parliamentary majority, as he has lost support from the small nationalist parties EVROKO and the Green party, and even his main coalition partner DIKO is shaky. Mr. Anastasiades is now presiding over the worst crisis since 1974 and is pushing for the kind of austerity measures that have wrecked governments throughout Europe. More importantly, we have seen unprecedented mass mobilizations and a process of radicalization of the middle classes and working-class people, who are now bearing the brunt of the crisis.

Cyprus has a tradition of organized trade unions, a workers and peoples' movement built around AKEL (the continuation of the Communist party of Cyprus) in alliance with PEO, the Pancyprian Federation of Labour, being the largest force.[5] A proper reading of the role of the Left (i.e. AKEL and its allies) *within civil society* reveals an alternative perspective on the potential role of civil society in the modernization and the development of Cypriot/Greek Cypriot political culture. Historically, the Left played a crucial role in Cyprus' own route to modernity in the twentieth century. But the contest for hegemony between the Greek Cypriot and the Turkish Cypriot elite resulted in a distorted public sphere and has shaped civil society accordingly.[6]

The right has been organized around nationalism; the right-wing trade union SEK

(Confederation of Workers in Cyprus) is in a difficult position as it has allied itself with the President. Public sector trade unions and mostly banking unions have already been out on the streets.

The notion of an alternative strategy beyond the Troika and outside the Eurozone is only now emerging. As AKEL is no longer in power and having successfully presided over the EU Presidency for RoC in the second half of 2012, the party is capturing the public mood. It is playing a leading role in the revolt following the Eurogroup decision which outraged 7 out of 10 Cypriots.[7] There has been a similar mood amongst the Turkish-Cypriots for some time now, as they face their own austerity programme imposed by Ankara.[8]

It is early days yet, but a more militant public mood seems to have been triggered as the RoC enters the era of austerity. What can be termed as the 'social questions' are featuring more strongly than ever and endowing our society with a new politics of protest.

Bursting the Bubble of the Cyprus Economic Miracle: Destroying an EU tax haven and its runaway banking

Post-1974 development in areas under the control of the RoC was depicted as an 'economic miracle,'[9] and indeed the growth rate in the post-1974 years particularly in the early years after the war up to the late 1980s was remarkable, The exhaustion of the model marks the end of a strategy of accumulation as the RoC is nearing the limits of 'development' and convergence with the countries in the Eurozone.

The 'economic miracle' was structured by a number of 'external' factors such as the Turkish occupation of the north since 1974. This fact, together with a concerted effort by Government, political parties and trade unions, created the conditions for economic growth subsequently experienced in Cyprus based on the massive expansion of 'mass tourism.'

Despite these socio-economic transformations, up to 1974 the post-colonial social class structure retained essentially the same pyramid of wealth and income: the church continued to be the largest land-owner and expanded its commercial activities, whilst at the same time there was a growth in the Greek-Cypriot commercial classes. An abrupt change occurred in 1974 – the Turkish military invasion and occupation of the north and the mass expulsion of Greek-Cypriots in 1974, by default created the preconditions for rapid (capitalist) 'modernization,' in what Harvey (2004) refers to as conditions for "accumulation by dispossession." In spite of the severe drop in the GDP during 1973-75 and the sharp rise in unemployment and mass poverty, cheap labour was provided by Greek-Cypriot displaced persons, forcibly expelled and living in government refugee camps. The conditions of rapid development were therefore reminiscent of nothing so much as the early industrialization of western Europe. This fact, together with a concerted effort by the government, political parties and trade unions created the conditions for the development that was subsequently experienced in Cyprus.

The process of *tertiarization* has continued undeterred, shaping Cyprus as a 'paradise-like destination' for tourism and a modern EU tax haven. De-industrialization is now setting in as the industrial output to GDP has dropped from 18 per cent in the early 1980s to less than 11 per cent in the late 1990s. The signs of a slowdown began to show as the over-dependence on financial and service sectors made them more susceptible to fluctuations. The post-colonial 'developmental state' took the lead in development and encouraged private investment.[10] Economic growth continued until it was hit by the economic crisis in 2011, yet it was apparent that it was approaching the limits of growth finding itself up against a technological frontier as the limitations of the 'mass tourism model' became more apparent.[11] The dependence on tourism has receded from 22 per cent in 1990 to less than 10 per cent in 2012. Nevertheless, the process of tertiarization continues unabated due to the dominance of the service industry in the economy.

Examining the economy and society of the small island of Cyprus, one is struck by a number of crucial features.

First, Cyprus as a "border society"[12] is well-integrated in the regional economic system; in this sense it is also a *border economy*, operating as a bridge and a hub in the eastern Mediterranean. It is a southern European economy open to the west as a European Union (EU) member since 2004, which is connected to northeast Africa, Middle East and Asia, drawing on the labour reserves, tourism and financial services exported from its neighbours. It is listed as one of the high-income island economies, an off-shore financial center with associated tourism.

A second feature is the *de facto* divide, which generates multiple "states of exception" and contradictions in what can be described as a "non-border" of the EU[13] tearing the country apart. The so-called "Green Line" is not only a buffer zone, but a ceasefire line that since 1974, has been patrolled by one of the longest standing UN-stationed peace-keeping forces. The United Nations Force in Cyprus (UNFCYP) has been in the country since 1964. This situation is even today, after the end of the cold war, considered by all interested actors to be unsustainable and unacceptable and may threaten the stability of the southern flank of the North Atlantic Treaty Organization (NATO) and the wider region.

The situation is simultaneously perceived as a "deluxe partition," a tolerable compromise in the absence of a settlement and a "mini cold war" in what the UN has described as one of the world's most militarized zones. In this multiplicity of paradoxes, the evidence of growing economic interdependence[14] as well as the various initiatives from trade unions, teachers and activists in the Buffer Zone groups are worthwhile projects which counter the overall disappointing picture in the quest for reunification.

The third important feature is the centrality of migrant labour, which makes the country comparable to the southern European and Mediterranean island economies.[15] On both sides of the barbed wire, precarious migrant labour is a crucial feature in the accumulation regimes and the developmental models, which is radically affecting economic development and society at large. There are similarities in terms of the exploitation patterns; however there are crucial differences in the regulation and market operation of the migratory system, but this is beyond the scope of this paper.

The fourth feature is the specific mode of *tertiarization* of the economy: the motor of the economy is the service-based economy organized around financial/banking services and tourism. Paul Krugman is right to spot the three key characteristics which have allowed for prolonging the "Cyprus economic miracle" from the 1980s into the new millennium but which has now turned sour: 'runaway banking'; a big domestic real estate bubble; massive overvaluation. In general the country's economy is based on services: mostly financial services, tourism and education.

However, it is the long-lasting banking crisis that has generated the immediate problems. Cyprus 'runaway banking' is based on offshore money, low tax, high rates and good opportunities for tax avoidance/evasion. It has an English-law-based system of regulation and implemented the main EU and international regulations on banking and money laundering control and many double taxation bilateral agreements. With the collapse of Beirut as a financial centre in the early 1980s, its geographical location, good relations with its Arab neighbours and with the eastern bloc and later the collapse of the USSR and its allies allowed the sector to grow massively. The financialization of the 1990s and 2000s allowed for the growth of its finance and offshore sector.

With its accession to the EU in 2004, the RoC managed to preserve a competitive tax regime of 10 per cent for international companies, allowing it to compete favourably with other EU tax havens (Liechtenstein, Gibraltar, Luxembourg and the British Isles). This bloated sector became all too powerful and unaccountable – as the globalization and EU deregulation programmes steadily allowed this to happen. Banks took high risks for huge returns, fat-cat directors made massive bonuses, various professional companies all benefited as well (accountants, lawyers and financial advice, services etc). Almost 78 per cent of all school leavers continued their studies beyond secondary education, of which 42 per cent attended higher educational institutions abroad and 36 per cent in Cyprus.

These banks expanded their business massively to Greece, Russia and Ukraine. Then came the crisis, with huge government injections to boost liquidity, but with the former Cyprus Central Governor failing to fulfil his role and the Government which faced pressing internal problems and as a result dried up the local market. Overall, we can say that there are three important conclusions from the dramatic events that brought a small and divided island to the attention of the world stage.

Conclusion

There will be a lasting legacy of the Cypriot popular mobilization against the Eurogroup and their own newly-elected President’s decision which generated the first unanimous Parliamentary rejection to the Troika-imposed austerity programme: the ‘guaranteed’ €100,000 for the deposit had to be ‘re-won’ if the EU power-elites were to keep their word. This immediately triggered mass solidarity.

How will it affect Cyprus, the Eurozone and relations in the eastern Mediterranean? This is a region which has assumed greater significance recently with a renewed interest by all global and regional powers (such as the USA, the EU, Russia, Turkey, Egypt and Israel) as the discovery of gas reserves and the upheavals in the Middle East are causing new turbulence and polarization.

Mainstream or hegemonic discourses on ‘good economic governance’ often gloss over and obscure the ‘social question.’ It was the neoliberal governance model relating to the banking and finance sector that generated the massive bank debt crisis in Cyprus, threatening the robust economy of a country based on services. The Troika ‘recipes’ have not only sunk the RoC economy into crisis, but are likely to cause a major social crisis of the same proportion to the crisis in Greece.

The public debt of the RoC was relatively low (65 per cent) compared to the Euro area average (88 per cent) or the corresponding debt of Germany (82 per cent), France (85 per cent), or Italy (120 per cent) at the beginning of the crisis. However, the public debt ratio in Cyprus is set to rise as the government seeks international lending either from third countries or from the EU financial stabilization mechanism in order to finance the banking system's recapitalization requirements and the budget deficit and debt refinancing needs. The banking crisis in Cyprus is mostly related to the Cyprus banks' exposure to Greek public bonds and to the expected bad debts of the subsidiaries of Cyprus banks operating in Greece. This is set to modify dramatically both the public debt level of the Cyprus economy and the future prospects for economic development.

Cyprus needs a broader vision based on *new* principles of governance, to break down the ethnopolitical barriers and economic interests that generate and perpetuate its structural problems. Planning for an alternative model of economic and social development with due consideration of environmental protection taken into account means learning from the past, knowing that a continuation of the existing mode of economic and social organization will inevitably lead to renewed limitations and constraints in the not too distant future.

The institutional framework for the achievement of such objectives, which is made more complicated in a federal state context, must be robust. Embarking on an alternative path of sustainable development is a complex and ambitious objective that requires not only an appropriate institutional and governance framework but also political and social struggles to support it, challenging the resistance of vested interests.

Essential steps in the direction of an alternative sustainable model of economic development include moving away from the speculative, profit-seeking private banking system to social development banking which includes the cooperative banking sector, and moving beyond the mass tourism model. It means giving priority to knowledge-intensive industries, extending social provision, and protecting the environment. The issue of the democratic accountability and good governance of the banking sector is crucial.

Cyprus can certainly learn from Iceland when it decided to allow the banks to go bankrupt, fundamentally, and not taking on public debts to rescue the banks. It must protect the depositors who put their savings in the banks, but allow large bondholders, shareholders, and large deposit holders, to take the shock: the banking and financial sectors are completely distinct anyway. The domestic economy must be protected and particularly small deposit holders and businesses.[16]

The bubble which has maintained within it the bloated Cypriot middle classes and the many sections of the working-class who enjoyed high salaries and privileges, in stark contrast to the lower echelons of the working-class (migrants, precarious workers) – has burst. Cypriot people seem to have little choice but to struggle, inside or outside the Eurozone. This is a struggle for Cyprus – it is also a struggle for Europe and the world that is worth believing and living in. •

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Endnotes:

1. Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010 /* COM/2012/0280 final.

2. According to figures issued by the OECD's Financial Action Task Force (FATF), other countries do investigate more thoroughly and detect crimes four to 20 times more frequently than German authorities do, see www.dw.de/germany-a-safe-haven-for-money-laundering/a-16343313.

3. For more on Cyprus see Trimikliniotis, N. and Bozkurt, U. (ed.) (2012).

4. Former Finance Minister Stavrakis (2012) went further claiming that the Governor of the Bank had advised bankers not to buy RoC bonds and buy Greek bonds.

5. There are some small organizations to the Left of AKEL influenced primarily by Greek groupings but they do not have any significant mass support.

6. See Panayiotou 1999; 2012.

7. According to an opinion poll by Insight Market Research (IMR) – University of Nicosia.

8. See Trimikliniotis and Bozkurt 2012.

9. See Christodoulou, 1992.

10. See Panayiotopoulos 1996; Trimikliniotis, 2001.

11. See Ioakimoglou et al, 2011; Trimikliniotis et al 2012.

12. See Panayiotou, 1999.

13. See Constantinou (2008) and Trimikliniotis (2009); (2010).

14. See Economic Interdependence in Cyprus, Main findings and recommendations, (accessed March 23, 2013).

15. See Trimikliniotis, 2001.

16. See Lapavitsas "Cyprus Should Let the Banks Go Bankrupt."

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