Market Flash

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The Cyprus Bailout: Uncharted Territory

Absent further clarity, Cyprus' proposed levy on deposits sets an uneasy precedence for the euro area's future bailouts.

The European Finance Ministers agreed to a €10 billion bailout for Cyprus over the weekend, but for the first time since the euro crisis began, this bailout will require that a levy be imposed on deposits in Cypriot banks. This caused currency markets to open this morning with the EUR gapping down, on fears that the levy may set a precedent for future bailouts in the eurozone. At the point of writing (Singapore time 5 pm), the Cypriot parliament is scheduled to vote on the legislation needed for the bailout.

Cyprus may be a "one-off"

The proposed 9.9% tax on deposits above €100,000, and 6.75% for smaller deposits is expected to raise €5.8bn, which would bring the total size of the bailout package potentially to €15.8 billion. However, there are concerns that this tax could spur a run on bank deposits, not just in Cyprus, but also in the peripheral EU countries. This would put further pressure on peripheral bond yields as well as the euro. The announcement appears to have already triggered a risk-off mode in the markets with US Treasury and German bond yields trending lower, and gold trending up. Asian stock markets have registered declines of 1-2% whilst the European equity market has opened down.

Despite the jitters, there is reason to believe that Cyprus could be a special case. Firstly, without the levy on deposits, the originally discussed bailout package of €17b would have left Cyprus with a debt to GDP ratio of 150%. This would have been unsustainable and extremely challenging for the country to service given its limited resource base. At the same time, while the bailouts in other periphery countries had required the banks to deleverage and sell assets, there are concerns that bank loan assets in Cyprus may be largely unrecoverable as loan documentation appears to have been very weak. In addition, with Russian investors reportedly responsible for €30b of Cyprus banks' deposits, it is thought that Germany would not want to be seen bailing out Russian savers, particularly given prevailing suspicions of money laundering activities.

Brace for further volatility

Even if we were to see capital flight out of the peripherals, we expect much of this capital to make its way into Germany, where the banks are deemed to be in a better shape, rather than leaving the region completely. In our opinion, the re-emergence of a balance of payments surplus in peripheral Europe has been a major defence against an increase in volatility and renewed stress in recent months. Many of the peripheral countries have already implemented large recapitalisation programs and are progressing

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well in terms of meeting their budget targets and deficit reductions. They have also made significant strides in reducing unit labour costs and improving their competitiveness both within the region and abroad. Therefore, in the longer term, assuming the Cyprus parliament approves the bailout, and that the impact on deposits can be contained within Cyprus, we expect the markets to stabilise.

However, in the near term, until European leaders are able to clarify the special factors surrounding the Cyprus bailout and to reassure depositors, the bailout could put further downward pressure on the euro. Short term investors may want to avoid the temptation to bottom fish the currency. Instead, we suggest monitoring periphery bond yields for signs of contagion and of stress returning to the European banking/sovereign relationship. A material pick up in bank borrowing from the ECB by Europe's banking sector would also be potentially negative for the currency as this would signal reduced banking liquidity and funding challenges. Finally, should deposits leave the periphery, this could put stress on selected periphery banks to maintain their capital levels. This could in turn slow lending and delay the recovery in these economies.

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