Newsweek

Too Small to Fail

A 'bail-in' saved Cyprus. But dark days are ahead.

By: Steve H. Hanke – April 15, 2013

The political elites in Brussels can once again breathe a sigh of relief. Cyprus did not implode and take the euro with it. In many ways, the latest drama in Cyprus followed a familiar pattern: the so-called troika of European leadership (the European Commission, the European Central Bank, and the International Monetary Fund) flew to a country on Europe's periphery to rescue its failing banks, that country's leadership balked, and then eventually caved to Brussels's demands.

In the past, the troika had rescued failing banks with taxpayer-financed bailouts, where shareholders took a hit but bondholders and depositors were left unscathed. This is the familiar model we saw in Greece, Ireland, Portugal, Spain, and again in Greece. So what was different about Cyprus, and why did things turn sour? Well, this time, the troika changed the model from a bailout to a "bail-in."

Under the bailout model, taxpayers implicitly promise to bail out bank creditors and depositors when things go south. Accordingly, banks are regulated by the government, in order to "protect" taxpayers. By contrast, under the bail-in model, depositors and investors (who loan money to banks) must foot the bill and bail-in banks in times of trouble. This gives them a big incentive to keep a watchful eye over bankers.

Until now, Europe (and the U.S.) has chosen the bailout route. Banks were deemed "too big to fail," and the public believed it. Indeed, in Cyprus, it was well known that several large banks were insolvent as early as the fall of 2011. Yet most depositors didn't run for the exits. They thought the taxpayers (in other words, Germany) would bail them out.

They were wrong. Despite the Cypriot rescue package being only a fraction of the size of previous euro-zone bailouts, European leadership decided that, this time, taxpayers would not be left footing the bulk of the bill for the risks taken by bankers. Rather than simply penalize EU taxpayers and the owners of Cypriot banks, the troika made the bail-in conditional on a wealth tax on Cypriot bank depositors and creditors.

The problem was that, in the original proposed bail-in deal, this tax would have applied to all bank deposits, including ones implicitly insured by the European Central Bank. This sent shock waves through the European banking system, as depositors throughout Europe wondered just how safe their "insured" deposits actually were.

Fearing a financial panic, European leaders ultimately modified the program. As usual, in the eleventh hour, a deal was struck—one that preserved small, insured Cypriot deposits while exacting a hefty tax on larger, uninsured deposits.

In the long run, this new model may represent an improvement. But the euro remains a creature of politics, not economics and finance, and only time will tell if European leaders will stick to the Cyprus bail-in model. For now, this uncertainty and the persistent pattern of governing by crisis will spawn continued anxiety for European savers and investors. This will only exacerbate Europe's credit crunch, promising weak economic growth going forward.

Contrary to the relatively rosy picture being painted by European leaders, the Cypriot economy will be hit especially hard. By my estimate, Cyprus can expect its GDP to contract by 12.2 percent in 2013. For Cyprus, even if a financial apocalypse was averted, it appears the darkest days are yet to come.