{ CYPRUS BAILOUT }

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What the trials of one smallish Mediterranean island mean for the eurozone

Has Europe really established a new template for dealing with failing banks in its bailout terms for Cyprus, as widely claimed by policymakers? Or was it just victimising a marginal member state in a manner, which far from helping to cauterise the wider financial crisis, will only deepen it?

At just 0.2% of the European economy, Cyprus could in no way be considered part of the 'too big to fail' problem, which has dogged attempts to deal with failing banks. Indeed, Cyprus's misfortune is that it is 'too small to matter', which is possibly why this smallish Mediterranean island is being used as a testing ground for a more brutal approach to banking insolvency than much of what went before.

For the first time in the eurozone's unfolding financial crisis, unprotected creditors are being made to suffer the consequences of ballooning bank losses. Uninsured deposits of above €100,000 are taking major haircuts. On one level, this is a perfectly sensible approach that many would argue should have been applied right from the start of the banking crisis. People have grown angry at banks being treated differently from ordinary businesses. When a company goes bust, creditors should pay the price, right?

But banks have been above ordinary rules and market disciplines. Their apparently protected status was at its most visible in Ireland, where, in an attempt to stem the flight of capital, the government unwisely promised to underwrite all deposits. The upshot was that losses have almost entirely fallen on the public balance sheet, rather than private creditors. What made the idea of similarly underwriting Cypriot banks particularly galling was that at least some of the large-scale depositors involved were rich Russians who had chosen Cyprus for their euro nest eggs for reasons of secrecy and tax avoidance. The idea that Europeans should bail out oligarchs seemed preposterous.

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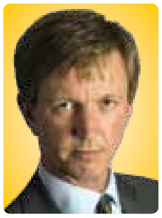
Nor was this even a dramatically new approach to banking collapses. In the US, where smaller banks go bust all the time, uninsured depositors are routinely bailed in. Even in Britain, there has been a case of it since the new, post-Northern Rock resolution regime came into force, albeit a very small one – the appropriately named Southsea Mortgage and Investment Company.

Yet to apply this approach to a country's two biggest banks is indeed something of a departure. This would never happen in the US, and even today, it wouldn't happen in the UK. Nor would it be allowed in Germany or France. Many banks are still too big to fail, and always will be. The knock-on financial and economic damage of allowing a Royal Bank of Scotland, Citigroup, BNP Paribas or Deutsche Bank to fail is too great to contemplate.

It's therefore one rule for the more dominant, larger parts of the eurozone, but a different one for the footlings. Such double standards may be acceptable within national borders, where plainly the impact of bailing in depositors in small banks is not going to be nearly as big as with larger ones. The euro area is not a country, however, but a collection of 17 fiscally sovereign nations. Looked at from the perspective of the eurozone as a whole, the failure of Cyprus's two biggest banks is but a flea bite, similar to a smallish regional bank going down in the US. But for Cypriots, the effect is completely devastating, plunging the country into a deep depression from which it will take years, possibly decades, to recover. What's more, if they can do this to Cyprus, they can do it to other economically weak countries, too. Logically, no euro deposit is any longer safe. Too small to matter? Perhaps not.



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