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EA opens Pandora's Box

- **So much for 'the crises are over'**
- **Who can now trust any guarantee?**
- **Cypriot opposition to deal in strong position**

Many descriptions spring to mind when thinking about the terms of the proposed bail-out of Cyprus: SNAFU or FUBAR, to use military terms. Or how about *fashla*, a Hebrew (actually Arabic) term meaning a major disaster? It is difficult to know even where to begin. Talking to contacts in the City in the wake of yesterday's Comment (*Another red line crossed*) a number of points have come up, including the following very valid observations:

- Why are depositors being subjected to haircuts in banks which are still in private hands?
- Why have shareholders' funds not been written down to zero?
- Why are these banks not now nationalised, if not in administration?
- Which part of the phrase "banking default" (as in, not honouring obligations) does the EU not understand?

- What is the on-going standing of the EU's deposit protection schemes? What does "the first €100,000 is protected" now mean – and will it have any credibility at all anymore anywhere in the EU? (Even depositors in the Icelandic banks were protected up to the deposit insurance ceiling, and they really were bankrupt).

- What credibility does the Cypriot banking system have now?
- Who will trust the Cypriot government not to levy a second and larger "tax" later?
- Why leave any money in the Cypriot banking system at all?
- How many banknotes are there on the island of Cyprus? What happens when they run out?
- What defences does Cyprus have against a bank run? What do Portugal or Spain have?

In my view, it is in principle right to bail in depositors. But then you cannot have – as the EU has – a bank deposit guarantee. If you have a deposit guarantee, and if – as is the case – there are banks in trouble or potential trouble elsewhere, then common sense dictates that you must be very careful to tamper with that guarantee. In this case, it seems that the (perhaps understandable) reluctance to use German (etc) taxpayers' money to bail out what is perceived to be a lot of Russian crooks, has overridden common sense. But the result of that is that it is now impossible to trust any explicit guarantees about the modalities of any bail-out or crisis package. This is of course strengthened by the fact that Greece was supposed to be the only country where the private sector was made to take part of the loss.

The inability to trust guarantees is reinforced by the fact that Jeroen Dijsselbloem, the Dutch Minister of Finance and – more importantly in this context - the President of the Euro Group, apparently has refused to rule out similar impositions in the future and in other countries. Mr Dijsselbloem's words "As it is a

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contribution to the financial stability of Cyprus, it seems just to ask for a contribution of all deposit holders" could just as easily be applied to another country.

The idea that the EA crises are over, assiduously peddled over recent months by various leading politicians and central bankers, is sadly disproved by the events of the weekend (not that it was true anyway, but it did calm markets). It is the more unfortunate in that it is very much a self-inflicted wound.

And there is another factor. This deal was agreed over the weekend. But, as is by now well-known, the Cypriot parliament is in turmoil and may not ratify the conditions. A vote was set for today – it is now postponed until tomorrow (presumably banks will remain closed tomorrow). What if parliament rejects the terms? One possibility is a very clear reply from the Troika: "No bail-in = no bail-out". But that is tantamount to expelling Cyprus from EMU. It is unlikely that the other EMU countries are prepared to take this step, primarily because of the double precedents it would set (you *can* leave EMU; and you *can* be expelled).

However, an equally unpleasant option would be for the Troika to accept Cypriot opposition and cave in. Although Ireland and Portugal have just been granted extended maturities on their bail-out debt, this would still almost certainly trigger demands for new concessions in the other bail-out recipients, notably Greece, where parliament would probably be only too happy to reopen previous deals. So the most likely outcome is some form of compromise, perhaps easing terms for smaller deposits – and harsher for larger. But this will have to be rapidly renegotiated *and agreed*, within a day or so. Cypriot banks cannot remain closed for an indefinite period, yet if they open before there is a clear and ratified agreement, they are likely to be drained of deposits the moment they open.

Could this *fashla* have been avoided? Apparently, the depositor levy was used instead of hitting investors, something the Cypriot government was opposed to. But, if banks are bust, why should investors necessarily be saved? Could the aim of not bailing out Russian depositors have been achieved in some other way? Possibly yes on all counts.

To its credit, the ECB apparently objected to the levy on depositors. It is a pity that by not listening to it, finance ministers have opened (re-opened?) a Pandora's Box. Once again, rapid action may force the lid down, but this time it won't fully close. And in the next crisis, whenever and wherever it will be, depositors will make sure they are a step ahead of events, exacerbating developments. Bank runs were supposed to be a thing of the past – now they look like a thing of the future.

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