From Greek tragedy to Cypriot farce

*The crisis in Cyprus may come to be seen as a turning point towards reduced moral hazard and a viable future for the euro, but **David Rowe** argues many pitfalls remain*

Karl Marx famously wrote that Hegel was right to state that history repeats itself but said he forgot to add that it does so "the first time as tragedy, the second time as farce". Marx certainly had the master polemicist's flair for an effective phrase, but I usually struggle to apply this one to unfolding events. Recently, however, his characterisation came to mind in the midst of the troubles in Cyprus.

For the tragic phase of this particular thread of history, look at what has happened in Greece since 2010, epitomised by a 20% fall in GDP. Of course, like all tragedies, the roots of this one run deeper than that. By forming a monetary union with no political or fiscal union, Europe's political elites attempted a fundamentally unworkable arrangement based on the triumph of hope over experience and common sense.

The hope was that eliminating the easy adjustment of exchange rate devaluation would force fiscally profligate countries to act more responsibly. No country would let its wages and prices get unreasonably out of sync with other eurozone members because the necessary corrective measures would be too painful. In an attempt to ensure countries would behave responsibly, the Treaty on the Functioning of the European Union contains an explicit 'no-bail-out clause'.[1] In the way of such things, however, other provisions undercut the no-bail-out requirements.[2]

In the end, the hoped-for fiscal discipline never materialised. In fact, the naively low interest rates that markets offered to all eurozone members for 10 years made fiscal profligacy easier, and more irresistible, than ever.

In fairness it must be said that the southern European countries were not the first offenders against the fiscal pact. Both France and Germany breached the rules without triggering penalties. Germany, at least, found the political will to reform its labour markets and put in place fiscal arrangements to enhance its competitive position and maintain a sustainable debt level. The acute phase of the crisis only began when fears emerged that Greece was on an unsustainable fiscal path and would be politically unable to make the necessary corrections. It was aggravated by the disproportionate amounts of domestic government debt held by Greek banks – a typical bias that was sanctioned, and even encouraged, by the Basel II rules that assigned a zero risk weight to such sovereign debt, helping foster the illusion that it was genuinely risk-free.

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An unwillingness to force losses on uninsured creditors of troubled eurozone banks allowed the acute phase of the crisis to morph into a chronic illness. Painful as the imposition of haircuts may have been, it would also have reduced moral hazard.

The irony is that discussions about long-term solutions consistently refer to 'bailing-in' uninsured creditors by imposing haircuts and debt-to-equity swaps, as is standard practice in conventional bankruptcies. Originally, such plans were supposed to take effect in 2018, but Germany, the Netherlands and Finland have recently pushed for an earlier date, even as the Dutch shielded senior bondholders of nationalised lender SNS Reaal. It is reminiscent of St Augustine's plea: "Oh, master, make me chaste and celibate – but not yet!"

As crisis engulfed Cyprus, tragedy became farce as a result of the initial proposal to impose haircuts on insured deposits that were explicitly guaranteed by law. If anything could have further damaged eurozone confidence in banks, this was it. Public faith in deposit guarantees that have been so successful in suppressing retail bank runs would have instantly been undermined. The potential consequences were so dire one has to wonder: "Who thinks up this stuff?!"

In the end, the more sensible step of imposing haircuts on the non-guaranteed portion of bank deposits was implemented. In effect, the powers-that-be were forced to set a precedent they had tried desperately to avoid.

I still think the future of the euro in its present form is far from assured. Events in Cyprus may represent a turning point, leading to reduced moral hazard and a viable future for the currency. With a continued need for internal devaluation to re-establish competitive balance, however, I wouldn't bet the farm on it. ■

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[1] Article 125 states that both the European Union (EU) as a whole and member states individually "shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another member state, without prejudice to mutual financial guarantees for the joint execution of a specific project"

[2] Article 122 states that when a member state is in difficulty or is threatened with severe difficulty caused by natural disasters "or exceptional occurrences beyond its control", the EU may grant financial assistance, under certain conditions