Cyprus Has Finally Killed Myth That EM Is Benign

John Mauldin | March 29, 2013

This piece from Ambrose Evans-Pritchard is about as hard-hitting an analysis of Cyprus as I have read and really makes an interesting introduction to this week's Outside the Box. No messing around:

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> The complicity of EU authorities in the original plan to violate insured bank savings – halted only by the revolt of the Cypriot parliament – leaves the suspicion that they will steal anybody's money if leaders of the creditor states think it is in their immediate interest to do so.

The IMF doesn't get off easy here, either:

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> Yet the Fund has already been through this charade in Greece, and her own staff discredited the doctrine behind EMU crisis measures. It has shown that the "fiscal multiplier" is three times higher than thought for the Club Med bloc. Austerity beyond the therapeutic dose is self-defeating.

I want to amplify Ambrose's comments by excerpting from another piece, by my über-liberal friend Yves Smith over at Naked Capitalist (although she might characterize herself as mainstream reasonable). But we share a healthy skepticism of large banks.

As we say in Texas, it ain't over till the fat lady sings. And that would be Italy, as Ambrose points out. (Which given the original intent of that quote and that Darrel Royal of the University of Texas (way back in the day) was referring to Opera Italiana, it is appropriate – in fact, we said it first!)

I have been spending a few moments here and there the last few days with my new granddaughter, Addison (and her parents). I'm now officially in a hotel room in Dallas for the duration until we can get the new place actually bought and construction done, which at best will be late summer; but I will be traveling a lot anyway the next three months, so it's just another hotel room. I am using it as an opportunity to learn minimalist living.

But I am having to become acquainted with a new knowledge domain, that of architecture and design. If I was just looking at another fund or investment manager, I would feel pretty comfortable doing it on my own, but I clearly need help here and no shame in admitting it.

Many of you may be in a similar boat when it comes to investing. You can leave it to the professionals entirely, but then you get the results that they design and not maybe what you really want. It works a lot better if you spend some time getting familiar with the rules and communicating your objectives.

Most of you would not think (or your wives would not!) of building a home without a great deal of input. Someone has to learn that language if you want to have something that really works for your situation and budget.

The same is true of investing. It is a knowledge domain that is unfamiliar to many, but it is critical to your future happiness. You really do need to get the basics down. The more you learn the better off you will be. And using professionals is important – unless you are going to spend a whole lot of time learning the rules and the tricks. In fact, it takes more than a minor investment of time and effort just to develop adequate skill to be able to pick the right professionals. Not all investment "designers" are the same level of expertise or appropriate for what you want and need.

I did a lot of construction as a young man and can understand the basics even today. But I was never skilled enough to do finish work or design. We will see if I can learn enough to pick the right team in short order! Thankfully, most of you have more time to choose investment professionals.

Have a great Easter weekend. I see more family coming my way and maybe Mavericks and Stars games in our future.

Your can't believe what everything costs analyst,

John Mauldin, Editor
Outside the Box

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Cyprus Has Finally Killed Myth That EM Is Benign

By Ambrose Evans-Pritchard, London *Telegraph*

The punishment regime imposed on Cyprus is a trick against everybody involved in this squalid saga, against the Cypriot people and the German people, against savers and creditors. All are being deceived.

It is not a bail-out. There is no debt relief for the state of Cyprus. The Diktat will push the island's debt ratio to 120pc in short order, with a high risk of an economic death spiral, a la Grecque.

Capital controls have shattered the monetary unity of EMU. A Cypriot euro is no longer a core euro. We wait to hear the first stories of shops across Europe refusing to accept euro notes issued by Cyprus, with a G in the serial number.

The curbs are draconian. There will be a forced rollover of debt. Cheques may not be cashed. Basic cross-border trade is severely curtailed. Credit card use abroad will be limited to €5,000 (£4,200) a month. "We wonder how such capital controls could eventually be lifted with no obvious cure of the underlying problem," said Credit Suisse.

The complicity of EU authorities in the original plan to violate insured bank savings – halted only by the revolt of the Cypriot parliament – leaves the suspicion that they will steal anybody's money if leaders of the creditor states think it is in their immediate interest to do so. Monetary union has become a danger to property.

One can only smile at the denunciations of Eurogroup chief Jeroen Dijsselbloem for letting slip that the Cypriot package is a template for future EMU rescues, with further haircuts for "uninsured deposit holders".

That is not the script. Cyprus is supposed to be a special case. Yet the "Dijssel Bomb" merely confirms that the creditor powers – the people who run EMU at the moment – will impose just such a policy on the rest of Club Med if push ever comes to shove. At the same time, the German bloc is lying to its own people about the real costs of holding the euro together. The accord pretends to shield the taxpayers of EMU creditor states from future losses. By seizing €5.8bn from savings accounts, it has reduced the headline figure on the EU-IMF Troika rescue to €10bn.

This is legerdemain. They have simply switched the cost of the new credit line for Cyprus to the European Central Bank. The ECB will have to offset the slow-motion bank run in Cyprus with its Emergency Liquidity Assistance (ELA), and this is likely to be a big chunk of the remaining €68bn in deposits after what has happened over the past two weeks.

Much of this will show up on the balance sheet of the Bundesbank and its peers through the ECB's Target2 payment nexus. The money will leak out of Cyprus unless the Troika tries to encircle the island with razor wire.

"In saving €5.8bn in bail-out money, the other euro area countries will likely be on the hook for four to five times more in contingent liabilities. But, of course, the former represents real money that gives politicians a headache; the latter is monopoly central bank money," said Marchel Alexandrovich, from Jefferies.

Chancellor Angela Merkel will do anything before the elections in September to disguise the true cost of the EMU project. It has been clear since August 2012 that she is willing let the ECB carry out bail-outs by stealth, as the lesser of evils. Such action is invisible to the German public. It does not require a vote in the Bundestag. It circumvents democracy.

Mrs Merkel can get away with this, provided Cyprus does not leave EMU and default on the Bundesbank's Target2 claims, yet that may well happen.

"I wouldn't be surprised to see a 20pc fall in real GDP," said Nobel economist Paul Krugman. "Cyprus should leave the euro. Staying in means an incredibly severe depression."

"Nobody knows what is going to happen. The economy could go into a free fall," said Dimitris Drakopoulos, from Nomura.

The country has just lost its core industry, a banking system with assets equal to eight times GDP, and has little to replace it with. Cyprus cannot hope to claw its way back to viability with a tourist boom because EMU membership has made it shockingly expensive. Turkey, Croatia or Egypt are all much cheaper. Manufacturing is just 7pc of GDP. The IMF says the labour cost index has risen even faster than in Greece, Spain or Italy since the late 1990s.

What saved Iceland from mass unemployment after its banks blew up – or saved Sweden and Finland in the early 1990s – was a currency devaluation that brought industries back from the dead. Iceland's krona has fallen low enough to make it worthwhile growing tomatoes for sale in greenhouses near the Arctic Circle.

If Cyprus tries to claw back competitiveness with an "internal devaluation", it will drive unemployment to Greek levels (27pc) and cause the economy to contract so fast that the debt ratio explodes.

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Yet the Fund has already been through this charade in Greece, and her own staff discredited the doctrine behind EMU crisis measures. It has shown that the "fiscal multiplier" is three times higher than thought for the Club Med bloc. Austerity beyond the therapeutic dose is self-defeating.

Some in Nicosia cling to the hope that Cyprus can carry on as a financial gateway for Russians and Kazakhs, as if nothing has happened. RBS says the Russians will pull what remains of their money out of Cyprus "as soon as the capital controls are lifted".

The willingness of the Cypriot authorities last week to seize money from anybody in any bank in Cyprus – even healthy banks – was an act of state madness. We will find out over time whether this epic blunder has destroyed confidence in the country as a financial centre, or whether parts of the financial and legal services sector can rebound.

Yet surely there is no going back to the old model, even though the final package restricts the losses to the two banks that are actually in trouble. Savers above €100,000 at Laiki will lose 80pc of their money, if they get anything back. Those at the Bank of Cyprus will lose 40pc.

Thousands of small firms trying to hang on face seizure of their operating funds. One Cypriot told me that the €400,000 trading account of his father at Laiki had just been frozen, leaving him unable to pay an Egyptian firm for a consignment of shoes.

The Cyprus debacle has taught us yet again that EMU has gone off the rails, is a danger to stability, and should be dismantled before it destroys Europe's post-War order.

Whether it marks a watershed moment in the crisis is another matter. Italy, Spain, France and Portugal have their own crises, moving to their own rhythm.

The denouement will arrive when the democracies of southern Europe conclude that recovery is a false promise and that the only way to end mass unemployment is to break free of EMU's contractionary regime.

It will be decided by Italy, not Cyprus.

Will Cyprus Be Contained? (Updated)

By Yves Smith, *Naked Capitalist*

In March 2007, Fed chairman Ben Bernanke said that he thought the impact of losses on subprime mortgages was likely to be contained. It took five months for events to start proving him wrong.

August 2007 marked the onset of the first acute phase of the global financial crisis, when the asset-backed commercial paper market seized up.

Last week, in a press conference, Bernanke indicated that he thought the likelihood of the crisis in Cyprus having larger ramifications was limited, and avoided using the “c” word. But the message was similar to that of March 2007. So now that Cyprus has agreed to resolve its problem banks on its own, the island nation has secured a short-term sovereign cash fix. As MacroBusiness described it:

> The restructure is enough for the IMF to agree to release a 10 billion euro bailout, which will do nothing whatsoever to address Cypriot public debt sustainability or the economy (other than hurt both).

And there also is a rather visible inconsistency between the Eurocrats’ insistence that Cyprus was too small to make any difference and the stock and currency market response to the news of a deal.

So are we likely to see the sort of delay between the assessment and the onset of trouble, as we did in 2007, or is Cyprus a nothingburger, as the Troika and many investors contend? I welcome reader input, but I’d say the odds of knock-on effects are greater than the cheery official assessments would lead you to believe.

As we’ve indicated before, the threat is that bank runs start in other periphery countries, based on a recognition that their bank is at risk plus a concern that they will be made to take losses, as large depositors were in Cyprus. We never thought the odds of a “hot” run, as in people lining up at banks to withdraw money, was all that high, and it’s been reduced even further by the fact that depositors under €100,000 were spared. However, we think the slow-motion departure of depositors from periphery banks is likely to resume….

First, confiscating bank deposits is now on the table in any future crisis. That’s toothpaste that’s not going back in the tube. Commerzbank chief economist Jörg Krämer has already suggested (Google translates) “a one-time property tax levy” for Italy and “a tax rate of 15 percent on financial assets.”

And adding fuel to the fire, the Leader of the UK Independence Party has urged expats in the periphery countries, in particular the 750,000 British in Spain to “Get your money out of there while you’ve still got a chance.”

Second, capital controls in Cyprus mean that there are now two Euros in effect: The Euro that you can use only in Cyprus, and the Euro you can use elsewhere in the so-called “monetary union.” So from the perspective of people in Cyprus, the results are in some ways worst that a breakup: rather than having depreciated dough, you have dough that has been impounded, particularly in terms of using it outside Cyprus.

In each case, why wouldn't every business owner or wealthy Euro-holder in the periphery go into "First, they came for the Cypriots" mode, take economist Krämer at his word, and move their money to where they had some reason to believe it was safe?

Third, these concerns may be amplified by how rapidly and visibly the Cypriot economy craters. The "rapidly" is due to the fact, as discussed in greater detail in the post from Cyprus.com below, that the Cyprus economy will suffer a one-two punch: the loss of a big chunk of wealth, plus the disappearance of much of the financial services sector, which was 45% of GDP. The author estimates a 20% to 30% fall in output in two years; that could turn out to be conservative, given that the tender ministrations of the Troika will only make a bad situation worse. This is almost certain to be a more rapid and severe decay than in Latvia or Ireland.

But the "visibly" is just as important. The financial media has taken perilous little interest in the human suffering in Greece, Ireland, and Latvia (that should actually be no surprise given who their advertisers are). Oh, you'll read the stories about how many medications aren't being imported in Greece, sheets are being re-used in hospitals, suicides have skyrocketed, and trash collection is erratic at best, but these articles are few and far between. The dire conditions and the depopulation of Ireland and Latvia get even less press.

By contrast, the revolt by Cyprus' parliament and the fraught negotiations have given this bailout negotiation far more profile than its predecessors. There is almost certain to be a fair amount of media coverage of the immediate impact of the bank restructurings and the capital controls. And we are also likely to get the BBC effect, which is ongoing coverage by the English press of conditions in Cyprus due to the number of expats living there (Richard Smith tells me that it was popular among RAF retirees, since their modest pensions and savings would not allow them to buy adequate housing in the pumped-up English market). That will probably produce some echo coverage in other English language press and possibly on the Continent. So the odd favor having ongoing media depictions of Cyprus' distress, which in turn would increase anxiety levels in periphery countries.

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