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Cyprus: assessment of the risks to the financial stability of the Euro Area (Art 13 of ESM Treaty)

In compliance with Article 13 (a) of the ESM Treaty, this note has been prepared by the European Commission in liaison with the ECB

Background

On 25 June 2012, the Government of Cyprus requested external financial assistance from the ESM Member States, in the context of a full-fledged economic stabilisation programme implying strict conditionality in the areas of financial sector, budgetary and structural policies. Article 13 of the ESM Treaty entrusts the European Commission, in liaison with the ECB, with the task to '*assess the existence of a risk to the financial stability of the euro area as a whole or of its Member States'.* Pursuant to article 13 of the ESM Treaty this note assesses the existence of a risk to the financial stability of Cyprus, its direct neighbours (notably Greece) and the euro area as a whole.

Financial stability risk to Cyprus

The financial situation in Cyprus is fragile. The Cypriot economy is characterized by a large financial sector. The consolidated balance sheet of the Cypriot banking sector is about 750% per cent of GDP (including foreign banks operating in Cyprus), with a high exposure to Greece and domestic real estate.

The Cypriot banks have been badly hit by the Greek crisis. The Cypriot banks suffered about 4 billion in losses from the Greek PSI, i.e. more than 22 per cent of GDP. The steep contraction of the Greek economy has caused a significant deterioration in the quality of the Greek loan book. In Cyprus the property market has gone from boom to bust, which has impacted negatively on the domestic loan book. Based on stress-tests, including by PIMCO, the capital shortfall of the Cypriot banks is estimated at around 10 billion, after bailing in junior debt holders, or almost 60 per cent of GDP.

The liquidity situation in the banks is tight. The only available liquidity backstop for Cypriot banks is ELA from the Central Bank of Cyprus (CBC). Due to the capital shortage and the erosion of collateral value large Cypriot banks have lost access to the regular financing operations of the ECB.

Since the start of the crisis the fiscal situation has sharply deteriorated. The ratio of debt to GDP has increased from 58.8 % of GDP in 2008 to 89.7% of GDP in 2012. Rating agencies have progressively downgraded the sovereign signature until it reached junk status in early 2013. The Cypriot government has lost market access in autumn 2011.

In the absence of an assistance programme the capital shortfall in the banks would not be addressed. As a consequence the Euro system could also not any longer grant a liquidity backstop to Cypriot banks. In the event of a bank default the Cypriot government would not be able to fulfil its obligations and would have to default on its current payments and debt service.

In this scenario the Cypriot government would be forced to instantly balance its books, resulting in a very sharp contraction of the economy and the collapse of the banking system. Cypriot citizens would suffer significant reductions in wealth and income and a large part of the companies would not survive the shock. The Cypriot government would also have to put in place a bank holiday, deposit withdrawal restrictions, and capital controls for extended period of time to avoid a flight of capital and liquidity.

Financial stability risks to Greece

The country that would be most directly affected is Greece. The economic and financial situation in Greece is still very fragile. This means that Greece is relatively vulnerable to shocks. A collapse of Cyprus would have direct and indirect impacts on Greece.

The direct impact on Greece will be primarily through the banking sector. The two largest Cypriot banks have systemically important operations in Greece via branches. The two banks account for 8 per cent of the Greek deposits. The collapse of the Cypriot banks would lead to a deposit freeze and the imposition of any other restrictions put in force in Cyprus also on the Greek branches of these Cypriot banks. There would be a direct confidence impact on Greek banks, at a time when the 4 major banks are consolidating and have two more months to raise missing capital from the market. Failing this, most of the Greek banking system will be nationalised (or publicly owned), with potential adverse impact of perceptions of sovereign debt sustainability.

There could be significant and negative signalling effect related to deposit runs, defaulting banks, sovereign default and the risk of imposition of administrative controls also elsewhere. Moreover, it could lead to renewed doubts about the integrity of the euro zone. Greece being the weakest link would likely be the first in line.

Financial risks to the euro

Cyprus, with its GDP of less than EUR 18 billion, is by all standards a small economy relative to the size of the euro area. For this reason one would under normal circumstances expect the direct impact of an outright default on the broader Eurozone to be limited. The situation in bank funding and sovereign markets however is still very fragile. The indirect consequences of a Cypriot default should be assessed against this backdrop. A number of risks can be identified.

- The example of very steep deposit losses in Cyprus, may negatively impact on deposit stability elsewhere.
- Apart from any possible instability in deposit base, Eurozone banks may see their ability to raise unsecured funding deteriorate.
- There is a risk of a negative impact on the funding outlook for vulnerable sovereigns. A number of countries are approaching the end of their programme and are working towards establishing full market access (for example Ireland and Portugal). Others have been working hard to keep market access. There is a risk that a new round of instability may reverse this.
- The imposition of capital controls in one part of the euro area may have an impact in and by itself on the private capital flows to other vulnerable countries.
- An uncontrolled collapse of Cyprus may create renewed doubts on the integrity of the euro zone. This could be very damaging for financial stability and economic growth in the Eurozone.

Conclusion

Despite the small size of the Cypriot economy, disorderly developments in Cyprus could undermine important progress made in 2012 in stabilizing the Eurozone. A default of Cyprus and banks would have direct stability implications for Greece and indirect consequences for the wider euro area, with possibly doubts about the integrity of the euro zone resurfacing again. This could lead to renewed financial instability requiring further mitigating policies and to a further loss of growth and jobs in the Eurozone.