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Communication as a policy tool: Important lessons from Cyprus

Leonor Coutinho

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Information is part of any policy-maker's toolkit. In the context of monetary policy this fact has been widely recognised; the communication strategy of modern central banks is as important as the decision whether to increase or lower interest rates. The communication strategy of policy-makers anchors expectations and builds credibility. One thing is clear about the recent policy actions in Cyprus to resolve its banking crisis: a well-structured communication strategy has been conspicuously absent. As a result, expectations have not been anchored, and credibility is being questioned.

Nicosia, Saturday March 16th: Cypriots wake up to the troubling news that bank deposits have been frozen and that levies of 6.7% and 9.9% will be charged on deposits below and above €100,000, respectively. The announcement comes after Cyprus' politicians had repeatedly reassured people that their deposits were safe. No further details and no official communication came that morning. Many questions were left unanswered: on what balance would the levy be applied (on an average monthly balance, the balance at close-of-business on Friday, on the balance on Sunday March 17th, etc.)? From that morning on traffic at the cash machines started to increase, with some residents withdrawing money simply to ensure that they would have enough liquidity to meet their everyday needs for a few days; others trying to 'rescue' as much of their savings as they could from the impending levy, just in case. Queues then started to form at the cash machines, and in subsequent days became more notorious outside Laiki Bank, as rumours began to spread about its insolvency. Throughout the weekend many more questions were raised about the details of the operation, and speculation came from many different directions. On Monday March 18th, the parliament rejected the government's proposal. There was no information about any 'plan B'. Hence there was more speculation: ranging from a possible exit from the euro to a plan to issue GDP-indexed bonds. The rush to cash points continued, demonstrations were starting to take place and there were rumours about food and fuel supplies running out as the country became more liquidity-strapped. All signs of confusion.

Nicosia, Sunday March 24th: the long-awaited plan B is announced. The plan broadly consists of the alienation of Cypriot bank branches operating in Greece, and the resolution of Laiki Bank – the second largest bank operating in Cyprus. Performing loans of Laiki Bank and deposits below €100,000 are to be incorporated into the Bank of Cyprus, but deposits in excess of €100,000 in both banks will be used to finance the rescue package. The exact value

Leonor Coutinho is Senior Researcher at Europrism Research (Cyprus) and a Special Scientist at the University of Cyprus.

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of the losses to be borne by large depositors is uncertain at this point. Official communication about the plan and its possible implications is poor: incitement to national pride, courage and hard work provide little information about what to expect in reality. Many important questions remain unanswered. How many bank employees may lose their jobs? Is there any plan to replace older workers, close to retirement age, by younger workers? Will there be any support for couples with children where both members of the couple lose their banking sector jobs? What will happen to large institutions like schools, which may have all the money they need to pay teachers and other current expenses deposited at Laiki Bank or at the Bank of Cyprus? Pension funds are also likely to be hit. Have these issues been factored into the bailout calculations? Will the resolution of only Laiki Bank be enough to restore the stability of the Cypriot banking system, or will further restructuring be needed?

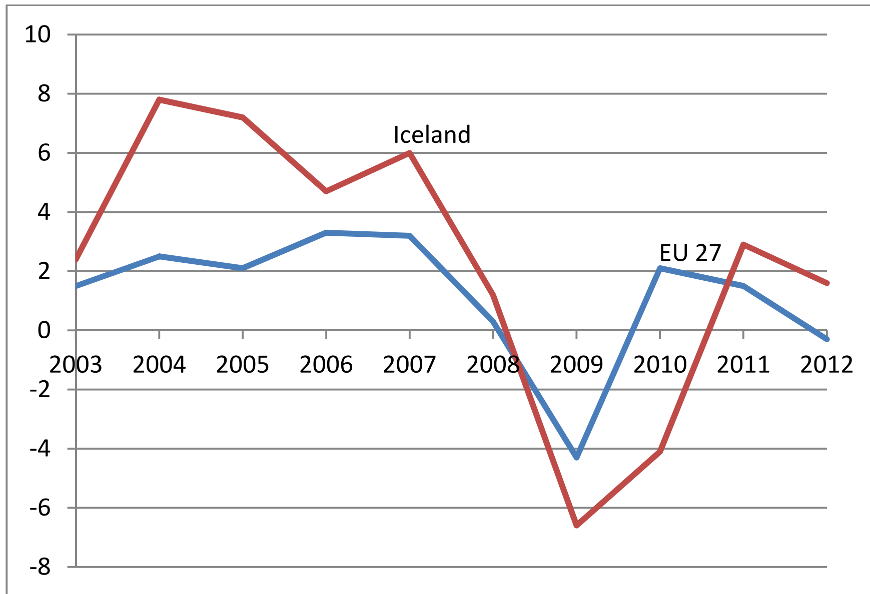
The policy strategy chosen in Cyprus is not without precedent. A very similar solution was adopted in the case of Iceland. Iceland allowed its three largest banks to fail as part of the solution to the banking crisis that struck the country in 2008. These banks had assets that were about ten times the size of the country's GDP; a ratio not dissimilar to the ratio of banking assets to GDP in Cyprus. The Icelandic experience could hold many lessons for Cyprus, since the impact of the re-structuring could be similar. The central bank of Iceland, for instance, suffered heavy losses in the value of the collateral pledged by the three collapsed Icelandic banks, accumulated during the time when the attempt was made to save them (see FT, 2013).[1] The fall in GDP in Iceland reached -6.6% (see Figure 1, below). It is true that this was accompanied by large currency devaluation, but experts agree that the devaluation has had a limited cushioning effect on the economy, due to its minimal impact on fish exports; a sector with rigid supply, and due to the effects of imported inflation. It is important, however, that any rescue programme for Cyprus does factor in a fall in GDP, certainly in the range of -6% to -10%, or it risks jeopardy from the start. Furthermore, the crisis in Iceland imposed a restructuring of the economy: the downsizing of the banking sector and its gradual replacement as a motor for growth by other economic activities, including traditional industries like fisheries and the energy sector. Cyprus will also need to reinvent itself.

The Icelandic experience has also shown that it is not easy to live with capital controls, and that these, once in place, are difficult to dismantle. Capital controls should be carefully studied so as to minimise the strain on businesses, as well as the disincentives for the banking sector to effectively restructure. This will be the case, for instance, if restrictions on domestic transfers or on loan restructurings are imposed. This type of restriction will not only deter depositors from undertaking a sensible diversification, but will also lead to complacency on the part of banks. Additionally, the crisis in Iceland has actually brought the island closer to the EU than before: isolation is not an option for a small island economy. Finally, to end on a positive note, the Icelandic economy (as shown in the figure) has recovered incredibly quickly, performing well above the EU27 average in both 2011 and 2012.

There are alternative strategies for solving a banking and financial crisis. But there is a textbook premise that is important to keep in mind: the financial sector is based on trust. Whatever the plan is it should be coherent and spelled out in a clear and transparent way, so that agents' expectations are anchored in the success of the plan from the outset. Destabilising leaks or statements that are later withdrawn should be avoided. In the case of a banking crisis it is even more important for policy-makers to treat communication as an important component of the policy toolkit, even beyond the borders of central banking.

[1] "Doubts Cast on Icelandic Crisis Model", Richard Milne, *Financial Times*, 3 March, 2013.

Figure 1. GDP Growth Iceland and the EU (boom and bust)



Real GDP growth rate, percentage change from previous year.

Source: Eurostat.