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The Cyprus Financial Assistance Package and EU–Russia Relations

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Despite having completely different views on Cyprus' financial problems, the EU and Russia have shared interests in the island country avoiding insolvency given the economic and political risks it carries. The adoption of the rescue package is just the first step on a bumpy road to Cypriot economic recovery. The details of the agreement, interpreted in Moscow as hostile to its interests, could not only cool Russia's relations with the EU but also reflect on other areas, such as conditions for European business in Russia.

After marathon all-night negotiations, on 25 March the Eurogroup, International Monetary Fund (IMF) and Cyprus managed to reach agreement on a financial assistance package worth up to €10 billion. Cyprus agreed to implement radical measures, including an orderly bankruptcy and restructuring of its two largest banks at the expense of shareholders and bondholders, a reduction of the financial sector and a comprehensive audit of it. Depositories in these banks, of which many are Russians or Russian-owned companies, will suffer losses of at least 20% of the value of their deposits. The holders of deposits under €100,000 will be spared. Cyprus has also been required to take on difficult structural reforms, fiscal consolidation and privatisation.

Cyprus' Importance to the EU and Russia. Although Cyprus' economy represents only 0.2% of the EU-17 GDP (and 0.14% of the EU-27 GDP), insolvency, especially in a disorderly manner, could cause a "domino effect" as investors lose trust in other weak eurozone states, possibly pushing them out of the single currency area.

The importance of Cyprus to the Russian economy—primarily as a financial operations centre—is proved by the fact that not only tens of thousands of Russian firms and private persons but also Russian state institutions used the services offered there. According to Moody's Investors Service, Russian assets in Cypriot banks reached $31 billion, with $19 billion in the form of deposits. The attractiveness of this financial hub was based not only on a favourable climate for investment, effective legal protections, a minor level of corruption compared to Russia as well as a developed financial infrastructure but also on the low level of transparency of the Cypriot banking system (resulting in illegal capital flows to Cyprus from Russia, Ukraine and other CIS countries). No less important in attracting Russian capital was Cyprus' favourable tax system, including one of the lowest CIT rates in Europe (10% in Cyprus in comparison to 20% in Russia) as well as the existence of a treaty for avoidance of double taxation.

The announcement of the original bailout package provoked Russia to sharply criticise the EU. Russia's main complaint concerned the lack of consultation on the plan. In response, the Cypriot Minister of Finance engaged Russia in an attempt to gain support for the measures without consulting with his European partners. However, both statements by European politicians and the course of the EU–Russia consultations held in Moscow revealed that the EU strongly opposed the inclusion of Russia to work out a solution. Consequently, Russia decided not to offer financial assistance to Nicosia, realising that it may not save Cyprus but would entail huge costs to the Russian budget. Another factor was harsh Turkish objections to plans to use disputed gas fields near Cyprus as collateral for the Russian loan. This attempt raised anger in Ankara and may in the future complicate the issue of the island's division.

Prospects for Future Developments. Agreement on the rescue package discounts the prospect of insolvency for Cyprus or the threat it may leave the euro area. It will also provide a few months of relative stability in the eurozone before elections to the German parliament. Yet, there are serious concerns about the development of the economic situation in Cyprus. Massive capital flight and a drastic contraction of the financial sector, which is the main driver of economic development in the southern part of the island, could deeply hurt the Cypriot economy and bring about a deep, long recession and a massive increase in unemployment. This may result in the need to revise the rescue package in a few months. Besides, the adoption of the financial assistance package is only the first step on a difficult path aimed at structural reforms and the creation of a rational basis for the further economic development of Cyprus. The growth of nationalist sentiment, treatment of financial assistance as a violation of sovereignty, and the vulnerability of political elites to populist demands does not bode well for the implementation of the reforms.

While Russian politicians will probably criticise the EU for a long time, they did not expressly reject the negotiated financial assistance plan. Russian authorities want to influence EU policy in this area and do not want to be completely excluded from future arrangements for the island. President Vladimir Putin's recommendation to continue talks about restructuring a loan of €2.5 billion granted to Cyprus in 2011 is evidence of this ongoing interest. A statement by Prime Minister Dmitry Medvedev in which he referred to Russian resources located in Cyprus banks as coming from theft might be interpreted to suggest that the interests of the Russian elite have been secured and those who may suffer from the levy on deposits above €100,000 are businessmen without close ties to the Kremlin.

Conclusions. The confiscation freezing of Russian companies' assets is a serious obstacle to their doing business. The negative effects of the decision in Cyprus may reach to the Russian banking sector. This is particularly important in view of the economic slowdown in Russia. Sluggish changes in the business environment in Russia as well as the need to increase profits may force Russian capital to look for new locations.

Given, that the rescue plan has been widely interpreted in Russia as a hostile action that affects its interests and therefore it can be expected that the Cyprus situation will lead to a cooling of relations with the EU, primarily with Germany.

The deterioration of relations will mostly be limited to signals of Russia's displeasure, for example, through diplomatic channels or in Russian media campaigns aimed at offering unfavourable views of German Chancellor Angela Merkel. One can also expect new obstacles for companies operating in Russia, especially those with German capital. This may take the form of a freezing of assets or the imposition of extraordinary levies. Besides those options, Russian authorities have a number of other administrative measures that can hinder the activities of European companies or German political foundations

Furthermore, the situation in Cyprus as well as the initiation in 2012 of an investigation into monopolistic practices by Gazprom represents a transformation of the EU's relations with Russia. The new element is a greater assertiveness by Brussels, which is not afraid of conflict with Russia and its economic interests in pursuit of EU policy. The reasons for this can be found in both disappointment with the slow pace of modernisation in Russia as well as the economic crisis in the EU. On the other hand, one can notice increasingly assertive attempts by Russia to weaken the image of the EU, including public criticism of its actions on the crisis in the euro area. This may be intended to strengthen the part of the Russian elite that advocates intensification of alternative activity to Western foreign policies through projects in the post-Soviet area or closer relations with emerging economies.

The outcome of the dispute over the aid package is important for Poland, which has an interest in mitigating the situation in the euro area. A return of the eurozone crisis may worsen the situation of the Polish economy, which is highly connected to the euro area. The imposition of a special levy on depositors may cause more caution among investors when choosing destinations for capital. This may be beneficial for states with more transparent public finances that lie outside the eurozone, including Poland, provided that they follow a long-term, reliable path of economic development.