

Capital Controls in Cyprus: Shooting at a moving target

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Capital controls have been in place in Cyprus now for about two and a half months following their introduction on March 27th. In the meantime, some 15 decrees have been issued by the Ministry of Finance, prolonging the restrictions but with substantial relaxation regarding to payments both domestically and abroad. In addition, exemptions have been granted for selected foreign banks for operations with non-residents. To date, 16 foreign banks have been placed on the list of institutions benefiting from these exemptions. Tight restrictions continue to be placed on cash withdrawals and transfers between institutions that do not correspond to payments that can be classified as ‘normal business’.

One can argue that capital controls in their current form should not significantly hamper the normal business of firms, or at least of small- and medium-sized enterprises. However, they do affect firms indirectly, through negative expectations. These negative expectations have already materialised into a negative shock with the downgrading of Hellenic Bank on April 23rd from a B rating to “restricted default”.¹ In the current context, banks in Cyprus have little access to new funds and are suffering a slower but systematic drainage of their existing funds. Capital controls can slow down the trend but cannot stop it. Figure 1 shows the deposit outflows registered in March and April 2013, and although the figures include the reduction in deposits due to bail-in write-downs, they still represent a significant outflow even if those are taken into account.² Furthermore, banks in Cyprus appear to have limited access to other funds as can be inferred from the still relatively high levels of ELA (emergency liquidity assistance) as a share of GDP, which appear in the balance sheet of the Central Bank of Cyprus.³

¹ Reuters, 23 April 2013.

² The bail-in represented a conversion of about €3.19 billion into capital (see Central Bank of Cyprus, Media & Publications, “The financial position of the Bank of Cyprus”, 17 May 2013).

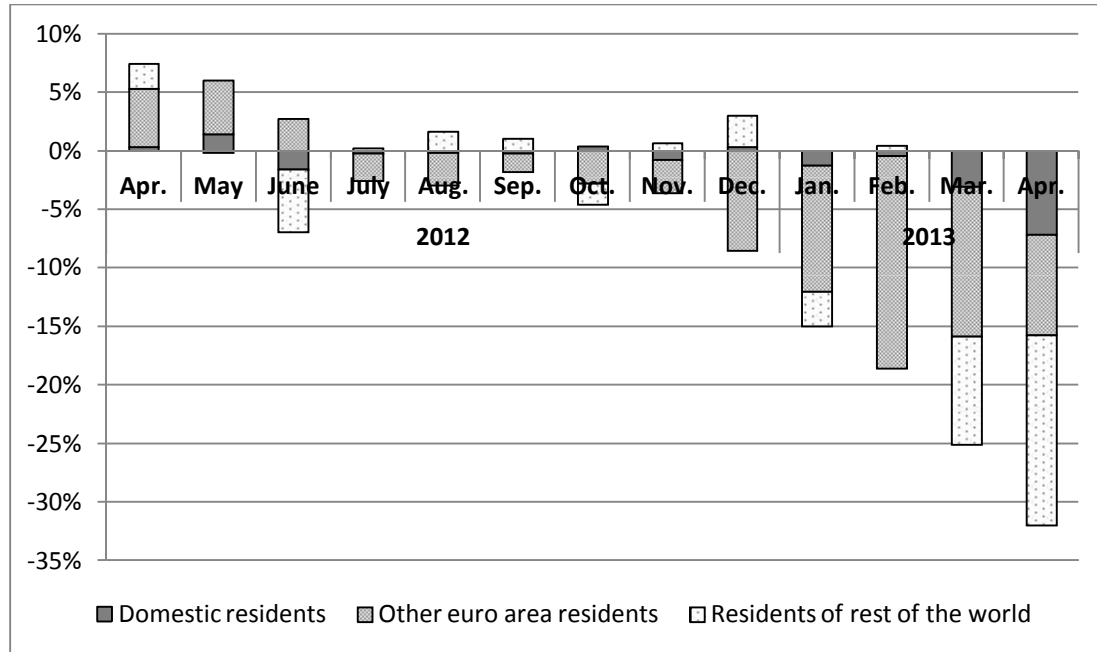
³ It was agreed by the Eurosystem in April 2012 to classify Emergency Liquidity Assistance (ELA) provided to the domestic credit institutions under “Other Claims on Euro Area Credit Institutions in Euro” (see Central Bank of Ireland Financial Statements, April 2013). The Central Bank of Cyprus has registered in its balance sheet an additional €2.3 billion under this classification from February to April 2013 (representing approximately 13% of Cyprus’ 2012 GDP). It is important to note that additional ELA represents further government debt if the collateral is not good enough.

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Figure 1. Total deposits of MFIs from non-MFIs in Cyprus
(transactions as a percent of outstanding amounts in the beginning of the period)

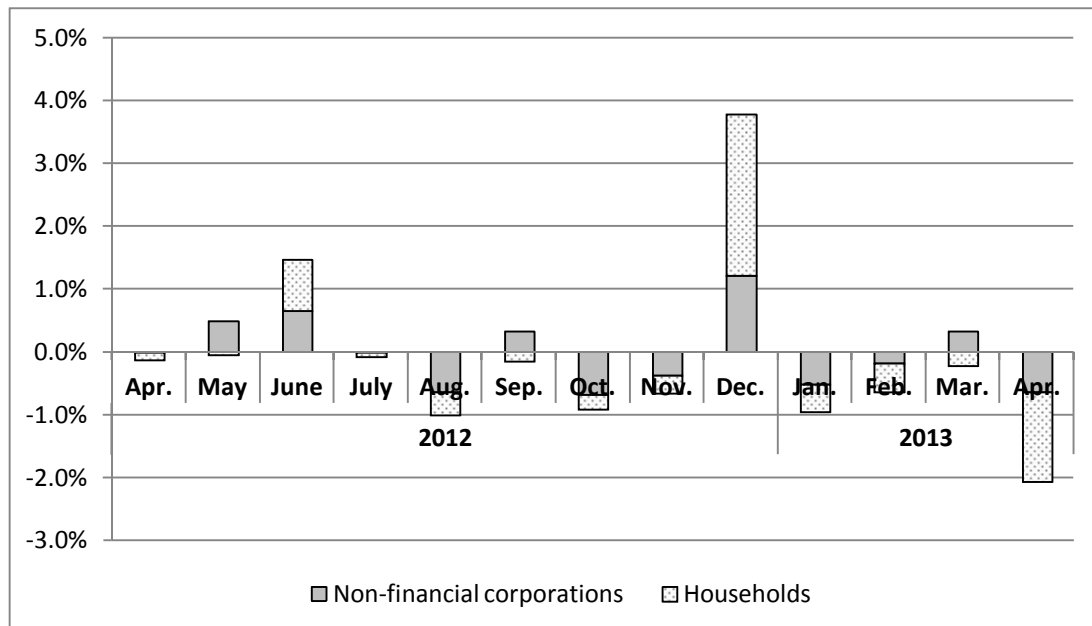


Note: MFIs = Monetary financial institutions.

Source: Central Bank of Cyprus, Monetary and Financial Statistics, May 2013.

With limited access to funds, banks have nearly frozen all new credit. Furthermore, no distinction is being drawn between consumer credit, investment or credit for working capital: all types of credit have been put on hold, resulting in a significant decline in outstanding loans, as shown in Figure 2. Although the household sector has been the most significantly affected, April witnessed a significant decline in loans to non-financial corporations, and the result is that more and more businesses are struggling with liquidity management, and few are likely to survive the strain.

Figure 2. Loans from MFIs to the non-MFIs and the household sector in Cyprus
(transactions as a percent of outstanding amounts in the beginning of the period)



Note: The peak in December is due to seasonal effects.

Sources: Central Bank of Cyprus, Monetary and Financial Statistics, May 2013.

When can capital controls in Cyprus be lifted? Conventional wisdom suggests that capital controls cannot be lifted until convincing recapitalisation plans for the Cypriot banking sector are finalised and made public. The final recapitalisation plans for the Bank of Cyprus, including the decision on the final haircut to be applied to unsecured deposits and the unfreezing of accounts (unsecured deposits have already been 'cut' by 37.5%, with the remaining 22.5% frozen in waiting) is expected by the end of June.⁴ By more or less the same time, the recapitalisation plans for the credit cooperative sector, including more than 90 institutions that have been treated as a whole due to their mutual guarantee scheme, are also to be disclosed. Banks that are not expected to apply for state aid can submit recapitalisation plans as late as September. So, in principle, capital controls could be lifted as early as October 2013. The problem is that unless credit starts pumping in liquidity to finance the working capital of businesses and to help them meet their tax obligations in time, non-performing loans will continue to pile up. Attempts by the banks to recapitalise will be akin to shooting at a moving target. Such a feat requires extraordinary swiftness – a quality that Cypriots have not seen much of in recent years.

The next question is whether recapitalisation plans will be convincing and whether the Cypriot banking sector will be able to regain the trust of the public. In the case of credit cooperatives and other commercial banks, it all depends on their revealed situation and on the plans that are unveiled for their recapitalisation. In the case of the Bank of Cyprus, one thing is certain: most if not all depositors who have suffered haircuts in the re-structuring process are likely to opt for moving their remaining funds out of this institution as soon as capital controls are lifted, and little can be inferred about the likely behaviour of the remaining depositors. There is a real risk, however, that the authorities have been futilely engaged in keeping banks afloat that could have been better left to default, as happened in the case of all three of the largest banks in Iceland (Kaupthing, Landsbanki and Glitnir).⁵

Cypriots are already braced for a difficult 2013, with a fall in the country's GDP for the 1st quarter already reaching -4.1% relative to the same quarter of the previous year, according to Eurostat (and -1.3% relative to the 4th quarter of 2012). It is important to observe, however, that the full extent of the blow may only come in 2014, several quarters after the beginning of the bank restructuring process. In Iceland, the largest fall in GDP was registered in the 4th quarter of 2009, a full four quarters after the decision to allow its three largest banks to collapse, which took place in the 4th quarter of 2008.⁶ The full impact of the crisis in Cyprus is also coming with a delay. The large drop in employment that should accompany the significant reduction in the size of the banking sector, for instance, is still to materialise. This will present an inevitable shock to the economy, which will also mark the end of the banks' restructuring period. This sector employs about 18,000 persons (according to 2012 data) representing about 4.85% of total employment in 2012 (see Figure 3). The laying-off of a significant share of these workers will of course have important multiplier effects throughout the rest of the economy. This shock will add to an already high unemployment rate of about 15%, as registered in April 2013, and to which another large pool of unemployed was added in May 2013 (unemployment in May 2013 rose by about 3% relative to April 2013, with the most seriously affected sectors to date being wholesale and retail trade and construction.

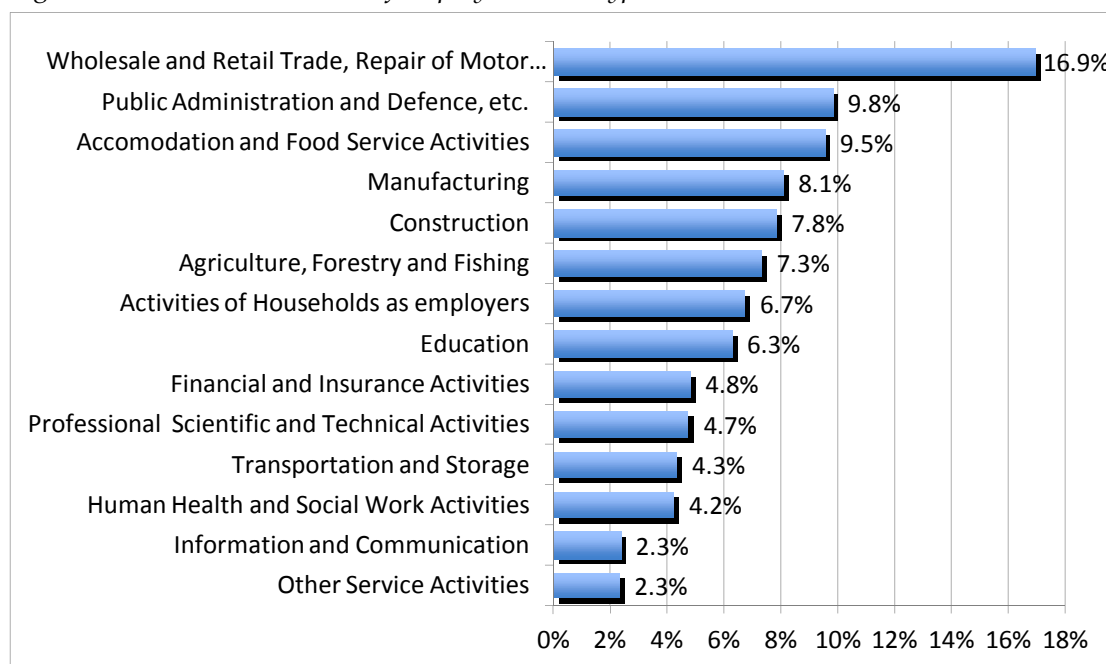
⁴ Reuters, 28 May 2013.

⁵ "Doubts Cast on Icelandic Crisis Model", Richard Milne, *Financial Times*, 3 March 2013.

⁶ In October 2008, the Icelandic Parliament passed the Emergency Act (No. 125/2008), granting depositors priority ranking in insolvency proceedings over that of other unsecured creditors, and enabling the Icelandic Financial Supervisor to transfer assets and liabilities from the collapsed banks to new banks (see EFTA Supervisory Authority, "EFTA Financial Crisis: Emergency Act Compatible with the EEA Agreement", December 2010).

In short, the only way to stop the downward spiral is to devise a good strategy for withdrawing capital controls soon and reinstating the normal functioning of the banking sector.

Figure 3. Sectoral distribution of employment in Cyprus, 2012



Note: Sectors that account for less than 2% of employment have been omitted.

Source: Cystat (Cyprus Statistical Authority).