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Saving Cyprus from its "Financial Crisis" in 2013 by the Troika: A Necessary Action Under the Right Terms and Conditions?

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Abstract

At June 25th 2012 Cyprus asked the Troika for financial aid after the two biggest banks of the small island state got into distress due to the contagion of the financial crisis from Greece. There were losses piled up of around 4 Bn. Euro. Through interlinkages between the public sector and the banking sector and an ever-intensifying financial crisis in the Eurozone, Cyprus was in jeopardy of losing the capability of repaying its debts. Since then among the EU-members (in politics as well as in society) the question of a bail-out necessity for distressed countries, particularly Greece and Cyprus were discussed. This paper discusses pros and cons of an imminent rescue-package in for Cyprus in terms of necessities as well as specifically a combined bail-out bail-in mechanism. The findings suggest, that both, generally and specifically regarding the Cypriot case, bail-ins have shown to be effective in reducing the financing needs for respective governments and creditors. Nevertheless, such measures do not come without a price. Therefore, political, social and cultural aspects and impacts on the citizens are regarded in this work.

Keywords: Financial crisis; Cyprus-rescue; Bail-out; Cross-country contagion; Eurocrisis

Introduction

Problem set

Since October 2009, when Greek government declared that the financial situation is much worse than expected and finally asked the European union for financial aid, in the Eurozone and its societies it was emotionally negotiated how to handle such situations in presence and future. Not only concerning the public notion, but also practical political and monetary-policy-related measures. On May 2nd, 2009 the EU decided to give a financial aid package of 110 Bn. Euro to Greece, as the state could not generate liquidity on the bond markets anymore and was in imminent danger of defaulting. Subsequently Cyprus applied for a financial aid-package amidst 2012 at the Troika. Again, the necessity, possible size and conditions of a potential aid package were discussed.

Even though it may not have been on the radar of most people as something other than a sunny holiday destination, it attracted attention in 2013, when it was hit by the contagion effects of the Greek financial crises and requested a bail- out amounting to € 17 bn. from the EU. Considering the high level of globalization leading to great financial-, market- and economic interdependencies among countries worldwide, the contagion of market downturns and financial crises has become a widely discussed topic among academics, politicians and policy-makers. Research and discussions are revived every time a new financial crisis hits the global or regional economies such as the Asian financial crisis in 1997-1998, the Dotcom crash in 2001 or the US Subprime crisis in 2008, which subsequently spurred the development of the global financial crisis that could be felt worldwide [1]. Often, one of the most popular approaches to deal with such financial crises is bailing-out the party in financial distress. While the term *bail-out* has already become general vocabulary, the term *bail- in* is rather unknown to the general audience. However, this is what happened in Cyprus. To receive a € 10 bn. bail-out from the European Union, the country had to come up with roughly € 5.8 bn. itself. This was done by hitting all bank deposits over € 100,000 with a 9.9% one-off levy and all others with 6.75% [2,3]. Even though this was a controversial decision in light of its effects on investor confidence and public reaction, it appears that it has paid off. Today, Cyprus has recovered from its financial situation while having used only € 7.5 bn. of its rescue package [4].

There was no common procedure before that dealt with state defaults in the Eurozone. Under consideration of the economic, political (nationally and supra-nationally) and social aspects this work intends to question the Cyprus-rescue in terms reasons, necessities and impacts of the implemented measures (for Cyprus itself and potential future state defaults in the Eurozone). In 2013 it was not only about saving Cyprus. No-one knew about how a potential bail-in requirement would affect the coherence of the Eurozone and its mutual currency, the Euro. Also, the fate of many EU citizens was negotiated.

Differentiation of the topic

The Cyprus-rescue was accompanied by restructurings of the financing facilities of the European union and expansionary monetary policy of the ECB. In the years before the Cyprus crisis there had been no common set of rules how to deal with distressed Eurozone-members, like with Greece or Ireland. The Cyprus rescue, for the first time, showed signals of setting new standards for rescuing distressed Euro-members, by introducing a combined bail-out-bail-in requirement, which recently was even adopted in the Basel III requirements. The particular scope if this work is the financial crisis in Cyprus in the year 2013, specific measures of the EU to remedy the distressed island, a necessity and effectively the efficiency of such measures. To understand the particular susceptibility of the Greek financial crisis to Cyprus one must understand the close economic and cultural ties both countries have. This is also done in this paper. On the contrary no

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further elaboration of financial crises of other Euro-members will be conducted, apart from Cyprus and Greece.

Structure and Methodology of this Work

In order to create insights for the reader about the necessity of a Cyprus-rescue, at first the author sheds a light on the particular reasons of the Cypriot financial crisis. In chapter two if this work the actual debt situation of Cyprus in 2013 is elaborated. As the necessity to assist a distressed Euro member state, in particular Eurozone-members, strongly relates to the contractual duties and intentions of the peer member states, this work deals with aims and planned actions of the Cyprus-rescue in 2013. Necessity and relevance of the Cyprus rescue for EU and Euro are worked on in chapter 4 and finally the aid-package in its final form as well as the actual impact of the monetary policy measures are evaluated in chapter 5. In this chapter, in hindsight 5 years after, the outlook for future policy measures in such cases as well as the burdens inflicted on local population are discussed. Least, the work concludes the findings of the five chapters.

The causes of the sovereign debt situation

In 2013 Cyprus had a GDP of 18.14 Bn. Euro (Figure 1) and a population of approximately 890,000 people (Figure 2). Hence, it can be seen as a rather small state of the European Union. Cyprus has a similar GDP to the mid-sized German city of Essen.

Sovereign debt (maastricht criterium I)

The sovereign debt of Cyprus compared to its GDP was estimated by the IWF to be 92.61% in the crises year 2013 (Figure 3). Eventually the sovereign debt to GDP rate was 102.6%, according to Eurostat (Figure 4) [5,6]. In order to maintain financial stability in the EU in 1992 the Maastricht-criteria were introduced. These criteria give a threshold level of gross debt of 60% of the GDP in order to avoid a bankruptcy of the joining and existing EU member states. This threshold was exceeded at the point of the Cypriot EU accession (gross debt to GDP 2004: 70.93% of the GDP) (Figure 3). Even in 2015 the gross debt to GDP even rose to an ever high of 107.5% (Figure 4).

State deficit (maastricht criterium II)

Analyzing the GDP growth in the last two years before the Cyprus financial crisis one must say, that this GDP growth was negative. In 2012 it was – 3.06% and in 2013 it was – 5.93% (Figure 2). The budget balance compared to the GDP (state deficit) was in 2012: - 5.55% and in 2013: - 3.28% (Figure 5).

The Maastricht-criteria impose a state deficit of maximum 3% of the GDP. In times of the financial crisis Cyprus was beyond that threshold, which the convergence criteria of Maastricht set. But also in 2004 (EU accession of Cyprus) the small island was exceeding this threshold: - 4.15% (Figure 5).

When a state regularly spends more money than it yields in income, this leads to a high gross debt level and restrains the possibilities of action of this state significantly. Such a case can be seen at the example of Cyprus.

An oversized banking-sector

Another noteworthy issue in Cyprus is its oversized banking sector, which put the solvency of the Cypriot state at stake in the financial crisis [7]. In May 2010 the asset volume of domestic and foreign banks in Cyprus was 176.34 bn. Euro, which equaled 1,041% of the former BIP (Table 1). The situation was similar in 2013, when the asset volume of the Cypriot banking sector denoted 750% of the island's GDP [8]. The share of assets in the banking sector to the country's GDP has decreased, but this was rather due to a general economic downturn in the Eurozone than due to political measures.

Low corporate taxes / high FDI

With 10%, Cyprus had one of the lowest corporate taxes in the EU before the financial crisis. This advantage, as well as the good name

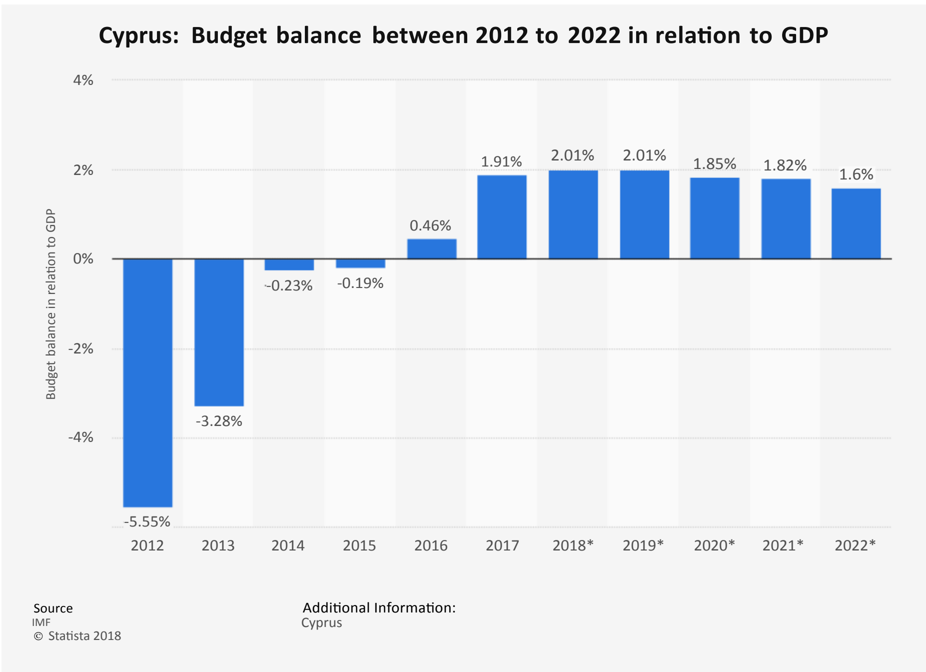

Figure 1: Cyprus: budget balance between 2012 and 2022 in relation to GDP.

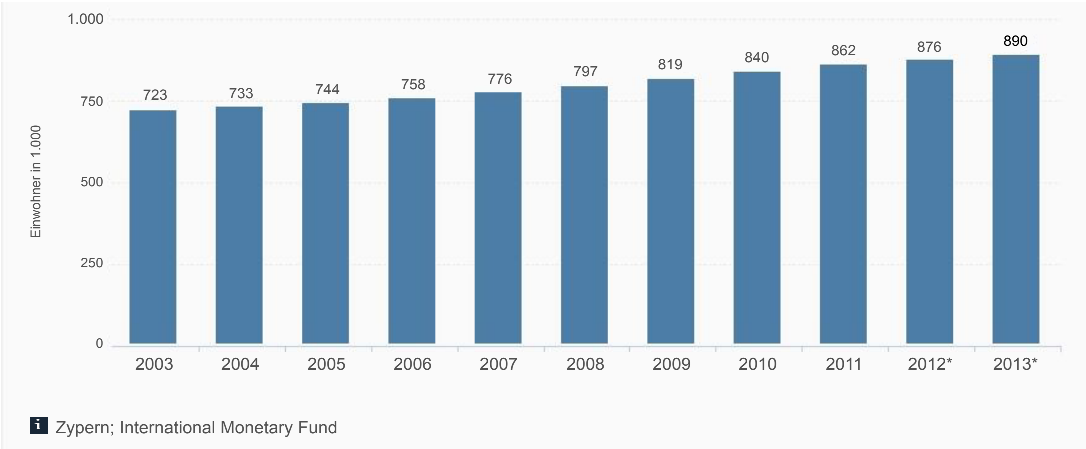

Figure 2: Cyprus: total population from 2003 to 2013 (in 1,000 inhabitants).

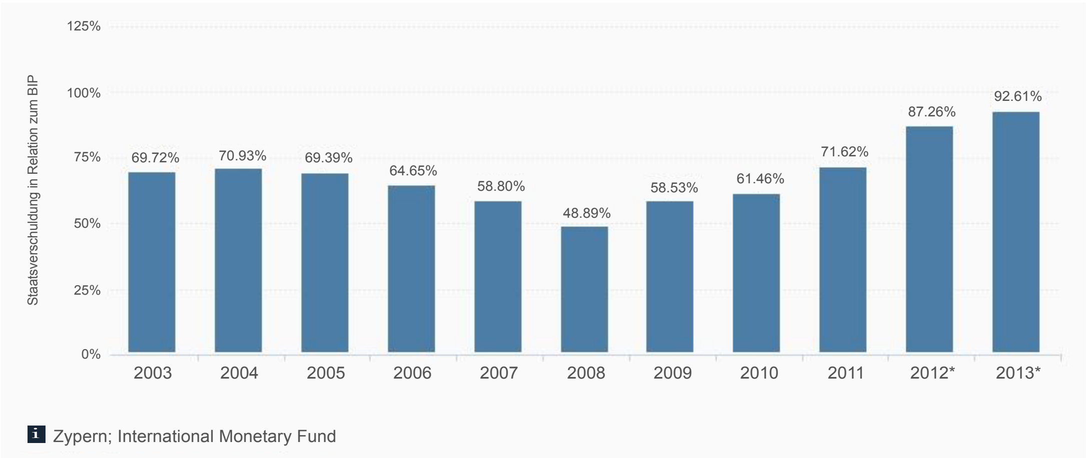

Figure 3: Cyprus: sovereign debt from 2003 to 2013 in relation to the GDP.

of the EU as a currency union brought Cyprus remarkable FDIs, especially from Russia [9]. Kar and Freitas remark, that the small island Cyprus was the highest source and receiver of Russian FDI from 2009-2011 [10]. Regarding the Cypriot GDP of 23 bn. US-Dollar, in 2011 alone Cyprus has invested five times of its own GDP (128.8 bn. US-Dollar) to Russia. And vice-versa remarkable amounts of money flow from Russia to Cyprus. According to Kar these bilateral FDIs are rather short term oriented and allegedly serve the purpose of revolving illegal funds between Russia and Cyprus [10]. This makes Cyprus one of the main money laundering machines for Russian criminals in the European Union [10,11].

This subsequently leads to two issues: First, Cyprus has the reputation of being a tax haven for criminals and second, the foreign money does not stay in Cyprus for long and therefore does not create sustainable tax revenues for the state of Cyprus, which it would desperately need, in balance with the high risk-exposure of the financial sector.

High share of greek assets of total assets

Central issue of the crisis in 2013 was the high share of Greek assets of the total asset volume in Cyprus.

By the end of 2010 alone, branches of Greek financial institutions had assets worth 46.1 bn. Euro invested in Cyprus, equaling 270% of the Cypriot GDP at that time [12]. The close junctions between Cyprus and Greece turned out to pose serious threats for both Cyprus and Greece.

The local banks in Cyprus in 2010 in turn held 5.5 bn. Euro of Greek government bonds and approximately 0.5 bn. Euro in Greek bank bonds (ibid). Through branches and subsidiaries Cypriot banks have lent further 23 bn. Euro to Greek enterprises and households (ibid). Further, the two biggest Cypriot banks, Bank of Cyprus and Hellenic Bank have accounted for 8% of the total asset volume in Greece before the crisis [8].

Cyprus certainly got very susceptible to the economic developments in Greece because of its close cultural and (meanwhile) economics interlink ages with Greece.

The catastrophic dimension of the investment in Greek government bonds by the Cypriot state and local banks became obvious when, amid 2011, all rating agencies put Greek government bonds on junk status. At a glance, Cyprus lost one of its biggest financial investment- and trade partner [13].

But the Cypriot banks were not innocent of this development. In December 2009 Bank of Cyprus assured the public with the fact, that they only held 100 Mn. Euro in Greek government bonds [14].

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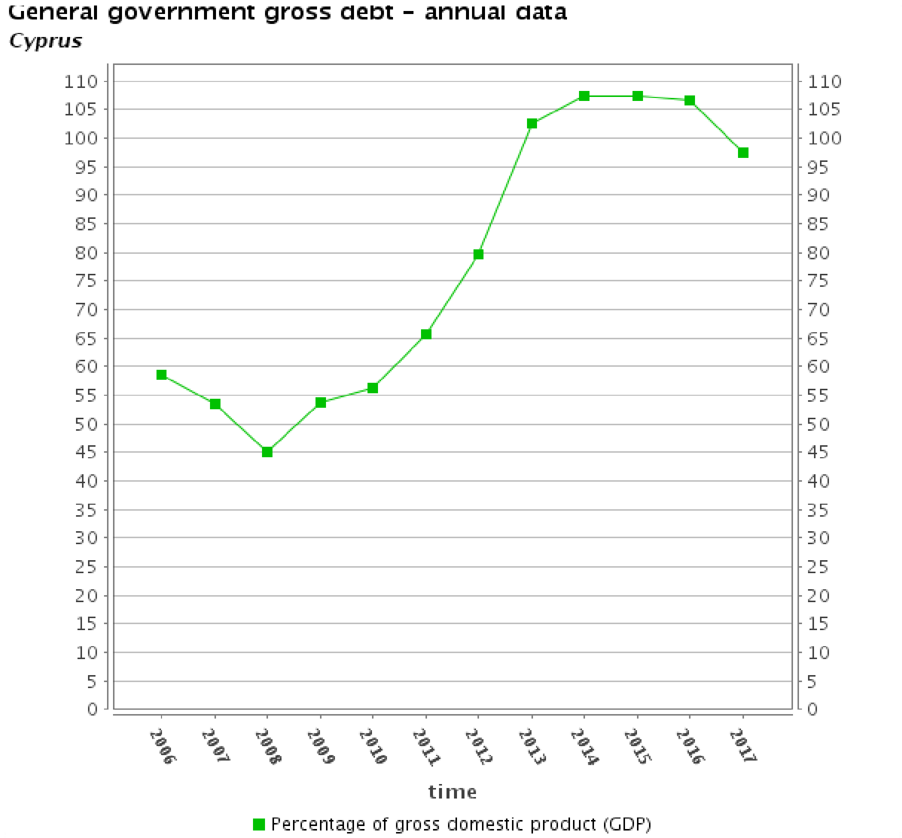

Source of Data Eurostat
Last update: 01.08.2018
Date of extraction: 02 Aug 2018 15:44:48 CEST
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Short Description: The indicator is defined (in the Maastricht Treaty) as consolidated general government gross debt at nominal (face) value, outstanding at the end of the year in the following categories of government liabilities (as defined in ESA 2010): currency and deposits, debt securities and loans. The general government sector comprises the subsectors: central government, state government, local government and social security funds.
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Figure 4: Cyprus: general government gross debt from 2006 to 2017 in relation to the GDP

In the following months the Bank of Cyprus literally got obsessed with buying Greek government bonds until they held government bonds amounting to 2 Bn. Euro in October 2010 (ibid). At this point, however, the loss potential could have been foreseen (ibid). Risk loving in a similar way acted Laiki Bank, true to the old adage of "absolute greed for profit" (ibid). Apparently, nobody anticipated the default of Greek government bonds.

At the beginning of 2012 in consequence of the Greek haircut the forgiveness of 53.5% of the debts by private owners in Greek state bonds was obtained (ibid). Cyprus suffered in twofold ways. On the one hand, in consequence of the financial crisis in Greece many FDIs from Greece were withdrawn. On the other hand, Cypriot banks lost significant amounts of money due to the Greek haircut. Standard & Poor's estimated, that Cypriot state- and bank bonds were affected valuing 6.4 Bn. Euro, meanwhile 37% of the Cypriot GDP [15]. Apart from that, Cypriot big banks like Bank of Cyprus and Marfin bank had issued 40% of the total issued debts on Greek territory (ibid).

The Cypriot banks maneuvered into the danger of not being capable to finance themselves because of the combination of these two ponderous facts [13].

First, the Cypriot state was due to relief the distressed local financial institutions. But due to the Euro-crisis the state had lower tax income and at the same time was supposed to strengthen a financial sector, which was ten times larger than the country's GDP. It became evident quite quickly, that through the developments in Greece and the EU not only the solvency of the Cypriot banks was in danger, but moreover the whole solvency- and ability to act of the Cypriot state was in jeopardy [16].

A rescue by the European Union seemed inevitable.

Nevertheless, the Greek financial institutions were saved without a bail-in with a two-digit billion sum from the Euro rescue package.

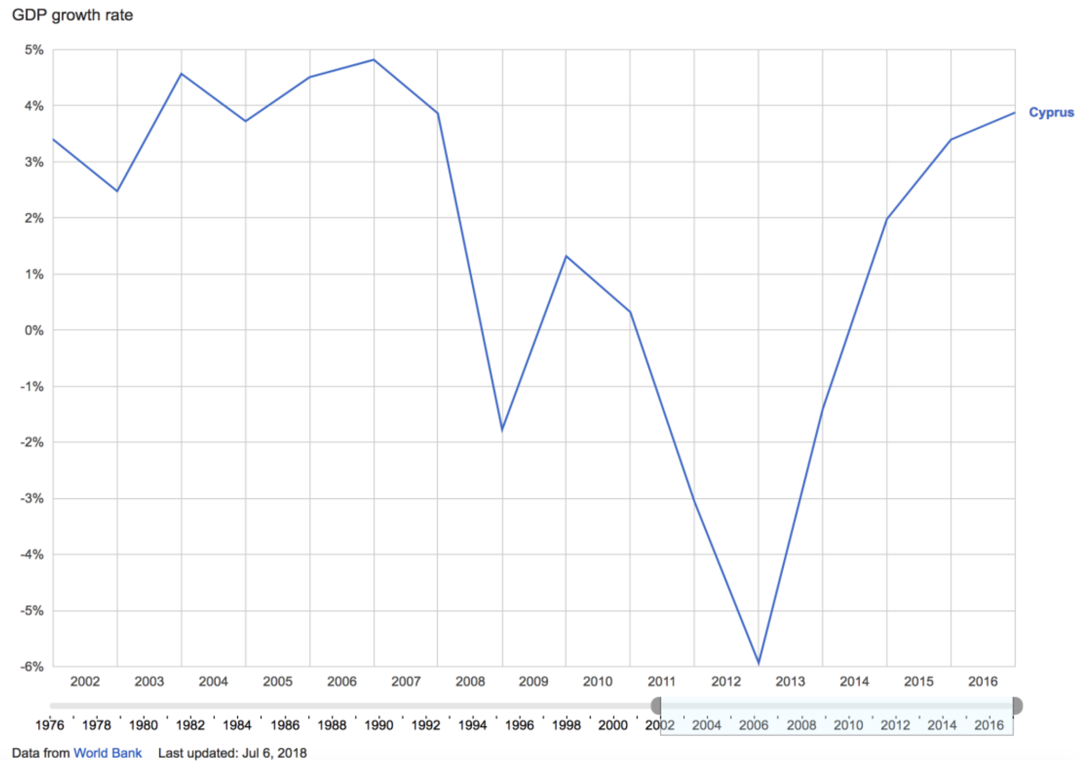

Figure 5: Cyprus: GDP growth rate from 2002 to 2016 (compared to previous year).

(Millions of euros, unless noticed otherwise) 1/A		
	Assests	% of GDP
Total banking system	176,339	1041
EU brances	1,183	7
Subsidiaries of foreign bank	60,873	359
Local banks	108,282	639
Of which: coops	15,886	94
Of which: commercial banks	92,396	545
Source: Central bank of Cyprus. 1/As of end of May 2010.		

Table 1: Structure of the Cypriot banking sector.

Such funds were not allocated for the Cypriot banks. Instead, in case of Cyprus a bail-in was considered by the Troika to exemplify a new way of approaching such crises in the future.

Aims and Actions of the Cyprus-Rescue

In turn of the ever-intensifying sovereign debt crisis in Europe further PIIGS-countries[1] got under pressure and the spreads for the government bonds rose continuously. Also, a recue-package, that was meant to stabilize Greece, could not restore the confidence of the financial markets fully [17].

The capacity to repay debts of a state is not only related to the amount of debts it has, but moreover the trust of the markets in this certain state and its solvency [18]. When it became obvious that the state debt was way higher than expected in Greece by the end of 2009, the returns on domestic state bonds rose.

By the beginning of 2010 the financial problems intensified. From the political sphere it was assumed, that speculative financial markets would have caused Greece's miserable condition, but it has to be kept in mind, that the imminent default of the Greek state was mainly due to a loss of confidence of the investors in the solvency of Greece [19].

As the massive bond purchases of the ECB could not restore trust in the solvency of the European PIIGS-states, EU finance ministers gathered in May 2010 in order to debate the introduction of a mutual European rescue fund to restore sustainable trust of the European financial markets [20]. At May 10th 2010 in an extraordinary meeting between EU finance ministers and IWF the rescue package was, which consisted of various mechanisms [17].

Explanations of EFSM, EFSF and ESM

First, the European Financial Stability Mechanism (EFSM) was introduced, which was replaced by the permanent European Stability Mechanism (ESM) amid 2013, as well as the European Financial Stability Facility (EFSF) [21].

The EFSM is a mutual Eurozone element and provides 60 Bn. Euro to distressed Euro-states on a temporary basis.

EFSF, however, has a credit volume of 440 Bn. Euro and does not grant direct loans. It takes funds from the capital market and passes them on to crisis-states [17]. EFSF has the task of short-term refinancing of the crisis-states.

ESM, in which EFSM transitioned since July 2012, is long-term oriented and is meant to strengthen the European economy and currency area. The capital stock of ESM is 700 Bn. Euro the participating Euro-countries payed five installments of 80 Bn. Euro into ESM [22]. Money can only be obtained, if the respective country signs a fiscal contract with the EU and implements a national debt limit [21].

[1]PIIGS-countries: Portugal, Italy. Ireland, Greece and Spain

Size of the aid package

In case of Cyprus the measures of the Cyprus-rescue were captured in the „Proposal for a financial assistance facility agreement for the Republic of Cyprus "by the ESM from April 24th 2013 [23]. There it was planned to grant Cyprus long-term loans amounting up to 10 Bn. Euro minus the contribution of the IMF of approximately 1 Bn.

The memorandum of understanding regarding the Cyprus-rescue

The conditions for the rescue package were put in to a Memorandum of Understanding (short: MoU) [24]. In this document the structural deficits and their intensity were written down and it was clarified by the Euro-states and the IMF that the money disbursed were loans to the state of Cyprus (ibid). This MoU was finally signed formally on April 26th 2013. The loan facility was divided into three main pillars [23].

The first pillar of the MOU – reforms of the financial sector

The first pillar of the MoU was a reformation of the financial sector. Namely, the Cypriot financial sector was planned to be reduced and to be restructured in order to minimize the cluster-risk due to an oversized banking sector. The dominant aim was to contain the risk of a spill-over by a European economic- and sovereign debt crisis.

In the past credit default risks in the Cypriot real estate sector systematically were disregarded in order to delay the defaults of the respective loans [24]. Hence, the surveillance-mechanisms inside Cypriot banks were intended to be improved by the subsequent measures, following the MoU [23,25].

Another aim was to reduce the size of the oversized banking sector in relation to real economy [26]. The domestic banking sector will always play a crucial role in Cypriot economy, as the service sector accounts for a majority of the Cypriot economy. It was crucial in the first pillar of the MoU to introduce measures to regain trust of domestic and international investors. In this context to MoU-parties planned to shrink the domestic banking sector to half of its original size in order to fit in to the average banking sector size in the EU [8]. In Figures 1-5 this meant, that the 639% big banking sector (May 2010) was supposed to shrink to 350% of the Cypriot GDP after 2013 [27]. It was planned to incorporate all owners of deposits and creditors at the restructuring, when their deposits exceeded 100,000 Euro. In the MoU it as further planned to convert 37.5% and if necessary further 22.5% of deposits at the bank of Cyprus, which were not covered by the deposit guarantee to bank shares in order to attain a "hard core capital quota of 9%" [27].

Further it was planned in the first pillar of the MoU to divide Laiki Bank and Cyprus Popular Bank into one "good bank" and one "bad bank" [28]. The good bank was planned to be incorporated into Bank of Cyprus in order to recapitalize it. The Central Bank of Cyprus (short: CBC) was intended to be the only bank liquidation instance in the Cypriot banking sector. The framework for this procedure was given by the law for the liquidation of credit institutions, which was passed on March 22nd in 2013 in the Cypriot house of representatives [29].

The Greek branches of Cypriot banks were planned to be immediately divided away from the Cypriot banking sector und to be integrated into the Greek banking sector. This measure was meant to reach higher independence from potential spill overs of financial trouble in the future [26]. The general notion at that time was, that a surveillance of Greek transactions could be conducted more efficiently by a Greek "core bank" in which all assets and liabilities are controlled.

Shifting Greek transactions of Cypriot banks and their surveillance to the Greek banking sector is nothing more than a trick, because the rescue package for Cyprus (10 Bn. Euro) would not be needed to be touched and Greece was bailed-out anyways. Without this "shift" of the financial transactions to Greece the financial need of the Cypriot banking sector would have been significantly higher.

The second pillar of the MOU – sustainable budgetary consolidation

The second pillar of the MoU was a budget consolidation, in order to lower the long-term debt level of Cyprus and in order to lower the state deficit.

The Troika planned to bring the gross debt level to 105% of the GDP by 2020 through macroeconomic adjustment programs.

Another aim was to reach a primary surplus of 3 percent of the GDP in 2017 and in 2018 to reach a primary surplus of 4 percent of the GDP. This aim was meant to remain in the following years.

Further objectives were the limitation of expenditure growth, increasing taxes and higher tax efficiency, as well as to create a budgetary framework, conforming to EU regulations.

Besides the budgetary consolidation it was noted, that the income side of the Cypriot state was to be strengthened. Through raising corporate tax from 10% to 12,5% in by raising taxes on interest the state budget were planned to be strengthened [30].

At least further 75 Mn. Euro were planned to be yielded through a wealth tax. The inheritance tax was abolished at April 1st 1997 [31]. Before Cyprus did not have a wealth tax as well [32].

The bank levy, which was 0.11% on deposits was planned to be raised to 0.15% [26]. A forty percent share of these revenues (25/60) were meant to flow onto a special account for the financial stabilization fund, which is deemed to remedy distressed banks in the future.

In pillar two of the MoU it was additionally intended to raise the interest tax from 15% to 30%, which is only relevant for taxable entities in Cyprus [29].

Further planned measures were raising fees for public services by 17% and selling gold reserves in the value of 400 Mn. Euro, as well as privatizing several deficient state-owned companies.

In course of the improvement of state finances the massive natural gas fields were planned to be exploited. According to estimations in 2013 there were 255 Bn. m^3 natural gas, additional 240 Bn. m^3 were suspected to be in a newly found gas field [33,34].

But also the expenditure side of the Cypriot budget had to be significantly improved in terms of lowering the expenditures. In 2013 the Republic of Cyprus negotiated with Russia about a credit arrangement from 2011 with a volume of 2.5 Bn. Euro. In 2013 the government of Cyprus planned to re-negotiate the interest rate of 4,5% and to prolongate the payback in 5 tranches of 500 Mn. Euro between 2018 and 2022 (ibid). More steps for reducing expenditures on a state level were planned by reducing wage- and health costs.

It has to be kept in mind, that in 2013 a study of Scottish Royal Bank of Scotland revealed, that Cyprus supposedly possesses oil- and gas reserves of "more than 600 bn. Euro", which equals twenty times of Cyprus state debts [35].

The third pillar of the MOU – structural reforms in Cyprus

The third pillar of the MoU for the rescue facility by the ESM contained structural reforms of the Cypriot state. Here again privatizations of formerly state owned companies were addressed, as well as the removal of impediments for competition and the reformation of the public sector [26].

The structural reforms of the small island intended to increase the competitiveness of the country regarding other European financial markets and to expand the service- and the industrial-sector. Regardless of that, it was also intended in the third pillar of the MoU to create sustainable growth and to find a mechanism for an automatic stabilization of the market after a macroeconomic shock [29].

However, the reformation of wage system was deemed a subject to reformation, because Cyprus had to become more attractive as a location for the industrial- and service sector. In specific, this meant, that no wage increases should be allowed after the memorandum and the wages should just be allowed to be increased by 50% of inflation in the future [29]. This was set in the MoU, because lower labor costs were seen to be a key to making Cyprus more attractive as a business location in Europe.

The third pillar of the MoU was also intending the reformation of Cypriot pensions system and to adjust it to its economic capacities. Cyprus has afforded an enormous pension system with many advantages before the crisis. Pillar three of the MoU planned a discount for early retirement and a cap of 50% of the highest received working income of the pensioner [26,29].

Apart from that, the Cypriot health care system was suggested to be adjusted and bundled in a national health care system (short: NHS) with a new and more restrictive framework and to reach synergisms in administrative structures and to cut costs (ibid).

The privatization of state owned industries and organizations to Public Private Partnerships (short: PPP) were written in the memorandum in order to downsize the public sector and to take away the pressure from the state finances. It was planned, that in the first step the government creates a list with all assets of the state. After that, it was planned to sell various state-owned companies in co-operation with the house of representatives. The expected revenue until 2018 was 1.4 Bn. Euro [30]. Additional and new state duties were decided to be performed by PPPs, whenever possible, in order to save administrative expenses and effort.

The above-mentioned measures were made condition for the disbursement of credit tranches to Cyprus by the Troika. The net financing needs of Cyprus (10 Bn. Euro) were planned to be provided between 2013 and 2016. The time frame of the rescue package was hence set to a rather short period. In the report „Assessment of the public dept sustainability of Cyprus" by the European Commission from April 12th 2013 it was expected, that Cyprus could show a small budget surplus already by beginning of 2015 and a slightly positive domestic demand (Table 2).

Relevance of Cyprus for the EU and the Euro

Population and GDP?

The Republic of Cyprus in 2013 had less than one million inhabitants and a GDP of 21.00 Bn. US-Dollar (Figure 6) compared to 505.17 Mn. Inhabitants in the EU (2013) (Figure 7) and a GDP of the whole EU amounting to 13 Bn. Euro in 2012 (Figure 8). In 2010 the Cypriot asset wealth amounted to 176.339 Bn. Euro (Table 1).

Looking at Figure 9 small island state of Cyprus had a share of 0.19% of Eurozone's GDP in 2012 (in comparison Germany: 28.24%). The Cypriot debts towards foreign creditors were approximately 50 Bn. Euro in 2013. A high share, as noted before, belonged to Greek creditors, which were already bailed-out by the EU [36].

Ties to the EU

As it can be seen with the Cypriot example, there is obviously a relationship between banking sector defaults and state defaults, because the European banks supported domestic state finances as well as foreign EU state finances by buying sovereign debts of the respective countries (Figure 10). These interlinkages between state finances and the banking sector are indeed very risky and are likely to lead to vicious circles [37]. If one EU state gets in distress, meanwhile the national banking sectors of other EU states are affected. Another system-inherent issue of the European Union was the risk weighting of sovereign debts. According to EU's capital requirement directive CRD-II, for instance with a risk weighting of 100%, eight percent of the credit volume would be needed to be equity. EU member state sovereign bonds, however, are classified with a risk weighting of 0% and are hence seen as riskless in the books [37].

Two central issues are created by this approach: On the one hand the bundled risks by the zero-risk-weighted sovereign debts in the European banking sector are neglected in stress tests, which are meant to simulate macroeconomic shocks. On the other hands financial institutes are very endangered of being contained by a financial crisis spill-over if they hold many foreign sovereign debts.

In 2013 Cyprus combined these two issues: The high share of

Real economy	2012	2013	2014	2015	2016
			Proj.		
Real GDP	-2.4	-8.7	-3.9	1.1	1.9
Domestic demand	-6.8	-13.9	-5.9	1.0	2.1
Consumption	-2.7	-11.5	-5.1	0.8	1.9
Private consumption	-3.0	-12.2	-5.6	1.6	3.0
Public consumption	-1.7	-9.0	-3.7	-1.7	-1.5
Fixed investment	-23.0	-29.5	-12.0	2.3	3.5
Inventory accumulation 1/	-0.9	0.0	0.0	0.0	0.0
Foreign balance	4.7	5.2	1.6	0.2	-0.1
Exports of goods and services	2.3	-5.0	-2.5	1.7	2.7
imports of goods and services	-7.2	-16.0	-6.5	1.7	3.3
1/ Contribution growth.					

Table 2: Macroeconomic projections for Cyprus 2012-2016.

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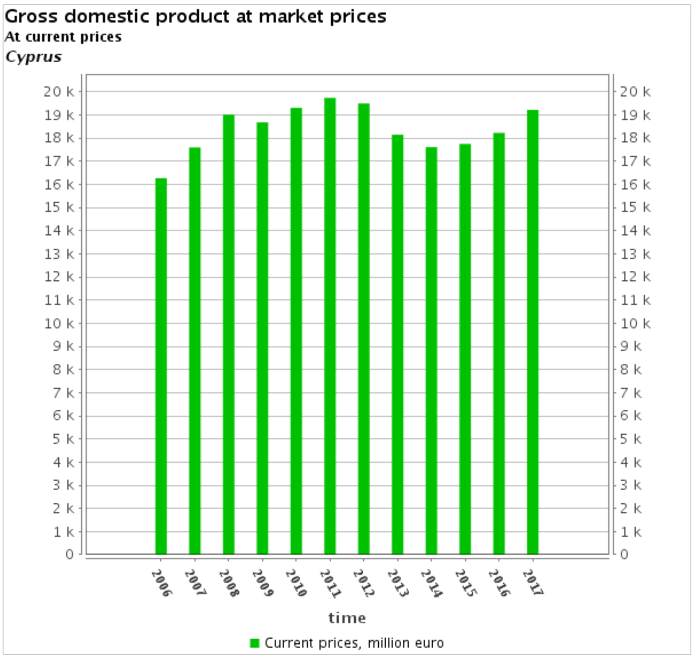

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Short Description: GDP (gross domestic product) is an indicator for a nation´s economic situation. It reflects the total value of all goods and services produced less the value of goods and services used for intermediate consumption in their production. Expressing GDP in PPS (purchasing power standards) eliminates differences in price levels between countries, and calculations on a per head basis allows for the comparison of economies significantly different in absolute size.
Code: tec00001

Figure 6: Cyprus: GDP in current prices from 2003 to 2013 (in Bn. Euro).

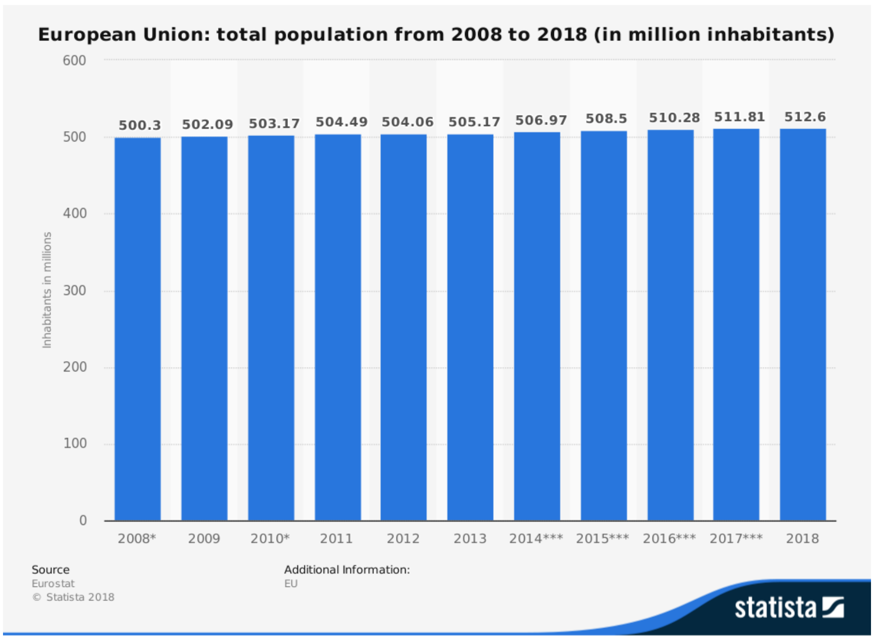

Figure 7: European Union: total population from 2008 to 2018 (in million inhabitants).

Citation: Fiedler FFHJ (2019) Saving Cyprus from its "Financial Crisis" in 2013 by the Troika: A Necessary Action Under the Right Terms and Conditions? J Glob Econ 7: 323. doi: 10.4172/2375-4389.1000323

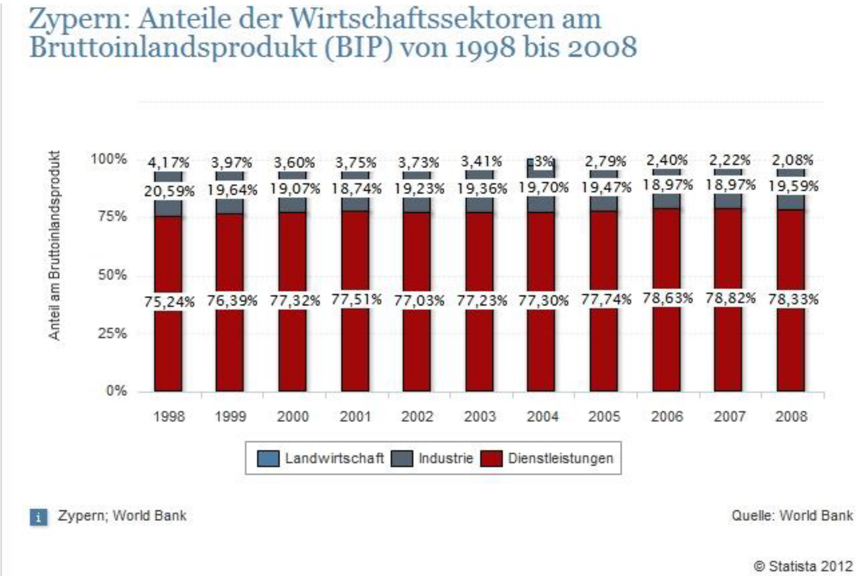

Figure 8: Cyprus: share of the business sectors for the GDP between 1998-2008.

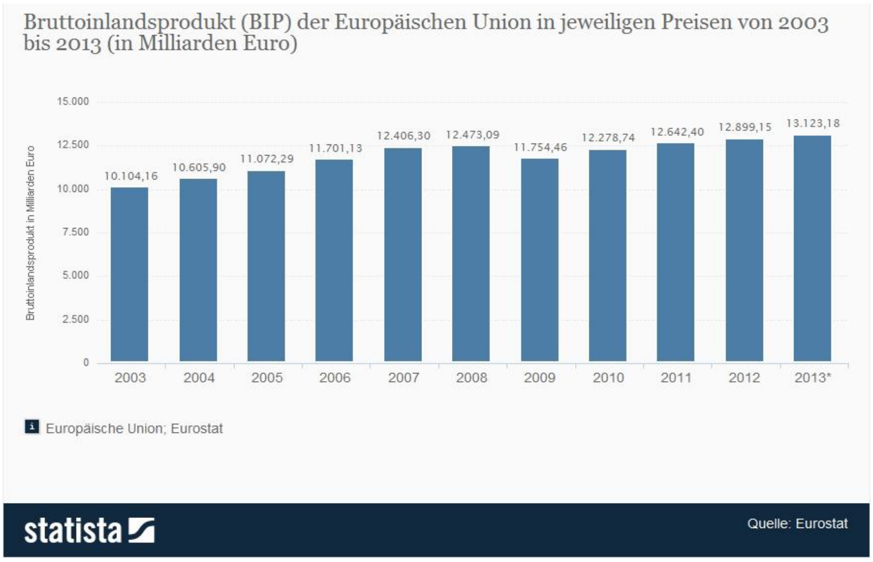

Figure 9: GDP of the European union in current prices between 2003-2013 (in Bn. Euro).

sovereign debts in the Cypriot banking sector was neglected in the European stress tests. Also, the low home bias[2] in the sovereign debt portfolio, which took one of the last places in the EU with 18% never made the EU monetary authorities wonder (Figure 10). In comparison: Germany, at the same time, had a home bias of over 40% (Figure 10). In contrary to the Germany with a high home bias, the Cypriot banking sector was particularly susceptible to the contagion of macroeconomic shocks originating from other EU economies, like Greece in this case.

It has to be mentioned, that also Ireland's, Portugal's and Spain's financial crisis, as well as the Greek haircut coincided and have hit Cyprus extraordinarily hard. This was due to the tight junctions with Greece as well as being the country with the highest share of foreign sovereign debt bonds (Figure 11). An alleviation of the situation was brought by the fact, that Cyprus was the country with the lowest share of domestic sovereign debt bonds issued to its equity capital (Figure 12). The issued sovereign debts have amounted far lower than the island's equity and meanwhile was not the main reason for bankruptcy of the Cypriot state. As Cyprus only had a GDP of approximately 20 Bn. Euro and an exposure[3] of under 30% of the equity, the monetary loss risk for other EU members was only marginal. There was only a maximum of 6 Bn. US-Dollar of Cypriot sovereign debts at risk of defaulting in 2013.

A higher risk for the EU originated from the financial engagement of foreign banks in the Cypriot banking sector. Only 8 of 43 banks which operated in Cyprus before the crisis had their headquarter in Cyprus [12]. 46.1 Bn. Euro of the 70 Bn. Euro invested in Cyprus in

[2]Home bias: Share of domestic assets of the total asset volume in a country. A high home bias shows a strong affection of the investors to their home market

[3]Exposure: Ratio of domestic sovereign debts to equity of the state

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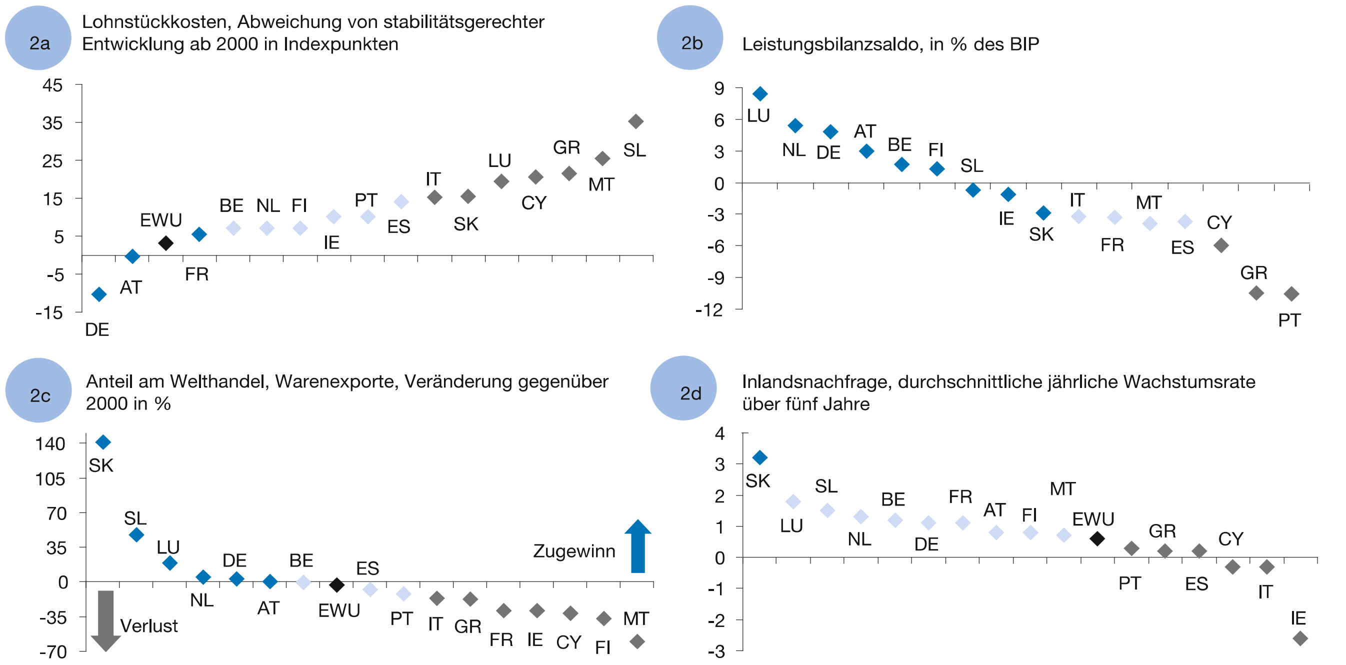

Figure 10: Competitiveness and domestic demand in Cyprus from 2000 to 2011.

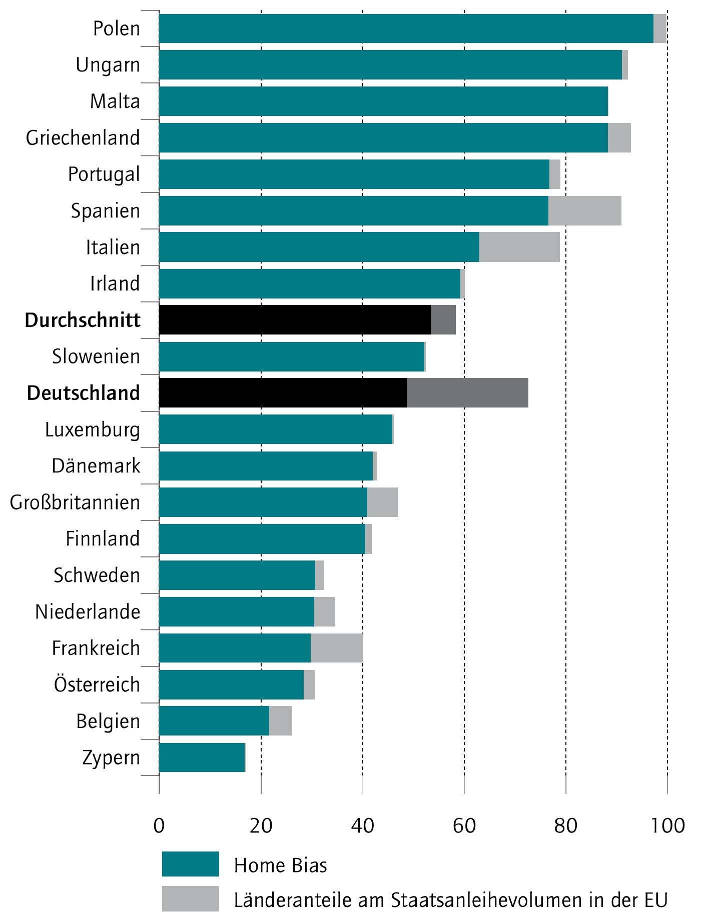

Figure 11: Home bias in the sovereign debt portfolio of assorted EU states (in percent).

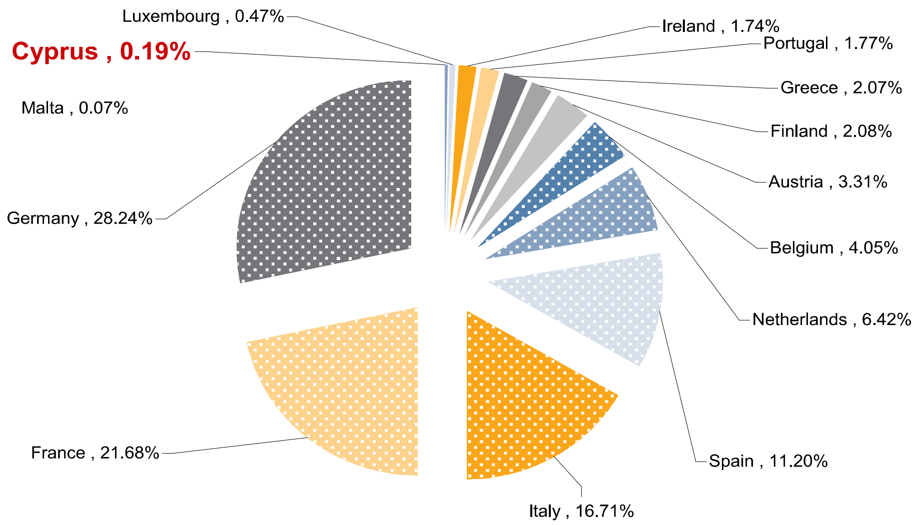

Figure 12: The GDP of assorted Euro-states compared to the GDP of the Eurozone in 2012.

2010 was invested by subsidiary companies of Greek banks (ibid). Only approximately 1 Bn. Euro was invested by branches of other European banks, whereas branches of non-EU banks had invested approximately 6 Bn. Euro (2010) in Cyprus (Table 1).

The rest of international asset values of 28 Bn. Euro were invested by subsidiaries of foreign banks directly into Cypriot economy and were divided into EU- and non-EU-money. It may be assumed, that the default of Greece at that point in 2013 was already anticipated by the international financial markets [20]. Also, the default of Cypriot deposits was covered by the EU-rescue package for Greece, as Greek subsidiaries of Cypriot banks were transferred to the Greek banking sector. Only remaining 30 Bn. Euro in foreign asset value was really at stake of defaulting.

Contractional duties from EU treaties

Cyprus is not a Schengen-member, but since 2008 full member of the Eurozone [38]. The abolition of border controls inside the island could not be fulfilled due to the ongoing territorial conflict with Turkey about the northern territory of Cyprus.

The treaty of Maastricht forecloses a liability of EU states for debts of other EU members with its no-bailout-clause. This clause became a crucial part of EU principles and was adopted in 2009 with almost identical words to the treaty of Lisbon[4]. In case of a state default in the EU an automated liability of other member states hence was foreclosed. Other opinions to the "no-bailout-clause" are, that only an automated liability-duty was foreclosed, but not a voluntary take-over of debts by other states [39]. Others argue, that the "no-bailout-clause" even defines a prohibition of bailing-out other distressed EU-member states in order to incite the member states to stay in the given frame of the Maastricht criteria [40].

On the contrary, the treaty about the European Union (EUV) and the treaty about the functioning of the European Union (AEUV) are based upon the principle of solidarity[5]. This concerns the participation at the mutual political entities as well as an enhanced collaboration between the member states[6]. When one EU-state is in distress the council of the European Union can grant financial aid. The question of a potential moral obligation of other EU members to remedy distressed peer countries, is difficult. It seems crucial to observe, whether the state in distress has caused its own situation deliberately. If one concluded, that ruthless speculation and greed were the major causes for the contagion of the financial crisis to Cyprus, it seems far-fetched, that there as a duty for the other EU member states to bail-out according to EUV and AEUV Cyprus, irrespectively of the indebtedness of the situation. The main question remains to be answered, whether Cyprus has mainly caused its financial trouble itself, in order to derive a potential duty of cooperation according to EUV and AEUV. Nevertheless, it should be noted, that principally a mutual liability for foreign debt obligations among the members was foreclosed by the treaty of Maastricht in order to incite the members in order to keep budgetary rigor.

Former German finance minister Wolfgang Schäuble in this context mentioned the birth default of the mutual currency [41]. According to his opinion other countries were reluctant to transfer competencies to Brussels after WWII and to create a political union (ibid). This is why, in his opinion, a mutual currency without corresponding unified fiscal policy was implemented on European level.

At November 25th 2011, art. 136 AEUV was created in order legitimate the forming of the ESM in order to bail-out distressed member states and to "grant stability of the whole currency area". Meanwhile, that bail-out (bail-in) (will be discussed in the 5th chapter) of Cyprus was defined as fiscal policy measure and not as a solidary action.

Fulfillment of the accession criteria

The Republic of Cyprus joined the European Union on May 1st, 2004. The accession criterium for a EU-membership was the fulfillment of the criteria of Copenhagen by 1993 [42]. The requirements were institutional stability, a democratic and constitutional order, the granting of human rights, but also competitiveness as an economy as well as to obey to aims of the European economic- and fiscal [43].

In order to create convergence in the EU-economies and to stabilize the EU, as well as to improve coordination of the economic policy in the respective countries, the EU-member states adopted Maastricht-treaties on February 1992 [44]. Reason for the Maastricht treaty was

[4]See art. 125 AEUV

[5]See art. 328 AEUV

[6]Union law (duty of collaboration). See art. 4 II EUV

also the fear of the EU-states for monetary stability and to avoid inflationary tendencies in the mutual economic area (ibid). Mainly two fiscal convergence criteria are set in the Maastricht treaty. One the one hand the new borrowing of a member state should not exceed 3% of the yearly GDP, on the other hand the total debt should not exceed 60% of the country's GDP[7].

In case of Cyprus 2003 the gross debt rate was: 69.72% of the GDP and even rose in 2004 to: 70.93% of the GDP (Figure 3). The Cypriot budget balance in relation to the GDP, according to IMF, was – 6.57% (2003) and – 4.15% (2004) and positioned above the threshold set by the Maastricht-criteria (Figure 13). It can be stated, that the fiscal criteria for the Cypriot accession to the European Union were not fulfilled back then.

The Copenhagen criteria claimed an institutional stability of Cyprus. This institutional order as a political criterium was not fulfilled, because at the time of the EU accession Cyprus was factually divided into the Republic of Cyprus and the Turkish Republic of Northern Cyprus.

The island of Cyprus is divided since 1974 by the Turkish invasion of Northern Cyprus [45]. The southern part of the island has more territory and is under control of the Republic of Cyprus. The northern part in turn is (factually) ruled by the Turkish republic of Northern Cyprus, which is only recognized by the Republic of Turkey as an own state. According to international law the republic of Cyprus extends across the whole island [46].

One cannot see Cyprus as a stable and homogenous society, as ethical conflicts led to the division of the island.

After civil-warlike conditions in the years 1963and 1964 between the Turkish and the Greek population, also the foreign policy between Greece and Turkey was under pressure [45]. These conditions were triggered by the planned constitutional change by the government of Makarios[8], which meant to cut the rights of the Turkish minority (e. g. the constitutional veto-right of the Turkish national minority) [47].

After the Turkish-Cypriot vice-president subsequently resigned, as well as Turkish-Cypriot ministers and numerous employees of the state, Turkey began with pure Turkish settlements in the northern area of the island, with the aim to reach a division of the island [45].

Remarkably, in the guarantee agreement by August 16th, 1960 between Cyprus and Greece, Turkey and the United Kingdom it was explicitly forbidden to divide the country[9].

In article I of this treaty it was set, that Cyprus has to undertake any efforts to safeguard the own constitution and territorial integrity[10]. Specifically article I sentence 2 says:

"She[11] abstains from, wholly or partially, to join any community with a state. She announces to abstain from any action to implement a union with another state or to promote the division of the island and to forbid such measures by law."

The above-mentioned article I and 2 and its prohibition to divide the island was subsequently neglected in the following years until the conflict culminated in the Turkish invasion in1974 and the proclamation of the Turkish of Northern Cyprus. Cypriot military occupied approximately 40% of the island's territory and 50,000 Cypriots of Turkish origin immigrated to the northern part of the island, whereas 170,000 Cypriots of Greek origin emigrated from the northern part to the southern part of the island [48]. Despite many negotiations, e. g. the Annan-plan from 2004 the situation remains unresolved until today.

But also, the Republic of Cyprus, as well as the EU, disobeyed and breeched art. I and 2 of the Treaty of Guarantee by the accession of the Greek part of Cyprus into the European Union on May 1st 2004. The Treaty of Guarantee prohibits Cyprus to join any political or economic community with other national states. It is of special attention and difficulty, that the unresolved territorial conflict in Cyprus was internalized with the EU-accession of Cyprus. Until the conference of the European council in Helsinki in 1999 the European Union pursued a very rigorous accession policy with hard accession criteria. Issues

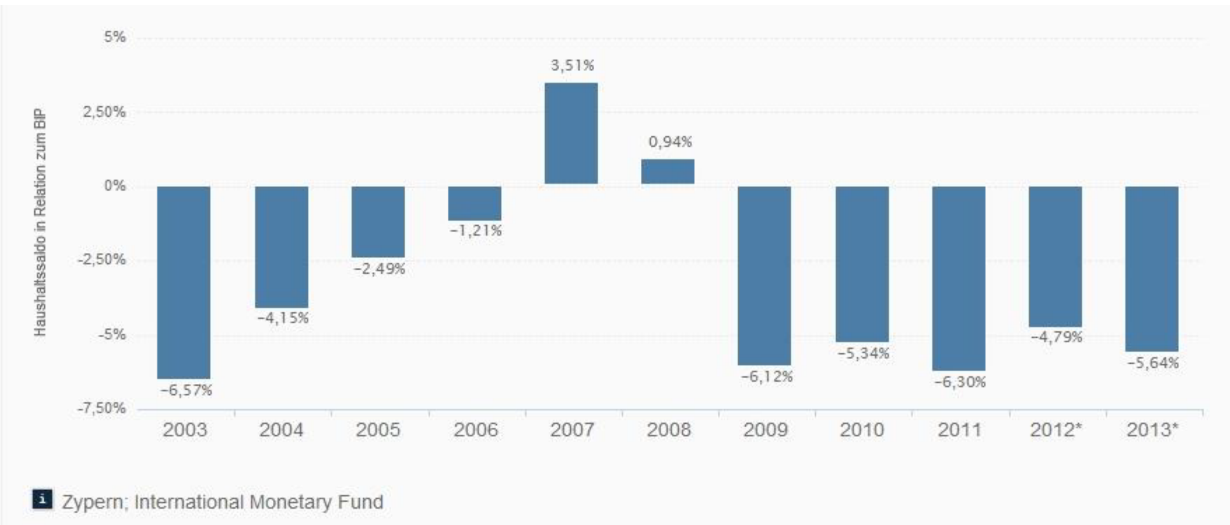

Figure 13: Cyprus: budget balance from 2003 to 2013 in relation to the GDP.

[7]See art. 104 c § 2 of the Maastricht Treaty in combination with the protocol of proceeding in case of an excessive deficit art. 2

[8]Former president of the Republic of Cyprus

[9]See art. I § 2 of the Treaty of Guarantee

[10]See art. I § 1 of the Treaty of Guarantee

[11]The Republic of Cyprus

of newly joining members were to be resolved before accession to the EU in order to keep political and economic fallacies away from the European Union.

In the particular case of Cyprus, the European council of Helsinki stated, that the resolution of the territorial conflict would well facilitate the Cypriot EU-accession but did not bind the resolution of the territorial conflict to the eventual EU-accession of Cyprus [49]. This was a novum, because the Copenhagen criteria of 1993 had previously set a tight frame of political and economic conditions for EU accession.

Today's situation reveals; until now there was no sufficient resolution for the territorial conflict in Cyprus and there is no institutional stability for the whole island as well. It is rather an unstable equilibrium with high risks for the EU. Especially looking at art. IV of the Treaty of Guarantee by 1960 grants Turkey, the Republic of Cyprus and Great Britain the right of a military intervention. For the EU this poses serious threats to the relationship with Turkey. Turkey, however, is also member of the NATO. Hence in case of a military intervention of Turkey for Germany there would be a double case for the alliance, the EU membership of Cyprus and the NATO alliance with Cyprus.

Foreign politics/Territorial expansion of the EU

Despite the questionable institutional stability of Cyprus in 2002 it was decided by the European Council in Copenhagen to grant accession to the European Union at the due date May 1st 2004 [50].

Certain conditions were set for the accession:

1. Cyprus should take any efforts to re-unify until the EU-accession. Therefore, the deadline for the implementation of the Annan-plan was prolongated until February 28th 2003

2. EU decision criteria were set. If, by the joining of the Turkish-Cypriot community, amendments and changes in the conditions for the accession would be needed, these could only be made by an unanimous resolution

3. The positive resolution for the Cypriot EU accession was only given for the Greek part of the island [51].

Nevertheless a unified Cyprus was „clearly preferred", the accession of the southern part of the island alone was not at all rejected, if the negotiations for a unification failed [43].

Especially the third condition for a Cypriot EU accession played a significant role. In order to protect the European Union an extension of EU law through the application of the acquis communautaire[12] was prevented in a way, that where the Republic of Cyprus factually did not control the territory EU law would not be applicable [52]. If the EU did not set such a condition, Greek Cypriots could have filed lawsuits in front of European Court of Justice for freedom of property acquisition in the northern part of the island [51]. A legal enforcement of such rights would have directly leaded to political tensions between EU and Turkey.

The non-application of the acquis communautaire for the northern part of Cyprus was an unprecedented step in the history of the EU.

Under international law the "Turkish Republic of Northern Cyprus" is not recognized by the European Union and was excluded from the negotiations about the Cypriot EU accession [51,53]. The question can be asked, whether on EU level a "half-state" could be taken into the EU, when under international law, no two-state solution is desired and recognized. This is highly contradictory, a dangerous foreign policy and inconsistent in its logic.

Also, the second condition reminds of the significant jeopardy a EU-accession of Cyprus brings to the EU. An eventual accession of the northern part of Cyprus to the EU would have needed an adjustment of the accession conditions according to the notion of the European Council [45]. The „Turkish Republic of Northern Cyprus" was seen as a "Turkish federal state" since 1974 and was accepted as an independent state by Turkey in 1983, but still remains close to the Turkish mainland in terms of society and culture [54]. This becomes obvious through the mutual currency (ibid). Until today the Turkish EU accession failed because of the difficult geo-political location, deficits in the democratic order of the state, deficits in the granting of human rights and nevertheless cultural difference [55,56]. Undoubtedly the Turkish role in central Asia and near east is remarkable, but this also carries out serious threats to the security of the EU [57]. The relationship with Turkey is actually already tensioned and Northern Cyprus can be the straw that breaks the camel's back.

An accession of Turkey to the European Union failed insofar also because of the unclear Cyprus-situation. Turkish prime minister Erdogan said in 2006 regarding the failure of Turkish EU accession: "It is a great mistake of the EU to try resolving the Cyprus-problem and to actively interfere" [55].

Moral obligation of the EU

The Cypriot financial institutions have been distressed mainly because of the Greek haircut (Matthes, 2013, p. 2) [58]. Strong interlinkages between European banks and states makes it difficult to get an isolated view on particular member states. Indeed, Cyprus has deliberately taken risks with its oversized banking sector. On the contrary the strong economic and cultural ties have grown because of the close familiarity of both states.

In the beginning of 2012 most creditors have voluntarily agreed to a debt cut with the Greek state [59]. Banks, insurances and funds exchanged their sovereign debts against new ones and abated 107 Bn. Euro in debts (ibid). This deal was a result of twisted negotiations between Greece, the governments of the other Euro-states, the European Commission, ECB and IMF. The Troika, in turn, agreed on securing (provisionally) further 30 Bn. Euro from defaulting (ibid). These measures were taken in order to prevent a collapse of Greek sovereign bonds and the creditors could hope to at least regain part of their investment. For this liabilities were shifted to European tax payers [17]. The imminent threat of a total collapse of the Greek state finances and possible contagion effects to other EU member states were in the foreground of reasoning [60].

The imminent default of the Cypriot state was a logical consequence of this debt cut of the creditors by 53.5% towards the Greek state [13]. Taking into consideration the numbers one could have known, that with the Greek haircut Cyprus would be at the brink of a state default [61].

Trust in the EU and the Euro

The European integration had political and economic reasons [62]. Also the implementation of the Euro as a mutual currency at January 1st 1999 was a political signal: Less sovereignty for in terms of monetary policy for the single states, but a strong mutual currency

[12] A joining member of the EU has to accept and adopt the whole legislation of the EU. Meanwhile, the Primary law, EUV and AEUV, as well as secondary law like acts and guidelines

for 290 million inhabitants with a share of 20% of the global trade [63]. The Euro was meant to be a counterpart for formerly dominating US-Dollar on international parquet and to play a major role as world reserve currency [64].

Especially before the sovereign debt crisis in Europe the Euro was seen as a stronghold, because of the size and economic and political power of the currency area. One can conclude that step-by-step the Euro established as an alternative of former lead currency US-Dollar [9]. According to Frankel the position of lead currency constitutes itself mainly through sympathy and trust. And: The Euro was a lustering example for a strong and mutual currency union [9].

There are no clear data, but it is assumed, that ¼ of the Chinese currency reserves (3.2 Bn. US-Dollar) were held in Euro in 2011 [65]. The Chinese portfolio contains currency reserves but also sovereign debt bonds of the Euro-states [66]. The ever-increasing financial engagement Chinas in the EU is metaphoric for many countries of the world, which are inclined to contain the influence of the US-Dollar and meanwhile the political and economic power of the United States [67]. The Euro as a mutual currency of the European states would have never had such a dominant role, if other states were not trustful in the stability and reliability of the newly founded currency [68]. In important monetary functions, like being a trade-, asset- and reserve currency the Euro became the second most important currency in the world (behind the US-Dollar) already nine years after its introduction [69].

In policy making among the EU states the "no-bailout"-clause of the Maastricht treaties was clear, but the introduction of the Eurozone investors got intrigued by the thought, that sovereign bonds of Euro-states were absolutely riskless [70].

In 2013 amidst the financial crisis the political justification for the Euro-rescue was mainly the Euro and trust in the European union. If international investors lost confidence in the „safe haven EU "due to bank- or state-defaults the Euros role as future reserve currency would have been questionable [71].

Interesting questions posed in the epicenter of the crisis were: Will investors be able to differentiate between systemically important and unimportant Euro states? Would Cyprus present a reference case for the whole Eurozone, every state could rely on to be bailed-out? How would the international markets react to a bail-out, bail-out or a combined bail-out-bail-in agreement?

In summer 2011 Merkel came up with the words: "If the Euro fails, the European project will fail" and hence justified the absolute necessity for a Euro-recue-package [21]. Jürger Fichter from German DIW in Berlin on the contrary is convinced, that politic contagion effects are negligible [36]. He trusts in the financial markets' ability to differentiate between "economic light weights" and "heavy weights" in the EU and that the markets would not principally doubt a Spain-recue if Cyprus was denied a rescue-package.

Necessity for Cyprus?

In 2008 Cyprus yielded 78.33% of its GDP in the service sector, 19.59% in the industrial sector and only 2.08% in the agricultural sector (Figure 14). A large share of the service sector is comprised of the banking sector. Indeed, the aforementioned measures defined by the MoU might mitigate the immediate risks of the financial crisis for the Cypriot state as well as for the European union, but it has to be kept in mind, that before the crisis Cyprus earned 1/3 of its GDP in the banking sector (Figure 3). A drastic reduction of the banking sector automatically led to a drastic decrease of the Cypriot GDP. Also, higher corporate taxes and state budget cuts had an amplifying effect on the Cypriot economy.

Famous American professor and Noble laureate wrote 2008 in the New York times:

"The reason is straightforward: staying in the euro means an incredibly severe depression, which will last for many years while Cyprus tries to build a new export sector. Leaving the euro, and letting the new currency fall sharply, would greatly accelerate that rebuilding" [72,73].

His thoughts are not far from reality. Hard austerity measures are often deterring economic development and innovations. In the papers of the EU it was planned in 2013 to cut the Cypriot financial sector by 50% in a very short time and it was planned to build a new export economy, even though the primary sector just accounted for 1/5 of the GDP before (Figure 15) [26]. Also the European ambitions to create a budget surplus for Cyprus already in 2015 were very ambitious. It remains to be seen in the next chapter how the combined bail-out-bail-in requirement sufficed in creating these economic parameters in such a short time [28].

The Aid-Package

After the Popular Bank and the Bank of Cyprus had to report combined losses of approximately € 4.5 bn., the government of Cyprus

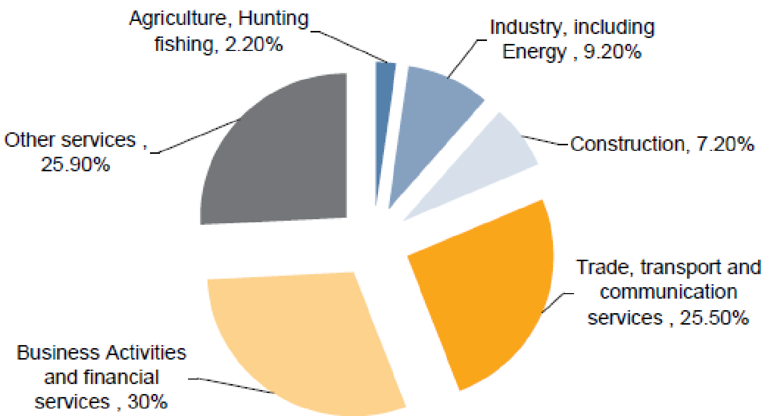

Figure 14: Business sectors and their percental share of the Cypriot GDP in 2013.

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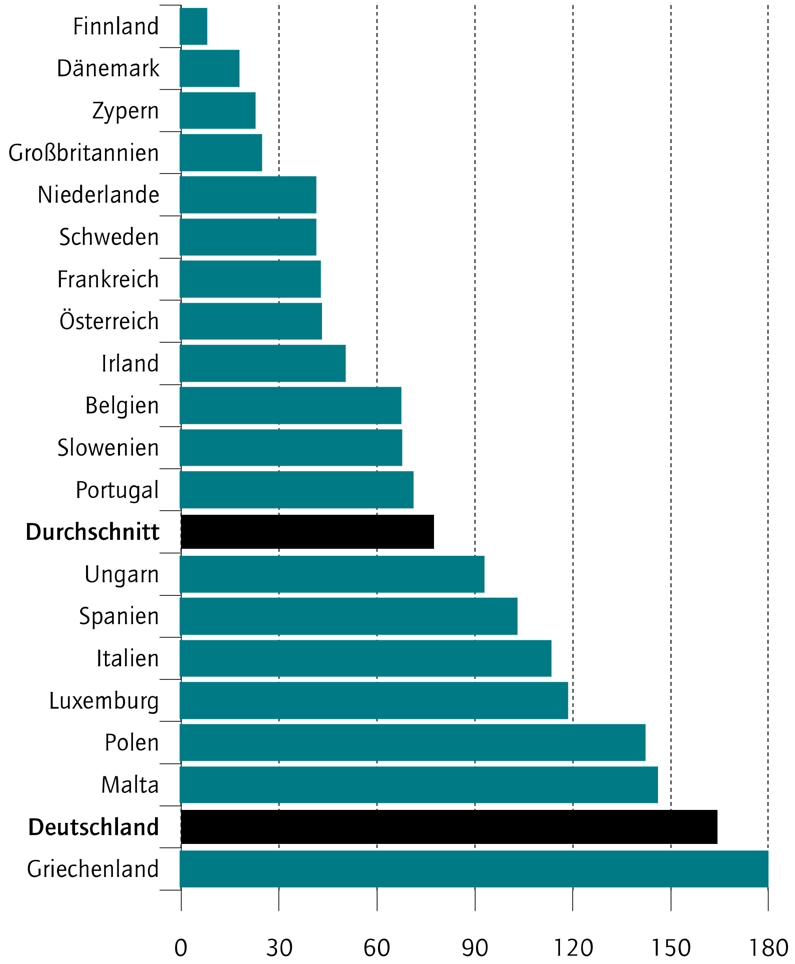

1 Verhältnis heimischer Staatsanleihen zum Eigenkapital (Tier 1–3).

Figure 15: Exposure towards home state for assorted EU-states.

decided to seek assistance from the Eurozone in terms of an aid package, being the fifth Eurozone member to be saved from bankruptcy [2]. Followed by continuous downgrading of Cypriot government bonds by major rating agencies, such as Moody's, Standard and Poor's and Fitch, the island faced serious financial difficulties.

After intense and lengthy negotiations, the bail-out plan for Cyprus was finally set on March 16, 2013. Different to bail-out plans formulated for other struggling EU-member states, the Cypriot aid-package included not only a bail-out package financed by the EU, but furthermore a bail-in requirement.

Bail-out or bail-in?

The initial amount to bail-out the island's financial sector was initially estimated to amount to approximately € 17 bn. However, this request was denied by the European Union. Instead, to secure an aid package of € 10 bn., Cyprus was required to raise roughly € 5.8 bn. itself. While other countries in financial distress enjoyed several bail-out packages from the Eurozone, Cyprus was required to implement a bail-in plan, in which bank deposits were hit with additional one-time taxes. Therefore, savings exceeding € 100.000 were hit with a 9.9% one-time tax levy and deposits below this amount were taxed with 6.5%. Additionally, corporate tax rates, which were previously some of the lowest corporate tax rates within the EU, were raised from 10% to 12.5% [2]. Even though this safety-net tool is understandably not well perceived by private citizens and investors, bail-ins do have a stronger positive effect on the financial needs of failing banks and the resulting public finance costs than bail-outs do [74]. Being the most popular tool to handle the effects of financial crisis contagion and the spreading of systemic risks, the following section will discuss bail-outs. However, while bail-outs can to handle the severity of a financial crisis, their effectiveness has historically been lower than anticipated, which has led to the development of bail-ins. Benczur et al. show, that while bail-outs, i.e. increased capitalization, can reduce the financing needs of failing banks by 30%, bail-ins perform even better by reducing financing needs by roughly 60% [74]. The effectiveness of bail-ins has been recognized by the European Central Bank, which has included this tool and its underlying logic into the newly published Basel III agreements [75].

Bail-out

Bail-outs have historically been a popular instrument to deal with financially distressed entities, including financial institutions, corporations and even countries, to reduce the systemic risks emanating from those entities and to handle the contagion of financial crises. It is not uncommon, that foreign countries bail-out a financially distressed country, if there are strong financial ties, such as high investments in government bonds and securities. In this case, if the indebted country starts to default on its bond payments, the foreign country may risk enormous losses, which could affect its own financial sector and public finances. One prominent example includes the US bail-out of Mexico in response to the Mexican currency crisis in 1995 [76]. With the financial crisis worsening in Mexico, it became more and more probable, that the government was going to default on its bond payments, threatening the US of losses worth billions of dollars. The US government, in cooperation with the IMF, the Bank for International Settlements and private banks responded quickly by providing a bail-out of more than $ 50 bn. Even though the bail-out served its purpose and helped to stabilize Mexico's financial situation, it was heavily criticized by national and international politicians and financial experts for its eventual effect on other countries and their management of foreign debt and financial risk taking [77]. Regardless, bail-outs became a common practice in response to financial actors in distress. Almost 15 years later, during the great recession of 2007-2008, the US government deployed government funds totaling $700 bn. to save failing financial institutions, including Bear Stearns and AIG, which were deemed "too big to fail", implying that their bankruptcy would have consequences too severe for the economy as a whole to be allowed to go bankrupt. While proponents of this concept claim, that bailing-out distressed financial institutions is the optimal choice if the social costs of bankruptcy are too high, opponents stress the perils of excessive risk-taking mentality, that can be induced by such policies since actors expect to be bailed out in case of failure [78,79].

While the majority of academic literature deals with the effects of bail-outs on the national economy and the financial sector, the recent financial crisis highlights the risks of cross-border contagion of financial crises. Acharya, et al. investgate the link between bank bail-outs and sovereign credit risks and find a mutually reinforcing link among these two factors [80]. If a distressed financial sector is bailed-out, this increases the sovereign credit risk, which in turn weakens the financial sector even further. Eventually, the value of government guarantees and bondholdings decreases considerably, which hurts the country's economy severly. Thus, even though bail-outs may appear like a quick fix to counteract financial crises, the consequences of such policy measures must be evaluated thoroughly, including the effect on the country's sovereign credit risk and the risk-taking mentality of relevant actors.

Bail-in

While in a bail-out, the funding for the financing needs of a failing country or organization come from an external party, such as international organizations like the IMF, the European Central Bank or private financial institutions, Roubini & Sester also discuss the possibility of a bail-in. In the latter, the financing needs are not satisfied by increased capitalization from external sources but by raising these funds from within from the bank's creditors, usually by hitting unsecured deposits with tax-levies based on a seniority ranking proposed by the European Central Bank [75,81]. The combination of bail-in and bail-out is also possible, as it was the case in Cyprus and has since become part of the Basel III agreement, published by the European Central Bank. Coeuré [75] argues, that the introduction of bail-ins as part of a bail-out plan and the associated requirements for banks to have sufficient loss-absorbing capacity, i.e. sufficient capital, ensure, that the risks of bankruptcy are reduced [74]. Additionally, the associated regulations and measurement tools help to better monitor the risk behavior exhibited by banks. Generally, the major aim of the new Basel III agreement is, to encourage banks and systemically important financial institutions to be more careful in their investment decisions, to eventually reduce the cross-exposure of banks and hence limit contagion possibilities.

Even though, there appears to be evidence that bail-ins are generally advantageous in reducing the financial needs of the financially distressed country further than bailouts do, it does not come without pitfalls. Bail-ins are designed to shift the costs of bankruptcy from tax payers to the financial institutions' creditors, including deposit holders [76]. This possibility, however, can have great effects on the creditor's investment behavior. If investors fear, that their financial institution is on the verge of bankruptcy and is facing the implementation of a bail-in plan, they are likely to withdraw their investments or deposits, fearing that they will otherwise have to carry the losses of the bail-in. This, however, weakens the financial institution even further, causing more investors to withdraw their investments. Thus, a self-reinforcing cycle develops, eventually leading to the bankruptcy of the institution. In light of the high level of interconnectivity of banks, other financial institutions and even businesses (through the role played by the payment and credit system, which is at the core of the economy), this is likely to cause other players in the field to run into financial trouble, exacerbating the financial crisis even further [82]. This is why bail-ins can damage investor confidence severely, hurting the economy and the financial sector in the long-run. In case of Cyprus, it is estimated that foreign investors withdrew approximately 18% of their investments in February 2013, fearing further taxes on their investments [83].

Hence, even though bail-ins are theoretically designed to shift the costs of financial distress from the taxpayer to the financial institutions' creditors, their effect on investor confidence, investor behavior and the overall financial system should not be underestimated. Many opponents of the bail-in system argue, that this tool merely redistributes part of the costs of financial distress without dampening its effect on the financial system or reducing its contagiousness [82]. Instead, greater monitoring levels of systemically important financial institutions is required, coupled with stricter regulations regarding their capital ratios and the separation of investment- and commercial-banking.

Cyprus Today

Today, Cyprus is celebrated as a success-story in how it overcame its financial crisis and exited its bail-out plan with utilizing only approximately 70% of the bail-out funds [4]. Even though the economy appears to be recovering with an economic growth rate of 1.75% in 2016 and the subsequent upgrading of government bonds by international rating agencies, the quick recovery did not come without costs [84]. One of the major factors enabling the small island to recover this quickly, was the implementation of strict austerity measures including the restructuring of the healthcare and pension system and the public sector [4].

On paper, the quick recovery of Cyprus may appear impressive. However, the austerity measures implemented to enable the quick recovery still poses a threat to the Cypriot population. During the financial crisis, unemployment rates rose as high as 16.8% in 2013 and 2015 and still exceed the long-term average of 7.81% today by several percentage points [85]. Considering decreasing levels of household income, the healthcare reforms, including budget cuts and the introduction of co-payments, appear counterproductive regarding the state of public health [86]. Especially in light of increasing levels of health problems emerging during financial crises, raising the barriers to access public health services can be expected to affect the population negatively in the long-term. Research suggests, that austerity measures in the public health sector have negative effects on public health [87].

Similarly, despite the economy appears to be recovering, outstanding banking loans classified as nonperforming are still high, inhibiting further growth opportunities [88]. Regardless, even though the bail-in policy cost many international investors millions of Euros, investor confidence has since improved considerably, leading to increases of FDI as high as 9.1% in 2016 [89]. Further, FDI is encouraged through increased speed and ease of issuing planning permissions, permits for joint tourist developments and already secured investments by large international investors, signaling high levels of investor confidence [90]. One of the most heavily criticized measures, however, has been the granting of citizenship based on investments in real estate, financial assets or companies operating in Cyprus, exceeding € 3 mil [91]. Thus, in spite the fact, that Cyprus has recovered considerably since the outbreak of the financial crisis, its aftermath can still be felt throughout the economy.

Discussion

With ever increasing levels of interconnection between national financial markets and market economies, the importance of understanding the development, as well as contagion and containment of financial crises becomes ever more crucial. During the recent financial crisis, originating in the housing- CDO and CDS-market in the US, it did not take long for the financial crisis to swap over the Atlantic Ocean to Europe and to start affecting the local economies and financial markets. One of the main contributors to the contagion of financial crises are the interlinkages among financial markets and market economies across countries. These normal interlinkages have been termed *fundamentals* and, even though they can offer great advantages through, for example cross-border trade, they can also be seen as unavoidable problems, if an important trading partner slips into financial distress [92]. This was the case for Cyprus, the small Mediterranean Island that was hit by a financial crisis in 2012/2013 due to its high exposure to the Greek economy. With the Bank of Cyprus and Popular Bank, the island's two largest and systemically important banks, having invested approximately € 4.7 bn. in Greek government bonds in 2011, Cyprus was inevitably due to be infected by the financial crisis. When Greece started to slip even further into financial failure and started to default on its bonds, Cyprus lost around € 3.5 bn. of its investments, approximating to 20% of its GDP [93].

There are, however, several factors, that can influence the likelihood of a contagion of sovereign financial debt crises. Firstly, the countries featuring low growth prospects and government deficits are more susceptible to being the next victim of sovereign debt crises [94]. This is caused by the fact, that those countries are often viewed as riskier. Meanwhile, in case of financial distress, these countries have to pay greater sovereign spreads, weakening their economy even further. Without enough capital to cushion the fall, the country plummets deeper into financial troubles. In Cyprus, government debt and government deficit far exceeded the threshold levels stipulated by the EU-convergence criteria, which aim at evaluating the financial strength of EU-member states. To counteract this problem, newly introduced regulations by the European Central Bank demand higher capital ratios to be in place.

A further aspect influencing the likelihood of a contagion of sovereign debt crises relates to investor behavior and investor confidence. Research suggests, that investors' individual investment decisions are not only influenced by the financial situation of one particular country or investment opportunity, but also by the interlinkages among countries in their investment portfolio. Thus, if one country in the portfolio weakens considerably, the risks associated with a financially or economically linked country increases. Meanwhile, investors are incentivized to withdraw their investments [95,96]. This situation could be avoided if countries, or systemically important financial institutions, ensured that their investment portfolio was well diversified. Cyprus, however, was financially strongly linked to Greece. Considering the high risks associated with Greek government bonds, it could be speculated that Cypriot banks hoped to reap the high return rates associated with risky investments [93]. This investment behavior, however, should have been closely monitored by external investors, who could have anticipated the danger of the situation and could have behaved accordingly. Regardless, once investor confidence is shattered, the financially distressed country or financial institution must implement incentives to encourage investors to invest again. Cyprus has implemented a series of measures, including citizenship by investment and faciliated real estate planning and construction.

In any case, once the financial crisis has been transmitted to a sovereign country, steps have to be taken to ease the situation and bring the country back on track. Historically, this has often been done through bail-out agreements in which the funding for financial needs comes from external sources such as other countries or international organizations. Even though this tool can dampen the severity of financial distress and eventually help the country to recover from its situation, it is often criticized by politicians and the general public, claiming, that the burden of the financial crisis should not be carried by foreign taxpayers. Therefore, the European Central Bank has passed the Basel III agreement including the terms and conditions for a combined bail-in and bailout plan for financially distressed countries. In contrast to a bail-out, in a bail-in, investors of unsecured deposits in the financially distressed country, are required to share in on the costs of recovery by having their deposits hit by tax-levies to fund the bail-in. Despite the fact, that this has shown to help reduce the financial needs of the troubled country considerably, it can have a disastrous effect on investor confidence of foreign investors. In Cyprus, which was a preferred destination for Russian FDI, approximately 18% of foreign investments were withdrawn, when news about the bail-out-bail-in plan became known. To counteract further withdrawals, the country implemented capital controls, controlling the amounts to be transferred abroad. This cost investors losses amounting to millions of Euros, impacting their willingness to re-invest in the Cypriot banking sector.

Additionally, the quick recovery was also enabled through the implementation of severe austerity measures including pay-cuts and lay-offs in the public sector and the reformation of the health-care system. While this has saved the government great amounts of expenditures, it should be kept in mind, that financial crises often result in decreasing household incomes. This, again, can influence the mental health of the population through increased levels of depression and anxiety. By increasing the barriers to public health services through, for example reduced insurance coverage and co-payments, infectious diseases and mental health problems can evolve further and become a major problem [87]. Thus, even though austerity measures may help to spur the recovery of the financial state of the economy, its effect on the population should not be neglected. How this will affect Cyprus in the long-run still remains to be seen.

In light of the high level of globalization and the economic and financial linkages among countries, the contagion of financial crises can pose a major threat to economies around the globe. Even though some countries may be especially vulnerable or invulnerable to the contagion of financial crises, due to government debt and government deficit levels, partially weak financial sectors and a generally high exposure to other countries' financial situation, most financial markets around the globe are so tightly interconnected, that it is virtually impossible not to be affected in some way. Still, if not directly affected by the collapse of a sovereign financial market, aid packages to the distressed country often contain funding from external sources, tying in foreign taxpayers' money. To counteract this situation, bail-in plans have been proposed. While this, theoretically, makes the investors of the respective country accountable for the costs associated with a recovery, it should be kept in mind that the deterioration of a country's financial sector does not happen suddenly but develops over time. Hence, countries on the verge of a financial collapse often apply to wealthier countries for loans, who are mostly very willing to provide those in hope of accumulating export surpluses. Thus, instead of recommending caution and encouraging preemptive measures, it could be claimed that wealthier countries are often inclined to exploit the situation. The blame for a financial crisis, however, should not be assigned to the financially distressed country alone. Given the high level of interconnectivity among countries, it appears that new regulations and tools aiming at preventing the contagion of sovereign debt crises should not only be developed on a country to country-based sight, but rather deal with the international architecture of financial markets and economies [97-102].

The imminent state default in Cyprus in 2013 was due to an oversized banking sector, which accounted for ten times the small island's GDP. Real economic equivalents were just a small fraction of the financial sector.

The question about a necessity of a Cyprus-rescue by the European Union was evaluated by economic, political, contractual (EUV and AEUV) as well as cultural and monetary aspects. Also, a potential necessity to remedy Cyprus due to the principle of solidarity among the EU-member states was discussed. To answer the research questions, one has to look at the intentions of the involved Euro-states and how they want to form a future Eurozone.

Many aspects are indicating against a necessity to rescue Cyprus by the EU back then:

A moral obligation of the EU to safe distressed Eurozone members could have been the case at most, of the particular country was not to be blamed at all for its own situation. Cyprus had deliberately taken systemic risks into account due to its special economic structure. A responsibility for the susceptibility of the financial crisis spillover from Greece was hence given.

Looking at the mere economic necessity to remedy Cyprus by the EU, there have been no indications for a systemic relevance of Cyprus for the European union regarding population size and economic power. In turn a state default would have had severe consequences for the local population and for Greece. But Greece was covered by a separate bail-out agreement, already.

The outsourcing of Cypriot subsidiaries in Greece to the Greek banking sector made these losses fall under the Greek rescue package, which had been politically decided already. The remaining loss potential of approximately 30 Bn. Euro remained systemically unimportant for the European financial institutions in terms of the sum itself. An imminent threat of the Cypriot default was priced in the Greek bail-out package already. Looking at the high economic power of the European Union a mid-sized two-digit Bn.-sum in losses was not itself the problem for the Eurozone.

Additionally, the Troika's rescue package always included strict conditions for granting financial aid. In 2013 it was not clear, whether Cyprus could ever pay back its debts, due to its high reliance on the financial sector (which was shortly before being massively cut). Also, the contractual framework of the EU poses the question about a necessity to save distressed member countries. Maastricht criteria even prohibit such an automatic liability for other member states in order to incite the members to keep budgetary discipline. International investors, however, should have observed the "No-bail-out"- order of the EU and should have individually checked the solvency of each member country. Every investor should have known, looking at the EU-laws, that a Euro-member could be in danger of defaulting. It was evident, that even when Cyprus joined the European Union, it failed to fulfill the Maastricht criteria.

EUV and AEUV have set an indirect duty of financial support for distressed EU-members by their principle of solidarity. But scope and specific measures are hard to define.

In the authors opinion the principle of solidarity is mainly linked to the responsibility of an EU for its own situation. In case of Cyprus there was (at least a partial) responsibility for the imminent collapse of the state finances. Hence, it is questionable whether there was contractional duty for the bail-out of Cyprus in 2013.

Neither monetary policy related conditions nor institutional stability (because of the ongoing ethnical conflict on the island) were existing in case of Cyprus.

Also, regarding the geo-political situation and the weight in international negotiations there was no indication for the necessity of a rescue.

The Cyprus-conflict has inflicted burdens on the relationship between the EU and Turkey ever since. Granting accession for Cyprus to the European Union and the Eurozone subsequently had turned out to be disadvantageous in this sense. Important business partner with a key position in near-East Turkey was turned upset. Additionally, the European Union has lost confidence, when one the one hand, the "Turkish Republic of Northern Cyprus" as not recognized as a state, but on the other hand only the southern part of the island was granted accession to the European union before the political and legal conditions were handled. First it was demanded, that the EU accession would be due to an execution of the Annan-plan in 2004, then it was just skipped when the Annan-plan failed. The unresolved territorial conflict in Cyprus even led to the termination of the accession talks between Turkey and the European Union.

But how can we see the necessity for Cyprus itself to be rescued? The ambitioned plans by the Troika to massively shrink the Cypriot banking sector and to build up a competitive industrial- and export-sector and to create a positive domestic demand in a few years were hard on the local citizens.

The economic structure in Cyprus with a strong dependency on the financial sector made the small island particularly susceptible to the shrinking of this sector. Even an own currency, as proposed by Paul Krugman, which could depreciate more easily would have not amended the structural deficits in Cyprus. But in fact, exports would have been cheaper on the European market and by a low exchange rate the Cypriot tourism could have been strengthened. It cannot be denied, that a state default and subsequent Cypriot exit from the Eurozone could have had manifold positive effects for the country itself in terms of relieving the crisis.

Even though there were many arguments against a Cyprus-rescue by the European Union back then, on the contrary there also were many aspects in favor of a rescue. Especially due to the fact, that an isolated view on Euro-states is not possible, the question about a possible responsibility of Cyprus for its crisis has to be looked at a more distinguished level.

The combination laissez-faire attitude in the assessment of European sovereign bonds by the EU-bodies and the historically grown high interlinkage between Greece and Cyprus are not direct wrongdoings by the Cypriot government but factors dragging Cyprus down, without direct intervention of the island.

Also, the debt cut with the private creditors in Greece was mainly due to pressure of the European commission, which has pushed Cyprus to the brink of state solvency. Hence, Cyprus itself but also the EU is to be blamed. A moral obligation of solidarity resulting from EUV and AEUV cannot be fully denied.

Tourism and the industrial sector would have never brought such a prosperity for Cyprus. It was advantageous for Cypriot state and the banking sector to be tied so closely culturally and economically with Greece. Legally, this procedure was flawless and logically understandable. Cyprus has done the obvious: To earn money legally by the easiest way. This was a broad financial sector, sustained by low taxes and lower regulations than in other EU-states.

At the first glance it seems far-fetched to implement a bail-in requirement for the Cypriot bail-out hitting the domestic population, who naturally brought their savings to a local bank. A local entrepreneur, who has straightforwardly earned and taxed his income, should not be made accountable for a crisis with his savings, which the Cypriot state and European Union had evoked by wrong frameworks and legal regulations.

The Cypriot banking sector had deliberately and partially very riskily invested in domestic and foreign sovereign debt bonds and had attracted deliberately many international investors. These investors should not be made accountable with savings above a sum of 100,000 Euro for the mismanagement of Cypriot government and financial institutions. This obviously excludes tax evaders, who came into the country in order to bypass taxing requirements in their respective countries like many Russian investors.

One has to differentiate between investors, who invested in high risk-papers and could have expected the loss of their money and those who just deposited their money on a bank account. Who deposits money on a bank account in the European Union should not expect to lose this money in any way. It is not the responsibility of an investor the create legal requirements for a stable banking sector and governmental regulations, but those of the respective EU country. In any way the funds of the investors should be used to create a balance between profit for the investors and utility for the country and the population of the country invested in.

EU bank-supervision did not expect the default of single EU-states or simply ignored the risks in the risk assessment. This is exemplified by the risk weighting of European sovereign bonds of zero percent, which European bank-supervision has set for country specific bank stress tests. If the stress-tests of the European Union did not indicate risks of European sovereign bonds, how should have others known about these default risks of the European sovereign bonds. The EU had deliberately stimulated the mutual buying of sovereign bonds of other member states among the EU-members.

All involved parties have to account for parts imminent state default of Cyprus. Nevertheless, the EU, its structures and its decisions regarding the Greece rescue have been main reasons for the contagion of the financial crisis from Greece to Cyprus in 2013.

It is hardly justifiable that in Greece all savings have been bailed-out and with Cyprus a role-model was set. To make private sovereign bond creditors liable in case of Cyprus seems at least fairer than to make deposit holders accountable, who just parked money on a bank account.

Also, the question about trust of the international financial sector in the stability of the EU and the Euro played a predominant role for the question of a possible Cyprus-rescue. The positions could not have been more diverging, but it became clear, that the value of the Euro largely consists of its functions as a mutual, trustworthy and sustainable currency.

It was at least questionable to differentiate the rescue packages by size and financial power of the respective country in a political sense. It breaks the political principle of equality of all EU-members and does not reflect a common procedure with distressed Euro-states. Furthermore, the trust in the mutual currency Euro was undermined.

It should be of foremost interest to maintain this mutual currency. Chinas monetary reserves alone account for approximately 800 Bn. Euro. This created wealth for all EU-members and should be always kept in mind when considering bail-out (bail-in) plans. The reduction of transaction costs due to the introduction of the Euro led to savings of a mid-sized two-digit Bn. Euro sum. Compared to that, the amounts for the Cyprus rescue seem negligible in sum.

Still: The liability of the single Euro-states should have been settled internally among the Eurozone members, e. g. by implementing a mutual rescue fund to which the Eurozone members would have contributed in advance. The "birth defect" of the European Union was the creation of a monetary- and economic union without defining a framework of liability for the single Euro states and to create a common monetary- and fiscal policy. This is why Cyprus was dragged in this unprecedented situation of a liability- and trust-trap.

The neglection of measures commonly implemented in an OCA (one currency area), like shock-absorbance-mechanism for macroeconomic shocks and some rescue fund was a main default of the founders of the EU and Eurozone. A rescue of Cyprus, under this light, seems just fair, because the EU and its bodies can be seen partially accountable for the disastrous spillovers of financial crises in the recent years. A combined bail-out bail-in requirement seemed feasible, especially by cutting sovereign debts. Before that point in time in 2013 when Cyprus was bailed-out (combined with a bail-in), it seemed like a red line to make normal deposit holders accountable for the crisis and to undermined confidence and trust in both EU and Euro.

Conclusion

In Cyprus, due to its high financial exposure to the Greek economy and high government debts and government deficits, the island was unable to avert the contagion of the sovereign financial debt crisis. Following other EU-member states, the country eventually applied for an aid package from the EU. However, in contrast to other countries, which received bailout funds totaling billions of Euros, the Cypriot agreement also contained a bail-in plan, in which unsecured deposits were hit with a 9.9% tax levy, thus shifting the costs of recovery from taxpayers to investors. While the country recovered quickly and without exhausting the complete bailout funds, the economy and the financial sector, as well as the public still have a long and troubled way to go. Even though bail-ins in some cases might be superior to bail-outs, in a way, that they reduce the costs to taxpayers and shift this burden to holders of unsecured deposits, this measure can have an adverse effect on the subsequent investment behavior of international investors. But not only the investors are to be seen, also the local population suffered severe financial losses due to the crisis. Apart from ruthless speculators, mostly the public were hit hard by the bail-in measures. This paper also gave evidence, that a bail-in can only be effective, if executed quickly and silently avoiding the investors to flee the country (which intensifies the downturn of the financial market then) and that the high degree of interlinkages of the global financial markets and market economies should never be underestimated in terms of the effects of uncertainty on global investments. Nevertheless, in any case investors' confidence is shattered, when they are forced to stay in with their money through capital controls, like it happened in Cyprus, while the bail-in was performed. It will take decades for Cyprus to regain full confidence of investors. Finally, one myth has been deconstructed: That the EU won't ever let one member down.

But one thing has to be kept in mind: The state of Cyprus and the financial institutes have to admit a large share of the responsibility for the crisis and the subsequent imminent state default of Cyprus. Nonetheless, the author sees a higher responsibility on the side of the EU, which missed the chance to set clear rules and liability mechanisms for the Eurozone. He would have tended to a Cyprus rescue without a combined bail-out bail-in requirement in order to show unity and confidence for a political, moral as well as an economic union. The trust of international investors in EU and Euro can grant wealth for the European union for decades, even in case of problems on the domestic markets. As the European union is also a political idea to avoid further wars and territorial conflicts and to grant peace apart from the economic necessities, these aspects should be kept in mind for bail-out (bail-in) decisions.

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