FRIEDRICH EBERT STIFTUNG

FES CYPRUS NEWSLETTER **Nr. 10 / APRIL 2013**

Contents

1. Cyprus Problem

On March 12, the UN Special Adviser Alexander Downer, met for the first time with President Nicos Anastadiades since the latter took over. After congratulating the new president, Downer stated that the peace talks need to restart in a timely and appropriate way after the conclusion of an agreement with the Troika. Downer also met with the Turkish Cypriot leader Dervis Eroglu.

Despite the fact that the Cyprus issue was not included on the March agenda of the UN Security Council, the special adviser travelled to New York to brief UN Secretary General Ban Ki Moon, on prospects for the resumption of talks, which were halted last April shortly before assumption of the EU Presidency by the Republic of Cyprus. Downer is due to return to the island in April and also plans to hold talks with the Turkish and Greek governments.

The Cyprus Problem was also discussed at high level talks held during the month in Istanbul between the Turkish Prime Minister Tayip Erdogan and Greek Prime Minister Antonis Samaras. Although Greco-Turkish ties are warming up, the deteriorating economic situation of the Greek Cypriots and the weakening of domestic position of Anastasiadis in the crisis, is likely to affect their negotiating position, which could have an impact on the peace talks whenever they are reassumed. With Cyprus battling to stave off bankruptcy and convince its Eurozone partners that it deserves to stay afloat and implement the terms of its agreed bailout, the island's on-going division is likely to be a second priority issue for months to come.

According to the Turkish Weekly, Turkish foreign minister Ahmet Davutoglu criticized the proposal of the Greek Cypriot government to use the gas and oil exploration rights as a collateral in the bailout package. Instead, he suggests a number of possible options to link the natural resources to a solution of the Cyprus problem. In accordance with Alexander Downer, Davutoglu wants to start talks only after the final conclusion of a rescue loan. Furthermore, a body should be established by both sides to jointly manage the marketing and extracting of the resources. The revenues should be blocked in an account and used for the peace process and the period after. In case the Greek Cypriots reject this proposal, Davutoglu advocates the idea of a two-state solution where Turkish Cypriots would have the right to exploit the resources in the north.

2. Hydrocarbons

Cyprus' estimated natural gas reserves provide the only light of hope for the island's economic development in the medium term future, as its banking sector collapsed within a night, eventually leading to a radical restructuring of its economy.

Natural gas estimated prospects were initially included in the discussion with international lenders for the country's bailout agreement. The troika, however, seemed reluctant to take into account possible future gas earnings for the purposes of a loan repayment, as the gas estimates have not yet been monetised, pending an appraisal drilling. While gas for local consumption might flow in 2015, the island is not expected to be ready to export and sell its Hydrocarbons before 2017 the earliest, more likely 2019. Hence, Energy and Commerce Minister Giorgos Lakkotrypis reiterated that the appraisal drilling is a top priority due to start between July and September.

Prime Minister Recep Tayip Erdogan stressed that Greece and Turkey should be included in the exploitation process as the island's guarantor powers, and that Greek Cypriots should not unilaterally take advantage of the gas prospects for purposes of economic assistance.

Meanwhile, a US brokered Israeli apology to Turkey for the 2010 Mavi Marmara incident has opened the door to the resumption of close relations between the two former allies, raising the prospect of energy collaboration in form of a gas pipeline from Israel to Turkey. This, however, causes concerns to the Greek Cypriots fearing that they might be bypassed in this project. Israeli Prime Minister Netanyahu stressed that due to the increasing danger emanating from Syria, a close cooperation between Turkey and Israel was necessary. Turkish Prime Minister Erdogan pointed out that this development will 'elevate Turkey so that it will again have a say, initiative and power, as it did in the past'. *Financial Times* reports that the American company Noble Energy and Israeli's Delek Energy who are both main investors in Israel's offshore gas fields, as well as partners in Cyprus' Block 12, have been investigating possible customers in Turkey. Whereas a pipeline to Turkey appears to be more cost efficient, the political implications of being dependent on Turkey for gas exports do not seem to be too attractive for the Greek Cypriots. On the other hand, Charalambos Ellinas, the Chairman of KRETYK, Cyprus' state hydrocarbons company, stated that building a costly liquefied natural gas (LNG) terminal is the only way for Cyprus to export its hydrocarbons and dismissed the option of building a pipeline to Turkey. In regards to the viability of building an LNG plant, Ellinas argued that estimates should not only be based on the 7 trillion cubic feet of natural gas found in the Aphrodite field of block 12, but also on the other 5 blocks, due to be explored next year by ENI-KOGAS and Total, which may account for a further 40 trillion cubic feet. Furthermore, Noble energy estimates that it could discover an additional natural gas reservoir of 5 trillion cubic feet within block 12.

The Egyptian MENA agency reported that the legislative committee of Egypt's Shura Council drafted a law cancelling the delineation of the Exclusive Economic Zones (EEZ) between Egypt and Cyprus. Nevertheless, Foreign Minister Ioannis Kasoulides played down the reports and reiterated that the governments of both countries fully respect and implement their 2003 EEZ delimitation agreements.

A KRETYK delegation travelled to Milan to discuss ENI's operational program and exchanged views on seismic studies for blocks 2, 3 and 9. *Fox Business News* reported an announcement by the Turkish Energy Minister Taner Yildiz that the current cooperation between Turkey and ENI is suspended due to the company's operations in Cyprus. Turkey had threatened that any company acquiring licenses off the coast of Cyprus will be excluded from the Turkish market. ENI is part of the Baku-Tbilisi-Ceyhan project (BTC) of which it has a stake of 5% as well as Blue Stream as part of a joint venture with Gazprom, transporting Russian gas to Turkey. The pipeline carries approx. 45 billion cubic meters of gas yearly and caters for one third of Turkey's annual gas consumption. The Italian company is also involved in building a 550 km crude oil pipeline with Istanbul-based Calik Holding to connect the Black Sea port of Samsun with the Mediterranean port of Ceyhan. According to ENI's Chief Executive Paolo Scaroni the project is currently dormant.

3. Greek Cypriots

Economic and domestic developments

Cyprus finally reached a painful agreement with its so called troika of international lenders (European Commission, European Central Bank and the International Monetary Fund), under the dilemma of having to choose between the spectre of a collapse of its leading banks and a Eurozone exit, or a 5.8 billion bail-in of large deposits on the two main Cypriot banks in order to secure a 10 billion bail-out by the EU and IMF. President Anastasiades held marathon talks with European Council and Commission Presidents Herman Van Rompuy and Jose Manuel Barroso, the International Monetary Fund's Director Christine Lagarde and representatives of the European Central Bank, before a deal was agreed upon and passed through the Eurogroup in the early hours of March 25th.

The details of the agreed deal included a heavy blow for the biggest bank in Cyprus, the Bank of Cyprus (BoC), and a fatal one for the Popular Bank (Laiki). The agreement foresees the closure of the Popular Bank and inflicts heavy losses on uninsured deposits above €100,000. Most of this money will be gone and only a fraction of it returned in a couple of years. Moreover, Laiki Bank's healthy assets and loans were merged with the Bank of Cyprus. Moreover, the BoC will take over debts of up to 9 billion accumulated by the Laiki Bank by receiving money from the European Liquidity Assistance (ELA), which casts a huge shadow over its future. Eventually, all small savers with deposits under €100,000 in both banks were not touched.

Uninsured deposits above €100,000 in both banks will be frozen and used to resolve Laiki's debts and recapitalize BoC. Reports estimate that 4.2 billion will be raised by the uninsured depositors of Laiki which will effectively close down with the prospect of thousands of job losses. Account holders in the Bank of Cyprus will lose at least 37.5%, another 22.5% will be frozen and might be used as well to contribute to the Cypriot bailout and liquidity of the bank. The precise percentage will be decided within 90 days. The Bank of Cyprus clients will be compensated by receiving shares of the Bank of Cyprus.

A first agreement reached during a Eurogroup meeting on March 15 had called for a 6.7% levy on depositors below €100,000, despite being guaranteed by European law, and a 9.9 % haircut on deposits above €100,000. The levy on bank deposits was needed in order to meet the Eurogroup's demand that the size of the overall bailout should be limited from €17 billion to €10 billion, essentially from 140% to 100% of the GDP, in order to make the debt sustainable, according to IMF terms. Any access amount needed to be raised by the Republic of Cyprus without increasing its national debt. A prominent role in the talks was played by Germany, where the Cyprus bailout got entangled in German domestic politics and was used by all parties to score points in a pre-electoral period. Consequently, the German government was determined to offload the burden of bailouts from the Eurozone (especially German taxpayers) to investors and creditors whom it perceives to be predominantly Russian oligarchs who, according to a German secret service report, use Cyprus for tax evasion and money laundering. Since privatizations could contribute no more than €1.4 billion, the lion's share of the €5.8 billion should come from bank deposits in Cyprus, worth €68 billion. All in all, the levy represented an unprecedented step in Europe's handling of a debt crisis and was overwhelmingly rejected by the Cypriot Parliament via a 36-0 vote on the 19th. Only the proposal of such a measure, however, was more than enough to inflict damage on the islands vastly oversized banking system, also known as an offshore financial haven for wealthy foreigners, many of them Russians and Britons. According to Moody's, Russian corporate and banking deposits in Cyprus accounted for €31 billion about, 1/3 of all deposits last year.

In the wake of the parliament's rejection of the tax levy on deposits, the government decided to proceed to a plan B by setting up an Investment Solidarity Fund in a bid to raise the required €5.8 billion that would unlock the €10 billion financial assistance package, an initiative that was turned down by the troika.

Nicosia also turned to the Kremlin to renegotiate a loan deal and obtain parts of the 5.8 billion from Russia. The Cypriot Finance Minister, Michalis Sarris, spent 3 fruitless days in Moscow trying to win help from Russia. The Russian government, however, turned down an offer including stakes in the island's banks and offshore energy reserves. There were even unconfirmed rumours of the possibility of the establishment of a Russian naval base on the island as part of the deal, though this seems unlikely given the British and American military presence on the island. Moscow also seemed unwilling to help companies and businessmen who had been legally (there is a double taxation agreement between both countries) avoiding to pay taxes in Russia. Moreover, some of the largest Russian investors are rumoured to be close to the opposition to the Russian President Putin; and this might serve as a further explanation. But following the agreement of a €10 billion European bailout, sealed on the 25th, and despite anger that the deal will impose heavy losses on many Russians, Moscow at least signalled it would negotiate the restructuring of the existing €2.5 billion loan that it had granted 2 years ago offering a lower interest rate and an extension of the repayment period. This was cold comfort for the Greek Cypriots and not really a major gesture since Moscow had signalled this willingness to help by easing the terms of the loan already prior to the bailout deal.

As Russia initially seemed reluctant to contribute unilaterally to the Greek Cypriots, the Cypriot Parliament conceded to a one time levy on bank deposits over €100,000 and the restructuring of the Bank of Cyprus and effectively closing down Laiki, a dramatic U-turn from a few days earlier when law makers angrily rejected a similar proposal as bank robbery. On Sunday 24th, President Anastasiades travelled to Brussels having in mind that if a bailout deal was not concluded by Monday, Emergency Liquidity Assistance from the European Central Bank to the Cypriot banks would be cut off. Struggling into the early hours of Monday and after intense negotiations with the European lenders, a bailout package was agreed, which avoided the economic collapse of the Cypriot banking system and kept the island in the Eurozone. The agreement scraped the highly controversial idea of a levy on insured bank deposits below €100,000 but still required losses on bondholders and depositors with accounts holding more than €100,000 in Laiki and BoC, while other banks and institutions were spared. In the eyes of the Cypriot government, the final deal did not require the approval of the Cypriot Parliament but this was contested by the opposition.

After almost two weeks with closed banks mainly to avert a bank run and limited ATM withdrawals, banks finally reopened on the 28th. The Central Bank of Cyprus imposed capital controls and restrictions including a daily limit of €300 for cash withdrawals, a maximum of €1,000 in cash for trips abroad and a maximum of €5,000 per person and month to be transferred abroad. Companies need a special permission for larger transfers issued by the bank and supervised by an committee in the Central Bank in order to ensure that the transfers are only used for business purposes and not to bring money out of the country.

The Eurozone policy makers may have avoided a catastrophic implosion of the island's banking system and a hasty exit of Cyprus from the Eurozone. It appears, however, that the outcome harmed the Eurozone and further undermined the credibility of its crisis response. The failed first agreement, that included a 6.7% cut on all deposits below €100,000 Euro, was sufficient enough to spread insecurity widely across Europe with citizens fearing for the safety of their deposits. In theory, all deposits within the Eurozone up to €100,000 are guaranteed by the national governments as stipulated in the Treaty of Lisbon. The proposal to include all account holders seems to have come from the Cypriot side in order to limit the damage on Cyprus as a financial centre by bringing the contribution of large account holders down to 9.9%. Since all Finance Ministers of the Euro zone endorsed the first deal, which was then widely perceived to be a major blunder, the responsibility for the agreement is shared, though a blame game ensued as to who came up with the idea. Moreover, international investment companies such as Pimco no longer consider the Euro as a reliable reserve currency.[1] Rating agencies such as Moody's and Standard & Poor's heavily criticized the bailout. Moody's has further downgraded Bank of Cyprus senior debt and deposit ratings and is outlining the scenario of a possible exit of Cyprus from the Eurozone.

The IMF and other Eurozone governments insisted that the reason for bailing in deposits was to ensure that a bailout would not saddle the island with an unsustainable debt. They also wanted to ensure that foreign investors, who had benefited from the low taxes and high interest rates in Cyprus, contributed and not just the European and Cypriot tax payer. The hit on foreign depositors and the nature of the negotiations has shocked the Cypriot economy, raising questions on whether the bailout under these conditions is at all sustainable. The Guardian estimates a drop of up to 25% in GDP within the next years, though it is to early to come up with reliable figures. Finally, the way the negotiations were handled domestically weakened the newly elected President, a pro-European, pro-reform leader who nevertheless argued against a haircut of deposits during his pre-electoral campaign.

The Russian deposits in Cypriot banks have been estimated by Moody's to be around $31 billion. It has been reported that many of the biggest Russian account holders had been able to remove most of their money through a number of loopholes. The Russian based Uniastrum Bank, of which Bank of Cyprus owns 80%, as well as the London branches of Laiki Bank and BoC were not placed under any restriction and therefore it was possible to channel capital out of the country. The exact amount of money that left Cyprus was not known at the time of writing. Furthermore, under the new legislation current accounts can be converted into time deposits, which will fall under the bailout levy. The Russian BBC Service reports that for those Russians who have not been able to take out their money there is still the option to file a case at the Cyprus Supreme Court.

While the general Cypriot population was not to be targeted by the bail-in deal, the social consequences for the ordinary population will be dramatic and are not yet fully foreseeable. Local and foreign businesses were not in a position to perform financial transactions and pay salaries

[1] Pimco, an investment firm with headquarters in the USA, was in 2000 acquired by Allianz SE, a global financial services company, based in Germany. The company undertook the due diligence of Cypriot banks before the bailout talks took place. Its assessment ranged from a baseline scenario of between €6.0 and €7.0 billion and a maximum of €17 billion to €17.5 billion.

or their suppliers. Even worse, since most Cypriot businesses have their accounts with the two big banks, many Cypriot companies are expected to suffer massive losses since many have more than 100,000 Euro in their various accounts in Laiki and Bank of Cyprus. How many will falter remains to be seen. Moreover, a number of educational institutions and municipalities as well as welfare organisations were in danger to face heavy losses or even closure. Last but not least, numerous Cypriots and foreigners in Cyprus lost a large part of their life savings or fixed deposits (like for example housing loans). Many of whom cannot be considered wealthy but belong to the middle class.

It was already clear with the first deal that due to the losses encountered by foreign investors the future of Cyprus' financial sector, which directly contributes to more than 40% of the GDP, was in tatters. It is widely anticipated that many of the foreign investors will take their capital out of Cyprus once they can, since they lost trust in the safety of their deposits and investments, the core capital of any financial centre. The end of the Cypriot business model with its huge banking sector (about 8 times the size of the GDP of the island) and high interest rates was a declared goal of the Euro donors. One can criticise with good reason the business model of tax havens in general (though the problems and weaknesses of the Cypriot business model were not really part of a sophisticated or self-critical inner Greek Cypriot debate) and probably the insufficient implementation of existing regulations in Cyprus (this was taken as a fact by the European donors but is still disputed by the government of the Republic of Cyprus). But the fact that the island was treated much harsher than other tax havens (for example Ireland) left many Cypriots with a feeling of deep resentment and injustice towards the EU and in particular Germany which is perceived to be the driving force behind the harsh terms of the deal. The radical and abrupt way by which the Cyprus business model was destroyed will inevitably lead to a very serious recession with a massive increase in the unemployment rate in the next years. Reduced state income and higher expenses for unemployment benefits are likely to lead to even harsher austerity measures than the one currently agreed upon and possibly the need of further loans of the Republic of Cyprus from the EU. The current sentiment is one of shock and incredulity. On the other hand, Cypriot stoicism and a sense of dignity seem to prevail most visibly on the day when the banks reopened and no incidents were reported nor was there a bank run as expected by the foreign media. Many Greek Cypriots liken the event to the situation after the Turkish invasion of 1974. The war led to the loss of 1/3 of the islands territory, massive displacement and the loss of large parts of the economy from a Greek Cypriot perspective.

4. Turkish Cypriots

Economic developments

During a month dominated by the unfolding financial crisis in southern Cyprus amid fear of pending capital flight, Turkish Cypriot authorities were keen to reassure investors of the solvency of their banking sector.

Finance minister, Ersin Tatar, revealed that Turkish Lira deposits as well as deposits in foreign currencies in Turkish Cypriot banks had significantly increased from December 2010 to the end of 2012. Turkish Lira deposits had grown roughly by 28% during the two year period, from 4.2 to 5.4 billion YTL. Foreign exchange deposits had gone up by more than 37%. The total of all deposits had reached the equivalent of 8.9 billion YTL (approximately US$5 billion) at the end of 2012.

Moreover, Tatar argued that as depositors were willing to provide longer term credit, confidence in the banking system was rising. 70% of deposits were being used as credit at the time the data was collected.

Against this, there was public speculation regarding the 'contagion' effects of developments in the south and whether the infamous 'haircut' or 'bail-in' was a precedent for financial crises elsewhere, including northern Cyprus. There were also concerns that changes in the south could affect competitiveness in the north. The casino industry warned that developments in the south, where the new government decided to allow casinos to open, would undermine the effective monopoly enjoyed so far by the Turkish Cypriots.

Meanwhile, private debt and the emergence of loan sharks served to frame media coverage of the suicide death of Can Denktash, grandson of the deceased leader Rauf Denktash. Can Denktash had incurred significant debt and was facing bankruptcy. His suicide was widely attributed to his financial situation.

The parliament unanimously adopted a law extending writs until 31 July 2013 as a stop gap measure pending the ultimate adoption of a law regarding debt restructuring for nonperforming loans and uncollectable debt. The non-compliance with court orders led to a crisis where numerous businessmen were facing arrest and incarceration and longer term imprisonment.

A similar law entailing deferment was adopted in the previous year, but an ultimate resolution remains elusive. The parliament established an ad hoc committee with the purpose of drafting a bill to resolve uncollectable debts comprehensively. In contrast, the Bar Association alleged that the parliament's approach to the matter was illegal. The Bar maintained that the legislators were negligent in failing to consult and acquire legal advice. The lawyers also warned that the net effect of deferments after the 1st of August (dramatically characterized as an 'explosive bomb') had not been calculated.

Domestic developments

The campaign for the Lefkosha (Nicosia) Turkish Municipality (LTB) took place as the most significant item on the political agenda during the month of March. The campaign was officially launched by the Supreme Election Council on 2 March. A total of 9 candidates ran for the post of Mayor.

On 22 March, KADEM, a reputable polling company, revealed that the Republican Turkish Party (CTP) and its candidate, Kadri Fellahoglu, was the front runneramongst the candidates with 34% of the prospective vote. The ruling National Unity Party (UBP) candidate, Hasan Sertoglu, was polling in second place at 30.4%, while Mustafa Arabacioglu of the Democrat Party (DP) was in third at 19.7%. Arabacioglu, considered an astute and relatively popular politician, had been hoping that disaffected UBP voters would defect and support his candidacy, since DP is also a moderate right-wing party.

Still, in contrast with the results of the 2009 municipal election, UBP's fall was significant. In 2009 the UBP candidate secured 43.3% of the vote (a decrease of 12.5 to the current 30.4%) whereas the DP candidate had received only 12%. Crucially, CTP's vote percentage was projected to increase from 27.2% to 34%, thus ensuring it the first place for the 7 April 2013 election.

UBP's situation was not improved by the internal rift within the party that had emerged through the controversial party congresses of 2012 and February 2013. The municipal election brought about political problems, including restrictions on government appointments, thus speculation regarding any potential cabinet shuffle would have to wait until after the 7 April election.

This rift affected the performance of parliament that in recent months had been failing to reach the quorum. The 'regrouping' civil society initiative (the Toparlaniyoruz Hareketi) headed by Dervish Eroglu's former special advisor in the Cyprus talks, approached the Speaker of Parliament, Hasan Bozer, to push for the application of disciplinary procedures against MPs failing to meet parliamentary duties.

5. FES Cyprus Events

26. April 2013, 5 p.m.

CAD / AHDR / FES
Conference, discussion on the
Cyprus problem:
Cyprus Peace Process - Alternative Approaches

University of Nicosia (UNESCO Amphitheatre)
Nicosia, Cyprus
open to the public

27.-28. April 2013

CAD / AHDR / FES

Workshop
Cyprus Peace Process: Alternative Approaches
Troodos, Cyprus
not open to the public

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25. May 2013

Archis Interventions / ERSTE Stiftung / AHDR / FES

Conference and workshop

Post-Conflict Development and Civic Imagination (Divided Cities)

Home for Cooperation H4C, UN Buffer zone,
Nicosia, Cyprus
open to the public

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