

TRENDMACRO LIVE!

On the ECB's Move Against Cyprus

Thursday, March 21, 2013
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Cypriot hardball is met with ECB hardball. It's the ECB's ball, but still a threat to the euro.

This morning the European Central Bank dramatically upped the stakes in what is turning into a deadly game of chicken with Cyprus (see ["On the Cypriot Depositor Bail-in"](#) March 17, 2013). In a statement, the ECB said that it [would not allow the central bank of Cyprus](#) to continue to provide Cypriot banks with Emergency Liquidity Assistance (ELA) beyond Monday, March 25 unless there was a troika program in place by then.

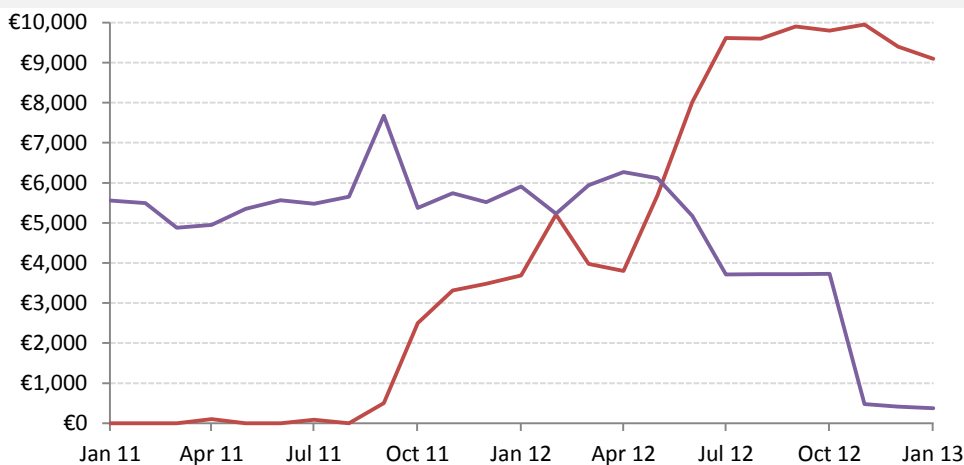
- For any clients who don't understand the critical concept of ELA, we urge you to read the explainer we published almost two years ago (see ["Understanding ELA: Emergency Liquidity Assistance"](#) July 15, 2011). While that report focused on Ireland, the principles are the same for Cyprus.
- In a nutshell, ELA is a form of distress financing for banks that don't qualify for regular ECB operations. It is administered through a bank's national central bank, not the ECB -- so it is not a collective obligation of the euro area -- but it occurs with the ECB's approval.
- Latest data shows that the Central Bank of Cyprus central bank was already providing €9.1 billion of ELA -- equal to 60% of Cypriot GDP -- to banks in Cyprus at the end of January (please see the chart below). ELA had entirely replaced conventional refinancing.

Update to strategic view

EUROPE MACRO, ECB, FX: The ECB has put a deadline of next Monday for continued Cypriot bank access to euro liquidity through Emergency Liquidity Assistance (ELA). If that deadline passes without a deal, the Cypriot banking system will collapse on Tuesday morning. While we are certain that a deal will be done, this raising of the stakes increases the risk of a political mistake. So the small but real chance of a euro exit by Cyprus becomes a live possibility. With so much at risk, Cyprus is likely to blink first and agree to a deal.

ECB lending to Cyprus EUR, millions

— Standard refinancing ops — Emergency Liquidity Assistance (ELA)



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Source: ECB, TrendMacro calculations

- By threatening to withdraw access to ELA, the ECB has thrown down the gauntlet to the Cypriot authorities: either agree to a deal that works for the so-called troika -- that is, a deal that does not increase Cypriot debt beyond the €10 billion the troika has agreed to lend -- or the ECB will force the closure of the Cypriot banking system.

Make no mistake; this has become a very serious situation for Cyprus.

- Currently Cyprus still seems to be clinging to the possibility of a Russian bailout. Unfortunately -- as we saw during the [Iceland crisis](#) in 2008 -- Russia tends to be all mouth and no trousers when it comes to deals at times like this.
- We view a substantive deal from Russia to be very unlikely.
- This means that Cyprus will probably have to find the majority of the €5.8 billion needed by what the eurogroup [euphemistically described as](#) "mobilizing internal resources."
- So, despite all the noise from Cyprus, it seems that a depositor bail-in is still the most likely outcome. The argument in favor of only including depositors over €100,000 seems to have been solved, with smaller deposits left intact. This comports with the European standard for deposit guarantees, and so in some sense represents a less ominous precedent than dispossessing *all* depositors.
- But, for Cyprus, this is still a bitter pill to swallow. Its banking sector is multiples the size of its economy, and a bail-in of depositors puts that at risk, by damaging what little credibility the banks have left at this point. The original deal (again, see "[On the Cypriot Depositor Bail-in](#)") included smaller depositors as it was felt by Cypriot authorities that asking for more from larger depositors -- many of whom are Russians for whom Cyprus is a refuge for flight capital, and a money-laundry -- would risk the Cypriot financial system -- a system that is already suffering from competition from countries [such as Latvia](#), who are due to join the euro next year.

But, there is one other alternative for Cyprus.

- It could [leave the euro -- or at least threaten to](#).
- While actually leaving would do nothing to help the banking system -- offshore depositors use it because it is member of the euro -- it is an idea that is been openly discussed [by Cypriot politicians](#).
- This is like Cyprus holding a gun to its own head -- a paradoxical form of blackmail, to be sure. But it plays on the very real fears that any country leaving the euro area would cause a collapse of the currency.
- While we agree that such fears are very real -- any country leaving would mean that *any* country *could* leave -- we do not see Cyprus as being that country.
- Its financial arguments against the deal are based on trying to keep its bloated banking sector. Leaving the euro would destroy its banking sector, truly cutting one's nose off to spite one's face.

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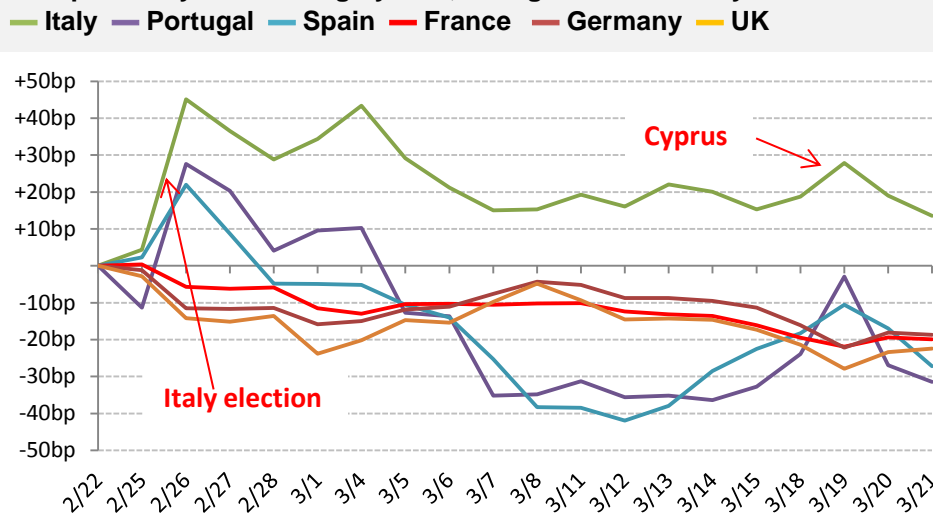
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- However in this superheated environment the risks of a political mistake are much higher now than they were earlier in the week, as politicians box themselves into corners looking for Russian bailouts that are unlikely, and make promises to citizens that they cannot possibly fulfill.

We view the chances of a Cypriot exit from the euro as very unlikely, but -- unfortunately -- not impossible. So far, markets have rightly been very relaxed, with sovereign yields across Europe -- including the fragile periphery -- barely seeming to take notice (please see chart below). We continue to view this as the right position to take (see ["Italy Gets Hung"](#) February 26, 2013).

The ECB's actions this morning mean that we will have an answer by next Monday evening at the latest. It is our conviction that a deal will be done.

European 10-year sovereign yields, change from February 22



Source: Bloomberg, TrendMacro calculations

Bottom line

The ECB has put a deadline of next Monday for continued Cypriot bank access to euro liquidity through Emergency Liquidity Assistance (ELA). If that deadline passes without a deal, the Cypriot banking system will collapse on Tuesday morning. While we are certain that a deal will be done, this raising of the stakes increases the risk of a political mistake. So the small but real chance of a euro exit by Cyprus becomes a live possibility. With so much at risk, Cyprus is likely to blink first and agree to a deal. ▶