Market Update: 3/18/2013
European Monetary Policy and its prospective ramifications
Written by: Doug Ciocca

Good morning and I hope you had a great weekend! There was cause for celebration across Europe last week – both in recognition of the conclave of cardinals electing a new pope, Pope Francis I, and the annual Feast of St. Patrick. There was, however, one less festive event that took place over in Europe in the last 48 hours and I thought I would reach out to you this morning on its behalf, as it has garnered a great deal of negative attention in the financial markets and the international news platforms.

And it is this: On Saturday morning, the "Troika" (composition of the European Central Bank (ECB), the International Monetary Fund (IMF) and the European Union (EU)) proposed a levy (aka: a tax) on deposits held in banks in the country of Cyprus.

Cyprus is part of the EU: a 17-member aggregation of European countries that share a common currency, the Euro, and are subject to the monetary policy of the ECB. Cyprus is a very small island off of the eastern coast of Greece in the Mediterranean Sea. It has the third smallest economy in the EU @ $22.4Billion dollars (only Estonia and Malta are smaller) which comprises 0.2% of total EU economic output. As a source of perspective, the Cypriot economy is roughly equivalent to that of Shreveport, Louisiana here in the U.S.[1]

The intent of the levy is to effectively bail-out/rescue their banking system from national default. The goal is to raise €10 billion (roughly $13 billion), which is needed because the Cypriot banks have experienced a considerable reduction in the, previously large, loan balances made to the country of Greece[2]. As reported in the UK Guardian this am:

> ***"Cyprus has faced two big problems. The first is that its banks went on a lending spree during the good times – by 2011, they had made loans worth more than eight times the country's national output. Even Britain, the most spectacular example of a big developed country that allowed an overblown banking sector to threaten the entire economy, did not go quite that far.***
>
> ***The second problem was the close links between Cyprus and Greece, a country gripped by a brutal slump that has seen the size of the economy shrink by 20% in four years. Cypriot banks had made loans to Greece worth 160% of GDP and the losses on that high level of exposure have been rising rapidly.Greece is also a key trading partner for Cyprus, so there has also been a direct impact on the Cypriot economy from the austerity imposed on Athens."***[3]

The proposed levy works like this: all depositors with account balances of less than €100,000 (approximately $130,000) will be subject to a one-time levy of 6.75%. All depositors with account balances of more than €100,000 will be subject to a one-time levy of 9.90%. Just to be clear – this is a tax on the deposits in the bank – not the bank's bondholders or equity owners, but the actual customers of the bank. Since the solvency (assets greater than liabilities) of the Cypriot banking system is questionable at best, the most certain source of funds were those of the deposit base. This is an approach not yet seen/utilized in the previous Troika bail-outs of Greece, Ireland and Portugal.[4]

Prior to actual enactment, the proposal needs to be ratified by the Cypriot parliament and the likelihood of it passing is inconclusive. As of this writing, there are revisions being considered and the vote, initially scheduled for today, may be postponed until tomorrow if not later. [5]

As you can imagine, the initial reaction on the part of many Cypriot citizens has been to withdraw money from these banks as quickly as possible. And if you pull up any news-based web site this morning you'll see pictures of long lines @ ATMs around Cyprus.

So why does this development have ramifications that extend beyond the borders of Cyprus? I think for 3 reasons:

1. The faith in the safety of deposits in all EU-based banks may be understandably shaken. While there has been strong insistence, from the ECB and the Cypriot finance minister, that this approach is situation-specific and not systemic, this claim is being met with natural suspicion. This suspicion could trigger capital flight and pressure the value of the Euro currency. As of this morning, the Euro has declined approximately 2% against the value of the US dollar[5] and is at its lowest level since December of last year[5];

2. Any suspension in the broader EU recovery could pressure international sources of demand that are critical for US traction in perpetuating its own economic progression;

3. Given the global intertwinement of the banking sector, not only does the source of the problem (Greece or Cyprus) need diagnosing, but the prospective referral pain does as well. It is critical to get a thorough understanding of the counter-party exposure to these problems, i.e. how much money has any bank lent to a bank that lent to Cyprus and what reduction in value may be likely? Already over the weekend, the Russian government and their banking industry has blasted the Troika for the tax proposal as they have large deposits represented that would incur a heavy levy. (Just adding to the intrigue, many of these Russian deposits are thought to be off ill-gotten sources and subsequently may have weighed on the Troika's decision for the imposition at this time.)[5]

I will keep in touch as this develops, particularly as it relates to the ripple effects back to the US markets, but wanted to give you a quick scoop on what I think is likely to be a widely discussed development today. dc

[1] http://www.businessinsider.com/size-of-cyprus-economy-in-context-2013

[2] http://www.npr.org/blogs/thetwo-way/2013/03/18/174613249/cyprus-bailout-to-hit-depositors-sends-shivers-through-market

[3] http://www.guardian.co.uk/world/2013/mar/17/cyprus-bailout-big-implications-small-rescue

[4] http://money.cnn.com/2013/03/18/news/economy/europe-cyprus-bailout/

[5] *Source: Bloomberg Market Data/Television*