TRANSCRIPT

CYPRUS

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How significant are the problems in Cyprus?

Cyprus is a small country that has been getting a lot of press lately regarding its ongoing economic problems. Its banking sector was significantly overloaded, forcing the country to seek bailout assistance, which was agreed to by the European Union (EU) and the International Monetary Fund (IMF) under a deal struck in March.

What are the terms of the deal?

There are still some aspects of the deal that have not been finalized. While the cost of the bailout was originally estimated at around $17.5 billion euros, the estimated cost has now gone up to $23 billion, a significant increase. Of the total package, $10 billion euros will come from the EU and the IMF. This leaves an additional $13 billion, or more than half the total amount needed, to come from Cyprus itself. A good portion of this will most likely come from bank restructuring.

What will be the effects on individuals of the bank restructuring?

There are two parts to the write offs that will occur as part of the bank restructuring, with a primary focus on the two largest banks. The first part is a fairly typical write down or discount of a large portion of outstanding debt. The second part is more unusual and involves writing down deposits. Previously, losses have been implemented on the liability side of bank balance sheet as part of Eurozone bailout restructuring deals. This has been an important factor in helping to avoid bank deposit runs in troubled countries.

Why then is Cyprus resorting to writing down deposits?

There are a few different reasons why Cyprus is somewhat unique.

- First, the depth of Cyprus' problem, measured by the bank recapitalization as a percent of GDP, is much greater than even the largest of other Eurozone countries that experienced a crisis. Cyprus bank recapitalization to GDP ratio is 60%, versus 40% for Ireland and Greece at 27%

- As a result, Cyprus is caught somewhere between a rock and a hard place since its sovereign debt is already approximately 86% of GDP and to push that up even further by partially financing the bailout would, in our opinion , have inflated the crisis even further

- There is insufficient capital in the remaining banking capital structure to support the recapitalization costs

- A good portion of the taxes imposed on deposits may fall on non-Cypriots, as about 37% of total deposits are those of non residents, who likely have higher balances which will be subject to the higher tax rates. This makes it a bit easier to swallow from a Cypriot point of view

It seems like just as one EU country crisis appears to have been addressed, another pops up or an existing one worsens. Is Cyprus likely to have a significant impact on the health of the Eurozone?

We believe that Cyprus alone is too small both economically and in terms of its financial markets to have that great an impact. This is especially true when you consider the much greater exposure that the EU has to other troubled European countries. One cannot, however, discount the emotional impact of still another EU crisis situation. This may spark new fears about sovereign debt and the financial sector. In addition, a psychological barrier has been crossed of taxing depositors to help fund the bailout. As a result, it may not be as easy in the future to prevent potential bank runs.

Are there other factors they may help minimize potential "contagion"?

We will continue to keep a close eye on the unfolding situation, but we do feel that there are some reasons that help lessen the potential spread to other countries.

High-level policy makers have been quick to reassure the public that this is a "one off" situation. We are seeing some hopeful signs that point to the stabilization of Europe's economic situation. Although GDP is not growing yet, it is less negative than it has been.

Other troubled countries such as Greece, Ireland, Portugal and Spain have capitalization plans in place and are working toward a better fiscal and economic state. The European Monetary Union appears to be stable at this time. While there was some concern that Greece would drop out, it has decided to remain

The European Central Bank has reiterated its commitment to avoid a system wide meltdown and maintain financial liquidity. All of these contribute to our belief that Cyprus will not have a major impact on the Eurozone situation.