

Will Russia rescue Cyprus?

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On 16 March a deal was presented by the Cypriot government and the Eurogroup (a group comprising the finance ministers of the eurozone states). Three days later, the Cypriot government rejected the terms and conditions of this deal. It detailed EU and IMF financial assistance for Cyprus amounting to 10 billion euros on condition that the Cypriot government introduces a one-off tax on bank deposits. It was supposed that an approximately additional 5 billion euros would be thus collected and spent on rescuing the country's banking system which on the verge of bankruptcy. The fact that the Cypriot government did not agree to adopt the solutions put forward by the EU has prompted the government in Nicosia to seek assistance from Russia. Thus far these attempts have been unsuccessful.

It is at present very difficult to foresee the further development of the Cypriot crisis. Germany and the Eurogroup seem to expect the Cypriot parliament to eventually approve the terms and conditions of the EU deal, possibly making certain minor amendments to it. As long as this problem does not threaten the eurozone as a whole, they will be rather disinclined to undertake any extraordinary rescue measures. As for Russia, it would rather see the EU shoulder the burden of rescuing Cyprus. Moscow would probably be ready to grant Cyprus limited financial aid but on condition that it would obtain economic assets in Cyprus (including in the area of energy). This solution could be difficult for the EU to accept.

Germany, Russia and the EU rescue plan for Cyprus

Negotiations on the agreement between the EU and Cyprus were protracted mainly due to resistance from **Germany**. Last year the Federal Intelligence Service disclosed information that the eurozone's financial aid for Cyprus may be used by Russian oligarchs who have deposited funds worth approximately 26 billion dollars in Cypriot banks. Due to this many politicians from the ruling coalition spoke out against granting aid to Cyprus. Opposition parties have also demanded that a tough stance be taken on Cyprus, including the consolidation of the banking sector and measures against money laundering. 63% of society is opposed to excessive concessions, and the government coalition has to take this into account ahead of the September election for the Bundestag. Furthermore, in Germany Cyprus is viewed as a small economy whose problems do not pose a threat to the eurozone.

The Eurogroup's position has been met with a strong and emotional response from the surprised **Russian** government. President Vladimir Putin described this decision as unfair, unprofessional and dangerous, Prime Minister Dmitry Medvedev called it a "confiscation of somebody else's money" and the State Duma Speaker Sergei Naryshkin deemed it a

“nationalisation of private funds deposited in bank accounts”. According to Russian experts, this will undermine the credibility of the EU financial system and lead to a flow of capital out of Cyprus where 80% of GDP is generated by banking services. Moscow took high dudgeon due the fact that it had been left out in the decisions made by the Cypriot government and the EU. In the public discussion in Russia it was also stated that the Eurogroup’s position, inspired by Germany, was in fact aimed to hurt Russian interests in Cyprus.

Russia's concerns arise from the fact that the stance taken by the Eurogroup has a significant effect on Russian companies and citizens. According to the Moody's rating agency, the volume of funds that Russian banks have deposited in Cypriot accounts amounts to US\$ 12 billion and deposits from Russian companies are worth US\$ 19 billion. Since the 1990s Cyprus has been Russia's largest financial centre abroad. It has been performing financial operations involving billions of dollars from Russian companies with the certainty that they involve funds from illegal sources and are linked to the criminal world and corruption. The planned taxation of deposits placed in Cypriot bank accounts is linked with multi-billions losses not only for account holders but also for the Russian economy, in which part of the funds placed abroad is reinvested. According to data from the Russian Federal State Statistics Service, the cumulative value of investments in Russia coming from companies registered in Cyprus reached US\$ 76.7 billion towards the end of 2013, with directs investments making up 69% of this volume. Cyprus is also the second largest country where Russian companies place their investments with a cumulative value reaching US\$ 29.5 billion.

Waiting for new solutions

In response to the Cypriot government’s rejection of the EU rescue plan, Chancellor Angela Merkel opined that the eurozone was expecting Cyprus to come up with a new proposal. There were voices, among them that of the Green Party leader Cem Ozdemir saying that the eurozone should not allow Russia to provide help to Cyprus since Russia could by this means gain influence on EU decisions, including those regarding the accession of Turkey to the EU.

Meanwhile the Cypriot government is expecting Russian financial aid which would rescue the country from bankruptcy. For this purpose on 20 March Finance Minister Michalis Sarris paid a visit to Moscow which in Cyprus was called a “visit of hope”. Talks held with his Russian counterpart Anton Siluanov and then with the first deputy prime minister Igor Shuvalov were focused on the restructuring of the 2.5 billion euro loan taken out in 2011 and a further loan worth 5 billion euros which Russia could grant to Cyprus. These talks have however thus far failed to result in any agreement being reached. A section of the foreign media, making reference to Cypriot sources, have also claimed that the government in Nicosia has submitted an offer for Gazprombank to take over control of the Cypriot bank Laiki and for Gazprom to take over the Cypriot gas company and gas fields in the Mediterranean. Russia has denied this information.

Outlook for the development of the situation

By taking these measures the EU wanted to demonstrate its resolution and a common stance in solving the eurozone's problems while recognising that a one-off taxation of deposits in accounts in Cypriot banks will not affect the confidence that investors have in the eurozone. The fact that the Cypriot parliament has rejected the compromise negotiated with the EU makes the situation in the country difficult and unpredictable.

From the German perspective, the Cypriot parliament's rejection of the agreement does not spell the end of negotiations. In Germany many politicians, including some from the ruling coalition, have criticised the idea of taxing deposits under 100,000 euros. Therefore Berlin may be ready to accept changes to the ways in which different volumes of deposits are taxed. Germany will be inclined to approve the offer to considerably increase the tax on deposits over 100,000 euros. Only a threat of a destabilisation of the entire eurozone and the return of panic in financial markets and among account holders in Southern European countries could prompt Germany to make larger concessions to Cyprus. So far, despite concern among investors, the Southern countries of the eurozone have remained in a stable situation.

Russia's role in solving the Cypriot issue has increased due to the fact that the Cypriot parliament has rejected the conditions of the agreement with the EU. Russia wants to leave the responsibility for rescuing Cyprus's financial situation to the EU. On the other hand, as it has interests in the financial stability of its largest operational and financial centre abroad and in defending its own business and the deposits of Russian citizens, Russia may be ready to give conditional, limited support to Cyprus. While doing this Russia will try to maximise its benefits from the situation, making any possible financial aid dependent on it taking over control packages of shares in banks which act as intermediaries in financial transactions involving Russian companies and on it taking over shares in the Cypriot energy sector. Russia is particularly interested in obtaining a license for the extraction of natural gas from the newly discovered Aphrodite shelf gas fields whose reserves are estimated at 1.7 trillion m³.

It is not clear whether such participation from Russia in solving the Cypriot problem would be acceptable to the EU. Statements made by the German chancellor Angela Merkel in which she has criticised Cypriot attempts to seek help from Russia would cast doubt on it. However, if the EU and Russia, with the participation of Cyprus, reached a compromise on a solution to Cyprus's difficult financial situation, it would lead to Russia having an increased influence in Cyprus's economic and financial structures.

The situation in Cyprus could paradoxically help President Putin "de-offshore" the Russian economy, a move which was announced in December 2012 and which would involve the need for measures to be taken to bring Russian capital back to Russia. However, Russia's approach to the Cypriot problem rather means that it is not interested in such radical action due to the fact that its consequences which would mainly hit representatives of the ruling elite. It is also rather improbable that Russian capital flowing out from Cyprus would be likely to return to Russia where there is a deficit in the rule of law and systemic corruption.