

Germany's 'Cyprus victory'?

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On the night of 24/5 March, the Cypriot government reached an agreement with the Eurogroup on a loan to rescue the country's public finances. In exchange for a loan of €10 billion, the Cypriot government will have to liquidate the country's second largest bank, the Cyprus Popular Bank (*Laiki*) and restructure the largest, the Bank of Cyprus. The details of the agreement are not known, but Cyprus's Ministry of Finance estimates that holders of deposits in excess of €100,000 in these banks will lose up to 80% of their savings in the case of the former bank, and up to 50% in the latter. The transfer of funds out of Cyprus will also be temporarily blocked. The agreement will hit hardest at some of the Russian money being held in Cyprus, although state-owned Russian companies are likely to avoid the confiscation measures. German politicians have reacted with satisfaction to the agreement, as it implements the most important of their demands – to charge Cyprus and Russian capital with part of the costs of rescuing the financial system. In Russia itself, reactions have been mostly critical, and President Vladimir Putin's self-restraint probably stems from the belief that the Kremlin will be able to protect its most important assets against serious losses, as well as the need to maintain a good image.

The Cyprus problem has revealed the *de facto* lack of trust in relations between Russia and the EU, which will deepen the crisis. This is especially true of Russia's relations with Germany, which Moscow sees – not without reason – as the main decision-maker in the Cyprus issue. In the Kremlin's eyes, Germany's activities in this and other political and economic issues are deliberately striking at Russia's vital interests. Thus the policy of Germany, which is still a key partner for Russia in Europe, poses a challenge to Moscow. From the German perspective, resolving the Cyprus question constitutes another experiment in the euro zone crisis, this time by getting the holders of bank deposits to cover the costs. This method could be applied in other countries which use the euro; thus, its consequences regarding relations with Russia are of lesser importance.

Reactions in Germany and Russia to Cyprus's agreement with the Eurogroup

German Chancellor Angela Merkel welcomed the outcome of the negotiations, recognising it as fair, as the costs were charged to those who contributed to the banking crisis in Cyprus, and the deposits of stable banks remain unaffected. Finance Minister Wolfgang Schäuble said that the outcome of negotiations meets all the demands of Germany's parliamentary parties, as the euro area's share in the aid package was limited to €10 billion, the contribution from the International Monetary Fund was guaranteed, and steps were taken to counter money-laundering and the concealment of income from tax fraud in Cyprus. For

these reasons Schäuble is counting on the German Bundestag's acceptance of the plan, which should be given in mid-April. The opposition SPD and Green parties have announced their preliminary support for the agreement.

The German media have described the Cyprus decision mainly in terms of a rescue for the euro zone, and have analysed its importance for the stability of the monetary union. However, there has been no discussion of the consequences of this approach to Germany's relations with Moscow. Most of the press agrees that Germany was quite right to strongly defend its decision that deposit holders in Cyprus should take part in the bailout. In the public perception, the successful outcome is also attributed to the fact that owners of savings below €100,000 were not burdened with financial costs, and funds from Cypriot pension funds were not requisitioned. The fact that the euro zone resisted the 'Cyprus blackmail', insisting on easier conditions for the financial aid, was also received with satisfaction.

The terms for the Eurogroup aid programme to prevent Cyprus from going bankrupt led to numerous critical comments in Russia. Premier Dmitri Medvedev (citing a saying by Vladimir Lenin) called the decision "a seizure of plunder", thus accusing the EU of using Bolshevik methods. The Association of Russian Businessmen in Cyprus shared a similar opinion, their President describing it as "sanctioned theft". However President Vladimir Putin's reaction was much more reserved; while not directly commenting on the agreement, he ordered the government and the Minister of Finance to examine the possibility of restructuring the loan of €2.5 billion given to Cyprus in 2011. According to the Russian Minister of Finance, extending repayment of the loan to 2022 and reducing the interest rate from 4.5% to 2.5% would cover 10% of Cyprus's debts.

The consequences of the agreement for Germany

In the short term, the agreement is a success for Germany, despite the fact that last week's turbulence around Cyprus undermined confidence in the island nation's banking sector. Assessing the long-term effects, however, is more difficult.

From a political point of view, the position and credibility of Germany were strengthened as the euro area countries adopted a common position. The events in Cyprus may also discourage other heavily indebted countries, such as Spain and Italy, from seeking leniency for economic reforms. Currently, the most powerful instrument for influencing countries' decisions is intervention by the European Central Bank; the threat of cutting off Cyprus's financing proved to be the most effective way of pushing through the euro zone's demands.

The decision also strengthens Chancellor Merkel's position domestically. The German media acknowledged with satisfaction that, for the first time since the start of the crisis, in addition to euro-area taxpayers, the costs were being borne by the banks, their shareholders and the holders of capital obtained from illegal sources. This is reflected in opinion polls conducted after the announcement of the final decision, according to which support for the CDU slightly increased, by 1 percentage point to 41%, and fell for the FDP, by 1 percentage point to 5%. The opposition's numbers remained unchanged. For some years, Chancellor Merkel has conducted a consistent policy of fighting against tax havens. The Cyprus solution strengthens her credibility, as it is another country (after Switzerland) which has

effectively lost its status as a tax haven for EU citizens. After German pressure on Switzerland in recent years, many German taxpayers have decided to report their undeclared income to the tax authorities, which has increased budget revenues in Germany.

In the longer term, however, the turbulence around the bailout for Cyprus may undermine confidence in the banking system and destabilise the euro zone once again, which would be especially dangerous at a time when it is in recession. Moreover, the negotiations have made the German people anxious about their savings. According to a survey, 54% of them do not believe that their bank deposits are safe, and only 41% think the opposite.

Germany has treated the Cyprus issue as the euro zone's internal affair, and it did not consult the Russian government during the later stage of the crisis. According to reports in the German press, Cyprus wanted to give Russia shares in Cypriot banks in return for a fee from Russian deposits; the euro zone did not accept this proposal, for fear that Moscow would block any decision about the banks which would prove unfavourable to it.

The consequences of the agreement for Russia

The Eurogroup's agreement on Cyprus has largely affected Russian companies and banks which, according to the credit rating agency Moody's, have deposited approximately US\$31 billion in Cyprus. Significant amounts were deposited in the Laiki Bank, which offered a number of facilities for the owners of the accounts, and is expected to be broken up as part of the deal. Limits on conducting financial transactions and transfer of funds will bring about additional serious losses to the Russian companies. They are particularly concerned about the power of attorney granted to the Central Bank by the Cypriot parliament; this gives the Bank the right to convert current accounts into deposit accounts, which may then be subject to partial forfeiture. It is difficult to estimate the losses to Russian business, because the banks in Cyprus will remain closed until at least 28 March; moreover, the final details concerning the size of the deposits to be confiscated are not yet known.

Subsidiaries of the largest Russian companies – such as Gazprom, Rosneft, Nornikel, NLMK (Novolipetsk Metallurgical), and many others – have offices or business partners in Cyprus. However, it is very likely that they will escape the confiscation of funds because, according to a report in the newspaper *Vedomosti*, their money is mainly located in the Russian Commercial Bank (RCB). This is the third-largest bank in Cyprus in terms of assets, and is a subsidiary of Russia's VTB (*Vneshtorgbank*, one of the major Russian state-owned banks). The RCB, in which according to First Deputy Prime Minister Igor Shuvalov Russian companies have deposits with an estimated value of €2 billion, will not be affected by the confiscation of assets. However, a temporary freeze on the transfer of funds may be a serious problem for the Russian companies. The financial solutions adopted will help to reduce the outflow of investments from Cyprus to Russia (reinvested Russian capital), which according to the Federal State Statistics Service make up 21% of all cumulative foreign investment. In 2012 alone, the volume of Cypriot investments in Russia amounted to US\$16.4 billion, 49% of which went into the processing industry (including oil processing). This will mean that Cyprus will lose its importance as Russia's main foreign financial centre.

Russia's initial offer of assistance in the form of restructuring the loan, on one hand, confirms Russia's desire to participate in solving the financial crisis in Cyprus. On the other hand, though, it is probably linked to Moscow's awareness of Cyprus's current inability to service its debt; the loan may also be an argument in Moscow's negotiations with Nicosia on the terms of implementing the agreement with the Eurogroup in relation to Russian business structures in Cyprus. Despite declarations to the contrary, the Russian government does not expect the returned Russian capital – which often comes from illegal sources – to return to Russia from Cyprus.

However, it is not impossible that despite their losses, Russian companies will not completely abandon those Cypriot banks and organisations which offer low-cost financial services, attractive interest rates on deposits and income, and favourable investment conditions. In the absence of attractive alternatives, and based on the gradual recovery of Cyprus's paralysed financial system, they may look forward to making further profits in the euro area.

The crisis of Cyprus's banking system will also have a negative impact on Ukraine. It is estimated that up to a quarter of the 'Russian' finances held in Cyprus are, in fact, Ukrainian funds. The Ukrainian government has not yet commented on the situation, although their position on the protection of non-residents' deposits is consistent with that of Russia.

The Cyprus crisis and Russia's relations with the EU and Germany

The Cyprus crisis and the EU's approach to resolving it will adversely affect relations between Russia and the EU. The tone of Russian comments seems to indicate that the Kremlin is convinced that the radical solutions dictated to Cyprus by the Eurogroup are aimed at forcing the liquidation of the *de facto* Russian offshore business in Cyprus. Moscow is also well aware of the very critical comments directed against Russia in many Western media. Moscow is especially annoyed as it apparently was not advised or consulted on the actions taken by European structures regarding the Cyprus issue.

Russia recognises the key role of Angela Merkel's government in pushing through the Eurogroup and the EU's tough stance towards Cyprus. From Moscow's point of view, this is another major component of the current German policy which strikes at Russia's interests in Europe. The Kremlin's irritation had earlier been aroused by criticism of Russian domestic politics from representatives of the German government; the involvement of German EU officials (led by the Energy Commissioner Günther Oettinger) in supporting Ukraine's pro-European policy vector; and Germany's particularly hard line on the principles of Russian-EU energy cooperation (some of the Russian ruling elite seem convinced that the German government inspired the European Commission's proceedings against Gazprom on the latter's possible abuse of its monopoly position). This means that the Cyprus crisis will lead to the policy of Germany – which is a key partner for Russia – being increasingly perceived in Moscow as a serious challenge to Russian interests in Europe. It is thus still possible that the Kremlin will look for ways to get its own back on Chancellor Merkel, by taking some limited action striking at German political or economic interests, although without resorting to open confrontation. An initial sign of this is the fact that the Russian branches of the main German political foundations have been caught up in the massive clampdown on selected non-governmental organisations which the Russian power structures have carried

out in recent days.