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Cyprus scrambles to avoid Greek contagion

By Daniel Dombey in Nicosia

Stelios Platis, a prominent Cypriot economist, is very clear about his country's place in the crisis that is spiralling outwards from Greece. "We are next in line," he says.

As the country scrambles to find billions of euros to secure its banking system and underpin its economy, Cypriots express a similar sense of foreboding.

"Things are going to get worse; I don't even want to think about it," says Elena Vassiliou, a hairdresser whose business has stuttered. "All we can do is wish that we don't become another Greece."

The spectre of Athens looms large in a 1m-strong country that has been sending food parcels and other assistance to its sister nation. While the recent discovery of offshore gas reserves in Cyprus might be expected to provide some consolation, commercialisation of those resources could be years away.

The fear in Nicosia is not that Cyprus would leave the euro but that after three years of stagnation and unemployment of 10 per cent, its economy now faces being dragged further down by Greece. The banking sector, which is both Cyprus's motor of growth and the main source of contagion, is particularly at risk.

The government has made clear it would prefer to obtain aid from Russia than to seek help from European institutions, with all the attendant conditions. Preserving Cyprus's low corporate tax rate of 10 per cent is a particular concern.

Moscow has already provided Cyprus with a €2.5bn loan on generous terms, which allowed the country to meet its debt payments this year and worried some foreign diplomats about deepening ties with Moscow – no small matter when Cyprus is about to assume the EU presidency and Russia is at odds with the west over Syria.

Many of Russia's rich and powerful have links with Cyprus. Russians hold a large proportion of the €22bn in Cyprus bank accounts belonging to those outside the eurozone. But to date there is little sign of Russian help for the problems of the banking sector, which needs at least €1.8bn in new capital by the end of this month.

The causes of the crisis are the subject of bitter controversy. Government critics say fiscal profligacy led to the country's exclusion from international capital markets, which has now lasted about a year. They argue that when Demetris Christofias, president, agreed with EU leaders on a 75 per cent writedown on Greek sovereign debt last year, he should have at least secured access to European funds for Cypriot banks.

Government supporters respond that the fault lies with reckless lending by those selfsame banks and a failure by the central bank to keep them on a tighter regulatory rein.

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The banks, which accumulated Greek holdings after Cyprus entered the euro in 2008, saw some €3bn wiped off their balance sheets in last year's haircut of Greek government bonds. Cyprus Popular Bank, the country's second largest, cannot raise enough capital to make up for the hit; hence the country's immediate needs. The government has committed to plugging the gap, which must be filled by the time EU capital adequacy rules enter into force on June 30. But it too lacks the funds to do so.

Michalis Sarris, Popular Bank's chairman, adds that private investors have been deterred from coming forward by the other big source of uncertainty – loans to the Greek private sector.

As the Greek economy deteriorates, so too do Cypriot banks' €22bn in loans to Greek individuals and enterprises, with the proportion of non-performing loans moving higher. Moreover, the banks' holdings of Greek assets and liabilities have moved out of balance as many Greeks have shifted their bank accounts to Cyprus. Cypriot banks hold €15bn in Greek deposits, some €7bn less than their total of Greek loans. In the event of a Greek exit, that €7bn mismatch – the banks' net private assets in Greece – would be exposed to devaluation.

Cypriots insist that a "Grexit" is unlikely and that departure from the single currency by Cyprus itself is unthinkable. The scale of the country's dependence on its banking system means that such a devaluation could be cataclysmic. While a cheaper currency could make Greece's economy more competitive, reducing the value of foreigners' euro-denominated accounts in Cyprus would do the opposite to the island's economic model.

Moreover, Cypriot officials argue that the island's total needs would barely bother European institutions, even if financing needs of about €2bn next year are taken into account.

But although Nicosia hopes to avoid full entry into an adjustment programme in which a troika of the European Commission, the European Central Bank and the International Monetary Fund sets out economic targets, conditions and reforms, the decision may not be its to make.

That could spell big changes in a country where the streets are clogged with traffic after public sector workers leave the office at 2.30pm, and where the finance ministry is all but deserted shortly afterwards.

Nor is the euro popular in Cyprus, as people contemplate the changes ahead.

“Greece is dragging us down... Before, when I had 50 Cyprus pounds in my pocket, that was something real, I felt strong,” said Andreas, a hypermarket worker in Nicosia. “Now, when I have €50 in [my] pocket, I don’t know what it is worth.”