Paul Krugman - New York Times Blog

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Cyprus: The Sum of All FUBAR

At this point the Cyprus situation is pretty clear — and clarity does not bring reassurance. In fact, it looks as if Cyprus has managed to combine in one place everything that has gone wrong elsewhere.

1. Runaway banking. Cyprus has a huge banking system — assets around 8 times GDP — based on a business model of attracting offshore money with high rates and good opportunities for tax avoidance/evasion.

I've done some asking around, and cleared up something that was puzzling me. Officially, only about 40 percent of the deposits in Cypriot banks are from nonresidents, which would imply resident deposits of almost 500 percent of GDP, which is crazy. But the answer is that I do not think that word "resident" means what you think it means. Some of the money is from wealthy expats living in Cyprus; much of it is from rich people who have resident status without, you know, actually living there. So we should think of Cypriot deposits as mainly coming from non-Cypriots, attracted by that business model.

And the business model only works until there's a big loss somewhere; since Cypriot banks were investing in Greece and in their own domestic real estate bubble, doom was inevitable. Which brings me to:

2. Big domestic real estate bubble, Spain or Ireland-sized. Not yet fully deflated, which means lots more losses to come. And the combination of the real estate bubble and the income from dodgy banking also led to:

3. Massive overvaluation, with Cypriot prices and costs having risen much more than in the rest of the euro area. In 2008 the current account deficit was more than 15 percent of GDP!

What can be done? First off, Cypriot banks cannot honor their debts, which unfortunately overwhelmingly take the form of deposits. So a default on deposits is inevitable.

As I now understand it, the initial screwup was a joint error of the Europeans and the Cypriots. Europe didn't want an explicit bank resolution, which would among other things have given clear seniority to small insured deposits; instead, it wanted this essentially fictitious tax scheme. Meanwhile, the Cypriot government still has the illusion that its banking model can survive, and wanted to limit the hit to the big overseas depositors. Hence the debacle of the small-deposit tax.

In the end this probably comes, in some version, to what it should have been from the start — a big haircut on deposits over 100,000.

But even then the situation is by no means under control. There's still a real estate bubble to implode, there’s still a huge problem of competitiveness (made worse because one major export industry, banking, has just gone to meet its maker), and the bailout will leave Cyprus with Greek-level sovereign debt.

So then what? As a number of people have pointed out, Cyprus is arguably better positioned than Iceland to do an Iceland, because devaluing a reintroduced Cypriot currency could bring in a lot of tourism. But will the Cypriots — who haven’t even reconciled themselves to the end of their round-tripping business — be willing to go there?

Truly awesome stuff.