



**From the desk of Komal S. Sri-Kumar, Ph.D.**

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### ***Lessons from Europe***

In recent weeks, Europe has served as a classroom for students of international finance. Developments in Italy and Cyprus provide a window into decision-making in the region, and offer lessons on how *not* to try to resolve the Europe debt situation. The potential impact on Slovenia and Luxembourg - - each with GDP roughly twice the size of Cyprus's \$25 billion - - is still unfolding.

In Italy, candidates led by technocrat Prime Minister Mario Monti got no more than 10% of the vote in elections held February 24 and 25, dealing a blow to austerity measures that had been championed by Mr. Monti with the support of the European Union. At the same time, the Five Star Movement campaigning against austerity and corruption in government got about one-quarter of the votes in the Movement's first national electoral effort. While its leader, Beppe Grillo, was derided by other politicians as a "comedian," the Movement's positions have captured national attention, and he may arguably be Italy's most popular politician today.

In Cyprus, a member of the Eurozone, the government, prompted by the European Union, the European Central Bank and the International Monetary Fund (the "troika") tried initially to confiscate a portion of even insured bank deposits to make debt payments. Authorities responded to widespread protests and decided not to tax deposits smaller than €100,000, but even these funds are to be rationed to depositors who now face strict restrictions on transferring funds out of the country. Depositors with accounts over €100,000 in size could lose up to 80% of the amount.

The European experiment is still playing out, but I thought it would be useful to outline some of the initial lessons.

#### ***Lesson 1: Perpetual belt-tightening does not resolve a debt crisis***

Italy's problems are a loss of competitiveness since the Eurozone's inception in 1999, and a lack of economic growth over the past decade. The proposed European remedy has been to raise taxes and reduce government spending - - moves which make the Italian recession deeper rather than solve the debt crisis. As the country is forced into another election in a matter of months, politicians recommending a move away from austerity are likely to emerge winners, posing a grave danger to the continuation of the patchwork bailouts arranged by the troika since the Greek problems first surfaced in 2009 - 2010.

#### ***Lesson 2: EU can willy-nilly confiscate deposits, especially in small countries***

The Cyprus experience showed that, although unwritten, smaller countries have less legal recourse than larger ones. The Cypriot government was forced to implement banking measures that will put the economy into a steep recession, and end its status as an offshore banking sector, because it was thought to be a haven for "unsavory" Russian depositors. The banking sector has a major impact on the Cypriot economy because bank assets amount to about 8 times GDP. Will the same rules apply to Luxembourg whose banking assets are over 20 times its GDP? Or, will it be exempted due to its being a founding member of the European Community, and because the foreign depositors are believed to be mostly German and French?

### ***Lesson 3: Confiscating deposits is easy, quick means of getting funds***

When the money is already within geographic borders, governments cannot resist the temptation to grab them. This would be faster than appealing to foreign creditors to restructure debt and provide additional funds. The ease of confiscating deposits increases the risk that it could be repeated in Italy or Spain, two governments with large refinancing requirements. Jeroen Dijsselbloem, the Dutch Finance Minister and head of the group of European finance ministers, has already suggested that the Cyprus model can be repeated elsewhere in the region.

### ***Lesson 4: Capital controls worsen the impact of deposit grab***

A currency union and controls on capital outflows are mutually incompatible. Yet, the Cypriot economy finds itself in that twilight zone. Imposition of controls increases the risk to foreign investors and makes it less likely that the economy can recover quickly. And controls, once imposed, do not come off easily due to authorities' fear of massive capital outflows. Consequently, an exit from the currency zone would be the other alternative. Cyprus may end up being the first Eurozone member to return to its own currency.

In conclusion, we learned something from developments in Italy, a large founding member of the Eurozone, as well as from Cyprus, one of its smallest members and a recent member of the club. Neither development bodes well for the continuation of the "bailout-as-you-go" method of solving the debt crisis. Expect major changes to be forced on the European powers located in Brussels and Frankfurt.

<http://srikumarglobal.com/wp-content/uploads/2013/04/Commentary-dtd-040113-Lessons-from-Europe.pdf>

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