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Financial crisis deepens: will the lessons be learnt?

By Martin Khor

This time it is Cyprus' turn to face bitter financial crisis as bank depositors get hit and capital controls are imposed. Will the lessons about these crises ever be learnt?

The Cyprus crisis has again shown that over-dependence on the financial sector and an unregulated and liberalised financial system can cause havoc to an economy.

The particular manner in which a financial crisis manifests itself may be different from country to country, depending on the ways that country became financially over-reliant or over-liberalised, and also on how ever-changing external conditions impact on the country.

For the past two weeks, Cyprus hit the headlines because of the rapid twists and turns of its crisis, the terms of the bailout it negotiated with its European and IMF creditors, the hit that bank depositors are forced to take, and finally the "capital controls" that the government has imposed to prevent bank runs and capital flight out of the country.

Depositors with more than 100,000 euros could lose more than half their savings. Bank customers can only withdraw 300 euros cash daily; cashing of cheques is prohibited; transfers of funds to accounts held abroad or in other credit institutions are prohibited; transfers due to trade transactions above 5000 euros a day require central bank permission; the use of credit cards overseas is restricted to 5,000 euros per account a month; and travellers can only take out 1,000 euros in cash or equivalent in foreign currencies per trip.

These capital controls, announced on 28 March, were highlighted in the media as the first to be imposed by a country belonging to the European Union. It was like the slaying of a "sacred cow", because the freedom to move funds out of and into the European countries has been treated almost like a human right.

But it is this total freedom for the flow of funds that has contributed or even been ultimately responsible for so many financial crises in so many countries in the past few decades.

This liberalised system of capital flows enables residents to place their funds abroad or to purchase foreign assets like bonds and shares. It also enables foreigners to bring in funds either for short-term speculation and investment or longer-term investment and savings.

After the Second World War, capital controls were the rule; flows of funds to and from abroad were mainly restricted to activities linked to the real economy of trade, direct investments and travel. But from the mid-1970s the liberalisation of capital flows took place in the rich economies and then gradually spread to many developing countries.

The de-regulated flows whether into or out of the country can cause volatility and instability. For instance, the huge flows of capital into emerging economies due to easy money policies in the United States and Europe have caused these countries' currencies to rise (making their exports less competitive) and their housing and property prices to inflate.

The finance ministers of Brazil and other developing countries have been protesting against the easy-money policies in rich countries that have had adverse effects on emerging economies.

When the internal or external situation changes and investor perception changes with it, the inflow of funds turns into its opposite. The sudden outflow of funds, and depreciation of the currency, can then cause an even more devastating effect on the economy.

In this reversed situation, the foreign reserves may fall to a dangerous level, and local companies and banks that borrowed from abroad because of the low interest rates face difficulties to service their foreign loans because the local currency has depreciated.

In the 1997-99 crisis, East Asian countries that had over-liberalised their financial system found that local banks and companies had borrowed heavily in US dollars and when their currencies depreciated, many of the borrowers could not service their loans. The countries' foreign reserves dropped to danger levels, forcing them to go to the IMF for bailout loans.

Malaysia fortunately had some controls then over the amounts local companies could borrow from abroad, which prevented it from falling into an external debt crisis.

But the large ringgit depreciation, huge outflow of funds and declining reserves almost landed the country into a crisis nevertheless. At that point the imposition of capital controls over outflows in September 1998 enabled Malaysia to avoid a financial crisis requiring an IMF bailout.

The immediate response from the IMF and the Western establishment was that the capital controls would destroy the Malaysian economy. Today the economic orthodoxy has changed, and most analysts including at the IMF give credit to Malaysia for the capital controls.

The Malaysian controls included a temporary ban on foreigners transferring their ringgit denominated funds (for example in the stock market) to abroad, a limit to the funds local travellers could take out of the country, and limits to overseas investments by local companies and individuals. Outflows of profits by foreign direct investors and transfers of funds arising from imports and exports were allowed.

The controls were relaxed and then removed in a few years as the economic situation improved.

Today, the IMF itself has changed its position, saying that capital controls in certain situations are not only legitimate but may also be necessary. It has partially recognised that unregulated capital flows can cause financial instability and economic damage.

In the case of Cyprus, on hindsight the analysts now conclude that its growth model was flawed because it was too reliant on a bloated financial sector, having become a haven for foreign savers, especially from Russia.

But a major factor in its recent crisis was that the country's biggest banks invested in Greek government bonds. In October 2011, a bailout package was arranged for Greece by the European Union and the IMF.

Part of the bailout terms was that holders of Greek government bonds would take a "haircut" or loss of about 50%. This Greek debt restructuring meant a loss of 4 billion euros for banks in Cyprus, a huge amount in a country whose GNP is only 18 billion euros.

Now it is Cyprus' own turn to be reconfigured and re-created as part of a 10 billion euro bailout scheme. The two biggest banks, Bank of Cyprus and Laiki Bank are to be drastically restructured, with the latter to be closed.

The biggest innovation designed by the European Union and IMF creditors is that the bank depositors will have to take losses. Deposits less than 100,000 euros are to be spared, after an original plan to also "tax" them by 6.75% was cancelled after a huge outcry and the fear of contagion, with bank runs in many European countries.

The final plan is for deposits over 100,000 euros in the two banks to take losses not by the originally planned 9.9% but by much more. Big depositors may lose half of their money in the Bank of Cyprus whereas those in Laiki Bank may lose even more than that.

The big depositors are not only rich Russians who parked their assets in Cyprus but local institutions like the University of Cyprus which had its assets deposited in the two banks.

The new European policy of getting bank depositors to take a big hit in bailouts of banks will have big ramifications for public confidence in banks. The new perception is that money put as savings in banks is no longer safe.

The capital controls are another European first. They are considered draconian, but necessary in the changed conditions of Cyprus.

The orthodoxy in finance and in economic policy is changing due to one crisis after another. Sixteen years ago the crisis was in Asia; five years ago its epicentre was the United States and today Europe is in the grip of the crisis.

The question remains: will the policy makers learn the real lessons from these crises?.

Author: Martin Khor is the Executive Director of the South Centre. Contact: director@southcentre.org.

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For more information, please contact Vicente Paolo Yu of the South Centre: Email yu@southcentre.org, or telephone +41 22 791 80 50.