AMERICAN FOREIGN POLICY COUNCIL

The Cyprus-Crisis Culture Clash

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On the surface, the Cyprus crisis was about money, but actually it was the result of conflicting political cultures: European, Greek Cypriot and Russian. The fissures exposed during the March 2013 crisis will leave a legacy of mistrust and enmity far beyond the eastern Mediterranean island that staged the drama. The underlying problem was that Europe had accepted a non-European entity (Cyprus) into its institutions and then failed to enforce upon it Europe's standards of financial governance. Russian money became fuel for the catastrophe, but was not itself the cause. Money laundering and bank insolvency are both deplorable but are not the same thing.

Greek Cyprus (aka, Republic of Cyprus, as the Turkish north is not directly involved in this story) is a distinct political culture from mainland Greece. The Hellenic Republic is Greek and Balkan, while the Republic of Cyprus is Greek and Levantine. This is a distinction with a major difference. Greece was the Bad Boy of the European Union for a quarter-century, but Athens genuinely sought a European identity and vocation. The prime ministers during the country's financial crisis, George Papandreou and Antonis Samaras, both worked hard to behave as responsible Europeans. If Papandreou had been as ethnocentric as most of his predecessors, he would have defaulted on his country's sovereign debt early on and left the French and German governments to bail out their respective banks. Greek political leaders broadly accepted that their country's crisis was the consequence of its own fiscal profligacy.

In contrast, Nicosia never treated its European citizenship as more than a convenience. Greek Cypriots consider themselves "European"—indeed, they regard their island as the birthplace of European civilization—but did not exchange their Levantine business model and practices for European standards when they joined European institutions. They believed they could have it both ways, manipulating their European partners while maintaining what the Germans call a "casino economy." Until the very last moment, Greek Cypriots—from the streets to the presidency—anticipated a full bailout from Brussels and Frankfurt as theirs by right. No other Eurozone government approached the Troika (European Commission, European Central Bank, IMF) with such nonchalant self-confidence and indifference to accountability.

Two events set the stage for the transformation of Greek Cyprus from an island backwater into a thriving international financial brothel: first, Egyptian President Gamal Abdel Nasser's expulsion of foreign communities from Egypt after 1956; and, second, the Lebanese civil wars. These developments dislodged Alexandria and Beirut as the regional financial entrepots, which they had been time out of mind. There weren't many viable candidates to fill that role. Athens in those days was provincial and non-English speaking. Nicosia (along with Limassol and Larnaca) was even more provincial, but it offered the attractive combination of British commercial law and Levantine enforcement.

Then the disruptions caused by the 1974 division of the island into Greek and Turkish sectors reduced the Greek south to a haven for offshore business, a kind of Dubai in miniature. Cyprus provided not just accommodating financial services but also an ideal legal environment for shell companies, flag-of-convenience shipping, weapons and narcotics trafficking, and tolerance of Soviet bloc espionage. (Cyprus also turned a blind eye to various British and American activities conducted from the two British Sovereign Base Areas on the island.)

Among the myriad financial clients attracted to the island during those years was the KGB and its financial affiliate, the Soviet foreign trade bank Vneshtorgbank. For Soviet covert finances, Nicosia served its region as Vienna did central Europe. Thus it was natural that post-Soviet Russian oligarchs would take their loot there for laundering and investment. Obviously, Cyprus was only one of many such financial nodes around the world, but it proved especially popular with Russians because of its proximity, climate, beaches, and lifestyle and Orthodox Christian fraternity.

It bears emphasis that much of the so-called "Russian" money on Cyprus was in fact Russophone, as plenty of the funds came from Ukraine, Serbia, Armenia, Bulgaria, Georgia and Central Asia, as well as from traditional sources outside the former Soviet space. Russian money in time became the largest component of foreign funds on Cyprus, but the "casino economy" was in place and thriving before Russia even had oligarchs.

Russian financial activities on Cyprus took two distinct forms. First was what might be thought of as overt money laundering. Most Russian businesses, including those in the state sector, routinely employ offshore banking to obtain the range of financial services unavailable at home. To this end, VTB (formerly Vneshtorgbank) established an affiliate on Cyprus, the Russian Commercial Bank, in 1995. VTB is the second-largest financial institution in Russia and a parastatal entity. It moved onto Cyprus to service other Russian parastatal entities, of which Gazprom is only the most prominent.

Whether this constitutes money laundering depends on your definition. These financial services were entirely legal on Cyprus and officially sanctioned in Moscow. Russian Commercial Bank clients include many Russian private citizens who maintain accounts both at home and abroad. VTB is owned and operated by the Kremlin, so whatever “laundering” it may conduct on Cyprus is an act of state policy. In addition, the Russian Commercial Bank is financially secure and solvent. It was in no way responsible for the financial crisis.

The second form of Russian financing on Cyprus involved actual money laundering by Russian oligarchs (and Ukrainians, and Arab sheikhs, and Israeli businessmen, and . . .). The scale of this activity is subject to conflicting estimates, but clearly it became huge (though whether it exceeded the activities of Russian parastatal entities is not clear). This was a for-fee service often conducted in cash, though gold and gems were also accepted. The decision of the new European Central Bank to issue a five-hundred Euro note favored Cyprus as a laundering center. Money laundering is not cheap, while trust is the essential stock in trade of those accepting unaccountable funds from persons with unaccountable incomes. Thus, massive fees were earned from these transactions. When Cyprus entered the European Union in 2004 and the Eurozone four years later, Cypriot banks could provide the very special service of legal entry into the European market for these moneys and their owners. Indeed, it has been reported that eighty Russian depositors were granted Cypriot passports with full travel and residency rights within the Schengen zone in return for maintaining major assets on the island.

The most important vehicle for the money laundering was Laiki Bank, the second-largest bank on the island and an institution well known in the eastern Mediterranean for the flexibility of its services. Among its other coups was removing the assets of Slobodan Milosevic and his family from Serbia to Cyprus. As banking institutions in Switzerland, Liechtenstein and elsewhere came under increasing pressure from Western governments to tighten up their standards, Laiki boomed. The largest share of the money flow was certainly Russian, but Russian money had lots of company.

Despite the tabloid headlines, Russian money did not cause the financial crisis on Cyprus. Money laundering and insolvency are different issues. The Cypriot financial sector grew to eight times GDP, as it had in Iceland and Ireland, but that was not the problem. (Iceland’s banks suffered insolvency with no record of money laundering.) Luxembourg has a financial sector twenty-two times GDP without loss of sleep, because the Grand Duchy maintains strict regulations to assure its financial institutions remain solvent.

But on Cyprus, financial insolvency resulted from irresponsible investment decisions by major banks (Laiki to the fore), the downgrading of Greek sovereign debt, plus systemic failures of financial governance in Nicosia and by Brussels/Frankfurt. The Russian and other foreign money scaled up the problem, but Greek Cypriot bankers and authorities caused it.

The source of the crisis was apparent at least two years before it hit. The Bank of Cyprus and Laiki Bank took on large amounts of Greek sovereign debt as security because the interest payments on Greek bonds were favorable. Indeed, Laiki massively bulked up its holdings of Greek bonds in 2009 just as Athens headed into its own financial crisis (similar to Wall Street firms buying derivatives just in time for their collapse). In common with other institutional holders of Greek bonds, Cypriot bankers assumed that Eurozone sovereign debt enjoyed an implicit Eurozone guarantee. They were wrong. The Cypriot holdings were small compared to those of major French and German banks. But they were dangerously large in relation to the capitalization of the Cypriot banks and the capacity of the government in Nicosia to bail them out. Laiki began 2011 with equity capital of 3.6 billion euros, of which 3.1 billion were in the form of Greek sovereign debt on which the bank took a loss of 2.3 billion. This contributed to a 2011 bank loss of 4.1 billion euros, half a billion more than its equity at the start of the year. Not surprisingly, Laiki then failed a Eurozone “stress test” and in June 2012 received a state bailout of 1.8 billion euros. But that was quickly wiped out by the bank’s continuing losses. The question, then, was not why Laiki was declared insolvent in March 2013, but how it had avoided that fate for so long.

Thus, the Cyprus crisis was by no means a surprise, as the crunch had been approaching for months. The Troika delayed confronting the problem for two reasons. First, it wanted things to quiet down elsewhere in the Eurozone, especially in Spain. Second, it anticipated a change of government in Nicosia. Suffice to say, the Troika would not have trusted the previous AKEL (Communist Party) administration with a centime. But, with the election of the centrist Nicos Anastasiades as president in February, the Troika was ready to lance the Cypriot financial boil.

The ensuing negotiations exposed two critical conflicts of political culture: European vs. Greek Cypriot and European vs. Russian. The new Greek Cypriot leader was unprepared for the shock of the Troika’s draconian demands, but he negotiated a first “package” that reflected a desire to protect his country’s offshore depositors more than his own citizenry. Whether or not Anastasiades agreed to apply a tax on insured deposits in anticipation that his parliament would reject it, the implication was that protecting large foreign depositors loomed very large in his priorities. (Indeed, his own law practice serviced Russian and Ukrainian interests.)

Even more striking was that the initial package worked out with the Troika would have imposed the deposits tax (a form of confiscation) on all financial institutions, solvent as well as insolvent. If executed, this would have imposed a significant levy on VTB’s institutional and individual depositors on Cyprus despite the fact that Russian Commercial Bank was solvent, with the assets of Russia’s second largest bank behind it. At this point, Moscow screamed “theft,” and Moscow was by no means alone. Both provisions were removed by the Troika from the revised package within days, but Russian authorities and investors understandably experienced a severe loss of confidence both in the Cypriot government and in the probity of European institutions.

The European political culture in this story is, of course, largely German, with its tendency to regard money as inherently evil and debt as immoral. At the same time, Russia and Germany had enjoyed a special relationship in which Moscow looked to Berlin to “take Russian interests into account” on issues such as the Cyprus bailout. Things did not work out that way. German authorities had foreseen the impending Cyprus crisis for months. Indeed, Chancellor Merkel said publicly her biggest single concern within Europe was Cyprus. Once the value of Greek sovereign debt was reduced by more than half in 2011, the aftershock on Cyprus was a question of timing and management. The timing was determined by the collapse of Laiki’s Greek bond valuations and by the Cypriot presidential elections in February.

Unfortunately, the German political class and media chose to portray the Cyprus problem as a morality play with Russia as the villain. While fulminating against the “casino economy” on Cyprus, they portrayed Russian oligarchic money as responsible. In a German election year, political figures across the spectrum postured against bailing out Russian oligarchs as if that were the issue. Few German commentators acknowledged the failures of governance by European institutions in regard to a Eurozone member, or that the decision of Laiki Bank and others to take on so much Greek sovereign debt was their own blunder, or that the Troika’s imposed haircut on Greek bonds in 2011 made a Cyprus crisis inevitable. And there was no acknowledgement that the separate Russian bank on the island remained solvent despite processing large amounts of offshore funds.

The fact is that the core European mistakes dated to 2004 and 2007. First, European governments accepted the Republic of Cyprus as an EU member without resolution of the division of the island, against the advice of everyone knowledgeable on the “Cyprus problem.” Instead, they chose to accept the word of then-President Tassos Papadopoulos—a man known even to his supporters as a congenital liar—that his people would vote in favor of the United Nations unification plan. But, responding to the public plea of their president, the Greek Cypriots then voted “no” by two to one, after the Turkish Cypriots had voted “yes” three to one. Second, Europe took in this “casino economy,” which did not remotely meet the standards of existing European financial law and was by then awash with illicit offshore money. Third, less than four years later, an unreformed Cyprus was taken into the Eurozone. Thus, European governments have none but themselves to blame. Simple application of the “fool me once/fool me twice” principle should have barred entry of Cyprus into the Eurozone.

Given the history of bad faith by Nicosia in its dealings with Brussels and Frankfurt, it is not surprising the Troika felt the need to impose a clear “moral hazard” in the Cyprus case, but there was also an element of punishing Cyprus for excessive fraternization with Russians. Europeans increasingly are uneasy about the presence of Russian money in almost every nook and cranny of the EU, with the specter of Russian oligarchs behind it. Cyprus was used as a convenient object lesson in the dangers of doing too much business with Russia. This image dominated the European—and especially German—portrayal of the crisis.

Not surprisingly, this theme played poorly in Moscow, which believed the banking problems on Cyprus were well within EU capacities to resolve without investor losses. The Russian government had even provided a state loan to Cyprus early in the crisis, which unfortunately simply added to the republic’s already large debt load. When Russia’s leaders learned the terms of the first and even second Troika packages, they reacted with stupefaction followed by a presumption of bad faith on the part of Russia’s supposed European partners. Moscow complained loudly that it should have been consulted and directly involved in the negotiations.

Moscow certainly had grounds to expect better consultation from Nicosia, given the extent to which Russia had given official support to Cyprus. The failure of the Greek Cypriots to communicate with their Russian sponsors during the crisis was both shabby and poorly judged. On the other hand, Russia had no standing in a negotiation between EU institutions and a member state about the use of EU resources. It is difficult to imagine how the Troika could have legitimately involved Russia in the negotiations without accusations of favoring Russian depositors over domestic and other savers. The subsequent Russian proposal for a three-way negotiation of Europe-Russia-Cyprus produced genuine incredulity in Europe.

Unfortunately, the European Commission compounded the problem of misperceptions by proposing to Moscow that Russian financial institutions take over Laiki Bank, absorbing most of its losses while guaranteeing its depositors. In this case, incredulity emerged on the Russian side. The Russian official banking presence on the island was solvent. Why should Moscow buy out an insolvent Eurozone bank, with depositors from all over the world, to protect EU institutions from the consequences of their own policy shortcomings? In addition, only the state-owned banks in Russia have the scale for such a takeover, so in effect the Russian state would have absorbed Laiki. Even by contemporary Russian standards, this would have constituted malfeasance. The Europeans rationalized this high-handed proposal on the presumption that Moscow would be protecting its own national depositors in Laiki and, in essence, cleaning up a mess seen in Brussels as of Russian origin. In contrast, Moscow saw the EU proposal as “neo-colonial” and an attempt to use Russia as a dumping ground for failures of European governance.

As Greek Cypriots now endure currency controls (the first in a Eurozone country), the question is asked, how much Russian money got off the island before the door slammed shut? Several Russian (and non-Russian) oligarchs visited Cyprus in the months and weeks leading up to the crisis, presumably to remove their assets. Media leaks in Nicosia already indicate massive withdrawals from foreign accounts in the final days of Laiki Bank. Still, many Russians in the “high net worth” but not oligarchic category shared the Cypriot illusion that a European bailout was guaranteed. Many had yet to learn the new English expression, “bail in.” For those who trusted to presumed European “solidarity,” the losses will be considerable. However, Laiki was the kind of institution to maintain more than one set of books, so any coherent tabulation of how much was invested and/or lost will have to wait for accountants and lawyers to toil many a billable hour. For the true oligarchs, there will never be transparency. In terms of who will bear the brunt of the losses, the “Titanic” principle is likely to pertain: First Class gets the lifeboats while steerage and crew stay behind.

Cyprus will be in deep economic distress for a considerable time, as its major economic sector is in ruins. This will be a good time for Russian oligarchs to return, to benefit from fire-sale prices and the local hostility toward Europe/Germany. Greek Cypriot public sentiment remains very favorable towards Russia, while the island’s business elite will understand where its self-interest lies. Russian patience, opportunism and a bit of overt “solidarity” should work to Moscow’s long-term advantage on Cyprus. Russia, after all, has often felt more comfortable operating in the Levant than in Europe. If Cyprus chooses to leave the Eurozone (a real option), the Greek side of the island could become more Russocentric in future than it is today, with serious implications for Turkey and for Europe.

Between Europe and Russia, the Cyprus mess has exposed mutual mistrust and prejudices that were present all along but covered over by years of patient European *ostpolitik* and by Russian efforts to maneuver Europe away from its transatlantic ally. The tangible foundations of European-Russian cooperation remain in their economic interdependence and shared historic need for reconciliation. Nonetheless, March 2013 may represent something of a watershed between Moscow and its major European neighbors. True, the illusion of a “common European house” had wilted well before the Cyprus crisis. Still, the crisis was marked by blatant stereotyping of the “other” on both sides, by mutual assumptions of financial malfeasance, and by a stubborn adherence to a self-referential interpretation of events. These European and Russian attitudes, brought to the surface by the Cyprus crisis, will likely endure and hamper the ability of the two sides to deal with other issues. German-Russian ties especially will suffer from the pervasive tendency in Germany to treat the saga of the Eurozone in moralistic terms and the permanent tendency in Russia to see internal European Union policies as conspiracies aimed at Russia.

A striking feature of the post–Cold War world has been the extent to which Russians have become everyday participants on the European landscape and more or less accepted as “normal Europeans” after decades of self-exclusion. This was always somewhat tentative on the European side. After Cyprus—and as the Russian state turns increasingly inward and away from engagement with modern, foreign political cultures—Russians may again become the European “other,” even in their own eyes.