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Still clueless

Euro politicians aim for stability in the belief that they can rescue states in excessive debt from going bankrupt with a stability tax on deposits of (small) savers. This intervention could turn out to be a Trojan horse of major instability. The rescue to be achieved in Cyprus shows little thoughtfulness. The expropriation of savers destroys the European economic model, because the freedom of property is one of the supporting columns of a capitalist market economy. In Cyprus, the state will trample all over this if it sequestrates savings by law. The damage caused will leave lasting traces, regardless of how the subsequent negotiations end.

If property is not protected against state intervention, a market economy will inevitably collapse, because the state has become an unpredictable monster in the eyes of those who have had their assets expropriated. With the aim of a banking union announced at the end of 2012, the politicians of the eurozone wanted to achieve precisely the opposite, i.e. to strengthen the state framework conditions. We believe that the monetary union cannot exist on a sustainable footing without performing this step. Only then will the citizens again consider the state institutions as a framework that creates order and secures stability.

Being ill-fated

It would have been wiser to consider more thoroughly in advance, what vision is the right one for Cyprus. Is it really advisable to stick to the business model of the tax-friendly offshore banking hub for Russian oligarchs? After the events of the past weeks, the days of the Cypriot financial sector seem to be numbered. The trust of Russian investors, many of whom were granted Cypriot (dual) nationality as a gift for their deposits, is not likely to return for many years. The Cypriot economy will have to look for new growth models.

The actual problem of Cyprus is its banks, in particular the Bank of Cyprus and Laiki Bank. They are currently surviving only with the emergency support from the European Central Bank. They are so oversized and full to the rim with Greek government bonds that they are in actual fact bankrupt. If the banks are not cleaned up on a sustainable basis or wound up, they threaten to hold the country back for years to come. This is reminiscent of Japan ...

Where is the leadership?

Leadership would have meant, in the case of Cyprus, keeping an eye on the bigger picture. Germany's government is pushing towards limiting the aid package to a maximum of 10 billion euro in order to contain the encumbrance on the German taxpayer. Leaving the raising of the remaining 5.8 billion euro to the Cypriots themselves, and to permit the sequestration of deposits up to 100,000 euro was a major mistake. By breaking such a taboo, trust is destroyed and puts the core countries in an uncomfortable situation. Because of a possible breaking apart of the euro, it will be they who will be loaded with worthless receivables.

The banking crisis preceding the euro crisis expanded to the member states of the eurozone, because distressed banks in southern Europe and Ireland needed to be shored up to prevent the banking system from collapsing. A sustainable rescue operation of the banks must therefore start with the owners and creditors of the banks above all. They have made bad investments and should stump up for the damage caused. It would have been preferable to fall back on the shareholders of the banks and holders of bank bonds. But the Cypriot bank shares have now become nearly worthless, and the volume of bank bonds is small, because the banks predominantly financed themselves via deposits. Savers are, of course, also creditors of the banks. They can be accused of not having sufficiently checked with whom they entrusted their money. But the small savers of the entire eurozone were assured that deposits below 100,000 euro are safe. Anyone now demanding that savers pay is undermining legal certainty. No wonder then that the Cypriot parliament dismissed the rescue package.

It has two major faults: first, the plan is to desperately cling to the business model of the offshore banking hub in an attempt to encumber the major, predominantly Russian and Ukrainian savings deposits, as little as possible. Second, the sequestration of savings deposits siphons off purchasing power on a major scale, which – amplified by the austerity programs imposed by the activated bail-out program– is likely to push the country into a recession.

Disaster in Greek style

Nothing has been learned from the mistakes of Greece. As with the first Greek bail-out package, the rescue operation for Cyprus is likely to be only the start. The failure in Greece becomes apparent in the shockingly high level of unemployment and the fact that economic output after five years of recession has slumped by a massive 30%. There are economic grievances and political dissonances in the eurozone. Basically, the politicians fail because their ideas of a fair or at least appropriate sharing of the burden do not coincide. This disunity is blocking deeper reforms in the southern countries.

The basic principle of taxing the individual according to its economic capacity is being ignored. In Cyprus, small savers are now forced to pick up the tab, while the wealthy Cypriots have long transferred their assets into other currency areas. The anger is big, not only of the young father who is in net debt with the loan he took out and is now being taxed because he had 10,000 euro in his bank account on the day of the decision.

The finances of a state would need to be cleaned up via the standard taxation of its citizens, and not by accessing savings deposits. Cleaning up the state finances in Cyprus also needs to be based on a realistic vision of the country's growth model.

Good-bye dream beaches?

Cyprus has beautiful beaches, a financial services industry and the hope of the exploration of new gas deposits. The beaches and the hope of the exploration of new gas deposits will still exist in 2014 … With the hasty rescue operation of Cyprus, the euro politicians are again at a cross-roads, which the German Chancellor Angela Merkel wanted to avoid. If a step forward towards a real banking union is not taken, all that remains is a step back away from the euro. The politicians are, however, likely to again kick the can down the road, while time passes and the unresolved crisis takes its ever more painful toll: unemployment in the eurozone has reached a horrendous 12% and the time bomb of youth unemployment above 50% in Greece and Spain continues to tick mercilessly …

Our investment ideas

Equities: We currently favor continental European and emerging market equities over US equities. In general, we prefer large-cap, high-dividend stocks.

Bonds: In an environment of low growth, moderate inflation and low interest rates, carefully selected corporate bonds (high yield, investment grade) are likely to post attractive total returns in the coming months. Bonds with shorter maturities are less interest rate sensitive, which greatly reduces the risk of loss in the event of rising interest rates.

Gold: Gold is likely to become more attractive again after the latest correction, as doubts surrounding the sustainability of fiat money systems have gained fresh impetus in 2013 due to Cyprus's approach.

Our investment ideas can easily be put into practice using selected UBS Funds. Please contact your client advisor.
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