

Is cash still king?

"It may not be rational to start a bank run, but it is rational to participate in one once it has started." Mervyn King, Governor of the Bank of England

Cyprus has taken the extraordinary step of imposing a wealth tax on all depositors at Cypriot banks as the Government attempts to raise EUR5.8 billion to contribute to the EUR17billion bailout. German demands for a depositor contribution were backed by other northern European governments,and the ECB threatened to withhold emergency liquidity assistance to Cyprus's largest bank if no agreement was struck as Nicos Anastasiades, Cyprus's new president, attempted to walk out of talks in the small hours of Saturday morning. Initial plans put the levy at 9.9% on deposits over EUR100,000 and 6.75% below although the goalposts are being moved by the hour. Only a few hours into Monday morning in London and Cypriot politicians were proposing to cut the levy on small depositors to 3% ahead of a vote on the measures.

From our perspective, Euro bailout number five seemed to be a long time coming. So much time, in fact, that even we thought the EU might've used the time to get their ducks in a row before springing the bailout plan on a nervous and fragile stock market. The details of the negotiations do not inspire confidence. As we understand it the government of Cyprus was offered a fait accompli by a German led northern bloc demanding participation in a bailout that could only be funded by raiding bank deposit holders. In order not to undermine the maximum deposit holders insurance of EUR100,000 the expropriation would take the form of a tax thereby making the ten Euro note in your hand worth more than EUR10.00 in the bank.

And democracy could still thwart EU ambitions as there are signs that the Cypriot Parliament may not vote the measure through. Even as President Anastasiades warned that the whole banking system was at stake, only 28 out of 56 MPs backed him and that's before the population comes out in protest. Then, to make a moving target even harder to hit, the vote was delayed. So now the tax grabbing cat is out of the bag as far as depositors are concerned and, whilst banks are closed for wire transfers, the cash points are still dispensing EUR400 daily. Putting aside the question of why anyone still has any cash in a Cypriot bank after all the speculation and whether anyone there actually reads newspapers, it would seem the EU has laid the perfect foundations for a bank run that even Super Mario Monti could not stop. The additional bank holiday on Tuesday is now a given and it is likely that banks will stay closed until Thursday.

Behind the scenes the deal is starting to unravel. If the original proposal of a one-off tax stacked up (is there such a thing?), unlikely anyway in our view, what will compensate for slashing the sub-EUR100,000 levy from 6.75% to 3%? More fundamentally, it's extraordinary that the EU is prepared to set a new and frightening precedent for the eurozone bank depositor for the sake of EUR5.8 billion which is small beans in the context of previous bailouts. Furthermore, the imposition of a levy below the deposit insurance, whilst technically separate of course, will be seen by the man in the street as no different. The proposal sets up maximum downside risk of civil unrest and a bank run with the threat of contagion to Greece, Spain, Italy and Portugal.

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