Cyprus has finally killed myth that EMU is benign

The punishment regime imposed on Cyprus is a trick against everybody involved in this squalid saga, against the Cypriot people and the German people, against savers and creditors. All are being deceived.

If Cyprus tries to claw back competitiveness with an 'internal devaluation', it will drive unemployment to Greek levels (27pc) and cause the economy to contract so fast that the debt ratio explodes Photo: AP

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It is not a bail-out. There is no debt relief for the state of Cyprus. The Diktat will push the island’s debt ratio to 120pc in short order, with a high risk of an economic death spiral, a la Grecque.

Capital controls have shattered the monetary unity of EMU. A Cypriot euro is no longer a core euro. We wait to hear the first stories of shops across Europe refusing to accept euro notes issued by Cyprus, with a G in the serial number.

The curbs are draconian. There will be a forced rollover of debt. Cheques may not be cashed. Basic cross-border trade is severely curtailed. Credit card use abroad will be limited to €5,000 (£4,200) a month. "We wonder how such capital controls could eventually be lifted with no obvious cure of the underlying problem," said Credit Suisse.

The complicity of EU authorities in the original plan to violate insured bank savings – halted only by the revolt of the Cypriot parliament – leaves the suspicion that they will steal anybody's money if leaders of the creditor states think it is in their immediate interest to do so. Monetary union has become a danger to property.

One can only smile at the denunciations of Eurogroup chief Jeroen Dijsselbloem for letting slip that the Cypriot package is a template for future EMU rescues, with further haircuts for "uninsured deposit holders".

That is not the script. Cyprus is supposed to be a special case. Yet the "Dijssel Bomb" merely confirms that the creditor powers – the people who run EMU at the moment – will impose just such a policy on the rest of Club Med if push ever comes to shove. At the same time, the German bloc is lying to its own people about the real costs of holding the euro together. The accord pretends to shield the taxpayers of EMU creditor states from future losses. By seizing €5.8bn from savings accounts, it has reduced the headline figure on the EU-IMF Troika rescue to €10bn.

This is legerdemain. They have simply switched the cost of the new credit line for Cyprus to the European Central Bank. The ECB will have to offset the slow-motion bank run in Cyprus with its Emergency Liquidity Assistance (ELA), and this is likely to be a big chunk of the remaining €68bn in deposits after what has happened over the past two weeks.

Much of this will show up on the balance sheet of the Bundesbank and its peers through the ECB's Target2 payment nexus. The money will leak out of Cyprus unless the Troika tries to encircle the island with razor wire.

"In saving €5.8bn in bail-out money, the other euro area countries will likely be on the hook for four to five times more in contingent liabilities. But, of course, the former represents real money that gives politicians a headache; the latter is monopoly central bank money," said Marchel Alexandrovich, from Jefferies.

Chancellor Angela Merkel will do anything before the elections in September to disguise the true cost of the EMU project. It has been clear since August 2012 that she is willing let the ECB carry out bail-outs by stealth, as the lesser of evils. Such action is invisible to the German public. It does not require a vote in the Bundestag. It circumvents democracy.

Mrs Merkel can get away with this, provided Cyprus does not leave EMU and default on the Bundesbank's Target2 claims, yet that may well happen.

"I wouldn't be surprised to see a 20pc fall in real GDP," said Nobel economist Paul Krugman. "Cyprus should leave the euro. Staying in means an incredibly severe depression."

"Nobody knows what is going to happen. The economy could go into a free fall," said Dimitris Drakopoulos, from Nomura.

The country has just lost its core industry, a banking system with assets equal to eight times GDP, and has little to replace it with. Cyprus cannot hope to claw its way back to viability with a tourist boom because EMU membership has made it shockingly expensive. Turkey, Croatia or Egypt are all much cheaper. Manufacturing is just 7pc of GDP. The IMF says the labour cost index has risen even faster than in Greece, Spain or Italy since the late 1990s.

What saved Iceland from mass unemployment after its banks blew up – or saved Sweden and Finland in the early 1990s – was a currency devaluation that brought industries back from the dead. Iceland's krona has fallen low enough to make it worthwhile growing tomatoes for sale in greenhouses near the Arctic Circle.

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The IMF's Christine Lagarde has given her blessing to the Troika deal, claiming that the package will restore Cyprus to full health, with public debt below 100pc of GDP by 2020.

Yet the Fund has already been through this charade in Greece, and her own staff discredited the doctrine behind EMU crisis measures. It has shown that the "fiscal multiplier" is three times higher than thought for the Club Med bloc. Austerity beyond the therapeutic dose is self-defeating.

Some in Nicosia cling to the hope that Cyprus can carry on as a financial gateway for Russians and Kazakhs, as if nothing has happened. RBS says the Russians will pull what remains of their money out of Cyprus "as soon as the capital controls are lifted".

The willingness of the Cypriot authorities last week to seize money from anybody in any bank in Cyprus – even healthy banks – was an act of state madness. We will find out over time whether this epic blunder has destroyed confidence in the country as a financial centre, or whether parts of the financial and legal services sector can rebound.

Yet surely there is no going back to the old model, even though the final package restricts the losses to the two banks that are actually in trouble. Savers above €100,000 at Laiki will lose 80pc of their money, if they get anything back. Those at the Bank of Cyprus will lose 40pc.

Thousands of small firms trying to hang on face seizure of their operating funds. One Cypriot told me that the €400,000 trading account of his father at Laiki had just been frozen, leaving him unable to pay an Egyptian firm for a consignment of shoes.

The Cyprus debacle has taught us yet again that EMU has gone off the rails, is a danger to stability, and should be dismantled before it destroys Europe's post-War order.

Whether it marks a watershed moment in the crisis is another matter. Italy, Spain, France and Portugal have their own crises, moving to their own rhythm.

The denouement will arrive when the democracies of southern Europe conclude that recovery is a false promise and that the only way to end mass unemployment is to break free of EMU's contractionary regime.

It will be decided by Italy, not Cyprus.