THE WALL STREET JOURNAL.
*The Wall Street Journal*, March 28, 2013

# Regime Change Comes to Euro Policy

***The banking crisis in Cyprus prompted an overdue financial reckoning that, with luck, will spell the end of "too big to fail."***

*By Donald L. Luskin and Lorcan Roche Kelly*

A revolution in science began on the Galápagos Islands in the Pacific, where Charles Darwin conceived his theory of natural selection. Now, on an island halfway around the globe, we're watching Darwin's theory being applied to banks in Cyprus, their bondholders and their large depositors: The unfit are becoming extinct.

This is a revolutionary rejection of the dominant doctrine of "too big to fail," or too interconnected to fail, and moral hazard be damned. Cyprus marks the first full-fledged bank failure permitted in the euro area since the common currency's introduction in 1999. It is also among the very few anywhere since the failure of Lehman Brothers in 2008.

Small depositors at Laiki Bank and the Bank of Cyprus will be protected under European Union rules. But the banks will put into resolution (Laiki) and restructuring (Bank of Cyprus), and larger depositors and bondholders will likely take a big hit.

Since the Lehman failure, the presumption in Europe and around the world has been that enforcing market discipline on bondholders or large depositors would risk contagion throughout the global banking system. That fear has been especially intense within the 17 nations that, like Cyprus, use the euro. The dread has been that if banking stresses cascaded, it could lead to a disorderly break-up of the currency union, creating incalculable risks for the world economy.

Over the past week of negotiations, Cyprus did indeed threaten to leave the euro if the "troika"—the European Commission, the European Central Bank and the International Monetary Fund—didn't compromise on its refusal to bail out the banks. At the same time, the ECB threatened to cut off liquidity to Cypriot banks if they didn't agree to restructure the insolvent pair—an action that would have effectively kicked Cyprus out of the currency union.

In the end, Cyprus blinked. The ECB's threat was risky, given how relatively small the problem was. Bailing out the Cypriot banks would have cost the troika only about €6 billion ($7.7 billion). That's a pittance compared with euro-area loans to Greece, Portugal, Ireland and Spain, much of which went to bailing out banks. But it seems that drawing a line in the sand at Cyprus was a risk the euro area very much wanted to take.

On Monday, Jeroen Dijsselbloem, who heads the Eurogroup of euro-area finance ministers, bluntly told reporters that if other countries like Cyprus with highly leveraged banking systems get into trouble, "the response will no longer automatically be that we'll come and take away your problem." If the bank can't solve its own problems, he said, "then we'll talk to the shareholders and the bondholders, we'll ask them to contribute in recapitalizing the bank, and if necessary the uninsured deposit holders."

Why the tough policy now? Cynically, perhaps it is because so much of the immediate burden will fall outside of Europe—specifically, on Russians, whose flight capital makes up the bulk of the Cypriot banks' large deposits.

More fundamentally, even in socialist Europe the authorities realize that bank bailouts lead to an addictive cycle of excessive risk-taking with other people's money. When bondholders and depositors believe they are government-guaranteed, banks can raise capital at risk-free rates and become too big, too complex and too leveraged. Every bailout reinforces the behavior. Why else—except for repeated experience that the ECB and euro-area taxpayers would bail them out—would wealthy Russians have dared to keep their billions in Cyprus, creating a pool of deposits more than four times the tiny island nation's gross domestic product?

Allowing the bank failures to happen represents a serious policy change in the EU, and it will take some getting used to. As soon as Mr. Dijsselbloem's remarks hit the wires Monday, bank shares across Europe fell sharply, prompting him to issue a two-sentence memo clarifying that Cyprus was "a specific case with exceptional challenges."

In reality, views like Mr. Dijsselbloem's have been coming from the European Commission and the ECB for months. Now the policy has been put into practice. In part, that's because Cyprus's bank crisis arose after the euro area had already bailed out banks in Greece, Ireland and Spain. The cost in taxpayer money and moral hazard was high, but those bailouts stabilized the worst banking risks in Europe.

At the same time, the most at-risk nations have done much to save themselves by taking on the difficult work of eliminating the moral hazard baked into their socialist economies. For example Portugal has moved ahead aggressively with privatizations. Spain is on the way to becoming a net exporter by reining in union power and repositioning itself as a low-cost global manufacturing center.

So taking a tougher approach now toward troubled euro-area banks is really not as risky as it seems. As Mr. Dijsselbloem put it on Monday, "the situation is more calm." There's no reason to think that this will be a repeat of the ECB's disastrous decision two years ago to hike interest rates far too soon, just when the euro area was slipping back into recession and so many deep structural problems hadn't yet been addressed.

Regime change is never easy. The tantrum this week in euro-area bank stocks is misleading: Credit spreads in interbank markets—the best indicator of systemic stress—haven't budged. And despite endless media images of Cypriots lined up at ATMs, there has been not the slightest hint of a bank run anywhere else.

Maybe the policy revolution begun in Cyprus will spread. Perhaps even in the United States, too big to fail will be stricken from the thousands of pages of stifling new laws and regulations that enshrine "systemically important financial institutions." If natural selection were permitted to operate in banking—another phrase for the process would be creative destruction—the perverse incentives that have kept capital from flowing toward growth-enabling investment would be erased. That's what it will take to shift the world economy out of the weakest recovery on record, and into a true expansion.

*Mr. Luskin is chief investment officer and Mr. Roche Kelly is chief Europe strategist at Trend Macrolytics LLC.*