**The World Needs a Cyprus**

**When governments can't meet their obligations by borrowing money, they start printing it.**

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Smug slurs on Cyprus as a tax haven and money-laundering center are proof of the truism that, in media conversation, all nouns decompose into synonyms for good or, in this case, bad.

If Cyprus bank depositors are Russian no-goodniks, Russia's government seems remarkably solicitous for their well-being in the current bailout brouhaha. Russian Prime Minister Dmitry Medvedev has repeatedly insisted that European Union officials are the real thieves.

If Cyprus is a tax haven and tax havens are bad, Russia has been a peculiar conspirator every step of the way. The island's chief selling point, as every come-hither to investors and companies attests, is its 1998 tax treaty with Russia. Wily Cypriots didn't impose this treaty on dumb Russians. When Moscow decided in 2008 to tweak the agreement, Cyprus was abruptly named to Russia's so-called blacklist. Within months a new treaty was signed, with Mr. Medvedev beaming that the result was "more predictable, transparent and understandable for the authorities regulating it."

Money in Cyprus has been laundered *into* Russia, not out of it. Cyprus has been valuable to Russia because it offers democratic stability, a British legal system and a history of predictable justice. Cyprus is a refuge that makes Russians willing to reinvest in Russia, to the tune of $50 billion since the Soviet Union fell.

The age-old word entrepôt came into the language not as a synonym for bad but as a useful descriptor. China, with many of the same issues as Russia, relies on Hong Kong and Singapore. India has Mauritius. Cyprus is sunny, pleasant and a three-hour plane ride from Moscow—shorter than the drive of many Muscovites to their summer dachas. Its previous president was a Moscow-trained Russian speaker. Its currency (since 2008) is the globally acceptable euro. Perhaps 50,000 of the island's full-time inhabitants are ex-Soviet émigrés.

Enlarge Image



*Associated Press*

Cypriot students protest the bailout package in Nicosia, March 26.

Mixed in with every analysis of Europe's latest blowup are disapproving asides about how Cyprus's banking sector is many times the size of Cyprus's economy. If this is proof of pathology, it extends to Britain, Germany, France, Austria, Spain, Luxembourg, the Netherlands and others, all of whose GDP is a fraction of their banking assets. Is the implication that banks should only serve the countries in which they happen to be domiciled? Then we might as well kiss global trade and investment goodbye.

Of course not. The bank-to-GDP ratio becomes a pejorative only when international civil servants are casting around for someone to bail out an inconveniently troubled bank when the domiciling country can't afford to.

Cyprus turns out not to be an island of special iniquity at all—just another instance of the European problem of insolvent governments trying to prop up insolvent banks.

Cypriot banks were large holders of Greek government debt—the same Greek government debt that the European Union insisted would never be allowed to default, that the European Central Bank blessed as collateral equal to the best in Europe. Then the EU reversed course and insisted on a Greek default. Cypriot banks, already reeling from business-loan losses due to the Greek depression prompted partly by the EU's previous bailouts, faced calamitous write-downs.

Now it happens that the latest Cyprus "resolution" is highly suitable to the world we wished we lived in. Uninsured depositors, many of them Russians, will bear major losses (as they should) thanks to Cypriot banks reinvesting their deposits in assets that are now severely underwater.

But this wasn't the resolution imposed on Spain, whose banks represent 320% of Spanish GDP. The European Union came up with $128 billion when it was obvious Spain couldn't rescue its own banks, which are big holders (along with banks across Europe) of Spanish government bonds.

All across Europe, in fact, governments owe money to banks they can't afford to pay back, and banks owe money to depositors they can't afford to pay back. Europe's central bank has been the stopgap, printing money so everyone can keep making timely interest payments, while waiting for Europe's lugubrious political processes to decide finally who will bear the losses.

Cyprus, though an EU member, has awoken to discover its banks are left out of this solution. Cyprus is small, its banks are full of Russian money. But, wait for it—another crisis is coming. The Cypriot government, with its economy collapsing, may soon default on its own debt, some of which is conspicuously owed to Russia. The EU will have to choose between orchestrating another bailout or risking the precedent of a member government flaking out of the euro.

We could draw many lessons, including the mounting cost of Russia's dilatoriness in upgrading its civil institutions. But the overarching problem is a global financial system built on a mountain of government debt, which has made governments and banks into highly incestuous bedfellows. Too Big to Fail is merely derivative of this larger phenomenon. The next chapter of the story is now unfolding. When governments can't meet their obligations by borrowing money, they start printing it. Soon savers across Europe may be looking for a financial haven on Mars.

About this, Americans can hardly afford to be snarky. Our U.S. Agriculture Department is contemplating buying up surplus sugar (using borrowed money) to save sugar processors from defaulting on loans from the Agriculture Department.

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