



Министерство иностранных дел Российской Федерации

Бюро Специальных Консультациям
МОСКВА 119 200, Смоленская-Сенная Площадь 32-34

Уважаемый господин Президент
(Dear Mr President)

THE SITUATION IN CYPRUS

Your office has asked for advice on the situation in Cyprus, and for recommendations on possible courses of action by the Government of the Russian Federation (“GRF”).

In addition to GRF, there are three main groups of participants in the crisis that are of interest. These are the taxpayers of the Eurozone, the Government and people of Cyprus, and the Cypriot banks and their creditors. This brief analyses each in turn and then considers how GRF should use the situation to further its own ends.

The **taxpayers of the Eurozone** face a call which could be as much as €17 bn, this being the estimated amount of the shortfall in the Cypriot government and banking system. In general terms this is not a lot – far larger sums have already been expended – but even the most optimistic of Eurozone governments have concluded that the chance of Cyprus ever repaying such a sum is nil. Rather than extend this money in full, therefore, it is politically necessary for the other Eurozone governments to show their populations that the burden is being shared with the creditors of the Cypriot banking system. This political imperative is given more weight by the approaching German federal election: in simple terms, the Germans know they will shoulder the bulk of the cost and are in no mood to support any political party that commits them to the full amount. Merkel has therefore decided that the terms of any loan from the Eurozone (ie, from Germany mainly) must include burden-sharing with depositors in the Cypriot banks.

Analysis: This undermines several commitments that the EU has made, for example that deposits under €100,000 are protected and that after the Greek default, the Eurozone’s various rescue packages will not include private sector involvement, and risks at the very least a serious bank run, not only in Cyprus but also in other peripheral states. The foreign press has speculated that the German government simply does not understand this: we suggest that it probably does, but has chosen this course of action as the lesser of two evils. If this is so, then this should be seen as a decision of considerable weakness: Merkel has shown that she is not confident of being able to pursue sensible but electorally unpopular policies so close to what promises to be a hard-fought election.

GRF interest: *GRF should see this as an opportunity to pursue national interests. The EU is currently experiencing a period when 4 of the 5 major governments, viz France, Italy, the UK and Spain, are all weak, unpopular and distracted by internal matters. And the fifth major government, Germany, has just indicated it may join them. This conjunction is possibly unique in the 55-year history of the EU.*

The action by the Eurozone has been defended with the sentiment that “the international depositors are mostly Russian and probably laundering illegal money, so they do not deserve to be made whole”. This is probably true, but provides the opportunity to take public offence at a “slur on the legitimate activities of Russian citizens”, and to visibly defend their interests against illegal acts by foreign governments. Such a move could prove popular with the electorate and portray GRF as strong in defence of the interests of Russian nationals. Note that the UK government has already promised to make good the losses of some of its citizens.

The **Cypriot Government and people** are clearly the main losers in the story. But they have no international sympathy and no voice: they are deeply unpopular in the EU because of their intransigence over Turkish Cyprus and widely seen as untrustworthy. They are also small enough to be ordered around by their Eurozone partners with apparent impunity.

Analysis: *The German decision that has been forced on Cyprus illustrates the true regard and concern for their welfare in other European capitals. Much of the antagonism towards the Greek Cypriots may be justified, but whatever the cause, it is fair to say that events now show that with the possible exception of Greece, they have few friends and no sympathisers in the rest of the EU.*

GRF interest: *Friendless states are clearly forced to find succour where they can. But “friendless” is not the same as “without assets”, and GRF should consider what assets Cyprus has that may be of interest. The island has hydrocarbon potential, which could be useful to Russian interests, and has warm-water ports, which could become very convenient replacement facilities should current facilities in Syria become unavailable.*

The **Cypriot banks** are bankrupt, and the state cannot support them. There is little by way of equity or debt funding for the banking system, which is to a very large extent funded by customer deposits. In principle therefore these deposits are already severely impaired and not worth face value. In practice, without the Eurozone rescue the banks will in all probability collapse, perhaps before the end of the week.

Analysis: *The Eurozone package could be seen as extremely generous, as it is giving creditors more than 90 cents in the euro for each deposit, when their true worth is a fraction of this amount. But no depositor is seeing the package this way, and there is a possibility that the package will be rejected in its entirety. At this point the banking system becomes unviable – the Cypriot government would not be able to recapitalise it in euros and would almost certainly have to leave the Eurozone.*

GRF interest: *GRF direct involvement is nil, but there is no doubt that a number of oligarchs have found the Cypriot banking system useful and would be inconvenienced were it to collapse. Indeed we know that several of them have been highly active in money laundering, though we have not yet got enough evidence to make prosecution worthwhile and GRF policy has until now been to let things wait. This new situation offers a chance to put certain individuals very much in GRF’s debt, and although it is not standard GRF policy to act in the interest of individual*

oligarchs, the opportunity to create a general obligation of the oligarch class overall to GRF may offer potential for future leverage and therefore be worth pursuing.

Summary and recommendations

It is open to GRF to do nothing. No direct interests of the state are involved. But this could be portrayed both externally and internally as a position of weakness and in addition would in the Ministry's opinion be a missed opportunity.

It is open to GRF to take public offence at the Eurozone's high-handed and possibly illegal actions, and for example to threaten to withdraw or terminate the finance that we have made available to the Cypriot government. While momentarily satisfying, and perhaps the reaction that most of the electorate would expect GRF to take, this would however achieve nothing except to confirm the write-off of our current financial position and the loss of future influence.

It is therefore recommended that GRF use this crisis to achieve a number of state ends, as follows:

1. Condemnation of Eurozone action as both unwise and possibly illegal, and very harsh on Cyprus. Express concern that "the Eurozone will be destabilised and confidence sacrificed in order to meet electoral concerns in one member state". Explain expectations that official EU guarantees to protect small depositors anywhere in the Eurozone will be upheld. Offer of sympathy to the Cypriot government. *Objectives – embarrass EU, be seen to uphold international law, position GRF as a friend of Cyprus.*
2. Offer to renegotiate loan finance for Cypriot government. Suggest that they should realise who their real friends are. Seek warm-water naval facilities and preferential treatment for Russian hydrocarbon expertise in developing Cypriot gasfields. *Objectives – protect value of existing financing, tighten grip on useful client state, protect against loss of Syrian facilities, create opportunities for future co-operation in the hydrocarbon sphere.*
3. Offer to make good any losses suffered by Russian citizens as a result of EU tax levies. Threaten to recoup the money by a surcharge on gas exports to northern Europe. *Objectives – create a debt of gratitude owed by oligarchs and others to GRF, remind Germany that unilateral action against Russia is not without consequences.*

The Ministry stands ready to respond to any further requests that your office may have.

От имени министра иностранных дел

(signed)

М.И.Борисов

19.03.2013г

