FINANCIAL FALLOUT

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Cypriots are paying a dreadful price for monetary machinations. Unfortunately, they will be paying it for an extended time. Those non-Cypriots with large deposits or stock or bonds of major Cypriot banks are also paying a painful price. It may not be obvious at the moment but many with no direct financial involvement with Cyprus are likely to also pay a heavy price in the future.

The reason is that two underpinnings of the world financial system have become questionable.

One is the euro, the second most important currency in the world. Major attributes of the euro were its universality -- you could use it, trade it, invest it anywhere -- and its equivalency -- no matter where you were, its value was the same. That is no longer true. A euro in Cyprus could lose 60 % of its value if it was in a large bank in a large deposit. You might not be able to withdraw it ever but have to take ownership shares or the bonded debt of a questionable bank. Even if you are able to withdraw from a bank, the amount is limited and the transferability to others is limited and confined. That is not true of euros in other countries that use the euro.

Put simply, the euro is no longer a unified common currency. The wise holder of assets should question whether to retain ownership of it, or claims denominated in it, for very long. And this is particularly true of euros in other euro-using countries that have teetered of late or are likely to. An obvious reflection of this is the lowered exchange value of the euro against the dollar.

But it would be even more obvious were there an organized market price for euros-in-Cyprus against the dollar. Their value would be even lower. In other words, euros in Cyprus have been devalued.

In the past, when each country had its own currency, one route out of a financial debacle was currency devaluation which lowered internal prices when viewed from abroad. This led to increased exports which mitigated the economic and social pain. But Cyprus no longer has its own currency. It is experiencing a devaluation without the associated remedial effect that comes with devaluation.

Some are saying that it is appropriate that Cyprus suffer because it allowed its financial sector to grow so disproportionately large relative to the rest of its economy and because of its lax regulation of its financial institutions. (They prefer not to notice that their "haircut" of Greek banks was one of the keys to the present problems.) But even those in the euro zone who believe the suffering appropriate will learn that they too will pay a price. The role of their unified currency in the world economy is diminished. That will injure their domestic economy and prospects.

The second underpinning of the world financial system that has suffered is the banking system. One of the lessons learned in the Great Depression was that runs on banks were intolerable. What happened in response to the Cypriot financial mess tells depositors that when there is a whiff of problems, get your money out of the bank. The intolerable has been encouraged.

Depositors may say that they have money in the bank but that is never fully true. In a world of fractional bank reserves, most of "their" money leaves the bank as fast as the bank can find a use for it. If everyone tries to withdraw substantial amounts simultaneously, the bank can't give them "their" money back. It doesn't have it.

To forestall runs on banks, monetary systems have devised various forms of assurance to depositors that the government will give them their money if the bank cannot. Usually, there is some explicit maximum amount that is assured but implicitly, depositors have confidence that all deposits can ultimately be withdrawn. (Example: In the US financial crisis, the maximum deposit coverage was raised from $100,000 to $250,000.)

This assurance to depositors is so vital that the treaty establishing the euro requires that deposits up to 100,000 euros receive government insurance. Yet the original proposal for a bailout for Cyprus included a "tax" on all deposits. And the IMF, the guardian of monetary rectitude, supported the EU's requirement.

The lesson from this for depositors is that an unconditional promise is conditional. The wise depositor will know that the funds deposited in some nations' banks may not have all the protection announced. And the world has to know that the specter of bank runs in major currency countries is a more potent threat than it has been for many decades.

For about 40 years, Cyprus has had its "problem." It now has another one. The hope has to be that this one has a far shorter life. It is unknowable now how long it will take for the world financial system to first fully recognize and then remedy what has happened to it.