EUROPEAN ECONOMICS UPDATE
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Who will be the next Cyprus?

- **Cyprus has shown that even the smallest members of the euro-zone can rock the single currency area.** Slovenia is probably the next country most likely to be forced into a bailout programme, but Malta and Luxembourg are also vulnerable given the size of their banking sectors relative to their economies.
- As Chart 1 shows, there is already evidence of market stress in Slovenia, with government bond yields rising from 4.5% to 6.5% over the last two weeks.
- **The focus of market pressures on Slovenia is unsurprising.** Although the banking sector is much smaller than Cyprus's (see Table), banks' non-performing loans have risen to 15% of total assets, with the ratio in the three largest banks topping 20%. These numbers may increase further given that the economy is set to contract by at least 2% this year. The IMF recently estimated that the government needs to recapitalize the banks to the tune of at least €1bn, or 3% of GDP.
- **But the government will probably struggle to raise the required funds, and may therefore be forced to request a bailout.** Although public debt is low, official financing needs for this year amount to at least 10% of GDP because of bank recapitalisation costs, revenue shortfalls and maturing debt. In their current shape, domestic banks will struggle to absorb this issuance, while foreign investors will be wary of investing in small countries with shaky banks after their experience in Cyprus.
- **Malta may also come under the spotlight. On the surface, it looks similar to Cyprus, with bank assets of over 700% of GDP and non-resident depositors accounting for over 60% of bank funding.** Admittedly, international banks dominate the sector and use the island to manage intra-group liquidity, posing a much smaller risk to Malta than Laiki, the wound-up Cypriot bank, posed to its own banking system. **Nonetheless, Malta's deposit insurance fund could be overwhelmed by solvency problems in one of these large foreign-owned banks. And, depositors may be quick to run because, as in Cyprus, banks have few debt securities that could be restructured ahead of hitting depositors.**
- **Luxembourg could also suffer a loss of faith in its banks given that bank assets amount to over 2000% of GDP.** As in Malta, this figure substantially overstates the country's exposure given that most banks are foreign-owned and focus on intra-group activities. But the economy is not completely insulated from a disruption in these flows and there is still no clear mechanism for cross-border bank resolutions. Indeed, Luxembourg felt the need to contribute to the joint-rescue of Dexia and Fortis banks, which were active in several European countries.
- Estonia and Slovakia are the two other small euro-zone members. Although Estonia's banks are reliant on foreign funding, this has come from historically stable Nordic sources, and the country's fiscal position is very strong. Slovakia, in turn, has the smallest banking sector in the euro-zone and the economy has grown robustly throughout the euro-zone crisis. **That said, should market concerns towards smaller economies in general continue to intensify in the wake of the Cyprus bailout, both countries could still be vulnerable to contagion effects.**

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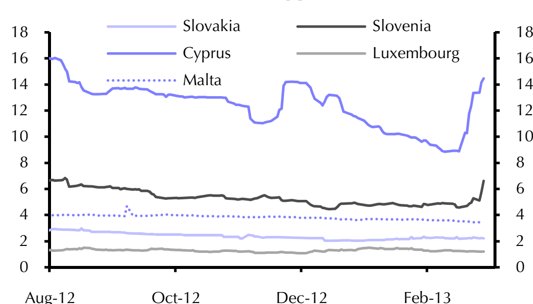
Chart 1: Government 10Yr (Approx.) Bond Yields (%)



Source – Bloomberg

Chart 2: Fiscal Position & Bank Assets in 2012 (%GDP)

	Government Debt	Fiscal Balance	Bank Assets	GDP as % of EZ
Cyprus	84	-4.9	716	0.2
Estonia	10	-0.5*	109	0.2
Luxembourg	21	-1.5*	2107	0.5
Malta	73	-2.6*	760	0.1
Slovenia	48	-4.2	144	0.4
Slovakia	51	-4.8*	81	0.8

Source – Eurostat, *estimates from EC's latest *Economic Forecasts*