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Entering a War Zone

...over the period 2004-2010, Cyprus banks grew dangerously large through a combination of aggressive management and weak governance, compounded by a failure of the public authorities to appreciate the risks that the banks were running, and therefore to take effective measures to rein them in. At its height in 2009, the banking sector was equivalent to 9 times GDP, one of the highest levels in the EU.

Independent Commission on the Future of the Cyprus Banking Sector, Final Report, 31 October 2013 (http://www.centralbank.gov.cy/media/pdf/LSE_ICFCBS_Final_Report_10_13.pdf).

EU Membership

The Cypriot banking sector started growing uncontrollably in 2004, the year that Cyprus became a full member of the European Union. By 2011, banking sector assets more than doubled to reach €141.0 billion, or 9.5 times GDP. In order to qualify for membership, Cyprus had to adopt the *acquis communautaire* (the body of legislation and regulations constituting EU law), including fully liberalising its hitherto tightly controlled financial system. The changes to the structure of the economy were, however, not

fully appreciated, largely because the motivation for joining the EU wasn't economic but political.

EU membership was, and still is, considered by the majority of Greek Cypriots as essential for the long-term survival of the Republic of Cyprus. Indeed, the biggest hurdle Cyprus faced in its desire to join the EU wasn't the island's tightly controlled economy but 'the Cyprus problem', i.e. the de facto division of the island since 1974. The Republic of Cyprus, which applied to join the EU in 1990, only controls the southern part of the island. The northern part representing 36% of the Republic's territory is, at the time of writing, controlled by the 'Turkish Republic of Northern Cyprus', a pseudo state recognised only by Turkey. Nicosia, the capital city, remains at the time of writing, the only divided capital city in Europe.

It is largely because of the tragic events of 1974 that EU membership came to be considered as essential for national survival by the majority of Greek Cypriots. With the Cyprus problem uppermost in most people's minds, the key economic challenges facing Cyprus, including the institutional changes that needed to be made, received little more than passing attention. The common misconception was that the economy was sufficiently robust to withstand any shocks from EU membership, which, at any rate, would be mostly positive. Few recognised the risks emanating from a fully liberalised financial system and hardly anyone thought that the banking system, if left unmanaged, could become the source of another national disaster.

Early on during my period in office, I came to realise that many politicians and journalists had little, if any, appreciation of European institutions. Few, for example, understood that central bank independence is one of the cornerstones of economic and monetary union. Even fewer appreciated why. For many Cypriot politicians and journalists, central bank independence was a European curiosity that simply had to be embedded in Cypriot legislation and then conveniently forgotten.

Neither the Greek Cypriots' determination to join the European Union nor Cypriot politicians' casual respect for European rule of law can be adequately understood without gaining a deeper appreciation of the island's turbulent pre- and post-independence history, to which much of the rest of this chapter is devoted.

Turbulent History: From Ancient Times to British Rule¹

‘He who would become and remain a great power in the East must hold Cyprus in his hand. That this is true, is proved by the history of the world during the last three and a half millenia from the time of Thutmes III of Egypt to the days of Queen Victoria’. These were the words of the German classical archaeologist Gustav Hirschfeld in 1880, soon after the British took over Cyprus from the Ottomans in 1878.² These wise words, which remain as relevant today as they were in 1880, not only neatly encapsulate the island’s strategic importance but also hint at the source of its turbulent—and at the same time rich and fascinating—history. For while Cyprus is only the third largest island in the Mediterranean—it is smaller than Sicily and Sardinia—its close proximity to the Middle East is second to no other European land. Modern-day Turkey and Syria can be seen from Cyprus with the naked eye, while Beirut, Haifa, Port Said and Alexandria are all within easy reach by sea.³

Cyprus was settled by humans during the Palaeolithic period: water wells, believed to be among the oldest in the world, which date back over 9000 years, provide the first evidence of human presence on the island and indicate the sophistication of these early settlers. The neolithic settlements of Khirokitia and Kalavassos, near Limassol on the south coast, which date back to 5800 B.C., provide further evidence of a relatively developed civilisation. The discovery of copper at around 3000 B.C., from which the island seems to have derived its name, transformed Cyprus into a centre of trade by attracting traders and settlers from the region, as well as Egyptian invaders around 1500 B.C. The Minoan traders were the first Greeks to visit Cyprus and although they never settled on the island, their highly developed civilisation became a source of cultural influence on its inhabitants. Achaean and Mycenaean traders followed from around 1400 B.C. but they only started settling on the island towards the end of the Trojan war (around 1184 B.C.). The Achaeans and Mycenaeans were followed by the Dorians around 1100 B.C. During that period, ten independent city kingdoms were founded,

¹This section draws on a number of historical and other sources, including Hill (2010), Trimikliniotis (2012), Hitchens (1997), Karageorghis (1968).

²See Hill (2010).

³For example, the distance from Larnaca to Beirut is 112 nautical miles while the distance from Limassol to Haifa is 139 nautical miles.

which gradually adopted the Greek language, religion and culture.⁴ Cyprus, in turn, exerted its own influence on the Greek mainland and became an integral part of Greek religion, culture and mythology. One of many examples of such influence relates to Aphrodite, the Greek goddess of love and beauty whose mythical birthplace was on the western part of the island.

The Assyrians were the first foreign power to occupy Cyprus in ancient times, following the victory of King Sargon II in 709 B.C. Assyrian direct rule lasted for four decades and was followed by around 100 years of relative independence. The island was then conquered by the Egyptians around 570 B.C. and the Persians around 545 B.C. Alexander the Great put an end to Persian rule in the late fourth century BC. The Ptolemaic period that followed—which also turned Egypt into a Hellenistic kingdom and Alexandria into a city of Greek culture—resulted in the full Hellenisation of the island.

The Ptolemaic period ended in 58 B.C., when Cyprus became part of the Roman Empire. The people of Cyprus were converted to Christianity during the first century AD by the Apostle Paul, who travelled to Cyprus with the Levite Barnabas, who was a native Cypriot. The Church of Cyprus became independent in 431 AD. Cyprus became part of Byzantium after the division of the Roman Empire into East and West and remained as such until it became a target of the crusaders in the twelfth century AD. In 1192, Issac Comnenus, the last Byzantine Governor of Cyprus, conceded control of the island to Richard the Lionheart, who had landed in Limassol a year earlier in search of his bride Berengaria. Later that year, Richard sold Cyprus to the Knights Templar who passed it on to the French Lusignans, which resulted in Latin being declared the official language. In 1196, they established the Latin—Roman Catholic—Church and started persecuting the independent Eastern Orthodox Church of Cyprus. The Lusignans remained in control of the island until 1489, when the Venetians bought the island from Catherine Cornaro, the last Lusignan Queen of the island, who was subsequently forced to abdicate. The Venetians fortified the island to protect it from frequent Ottoman raids. Venetian rule lasted until 1571 when the island finally fell to the Ottoman Turks, following the historically famous siege and naval blockade of Famagusta on the island's south-eastern coast, which lasted eleven months.⁵

⁴The ten kingdoms were: Salamis, Kition, Amathus, Kourion, Paphos, Soli, Tamassos, Ledra, Idalium and Chytri.

⁵These events provide the historical setting to Shakespeare's *Othello*, that tells the story of the commander of the Venetian garrison defending Cyprus against the Ottoman Turks.

Ottoman rule lasted over 300 years, during which the supremacy of the Greek Orthodox Church was restored and Catholicism displaced. It was, by and large, a period of economic and cultural oppression. During Ottoman rule, the Archbishop—the head of the Greek Orthodox Church of Cyprus—was recognised as the sole representative of the Greek Cypriot population. The Church was also given power to govern and raise taxes from the local population, all of which raised the status of the Archbishop from a religious leader to ‘ethnarch’—ethnic leader. In addition to the Archbishop, the Greek Cypriots elected a Dragoman, an official ‘interpreter’ chosen from candidates nominated by the Archbishop. The Dragoman played a significant administrative and diplomatic role as the leading intermediary between the Christian population and the Ottoman rulers.

The importance of this period for modern times cannot be overstated. This was the period during which a new ethnic group, the Ottoman Turks, mainly soldiers and their families, were incentivised to settle in large numbers on the island. This development, combined with the rise of nationalism in the twentieth century, was to lead to significant ethnic tensions in modern times between the Greeks and Turks of Cyprus, which culminated in the invasion of the island by Turkey in 1974.⁶

Cyprus came under British rule in 1878, following a secret convention with the (by then) weakening Ottoman Empire. The convention obliged Britain to use the island as a base to protect the Ottoman Empire from Russian aggression. Cyprus’ strategic importance for Britain was related to the opening of the Suez Canal nine years earlier, which made the island a particularly useful naval outpost as it could be used to protect the sea route to India, Britain’s most important overseas colony at the time. With the onset of World War I in 1914, Britain found itself on opposite sides of the Ottoman Empire and, as a result, rescinded the convention and annexed the island. In 1925, Cyprus became a Crown colony and remained under British colonial rule until 1960. Although the island remained largely underdeveloped, under British rule Cypriots enjoyed greater freedoms compared to Ottoman times, including freedom of speech and access to formal education, which was largely provided by the Greek Orthodox Church. This facilitated the emergence of Greek nationalism and its vision of Greater Greece, which eventually led to the idea of ‘enosis’—union of Cyprus with Greece.

⁶See, however, Panayiotou (2006) for a more nuanced sociological perspective on the historical conflict between Greek and Turkish Cypriots.

At the same time, the poor living and working conditions of much of the population during the 1920s led to the rise and propagation of left-wing ideas, influenced by the Bolshevik Revolution of 1917. The Communist Party of Cyprus, established in 1926, declared its support for independence, thereby providing a plausible alternative to enosis. A non-nationalist alternative gained further ground and momentum with the establishment in the 1940s of AKEL—the Progressive Party of the Working People—the mass party created by the communists and trade unions when the Communist Party was disbanded by the British colonial administration. AKEL rejected nationalism from the outset and sought to unite Greek and Turkish Cypriot workers in their struggle for better working conditions.⁷ In 1947–1948, AKEL embarked on negotiations with the British on self-government. However, the right, which was both more staunchly pro-enosis but also more pro-British (until the mid-1950s) objected to the idea of an independent, or even, initially, a self-governing Cyprus. Meanwhile, the idea of partition of Cyprus along ethnic lines started gaining ground among the Turkish Cypriots.

Troubled History: From EOKA to Christofias

Cyprus gained its independence from Britain in 1960, following a four-year campaign against British rule by a Greek Cypriot guerrilla organisation named EOKA (National Organisation of Cypriot Fighters).⁸ EOKA, whose goal was ‘enosis’ was led by Georgios Grivas, a Cyprus-born retired officer in the Greek army with a distinguished military record in the 1919–1922 Asia minor war against Turkey. During the EOKA campaign, Grivas adopted the pseudonym ‘Digenis’, after a Greek hero who had defended the borders of the Byzantine empire against Ottoman attacks.

Grivas was a highly controversial character because of his extremist, far-right political views. During the German occupation of Greece, he founded and led a secret organisation named ‘X’, which collaborated with the Nazis against the communist-led Greek resistance.⁹ Grivas was also a fierce Greek nationalist with extreme anti-Turkish views; he could never accept that Cyprus could aspire to be anything other than a part of Greece. He showed

⁷For a comprehensive history of AKEL and the left-wing movement in Cyprus, see Katsourides (2014). Note, however, that over the years AKEL’s position on independence fluctuated.

⁸For a fascinating British soldier’s perspective on EOKA, see Bell (2015).

⁹See, for example, Hondros (1983), Richter (1985) or Close (1995).

little tolerance for those who were prepared to consider the future of Cyprus as an independent state. In his memoirs, he referred to his campaign not only against the British but also against the 'communists and the Turks'. Hundreds of Turkish and Greek Cypriots, whom he branded 'traitors' or 'collaborators', were assassinated by EOKA under his orders, in addition to similar numbers of British soldiers and civilians.

In the late 1950s, as a reaction to the Greek Cypriots' demands for 'enosis', Turkish Cypriots began advocating 'taksim', the partition of Cyprus into Greek and Turkish parts and their respective union with Greece and Turkey.

During British rule, the Greek Orthodox Church remained the leading institution representing the interests of Greek Cypriots as had been the case during Ottoman times. The Archbishop continued to play the role of 'ethnarch'.

In 1950, the Church acquired a new, young and charismatic leader, Archbishop Makarios. Makarios had studied theology and law at Athens University, before heading to Boston University in the USA to embark on his doctoral studies, funded by a World Council of Churches scholarship. Makarios, who was from the Paphos district, rose quickly through the ranks of the Church and became Archbishop and leader of the Church at the age of 37.

Makarios was a leading advocate of the principle of self-determination for Cyprus well before the start of the EOKA campaign. Given the demographics, self-determination, if granted by the British, would in all likelihood have resulted in the island's union with Greece from the early 1950s. Although the extent of Makarios' collaboration with Grivas during the EOKA campaign remains uncertain, what is known with certainty is that the British Governor of the island, Sir John Harding, believed that Makarios was the spiritual leader of EOKA. Perceived as a threat to British rule, Makarios was secretly removed from the island by British forces in March 1956, less than a year after the start of the EOKA campaign. He remained in exile (in the Seychelles) for three years.

Makarios returned to Cyprus in 1959, after an agreement reached in Zurich between Britain, Greece and Turkey to establish an independent Republic of Cyprus, with Britain maintaining military bases on the island. Makarios, who was a pragmatist, realised early on that 'enosis' was not a realistic prospect for Cyprus. Although initially against the Zurich agreement, he was eventually persuaded by the Greek and British govern-

ments to endorse it and contributed to its further refinement in London. In December 1959, soon after his return to the island, Makarios was elected as the first president of the newly established Republic of Cyprus, defeating his opponent, George Clerides, who had been supported by AKEL.¹⁰

The 1960 constitution envisaged power sharing between the Greek and Turkish communities on the island. In an attempt to protect the Turkish Cypriot (T/C) minority from the Greek Cypriot (G/C) majority, it provided for over-representation of Turkish Cypriots at all levels of government and the civil service. It also provided the T/C minority with veto power over important decisions. The arrangement did not last long. Continuous friction between the two communities over power sharing led Makarios to propose changes to the ethnic restrictions agreed in London and Zurich, with the aim of creating a more efficient public administration. The T/C community, however, responded by withdrawing completely from the government and civil service in December 1963, from the lowest ranking civil servant to the Vice-President of the Republic, Dr Fazıl Küçük. As a result, the position of vice-president, which was intended by the 1960 constitution to provide an important check and balance on the powers of the president, has remained vacant since 1963.

By contrast, other positions that were intended by the 1960 constitution for Turkish Cypriots, such as those of Deputy Attorney General and Deputy Chief of Police, were, over time, filled with Greek Cypriots, by appealing to the so-called law of necessity, so that the state could remain functional.

UN peacekeeping forces were deployed on the island in 1964 and have remained ever since. They were not, however, able to prevent further episodes of intercommunal strife. The Turkish Cypriots withdrew into enclaves and formed their own administration in 1968.

On 15 July 1974, there was a military coup against Makarios, ordered by the Greek junta in Athens. Turkey invaded the island five days later, claiming it had the right to do so in order to protect the T/C minority under the Zurich-London agreement. By mid-August, Turkish military forces occupied 36% of the island, defeating an under-equipped and demoralised Greek Cypriot National Guard. Around 200,000 Greek Cypriots (representing about one-third of the G/C community) fled for safety to the southern cities of Limassol and Larnaca. At the same time, an agreement was reached

¹⁰George Clerides attracted about one-third of the vote. His son, Glafcos Clerides, had better luck: he was elected president in 1992 and served until 2002.

between the two sides to move 60,000 Turkish Cypriots to the areas controlled by the Turkish army, with the help of British and UN forces.

The coup against Makarios, which triggered the Turkish invasion, was the pinnacle of a campaign of violence, terror and intimidation directed against Makarios and his supporters by right-wing nationalists, who justified their actions by claiming that they were continuing to fight for 'enosis'. There were in total four assassination attempts against Makarios, but also numerous bomb explosions, frequently outside police stations.

In 1968, Makarios was re-elected to the presidency with an overwhelming 96% majority against Takis Evdokas, a nationalist candidate who had the support of the Greek military junta. Makarios' popularity did not, however, prevent the junta from stepping up the campaign against him. In 1971, the junta secretly dispatched colonel Grivas back to Cyprus with a new remit: to destabilise the government with the ultimate aim of overthrowing Makarios. Prior to his return, Grivas had publicly accused Makarios of being a traitor. For Grivas, it was enough that Makarios had abandoned the aim of 'enosis'. Makarios had also shown leanings towards the left in the 1968 elections, something which Grivas could not tolerate. On his return to Cyprus, Grivas founded the paramilitary organisation EOKA B, which launched a terror campaign against Makarios and his supporters.

By that time, Makarios had become a prominent figure in the non-aligned movement worldwide, alongside Egypt's Gamal Abdul Nasser and Yugoslavia's Josip Tito. This development, which coincided with the height of the cold war, certainly alienated the USA, which had expected a more pro-western stance from him. Makarios was branded 'the Fidel Castro of the Mediterranean' (see, e.g. Hitchens 1997) in view of his moderate beliefs and tolerance of communism, fuelling the Greek junta's determination to overthrow him. After all, the colonels' 'revolution' of April 1967 was mainly intended to save the Greek nation from what they saw as widespread communist infiltration.

In addition to Grivas and EOKA B, the junta also used its control of the Greek Cypriot National Guard, which was managed by officers from Greece, to undermine Makarios and the rule of law. It funded three new newspapers which started a propaganda war against Makarios. Grivas' supporters infiltrated the local police force, upon which Makarios depended for his own security, and stole weapons and ammunition to arm the paramilitaries of EOKA B. Makarios' dual role as head of state and head of the Greek Orthodox Church, or perhaps because of his Christian beliefs, resulted in extraordinary levels of tolerance and forgiveness, even of the people who repeatedly attempted to kill him. However, violence escalated during the

period 1971–1974 and he was forced to create a special police force, staffed by loyal supporters.

In an attempt to regain control, Makarios removed from the Cypriot police force a number of police officers who had openly revolted against him. The most prominent was Chrysanthos Anastasiades, who was the head of the Limassol police force and had been dismissed by Makarios for assisting EOKA B.¹¹ On 15 July 1974, soon after the presidential palace and the archbishopric in Nicosia were attacked by National Guard tanks and artillery, the paramilitaries, with help from National Guard conscripts, attacked Limassol's main police station, which was being defended by Makarios' newly created special police force. On 16 July 1974, Chrysanthos Anastasiades was installed as the director of the Limassol police force by Nicos Sampson, the new president chosen by the Greek junta.

Within three days of the Turkish invasion of the island on 20 July 1974, the Greek junta collapsed. Support for Brigadier Dimitrios Ioannides, the secretive dictator who had taken control of the junta in late 1973, dwindled.¹² Ioannides quickly lost the support of senior military officers once it became obvious that, either through his actions or his incompetence, Cyprus was, in effect, being handed over to Turkey. General Phaedon Gizikis, who had been installed as a figurehead president in November 1973, asked Constantinos Karamanlis, a veteran politician who had been residing in Paris since 1963, to form a government. Without backing from Greece, the President of Cyprus, Nicos Sampson, who had been installed by Ioannides, resigned after just eight days in office. Glafkos Clerides, speaker of the House of Representatives (and subsequent President of the Republic during 1992–2002), took over the presidency of the Republic and gradually helped to restore constitutional order. Makarios, who had fled the island from the British air base in Akrotiri on 16 July 1974, returned to the island in December 1974. By that time, he had secured sufficient international

¹¹Chrysanthos Anastasiades was the father of the current President of Cyprus, Nicos Anastasiades. A photograph of the young Nicos Anastasiades, a lawyer, with the defendants outside the court has been used to link him to the defence of EOKA B in court.

¹²Ioannides had replaced George Papadopoulos who was removed following the student uprising at the prestigious Metsovion Polytechnic, which ended in bloodshed. It is believed that Ioannides, a hardliner who was the head of the military police, staged the events in order to justify Papadopoulos' removal, as the latter was planning a softening of the military's grip. Ioannides formed a puppet government comprising of individuals who would take orders from him. It is widely believed that the individuals he chose for various ministerial roles were not consulted, but were rounded up by the military police and ordered to take up office.

support to ensure that his government was recognised as the lawful government of the whole island.

Sixteen years later, Cyprus applied to join the EU and eventually did so in 2004. A lot had happened in the period between the coup and invasion of 1974 and the island's application for EU accession in 1990. Cyprus, like any country wishing to join the EU, needed to have stable institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities, before it could apply.

Negotiations for EU membership began in 1998. Although the island remained divided, notwithstanding numerous attempts at reunification, the reasoning that was given by the European Commission in its support for Cyprus' EU membership was that it would bring '...increased security and prosperity and that it would help bring the two communities on the island closer together'.¹³

As part of the process of gaining EU membership, Cyprus, like all candidate member countries, had to adopt the *acquis*. Among the numerous legislative changes that were introduced, the country had to amend the 1960 constitution and banking laws in order to strengthen the independence of the central bank. The 1960 constitution allowed the President of the Republic to dismiss the central bank Governor at will. The same was true of the deputy Governor, a position earmarked for a Turkish Cypriot, aimed at providing cheques and balances on the powers of the Governor. The deputy Governor could be removed from office by the Vice-President of the Republic. What also had to change was the government's veto power on the central bank's board of directors. Before this change, the government had complete control over all central bank strategic decisions, through the minister of finance, whose representative on the central bank board had veto power. The 1960 constitution was amended so that the Governor and deputy Governor could only be removed from office through a judicial process, if they were either no longer capable of carrying out their duties or if they had committed a 'grave offence'. Following EU membership, additional protection of central bank independence was provided by the Treaty of Establishment of the European Union, which in practice means that any national decision to remove a sitting Governor from office needs to be ratified by the European Court of Justice.

¹³See European Commission, Press Release Database: http://europa.eu/rapid/press-release_DOC-93-5_en.htm.

EU membership, along with the financial liberalisation it entailed, brought with it unprecedented levels of euphoria, which fuelled the unchecked growth of the banking system in the years that followed. With a secure future within the EU, Cyprus' banking system began to attract capital inflows from Russia and other former 'eastern bloc' countries, looking for a safe, tax-efficient, home. By that time, Russia had begun its own return to prosperity, following more than a decade of transition. Geographically, historically, culturally and, more recently, politically, Cyprus offered all that nouveau-rich Russians wanted from a safe haven. Cypriot law firms, closely connected to the banks and local politics, were the key conduit in this process, acting as 'introducers' of wealthy Russian clients (often politicians themselves) and frequently receiving commissions from the banks for these services (Demetriades 2015).

Europe had hoped that EU membership would act as a catalyst for reunifying the island. In 2004, a preliminary agreement, known as the Annan Plan, was brokered by the United Nations. However, the G/C community rejected the Plan in a referendum after President Tassos Papadopoulos made an emotional appeal on television stating that he could no longer support the agreement, citing last minute changes intended to secure the support of Turkey.

The only Greek Cypriot political leader who supported the Annan Plan was, in fact, Nicos Anastasiades. Anastasiades' stance won him western plaudits and laid the foundations for his election to the Presidency in 2013, as it helped to transform his public image into that of a moderate centre-right politician with a pragmatic outlook on the Cyprus problem. By contrast, Tassos Papadopoulos became comparatively isolated internationally and began losing support domestically. In the 2008 presidential elections, Papadopoulos, who stood for re-election, came third, although by a small margin. Ahead of him were Dimitris Christofias, leader of AKEL, and Yiannakis Kasoulides who was the conservative candidate backed by Democratic Rally (DISY). Anastasiades, the leader of DISY, did not stand, fearing a backlash because of his support of the Annan Plan. The elections were won by Christofias, who made renewed efforts at reunification soon after his election. At that time, the Turkish Cypriot leader was Mehmet Ali Talat, also a left-winger. Given the traditionally good links that AKEL had maintained with their fellow left-wingers on the Turkish Cypriot side, expectations for a settlement were rather high and go some way in explaining Christofias' electoral success. These expectations were not realised, in part because Talat lost the 2010 election to Dervis Eroglu, a nationalist who

was less inclined to seek compromise. Nevertheless, the convergences that were achieved during that period provided the basis for the present round of negotiations when a new pro-solution Turkish Cypriot leader was elected in 2015.

Christofias' term coincided with the start of the global financial crisis in the USA and the beginning of the Eurozone crisis. Christofias, who was educated in the former Soviet Union and frequently boasted about his communist ideals, nevertheless appointed a banker as his finance minister. This was a clear signal to everyone that it was 'business as usual' when it came to the running of the economy. These, however, were not usual times. Christofias and his first finance minister, Charilaos Stavrakis, were criticised for being too slow to recognise that the global financial crisis would sooner or later affect Cyprus. The country's public finances rapidly deteriorated with the bursting of the property bubble in 2009, which was triggered by Britons selling retirement and holiday homes. Christofias was also criticised for increasing pension and other social security spending, which was, perhaps, the only 'socialist' policy that he had managed to implement.

The biggest criticism of Christofias, however, arose as a result of the devastating explosion at the Evangelos Florakis naval base near Mari that occurred on 11 July 2011. The explosion resulted in the death of 13 military and fire service personnel. It also damaged the nearby electricity generation plant, the largest on the island, resulting in widespread blackouts. The explosion was caused by the inappropriate storage of 98 containers of ammunitions destined for Syria from Iran that were seized by the US navy in the Red Sea from a Cypriot flagged, Russian-owned, vessel and offloaded in Cyprus. Critics alleged that Christofias had turned down offers from the USA, the UK and Germany to dispose or safely destroy the ammunitions, fearing an adverse political reaction from Syria. Following the explosion, the media mounted an attack on Christofias and thousands of people, encouraged by opposition political parties, demonstrated outside the presidential palace demanding his resignation. The explosion triggered the withdrawal of centrist DIKO from Christofias' coalition government, which resulted in a de facto minority government of the left, as AKEL had no majority in Parliament. Christofias became more and more isolated but did not yield to the demands of the demonstrators and the opposition political parties. With the continued support of AKEL, he remained in office until the end of his term, although he was vilified by the local media, with the exception of the left-wing daily *Haravgi*.

Back to the Present

I met Dimitris Christofias for the first time in March 2012, following an invitation that I had received from his office a few days earlier. By that stage, Christofias had decided not to reappoint my predecessor and was looking for a replacement. My name had been put forward by several people who had followed my career since leaving the Central Bank of Cyprus in 1990 to become an academic in the UK. At that meeting, Christofias shared with me the circumstances of my predecessor's appointment, which, although fascinating, encapsulated the way in which Cypriot politics and policymaking were conducted.

Christodoulos Christodoulou was the Governor before Orphanides. He had only served one term and the then President, Tassos Papadopoulos, decided not to reappoint him because of differences over Laiki. At that time, Papadopoulos, who was the leader of centre-right Democratic Party (DIKO), and Christofias, who was the leader of AKEL, were allies—they had formed a coalition government together.¹⁴ Tassos asked Christofias his views about the two candidates he was considering for the governorship. One of them was Athanasios Orphanides, an economist working at the Federal Reserve Board in Washington, D.C., with impeccable research credentials in the field of monetary policy.

Christofias happened to know Orphanides' parents well because both of them belonged to AKEL. The other candidate was a respected and successful academic econometrician based in the USA whom, however, Christofias did not know. Orphanides was born in Brno in the then Czechoslovakia during the depths of the cold war to a Greek mother and a Greek Cypriot father. His parents had met in the Socialist Republic of Czechoslovakia. His father was a student there while his mother, who had been a young resistance fighter during the German occupation of Greece, fled Greece at the end of the Greek civil war, like many other communists.

For Christofias, it was an obvious and easy choice; he recommended Orphanides without any difficulty over the other candidate.¹⁵ What Christofias was not aware of, given the solidly red credentials of Orphanides'

¹⁴The relatively modest percentages of DIKO meant that they needed support from either the left or the right to win an election.

¹⁵Orphanides was also recommended by the then finance minister Michael Sarris, who was well acquainted with Orphanides' career as they both had spent large parts of their careers in Washington D.C. Sarris was a World Bank economist before returning to Cyprus to take on the role of finance minister.

parents, was that Athanasios had acquired views on economic management that could not be further removed from those of his parents. Later on, when Orphanides started to publicly espouse his strong pro-market views, Christofias came to the conclusion that this child of the left had been converted to the 'neoliberal ideology' prevalent in the USA. However, by that time, it was too late for Christofias to do anything, other than wait for Orphanides' term to end. Christofias, for all his stubbornness and somewhat romantic socialist beliefs, had considerable respect for EU institutions, including that of central bank independence.

When it came to banking supervision, it appeared as if Orphanides had adopted a Greenspan-style *laissez-faire* stance towards the big banks. It was thus no surprise that the bankers wanted his reappointment. They offered higher deposit rates than anywhere else in Europe, which helped them to attract billions of foreign currency funds. These were used to lend to domestic property developers, paying little attention to systemic risk, thereby helping to fuel an unprecedented property bubble with the help of strong demand from wealthy Russians.

Early during his term, Orphanides made a relatively feeble attempt to prevent the property bubble from inflating further by suggesting the introduction of a ceiling on the loan to value ratio for primary and secondary residences. The proposal was, however, abandoned as soon as it encountered resistance from politicians and property developers. No further attempt was made to contain property lending, which could have been achieved through tighter regulation or stricter corporate governance. For example, if the number of independent directors on bank boards had been increased to achieve majority-independent boards, it would, in all likelihood, have resulted in more prudent lending standards and lower appetite for risk. Instead of being reigned in, property developers' influence over bank boards increased. In one obvious case of conflict of interest that remained unchecked, Theodoros Aristodemou, a large property developer connected to the Bank of Cyprus' largest shareholder—which happened to be Cyprus' Greek Orthodox Church—became Chairman of the Bank in 2008. As the rules on connected lending to bank directors and the definition of non-performing loans (NPLs) remained lax until mid-2012, asset quality in banks continued to deteriorate. Cyprus, according to the latest statistics at the time of writing, continues to have one the highest ratios of corporate lending to GDP in Europe as well as the highest ratio of NPLs. At 49%, NPLs in Cyprus dwarf Italy's NPL ratio which stands at 17%. Even Greece, which experienced

seven consecutive years of recession, has an NPL ratio that is two percentage points lower than Cyprus'.¹⁶

Lax lending standards were not the only source of poor asset quality. Both Laiki and Bank of Cyprus started expanding in the 'new lands of opportunity'—Russia, Ukraine and Romania. The Bank of Cyprus paid over €1 billion to acquire and support a Russian retail subsidiary—Uniastrum bank—lacking any synergies with its core business. It continued to expand in Greece up until 2011 as it saw the Greek crisis as an opportunity to grow at the expense of their Greek competitors. Bank of Cyprus and Laiki became, through their advertising expenditure, the main funders and financiers of the local media. Not surprisingly, the media made little attempt to mention the excessive risks undertaken by the two banks. Even when the rating agencies started downgrading Cyprus because of its large banking sector and the exposure to Greece, the media remained relatively silent on the issue.

Some of the politicians who backed the bankers through thick and thin worked in law firms that benefited directly by 'introducing' Cypriot banking services to their rich Russian clients. Others were closely connected to property developers and other big business. With the successive downgrades, the excesses of the banking sector became increasingly difficult to sustain, even with all the help from the local media.¹⁷ The supporters of the bankers needed a scapegoat. Christofias became an easy target, especially after the naval base explosion. The credit rating downgrades mentioned the link between banks and public finances—a small country could not support a large banking system without sound public finances. This was a very clear warning but it was ignored by the political establishment, including Parliament which had a duty to call the CBC to account for the growing risks in the financial system.

With the help of large sections of the local media, the causes of the downgrades were systematically distorted so as to put the blame entirely on Christofias and the deterioration of the public finances. Some of his critics—including Orphanides—went as far as to say that the Christofias gov-

¹⁶See EBA Report on the Dynamics and Drivers of Non-Performing Exposures in the EU Banking Sector, published 22 July 2016. <https://www.eba.europa.eu/documents/10180/1360107/EBA+Report+on+NPLs.pdf>.

¹⁷An article by the columnist and chairman of the investors' Association, Michael Olympios, which appeared in *Politis*—a major newspaper—entitled 'Too big to save' (which was inspired by a similar article of Joseph Stiglitz) alarmed the CEO of Bank of Cyprus. According to Michael Olympios who had a conversation with the editor in chief, Andreas Eliades threatened to cut €50,000 worth of advertising, forcing the paper to drop his column. The events were described in a sworn testimony in court during one of the criminal cases against Bank of Cyprus and some former executives.

ernment should have vetoed the Greek PSI in order to protect the Cypriot banking system.¹⁸

Against this background, whoever Christofias had chosen to replace Orphanides, was bound to face hostility, unless they were an ‘insider’. Bankers wanted the party to go on and so did the developers as well as the businessmen who benefited from easy credit. The media was equally reliant on the banks for easy credit and advertising revenues, especially after economic conditions begun to deteriorate in 2010. Lawyer-politicians and those politicians who depended on developers and big businessmen had every interest to maintain the status quo. However, with Laiki failing to raise private capital and needing state support, the party was nearing the end, although the news had been kept secret until after the changeover of Governor at the central bank. Bank of Cyprus was also destined to request a bailout, although it did not reveal this until after its AGM in June 2012.¹⁹ The party had to go on for as long as possible.

I certainly wasn’t an insider. Perhaps that is why Christofias appointed me. Or maybe it was because my own grandfather, Christodoulos Petrou, had been a key figure himself in the left-wing movement. He was among the founders of the metal workers union in the 1930s. Later on he became a successful entrepreneur, but remained firm in his beliefs and continued to hire employees from the union he helped to found—which by then had become affiliated to AKEL—both Greeks and Turks. His workshop, which was named ‘Μηχανουργείο ο Πορσεβίκος’ (‘Bolshevik metal works’) was located on the boundary between the G/C and T/C communities in Limassol. It was never damaged or vandalised, even though the area was at the centre of several episodes of intercommunal violence. His Turkish-Cypriot workers had a deep respect for him and helped to protect him, his family and his business.

¹⁸Christofias, however, confided in me that he was never briefed about the effects the PSI would have on the Cypriot banks. By contrast, on 19 April 2011, when Greek debt restructuring was being publicly floated, Orphanides gave an interview to Reuters in which he claimed that Cypriot banks could withstand Greek debt restructuring. Specifically, he said: ‘With respect to the exposure of Cypriot banks to Greek debt, we have examined the situation and we have come to the conclusion that even though there is exposure in our banking system, that exposure is manageable because our banks are very well capitalized. So even in the highly unlikely situation, if you wanted to run the counterfactual, for example, of imposing losses on the holdings of Greek debt, our banks would manage to weather that’. See: http://www.centralbank.gov.cy/media/pdf/INTE_GOVINTERVIEW_190411.pdf.

¹⁹A Cyprus Securities and Exchange Commission investigation subsequently fined the bank for failing to promptly announce to shareholders the capital shortfall. The bank and the bankers involved are now facing criminal charges over this and related violations.

Media hostilities started even before my appointment was announced. My ‘Bolshevik’ roots were exposed by the gossip columns. My popular writings were scrutinised by the ‘serious’ press, who competed among themselves as to how much they could distort and criticise my ‘Keynesian’ views, as if being a Keynesian was equivalent to being a reckless revolutionary. My sceptical views on Europe and the role of Germany in the EU were described as explosive and dangerous, not only for Cyprus but also for the whole of Europe.

The hostilities continued unabated after my appointment was announced and during all of my 23 months in office. According to the critics—which included the bankers whose banks needed large bailouts and my predecessor—I was part of ‘a communist conspiracy to destroy the banks’.^{20, 21}

On Sunday, 6 May 2012, during my late night meeting with the Laiki bankers, I was struck by the flashing lights of the gigantic Turkish flag on the Nicosia side of the Pentadaktylos mountain, that seemed designed to intimidate the G/C population, as it was visible from literally everywhere in Nicosia and beyond.

I had clearly entered a war zone. In more ways than one.

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²⁰According to reliable sources, PIMCO, in collaboration with AKEL and Demetriades, had been plotting the demise of Cyprus banks for several months before PIMCO came to Cyprus’, Vassilis Rologis, a former chairman of Bank of Cyprus, exclaimed in my presence at a parliamentary session that was looking into the causes of the crisis in 2013. Aristodemou, the property developer who took over from Rologis in 2008 at the helm of Bank of Cyprus, hailed his ‘agreed’ sale of Venus Rock, a massive development near Paphos financed by Bank of Cyprus, to a Chinese investor at approximately €300 million in the summer of 2013 as tantamount to disproving the results of the independent diagnostic exercise, as, he claimed, the property prices he obtained were above forced sale values used by PIMCO. By June 2014, and notwithstanding generous government support in the form of visas for Chinese property buyers and town planning relaxations, Aristodemou’s company was forced to admit that the sale had fallen through.

²¹Parliament’s inquiry, in fact, endorsed the bankers’ views that the capital needs of the banks were exaggerated, failing to note that, even after the banks were fully recapitalised using PIMCO’s adverse scenario, the capital buffers of banks remained thin and well below banks that had been bailed out in other countries.

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