Many in Cyprus feel caught between Russia and the E.U.

LIMASSOL, CYPRUS

BY ANDREW HIGGINS

ALEXANDROS DEMETRIADES FOR THE INTERNATIONAL HERALD TRIBUNE

Sergei Ivanov, left, a wine business operator, and Alexei Voloboev, a restaurateur in Cyprus. Mr. Ivanov said honest businessmen are viewed with suspicion because they are Russian.

Andreas Marangos, a Porsche-driving lawyer here, had just woken up when he heard the news that threatened to destroy his and Cyprus's most lucrative business: setting up shell companies and providing financial services for wealthy Russians.

He rushed to his computer to check whether the ''crazy talk'' he had just heard was true — that his government had agreed to effectively confiscate 9.9 percent of any balances above €100,000, or $129,000, on deposit in a Cyprus bank.

A week later, this Mediterranean island nation is still trying to figure out how to raise the €5.8 billion that European lenders say it must have by Monday in return for a bailout. Late Saturday, the tentative plan was to seize a portion of all deposits above €100,000, with the bite set at 20 percent for those banking with Cyprus's biggest bank.

For Mr. Marangos, either plan is bad news.

''Since last Saturday, we are just answering calls from angry clients,'' said the lawyer, whose firm has helped Russians and Ukrainians set up 6,000 companies in Cyprus so that they can avoid taxes, benefit from a sound legal system and, they hoped, keep their money safe. Cyprus still offers those draws, he insisted, but his clients ''thought we had betrayed them.''

Accusations of treachery, mostly aimed by poorer nations at Germany for demanding budget cuts and other painful steps in return for help, have become a regular feature of Europe's three-year-old debt crisis. But what began in Cyprus as just another episode in a now-familiar narrative of stingy, rich North Europeans versus put-upon, poor Southerners has escalated into a bigger drama tinged with Cold War-style language and strategic calculations involving not just money but also energy and even military power.

Cyprus had been haggling with Europe for months over a bailout deal to rescue its bloated banks. The initial plan to seize money from even modest bank depositors sent swarms of panicked residents to automated teller machines. But the crisis involves more than financial considerations.

''There is a geopolitical game going on behind all this,'' Mr. Marangos said.

With just 860,000 people and a gross domestic product of only €18 billion, the Republic of Cyprus makes an unlikely strategic prize. But it sits atop a web of overlapping and potentially volatile fault lines — between East and West, the European Union and Russia, and Greece and Turkey, whose troops occupy the northern part of the island. It also has natural gas in the waters off its coast toward Israel. Nobody knows for sure yet how much — that may become clearer later this year when Noble Energy, a company based in Houston, carries out a new round of exploratory drilling.

But just the possibility of significant reserves has raised hope in Brussels, and fear in Moscow that Cyprus could help break the European Union's dependence on Russian-supplied gas.

''There is a clear danger of this area becoming a platform for confrontation between East and West,'' said Harry Tzimitras, director of PRIO Cyprus Center, a research organization in Nicosia.

Cyprus has until now frozen out Russian interests from offshore gas concessions, snubbing a low bid by Novatek, a Russian company whose directors include Gennady N. Timchenko, a wealthy oil trader and judo club acquaintance of President Vladimir V. Putin. In recent talks in Moscow over a possible loan to Cyprus, Russia made clear that it expected a piece of the gas pie for its own companies, according to Cypriot officials and politicians.

In Russia's view, Cyprus, which has two British military bases, a legacy of the country's colonial past, would also be an ideal place to set up a small naval installation should the Kremlin lose access to Tartus, a Syrian port that risks being swamped by that nation's civil war.

The Moscow talks yielded no deal and dashed hopes that Russia might ride to the rescue. But many Cypriots still view Russia as a useful counterweight to bullying by Brussels. ''We are not a Trojan horse for Russia in Europe, but we are trying to protect our interests like everyone does,'' said Petros Zarounas, a diplomatic adviser to the Democratic Party, part of the governing coalition.

''There is a generation of Russian businessmen like me who have lost faith in the Russian government.''

According to a recent opinion poll by Cyprus's Sigma television, the public mood has turned decisively against Europe and toward Russia. More than two-thirds of those surveyed agreed that Cyprus should drop the euro and move closer to Russia because of the ''behavior of our European partners.'' Protesters outside Parliament have waved banners cursing the Union and Chancellor Angela Merkel of Germany.

With Cyprus's banks closed for more than a week now, fear-driven rumors of secret deals and big power politics have become the main coin of the realm.

As a team of E.U. experts set up camp in Nicosia to try to figure out how to resuscitate the bailout package announced in Brussels on March 16 and declared dead on arrival by the Cypriot Parliament, a Russian-language radio station here led its news bulletins with reports of a ''direct strike against Russia's position'' in the Mediterranean by the U.S. secretary of state, John Kerry.

The report, on Russian Wave radio, said that Mr. Kerry had telephoned the Cypriot finance minister and told him Washington was ready to help out, as long as Cyprus guaranteed a bigger role for the United States in gas concessions and raised the levy on large foreign depositors, many of them Russians, to 15 percent.

American officials said they knew of no such call by Mr. Kerry, and the radio station's news anchor, Nedezhda Braun, acknowledged that her report might not be true. No matter, she said. Russians here were desperate for information about a crisis that has hit their community hard.

There are more than 50,000 Russian speakers from across the former Soviet Union living in Cyprus, according to the Association of Russian Businessmen in Cyprus. Many live in Limassol — or ''Limassolgrad,'' as some now call it. The city has two Russian-language newspapers, dozens of shops selling Russian products and a memorial to Russia's national poet, Aleksandr Pushkin.

A host of Russian plutocrats have registered shell companies here and some have bought villas, but most fly in for short trips to consult with lawyers and bankers.

A few have even invested in real businesses. Dmitri E. Rybolovlev, a fertilizer billionaire, is one of the largest shareholders in the troubled Bank of Cyprus. One proposal said to have been under consideration in Moscow would have involved Mr. Rybolovlev's increasing his stake and other Russian investors taking over the Popular Bank of Cyprus, an institution that the Cypriot government has since decided to effectively shut down.

The majority of the Russians who live here full time are of modest means, and they resent a widespread view of Cyprus as a haven for Russian crooks and dirty rubles. This view, encouraged by a leaked report from Germany's foreign intelligence agency, underpins much of the resistance in Berlin and other European capitals to any bailout for Cyprus that does not squeeze wealthy foreigners.

''We are not criminals, arms dealers or bootleggers,'' said Sergei Ivanov, a Russian who runs a wine business in Limassol. ''There is a generation of Russian businessmen like me who have lost faith in the Russian government, in Russian banks and in Russian laws. That is why we are in Cyprus.'' He said he was now wondering whether he should go home.

Others have already decided to call it quits, including Alexei Voloboev, who owns Russian Wave radio as well as a Russian restaurant and stakes in other Cypriot businesses. He is so angry with the proposed confiscation of depositors' money and the damage this threat has done to business confidence that he now wants to sell and move to London.

''This is all a dirty game to create a banking collapse,'' fumed Yuri D. Pianykh of the Russian business association — aimed, he contends, at luring Russian money out of Cyprus to other European countries. He insisted the country had better safeguards to combat money laundering than many other European states and was the victim of a German smear campaign.

David Officer, a sociologist at the University of Nicosia, said Cyprus had indeed enacted tough legislation to fight dirty money, ''but the problem is implementation.'' He said that ''a culture of secrecy'' allows billions of dollars from abroad to slosh through the financial services and real estate industries with little supervision.

The dangers this creates are illustrated by the case of Sergei L. Magnitsky, a Moscow lawyer who was arrested after he helped expose how corrupt Russian officials had stolen $230 million in taxes paid by Hermitage Capital, an investment company formerly based in Moscow. After Mr. Magnitsky died in prison in 2009, William F. Browder, Hermitage's American-born founder, tracked $31 million of the stolen money to various bank accounts in Cyprus.

Any dirty money flowing through Cyprus, however, is dwarfed by funds generated by legitimate businesses looking for easy and legal ways to avoid taxes. There are so many Russian companies registered in Cyprus for tax reasons that the tiny country now ranks as Russia's biggest source of direct foreign investment, most of it from Russian nationals through vehicles registered in Cyprus.

While wealthier European countries object to practices that allow companies to sell their goods in one nation and book their profits in low-tax havens like Cyprus, Mr. Marangos, the lawyer, sees no reason for Cyprus to give up its financial service industry when its other best asset is sunny weather.

''We want to keep this industry,'' he said. ''Otherwise we will be selling ice cream and laying out sun beds.''

David M. Herszenhorn contributed reporting from Moscow, and Dimitris Bounias from Nicosia.

Cyprus's image as home to business is tarnished

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has continued since, the company's bank accounts — and all others on the island — have been frozen, making it nearly impossible to do business. Hundreds of other foreign-owned companies in Cyprus are in similar straits, whether new arrivals like Avid Life Media or long-timers like KPMG, PricewaterhouseCoopers and Lukoil.

As soon as Mr. Lalonde got the call, he punched the speed dial to Avid Life Media's chief executive in Toronto, Noel Biderman, to relay the news.

''We jumped into panic mode,'' Mr. Biderman recalled the other day by telephone.

Although Avid Life Media's business model has stoked controversy, and the occasional lawsuit, for Web sites like CougarLife.com and AshleyMadison.com that critics say promote promiscuity, the company has seen its European and global traffic grow rapidly. About a quarter of the sites' 18 million members are outside North America, almost 4 million of them in Europe, according to the company.

Mr. Biderman says he chose Cyprus for the same business-friendly, tax-attractive reasons that had drawn so many other foreign companies.

Now, Mr. Biderman and Mr. Lalonde are wondering whether to pull up stakes. If that happened on a large scale, Cyprus, which has evolved into one of Europe's most important financial centers in the past decade, would face a blow to the cornerstone of its economy. Other than mom-and-pop shops, most businesses in Cyprus have foreign owners.

''Most of the money here comes from foreign investors and companies like us,'' Mr. Lalonde said. But given the enormous uncertainty churned up, ''Why would anyone come here?'' he asked. ''They have put the nails in their own coffin.''

On Sunday, Mr. Anastasiades and finance ministers from the 17-member euro zone were meeting in Brussels, hoping to find a resolution to the Cypriot financial crisis.

Whatever they come up with, it may not be enough to contain the damage.

Much of what has made Cyprus so alluring to businesses has blown up in the past week. Cyprus's 10 percent corporate tax rate would rise to 12 percent under the tentative terms of the bailout. That would still be the lowest in the euro zone, still below Ireland's 12.5 percent and well under the 29.5 percent rate in Germany and 33.3 percent in France. But to be a tax haven requires a stability that Cyprus has lost.

The worst damage, however, came when policy makers opened a Pandora's box by proposing to alter a once-inviolable precept by skimming money from bank deposits to help make up the government's shortfall. On Sunday, the government continued to press for seizing a portion of savers' deposits above €100,000, even though it abandoned the previous proposal of hitting smaller deposits, too.

Avid Life Media, which began doing business in Cyprus shortly before Mr. Lalonde set up the international headquarters here, does not typically keep a lot of cash in its Cyprus accounts, although executives were attracted by the outsize interest rates, averaging around 5 percent, that banks have paid to lure customers worldwide — including an estimated $31 billion held by Russians in Cypriot banks, according to a report by Moody's Investors Service.

But Avid Life transfers a pile of euros at the beginning and the middle of each month in order to pay its affiliate partners in Europe, as well as other expenses.

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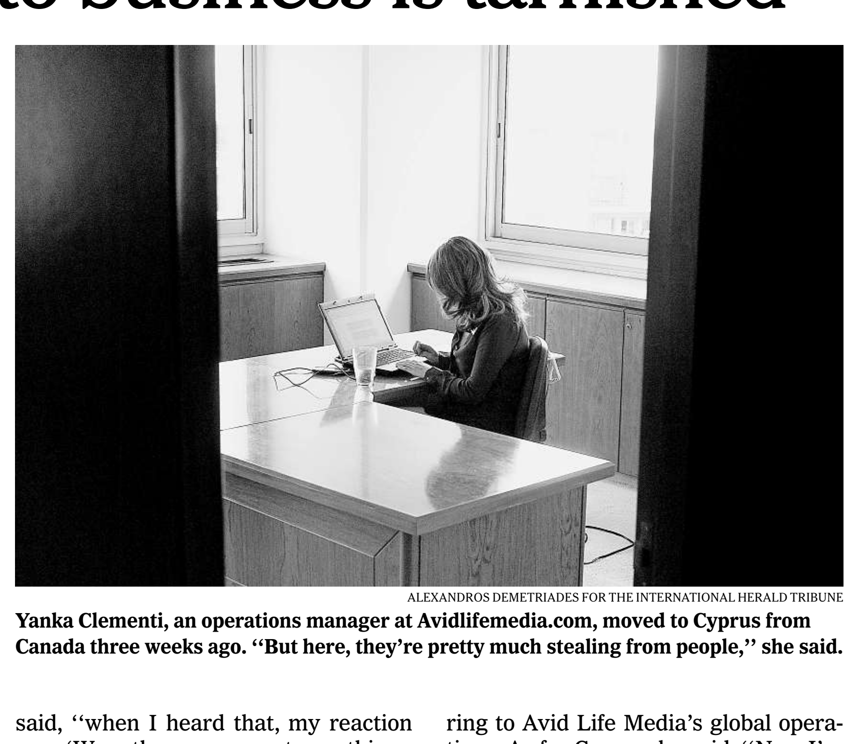

ALEXANDROS DEMETRIADES FOR THE INTERNATIONAL HERALD TRIBUNE

Yanka Clementi, an operations manager at Avidlifemedia.com, moved to Cyprus from Canada three weeks ago. ''But here, they're pretty much stealing from people,'' she said.

It was in the wee hours of March 16, shortly after about €2 million had just been sent to Avid Life's corporate account at the Cypriot branch of the Greek bank Piraeus, that Mr. Anastasiades agreed to take the unprecedented step of placing a one-time tax on private deposits in Cyprus. Although the president would later claim that Germany and Cyprus's other E.U. partners ''blackmailed'' him into the deal, European officials said the president himself chose to reach into bank accounts in a time of need.

Whatever the truth, Mr. Biderman said, ''when I heard that, my reaction was, 'Wow, the government sees this as their money, and they'll do what they please.' ''

Back in Limassol, Mr. Lalonde jumped into a car with one of his colleagues and headed straight to an automated teller machine to withdraw the €500 daily limit from their personal accounts.

''When you hear about a bailout, you think about the government and other countries helping,'' said that colleague, Yanka Clementi, 28, a manager of operations. Like Mr. Lalonde, she moved to Cyprus from Toronto only three weeks ago.

''You don't think the government's going to take your money,'' Ms. Clementi said. ''But here, they're pretty much stealing from people.''

Now, Mr. Biderman is trying to stanch the bleeding.

Having invested half a million euros to set up shop in Cyprus, he stands to lose tens or even hundreds of thousands of euros, depending on the final bailout deal. ''We weren't a party to their bubble or to any of the high interest rates yet,'' he said.

''I'm really concerned because I think I'm on the cusp of building a billion-dollar business,'' Mr. Biderman said, referring to Avid Life Media's global operations. As for Cyprus, he said, ''Now I'm just trying to figure out whether to cut my loss.''

Nor is he convinced it will be safer to bank in any other euro zone country. ''They have created a domino effect of uncertainty,'' Mr. Biderman said. ''I don't see why this wouldn't happen in Malta, Ireland, Spain,'' or anywhere else where a government decides it needs money for an emergency.

''These one-time measures can be very addictive to governments,'' he added. ''And this doesn't solve any of the euro zone's deeper problems.''

Late last week, as crowds of anxious Cypriots lined up at automated teller machines in Limassol, Mr. Lalonde swept his eyes around Avid Life Media's cavernous new wood-paneled offices. There were only two computers; he had planned to order others before the company's accounts were frozen. He gestured to a clump of empty desks meant to accommodate 12 new employees by next year.

Three new staff members, including Ms. Clementi, were just hired. Whether more will come aboard is now an open question.

When things settle, the company is likely to stay, Mr. Lalonde said.

Chinese official urges reduction in state control

BEIJING

REUTERS

A member of the top Chinese decision-making body called Sunday for sweeping economic changes, including a reduction in state control, as China's economy struggled with surplus production capacity and risks to the financial system.

Deputy Prime Minister Zhang Gaoli, a member of the Politburo Standing Committee, warned that failure to make changes would consign the economy to years of low-quality growth.

''There are increasing downward economic pressures, and the problem of excess capacity is worsening,'' Mr. Zhang said. ''Objectively speaking, there are potential risks in the financial area.''

China's economy, worth 52 trillion renminbi, or $8.4 trillion, fought its worst slowdown in 13 years last year after weak exports and interest rate increases from the year before dragged annual growth down to 7.8 percent — impressive by world standards but the grimmest for China since 1999.

The downturn, which surprised many with its length and depth, led analysts to warn that China's days of heady, double-digit economic growth were over and that broad changes were needed.

History has shown that the only way to surmount growth obstacles is to embrace sweeping changes, Mr. Zhang said.

''This is a very important job for us,'' he told a business forum, saying areas that needed change included government institutions, the household registration system and environmental protection standards.

''If not, even if our absolute economic size gets bigger, our economy, our growth standards, will still be at the mid to low end,'' he added.

Some areas often cited by analysts as in pressing need of change are freeing China's interest rate market, allowing more private investment in the economy, encouraging consumption and ''greener'' growth and enforcing the rule of law.

Mr. Zhang sought to assure foreign companies that China, which is often accused of impeding competition by subsidizing state-owned enterprises, was open for business.

''Some of our friends from abroad are very concerned about China's investment environment,'' he said. ''I can tell you fair competition is our common goal.''

The new Chinese government, which is led by President Xi Jinping and Prime Minster Li Keqiang and which formally took office this month, has vowed to start such changes. But resistance to change by interest groups means any shift is likely to be gradual, analysts say.

Mr. Zhang said, ''Where control is required, the government must exert control and control it straight and well. Where control is not needed, then the government should not control and intervene.''

Euro crisis worries China

China's new finance minister said Sunday that it was unclear whether the euro zone would solve its debt problems over the next decade and suggested that further turmoil would complicate efforts to reduce the Chinese budget deficit, Reuters reported from Beijing.

Lou Jiwei said external difficulties might oblige China to run deficits for longer than anticipated as government expenditure was rising quickly and revenue was growing only at a single-digit pace.

''I am really very worried about Europe. I am worried about whether it can get out of trouble in the next 10 years,'' Mr. Lou said in an address to an economic forum.

''When the external environment improves, we hope we can get back to fiscal balance after conducting reforms for several years,'' he added.

Mr. Lou, who was previously the chief executive of China Investment Corp., the country's $482 billion sovereign wealth fund, took office last month.

China has budgeted a deficit of about 2 percent of gross domestic product for 2013, up from 1.6 percent of G.D.P. in 2012. To counter a domestic downturn last year that was the worst in 13 years, China accelerated infrastructure spending and cut taxes for some small and medium-sized companies.