Learnings From the Cyprus Saga

March 29, 2013

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> - **Japan: A strong start to "Abenomics," but will it work?**
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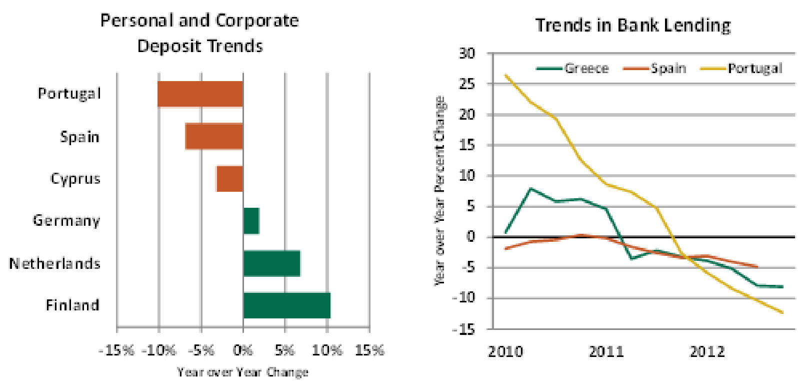
I have never been to Cyprus. The closest I've come to the country is one degree of separation: a friendship with a fellow soccer dad who grew up there. We've often talked about the island's economic travails, our conversation occasionally lubricated by Commandaria (a delicious Cypriot after-dinner drink). As the financial crisis deepened, it took more and more Commandaria for us to reach a solution. The price of success was a terrific hangover.

Unfortunately, what was true on a small scale for the discussions Mike and I shared may be true on a larger scale for Cyprus. The Commandaria at this level is funding, which was secured in an 11th-hour deal on March 25. But the hangover may just now be setting in all over Europe and could cause a migraine for world markets.

I'm sure many were hoping that the arrangement among the European Union (EU), the International Monetary Fund (IMF) and the European Central Bank (ECB) would resolve the situation in Cyprus conclusively, send the right messages to the rest of Europe, and get the whole affair out of the headlines (and out of our commentary). But it is unclear that it will succeed in doing any of those things.

Banks in Cyprus reopened on Thursday, but strict limits on money movement recognize that the risk of deposit flight remains significant. Even under the best case, the poor solvency of financial institutions in Cyprus will lead to a deepening credit contraction that will harm the economy.



Source: ECB, Bloomberg, Haver Analytics

The financial sector in Cyprus had been a significant source of its recent growth. In resolving Cyprus' problems, the EU made it clear it wanted this sector cut down to size. This will mean significant job losses, and lending is likely to decline much more steeply than it has in other troubled European countries. One wonders whether the severe economic damage that lies ahead for Cyprus was properly accounted for when the size of its aid package was calculated.

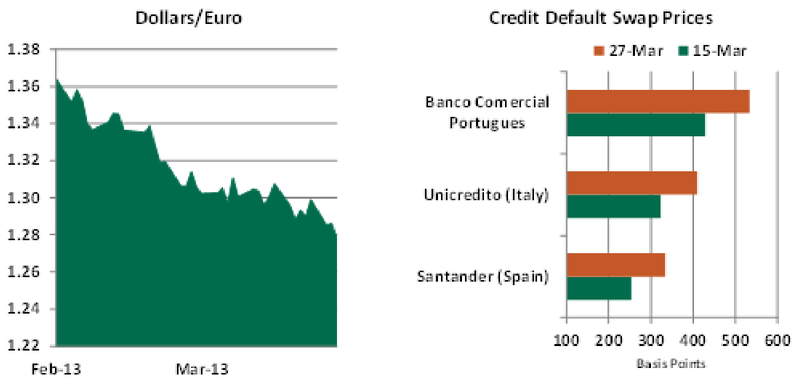
Ideally, European policy makers would send a message that the crisis will be confined to Cyprus, and invest time trying to restore financial stability. Instead, they have chosen this moment to warn bank depositors and debt holders across the continent that their money may not be safe.

I am a big believer in market discipline, and so are many bank regulators. When investors feel that their money is at risk, it sharpens their attention to an institution's solvency. In theory, banks that are riskier will have to pay a premium for funding and capital, which might place a natural limit on their ability to grow and create systemic problems. In default, professional investors should be aware that they could lose principal or become involved in a "bail in."

When a mismanaged bank fails, taxpayers understandably resent paying for the institution's mistakes. Equity holders, debt holders and uninsured depositors of the bank are expected to be the first line of defense.

However, the enforcement of this principle can ultimately be costly for taxpayers through the impact of the failure on the economy. These collateral costs can be severe if financial contagion ensues. In Europe's case, the fact that taxpayer support and deposit concessions can come from different countries brings a political element to the table. Policy-makers should, therefore, have undertaken a broad cost/benefit analysis before proceeding with resolution.

And the announcement of that resolution must be handled very carefully so that market psychology can stabilize. Shortly after support for Cyprus was arranged, a spokesperson for EU finance ministers suggested that the actions taken in Cyprus could be a template for resolving banks in other countries. This is a candid, and not altogether unreasonable message, but it might have better been kept a more private thought with investors on tenterhooks. Such comments have kept downward pressure on the euro, and upward pressure on the default probabilities of leading banks in Europe's periphery.



Source: Bloomberg

Careful communication can be a key to containing crisis. On this front, the observation about bank resolution is the second major misstep in the past fortnight, the first being the abortive attempt to tax small depositors in Cyprus.

Some have suggested that recent events in Cyprus are Europe's "Lehman moment." Given the aftermath of Lehman's failure, let's hope not. Lehman taught us that whatever its merits, striking out against moral hazard amid a gathering financial crisis isn't the best idea. Doing so risks extending the cost, duration and scope of the difficulty.

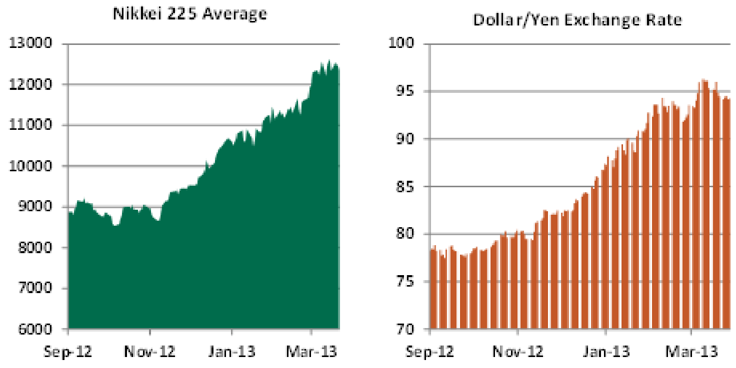
There are important differences between the situation in Cyprus and the challenges other southern European nations face that should limit the transfer of financial trauma. The hope remains that the ECB's promise to do whatever it takes to solve the sovereign debt crisis will ultimately settle markets. But access to certain types of ECB support requires reaching agreement on restructuring with the same European officials who have handled the situation in Cyprus so maladroitly.

Better to calm things down first and mete out discipline later. If Europe fails to appreciate this lesson, no amount of Commandaria will save them.

Japan's Promise

What a difference three months can make. In the short time since Shinzo Abe and his Liberal Democratic Party returned to power, Japan's outlook has changed from that of a moribund economy with officials unable to grasp the enormity of their situation to one where the government is willing to tap into the vaunted bushido spirit and fight to reverse the economy's decline.

Tokyo's plan to revive the economy's fortunes lies in what is being called "Abenomics" – a combination of fiscal, monetary and structural reforms geared toward putting the country on a steady growth path. Thus far, markets have responded by pushing the Nikkei 225 30% higher and weakening the yen by nearly 15% since December.



Source: Bloomberg

The obvious question: can this path be sustained? Pressuring the Bank of Japan (BOJ) to adopt an inflationary target was arguably the low-hanging fruit of Abenomics; following through with fiscal and structural reforms will be the real test.

Do Abe and the LDP have the political will to upset vested interests and put Japan on firm footing? We think so. Some periodic policy backsliding is to be expected, but the momentum created by the reforms announced thus far and the growing domestic realization that Japan is declining will likely suffice to keep reform on track.

As mentioned in previous commentaries, the big prize in the December elections was the right to nominate the successor for outgoing BOJ Governor Maasaki Shirakawa and two deputy governors. The appointments presented the opportunity to break with monetary policy, which was seen as too feeble to deal with the tasks at hand. Ironically, Japan pioneered the quantitative easing model employed by central banks worldwide, but its implementation efforts have fallen behind peers in scope and aggressiveness.

The first practitioners of quantitative easing have used it least effectively.

Shirakawa's stance was that real effort needed to take place on the fiscal side in order for the bank to act more aggressively to defeat deflation. The concern was based, in part, on the impact that reflation might have on the cost of servicing Japan's government debt, which stands at a frightening level of gross domestic product (GDP).

However, new Governor Hiroki Kuroda's stance aligns more with Abe's position that monetary policy should lead the way in achieving a 2% inflation goal in two years. As such, we can expect an expansion of Japanese Government Bond (JGB) purchases.

Source: Bloomberg

The government is in no immediate risk of a financing crisis, since more than 95% of JGBs are locally held. However, borrowing costs could increase sharply should a rise in inflation fail to be accompanied by an expansion in GDP. At present, the markets seem optimistic about the outcome, with current JGB 10-year yields considerably lower than they were last fall.

Stimulating growth will require incentives and pressure from the government to encourage profitable businesses to increase wages. On the fiscal front, the LDP has opted to offer corporate tax deductions of up to 10% of wage increases to firms that raise their average salaries. The new administration also intends to cut corporate taxes to below 30% from the current 38%. At the very least, these efforts show that the LDP is aware that the BOJ can only do so much and that any attempt to defeat deflation requires collaboration among the BOJ, government and corporations.

The last, and most difficult, pillar to implement will be structural reforms. Japan's economy has stalled in small measure due to its inability to grasp and creatively meet its structural issues. On one front – its notoriously closed economy – the government has shown signs of a shift by announcing plans to join negotiations of the Trans-Pacific Partnership and a free trade agreement with the EU. This could signify that the government is ready to move on opening up its agricultural and automobile markets, a key gripe among its trading partners.

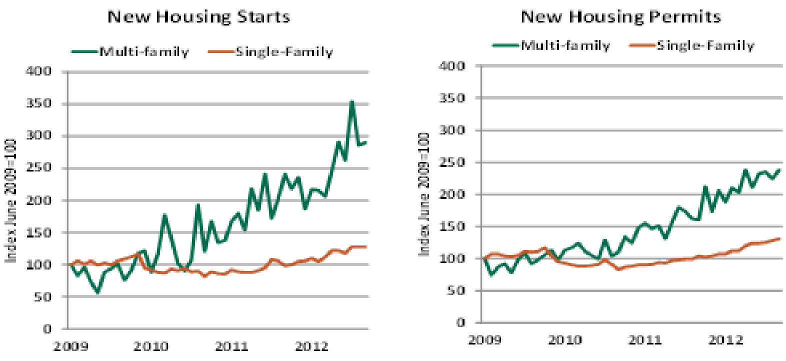
Japan has a plethora of issues to overcome, and change will not come overnight. But at least an attitude more conducive to confronting the problems at hand has emerged.

New Housing Market – Price Points Count

Reports on new home construction and new home sales send an unequivocal message that activity is picking up. Two questions come to mind when one considers recent readings: what type of homes are being built, and what is the impact of increased building on prices of homebuilding materials? Answers to these questions are useful to assess the nature of the turnaround in the housing sector.

Construction has continued riding on the momentum established last year.

Total housing starts rose 25% from a year ago in February. The number is impressive because the strong momentum seen in 2012, when starts advanced 28%, is being maintained. Of the two categories of housing starts, construction of multi-family units has taken the lead by posting larger gains compared with single-family starts.



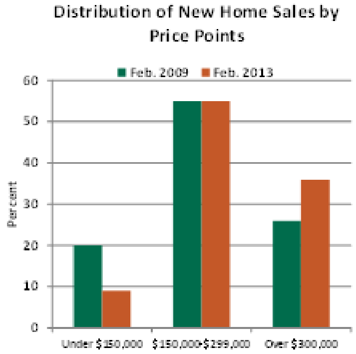
Source: Census Bureau/Haver Analytics

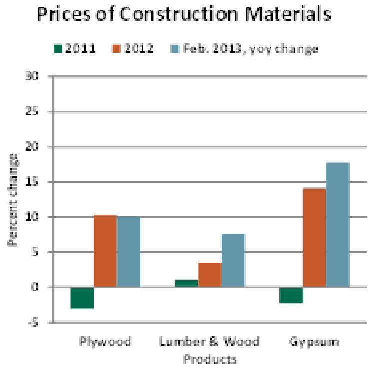
In the single-family sector, a large part of the increase in home building has occurred since early 2012, although the economic recovery commenced in June 2009. By contrast, activity in the multi-family sector commenced almost at the same time as the economic recovery and has remained consistent. Owing to tight mortgage standards, demand for rental housing from newly formed households and those facing foreclosures shot up and spurred construction of multi-family homes.

Permit extensions, the harbinger of future home building, stand at their highest level in nearly five years. Permits issued for multi-family units continue to surpass those issued for single-family units. Overall, the upward trend of housing authorizations supports expectations of continued growth in new home building activity.

Sales of new homes rose 50% over the past two years after hitting a historical low in February 2011. Some have wondered how this is possible, given very tight credit conditions and the large fraction of current homeowners who are still underwater. The distribution of home sales based on property values provides an answer.

As shown in the chart below, sales of higher-end homes have outperformed sales of middle- and low-end homes in the current recovery. It seems clear that those who still have home equity – and who have profited most from the recovery in the equity markets – are leading the way.





Source: BLS/Census Bureau/Haver Analytics

Increased home building activity has ramifications in other related markets in the economy. To this point, higher prices of lumber, plywood and gypsum suggest that contractors will need to watch their margins as home building activity gathers additional momentum. Manufacturers took a lot of capacity out of production during the housing bust, and it may be some time before it comes back on line.

As employment conditions make strong strides and credit availability improves, it should not be long before construction and sales of new homes are more evenly balanced across price points. The favorable mortgage rate environment and the Fed's resolve to improve labor market conditions should eventually broaden demand for new units and give builders reason to construct them. But for now, the high end seems to be where most of the action is.

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