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Why Could Cyprus Matter?

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"Risk is not knowing what you're doing."

Warren Buffett

Is Cyprus a Non-event?

Markets have hardly budged since the latest panic in Europe. As the crisis in Cyprus has unfolded the US and European equity markets have largely shrugged it off as the latest in a recurring sequence of non-events. But Cyprus could matter more than we think.

First, it's very important to understand why Cyprus matters at all. It's a rather insignificant economy on its own, but the precedent this nation sets could end up being quite important. I don't want to overdramatize this situation, but let's work through a few potential options in Cyprus and how why this small nation matters.

It's crucial to understand why Cyprus is in the position it's in. Cyprus is really just a symptom of the Euro currency as a whole. In other words, the currency system itself is unworkable and these flare-ups on the periphery are merely symptoms of problems within the actual construction of the monetary system itself.

The best way to think about the Euro is to compare it to the United States. In the USA we have a group of states who are all users of a currency without a floating exchange rate. There's an inherent problem within a system like this in that it causes trade imbalances. The same thing occurs within Europe. In a normal monetary arrangement a nation with a structural trade deficit will be able to defend its economy in a number of ways; 1) It can deficit spend thereby increasing

increasing domestic demand to offset the income loss via trade. 2) It can implement monetary policy to target the exchange rate and boost trade. 3) Or it can simply allow the market to works its magic by adjusting to the natural exchange rate arbitrage that develops when a nation has a competitive advantage and pricing inefficiencies develop.

States in the USA can do none of the above. Neither can the nations in Europe. So they rely on an alternative option. In the USA that option is a federal government who takes in tax receipts from all of the participants and pays out more than it takes to the participants who most need it. In Europe, there is no such federal entity to help offset the imbalances. So, what develops is a solvency problem as the nations spend up to the politically palatable limit and then get cut off. This reduces domestic demand AND the lack of rebalancing trade results in continued income loss via foreign trade. This leads to what we're seeing in Greece with a solvency crisis. The lack of a federal printing press or a floating exchange rate leads to solvency crisis. If Greece were able to tap a federal government it could offset a huge portion of its debt burden across the entirety of Europe and it would improve substantially from an economic perspective. This same exact thing occurs within the states in the USA where trade imbalances occur but the brunt of the financial burden is carried by a federal entity that all states contribute to.

The problem in Europe is that there remains a lack of political unity. So, we have a monetary union with a single currency, but we don't have the political unity to complete the monetary union through the formation of a federal entity (something like Eurobonds and a central Treasury would suffice). So the trade imbalances lead to one result—deflationary depressions on the periphery. Deflation is a devastatingly slow and destructive way to deal with trade imbalances. And there's no guarantee that it will actually rectify the problems because the debt:GDP levels are likely to remain above politically palatable levels. This creates a huge downside risk.

That risk is a nation leaving the Euro as they realize that deflation isn't the ideal way to go forward and that core Europe isn't going to approve any form of a federal entity. The risk then becomes a potential banking crisis and currency crisis. If Cyprus were to leave the Euro it could result in a domino effect. Cyprus will bring back the Cypriot Pound, their trade will rebalance as the Pound collapses versus the Euro and the economy will start to rebound in a similar fashion to Iceland as they become more competitive. The risk is that Greece, Portugal, Spain and Italy all mimic the move and we see a series of defaults and defections from the Europe.

While this would be good for the peripheral nations in the long-term it would be devastating for the core countries as the trade surplus nations will take on the brunt of the negative trade rebalancing. This means Germany and many of the other larger economies on the core will be hit hard by the defections. It could also lead to substantial banking problems as the Euro denominated debts are essentially defaulted on. This could reverberate through the entire global economy.

This scenario of defaults and defections is an absolute worst case scenario and could result in a disorderly unwinding of the Euro. I wouldn't place the odds of this as being very high, but I do think it's important to understand the potential worst case scenario in case Cyprus decides to make a bold move away from the Euro. My guess is Germany will do everything in its power to piece this all together and keep the union as is. But we must remain cognizant of the downside risk should such events transpire.

For now, it looks like all's fine, but these are fast moving events that could deteriorate quickly. Of course, I'll keep you informed of events and my opinion of the macro risks going forward.

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