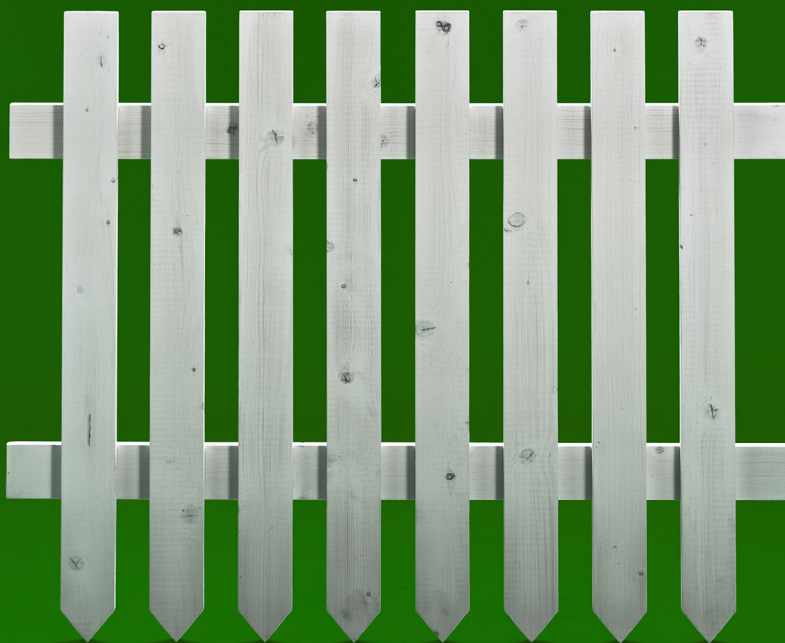




konzept



An inverted look at global housing

October 2015

06

Cover story
An inverted look at global housing

From bubbles in England and Japan to renting in America in Germany – this issue travels across four countries to explore today's upside-down world of real estate.

Editorial

Can lightning strike twice in the same place? Less than a decade after a housing market crash caused the biggest financial crisis in generations, global property

prices are booming once again. However, beyond the chatter about how impossibly expensive the likes of London and New York have become, the topic draws far less attention than it merits from policymakers and investors alike. That is unwise. Both economic theory and empirical evidence tell us that property prices are exactly where we should look for exuberance. Hence our four feature stories in this issue of *Konzept* focus on property.

The subject poses a dilemma for central bankers as they face tough decisions in the coming months. As the Federal Reserve considers whether to start withdrawing its extraordinary monetary stimulus after seven years, policymakers in Europe and Japan will contemplate further easing. The enormity of these choices should not be underestimated. It seems many years of living with what is essentially a great monetary policy experiment has dulled the urgency of pondering its risks. Whereas the introduction of quantitative easing sparked a robust debate at the time, subsequent calls for trillion dollar expansions of central bank balance sheets or one more year of zero interest rates assume the benign nature of their consequences.

That is far from certain. Recent data suggests the transmission channel between interest rates and property prices remains alive and well. A broad array of economies both developed; including the US, Germany, Britain and Australia, as well as emerging markets such as Brazil, South Africa, Indonesia and Turkey have seen property prices rise by over 20 per cent in the past three years. While in most places these increases have stretched valuation metrics, the US housing market remains an exception so far. Despite the recent run-up, American home prices are fairly valued relative to incomes and rents. But even in the US, pockets of potentially lofty valuations are surfacing. Commercial real estate prices are now 13 per cent above the pre-crisis peak, while the price of farmland has nearly doubled in real terms over the past decade.

To be sure, asset price inflation is one of the channels through which unconventional monetary policy was supposed to stimulate growth. But there is mounting evidence that this key transmission to the real economy may be waning, especially as widespread easing reduces the boost from currency depreciation.

Meanwhile, promoting financial stability, while an official mandate of some central banks, is far more difficult to achieve. Yet, the economic damage caused by bursting asset bubbles over the past several decades should lead us to question whether policymakers are giving undue weight to near-term growth and inflation.

So what should be done? Most central banks reckon the first line of defence against asset bubbles should be macroprudential instruments. Monetary policy is too blunt a tool, the logic goes. Raising rates can effectively curb bubbles but only by severely restraining growth. So while some Fed officials now agree that policy was too loose during the mid-2000s and contributed to the run-up in home prices, research has also shown that deflating prices using higher interest rates would have reduced real per capita output by a whopping 12 per cent. Recent attempts to preemptively tighten monetary policy to address budding financial stability concerns have been similarly discouraging. A slowing economy forced the Riksbank in Sweden to reverse course and cut rates shortly after raising them in 2010 to counter high household debt and rising house prices.

Central banks have an unenviable task of calibrating monetary policy in this environment. History has taught us it is often too late to deal with excessive valuations once they are upon us. Therefore, bubbles must be identified early and the policy response swift. However, the current rhetoric suggests a preemptive response is unlikely. The upshot is better near-term growth at the expense of increased financial stability risks in future years. Investors should take note.

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➤ To send feedback, or to contact any of the authors, please get in touch via your usual Deutsche Bank representative, or write to the team at research.haus@db.com.

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Immigration—a chance to secure Germany's future

Germany will probably receive more migrants than any other country in the world this year. This is a seminal moment in the nation's history, arguably on par in its significance with reunification a quarter of a century earlier.

It is understandable for such an upheaval to generate anxiety. Immigration on a massive scale, at least at the outset, is always painful for the recipient society. This is even more pertinent for countries such as Germany with a stable socio-economic environment and a strong ordnungs-drang, a desire for order. Immigration undermines the old order, forcing people to change their way of life and dragging them out of their comfort zones.

Much like free trade, immigration also produces winners and losers. In both cases the greater share of benefits tends to accrue to capital, as new workers introduce fresh competition into the labour market. Public services such as social welfare and education come under strain as immigrants start to consume these without immediately making a corresponding contribution to the fiscal and social security system. To complicate matters further, immigration tends to take place in waves rather than in orderly and steady streams.

Undoubtedly, integrating this current wave of migrants will require enormous effort and cost on Germany's part. However it also presents a political and economic opportunity, far outweighing the associated short-term inconvenience, fiscal costs and political risks. Immigration has the potential to transform as well as safeguard Germany's economic future for generations to come. In fact, mass immigration alone has the power to secure her place at the top table of nations in the future. Hence, the initial cost of accommodating immigrants should be viewed as an essential investment towards a more prosperous future.

There is much evidence to inspire optimism. The simple fact is that countries with large immigrant populations do better. Their societies are more vibrant, socially flexible, innovative, adaptive and accepting of change. Their economies, in turn, benefit from a higher degree of social and economic mobility that boosts the underlying rate of productivity and output growth. This should not be surprising since immigrants represent positive selection: they dare the hazards, want something better, crave freedom, and do not yet feel entitled.

These are precisely the reasons Germany should be welcoming immigrants today. Faced with adverse demographic trends, the country needs new people now more than ever. In their absence, the likely future entails fewer workers and a shrinking economy. As political power and influence shifts to the elderly in an ageing society, Germany risks becoming a conservative, risk-averse and inward-looking country where painting over the cracks is prioritised over building something new. A country where spending on health care, for instance, is prioritised over education.

An ageing Germany also risks being left behind in the global economic race. Wealth creation in today's economy is increasingly reliant on young industries like technology, industries that are created by the young, with their products consumed by the young. The combined market value of the world's three largest technology companies is more than all thirty companies in the DAX put together.

It must be said that even without immigrants, Germany can remain comfortably well-off in the near future. The famed Mittelstand engineering firms will continue to supply a growing global middle class with quality consumer and capital goods. This lack of urgency skews the politics in favour of the status quo and against disruptive immigration. However, without significant net migration over the next decade, Germany's population will decline by 3.5m and its labour force will shrink by an even greater 4.5m workers.



This fall in the number of workers alone will push down the economy's trend growth rate from the current 1.5 per cent to about half a per cent. The true consequences are likely to be even worse as an ageing population struggles to maintain its innovative capacity and productivity growth. Hence, growth will likely fall well short of half a per cent – indeed, by 2030 economic stagnation remains a distinct possibility.

However, maintaining Germany's current social welfare system with an ageing population requires economic growth rates significantly above two per cent. Without boosting growth, the welfare system, in particular pay-as-you-go pensions, will be forced to reduce benefits.

Even maintaining the current rate of growth requires doubling the share of immigrants to one-fifth of the population. As this stretches the country's Willkommenskultur, or its hitherto open arms welcome, to the limit, policymakers should bear in mind the historical precedent of America's rise over a century ago. While the mass migration of Irish farmers to America in the mid-18th century also faced resistance, the longer-term economic benefits to the country were immense. From 1830 to 1910 when immigration from Europe accounted for a third of US population growth, the US economy grew three times bigger than it would have without this wave of immigrants.

Indeed, Germans should also draw comfort from their own impressive track record in immigration. Despite the destruction of the second world war, almost a fifth of the Federal Republic's population in 1950 were refugees and

expellees. Over the following half century 80 per cent of West Germany's population growth was due to net migration. Since the beginning of the 1970s, Germany has grown only because of immigration as the domestic population has been in decline. The country welcomed three million 'Spätaussiedler' after the fall of the iron curtain and more recently workers from eastern Europe. Germany's history in absorbing immigrants is testimony to its strong institutional infrastructure, rule-of-law culture and a meritocratic approach.

Now that Germany has once again demonstrated its positive attitude towards migrants, large numbers from all over the world will likely continue coming here in the years ahead. After surpassing the inevitable initial challenges, immigration will reinforce Germany's predominant economic role within Europe. This will undoubtedly produce foreign policy challenges, but Germany can continue to exert a strong positive impact on the eurozone. Berlin can lead by example, inducing other countries to improve their competitiveness to make their social welfare systems sustainable.

The current immigration crisis has handed Germany an opportunity to strengthen its reputation as a global economic powerhouse and to regain its scientific and artistic pre-eminence. By utilising the full potential of this opportunity, Chancellor Merkel can secure her place in history as one of the great leaders who have transformed Germany far beyond their own generation. ●

Fedcoin—how banks can survive blockchains



Would you extend an unsecured loan to a firm with 20 times leverage that pays no interest and charges an administration fee for the privilege? No? Well, if you are anything like the average Briton, for example, you have happily deposited £3,000 with your bank on those conditions.

Why would anyone do that? For one, it is hard to go about life in developed countries legally without a current account. Officially, 97 per cent of British households have at least one current account and the rest are probably a statistical error. Those accounts function as safe stores of liquidity for savers, guaranteed by the Bank of England. But if that is the simple answer surely it would be easier for everyone to have a current account with their central bank.

The reason the Bank of England does not accept deposits is that administering 80m personal current accounts, settling 100m daily direct debit payments and maintaining 70,000 cash machines is cumbersome. Far easier to leave that to commercial banks and provide them with a central clearing and settlement platform. Banks are happy to step in, and not just to charge fees for deposits and payments.

Their main incentive is creating electronic money in vast multiples of the central bank base money. Therefore, in the UK so-called M4 money exceeds that issued by the Bank of England by 30 times. As economics students learn early on, the resulting excess of deposits over reserves is the essence of fractional reserve banking. The combination of deposit-taking and credit-creation functions means even a simple bank, therefore, is operating two fundamentally different businesses. While those functions are interlinked today, it is what James Tobin termed, “essentially an accident of history.”

Yet that accident ensures banks have long enjoyed great liberties in determining the broad money supply. Even today, central banks can expand reserves by purchasing financial assets through quantitative easing, but unless commercial banks create assets by making new loans the broad money supply does not expand even as the monetary base grows.

As a result, this arrangement is being questioned in the post-crisis world. Central banks have despaired with deleveraging banks’ struggle to meet what little credit demand there has been. Yet central banks’ hands are tied by the “accident of history” described above. They cannot, for instance, raise broad money supply at will by crediting the reserve accounts of those who would immediately contribute to aggregate demand, a potentially useful tool against high unemployment and low inflation.

Enter digital blockchain technology, which has the potential to remedy many of the limitations of the present system. Blockchains promise payment systems that no longer rely on a handful of agents keeping track of who owes what and who owes whom. Before the blockchain, payment systems were regulated by trusted third parties, like a bank, that time-stamped transactions. By contrast, digital currencies such as Bitcoin are based on decentralised ‘ledgers’ that record transactions in a particular order without the use of any trusted third party. The ledger is constructed and jointly administered by all members of the network. The legitimacy of the transaction is

verified by network members devoting their computer processing power to check that the currency unit in question can be traced from the sender's account all the way down its chain to the first creation of the unit.

This makes it possible for central banks to issue digital money without relying on commercial banks within a fractional reserve banking system. By maintaining accounts directly with the public, central banks can effectively separate the deposit-taking function from the credit-creation function currently embedded in commercial banks. In doing so they may, by other means, achieve what the 'Chicago Plan' for full reserve banking attempted in 1934.

Ironically, this will be anathema to Bitcoin users, the biggest proponents of blockchain technology, who envision it as an alternative to state-sponsored money. However, that radical monetary philosophy has unnecessarily marred the implementation of a revolutionary technology. For without the backing of the state, Bitcoin remains unanchored. Since citizens ultimately need to pay taxes in their home currency, receiving salaries in Bitcoin is a huge risk given the Bitcoin exchange rates fluctuate wildly.

For digital money to hold its value, central banks need to guarantee convertibility. This is the idea behind the so-called Fedcoin¹ where a central bank issues and controls the blockchain and renders Fedcoin legal tender at parity with, say, conventional dollars. If the Fedcoin's value drops below the dollar, arbitrageurs would swap it for dollars at the discount window, whereupon digital units would be deleted from the ledger until parity was effectively restored. The central bank is uniquely capable of doing this; any other private actor would be vulnerable to a run if they offered convertibility between conventional dollars and a digital currency.

For consumers, holding and exchanging money via Fedcoin would incur lower transaction costs than, say, through bank accounts or credit cards. Equally important, the value of Fedcoin would be even more explicitly guaranteed by the central bank than commercial bank deposits. Soon enough, digital cash underwritten by the central bank would replace electronic money generated by the banking system.

Meanwhile, for policymakers, such a payment mechanism eliminates the potential systemic risk posed by commercial bank failures. Moving from a daily clearing and settlement system to one in which each transaction is settled immediately reduces counterparty risk. Broad money supply could then be controlled absolutely without technical impediments. And digital cash would finally make the zero lower

bound on policy rates redundant for inflation-targeting central banks as the blockchain's underlying algorithm could be adjusted to reduce the value of Fedcoin over time.

If the Fedcoin took off, it would appear to be the death knell for credit card providers and deposit-taking institutions. Banks would have two options to avoid economic obsolescence. The first would be to transition toward a pure investment banking strategy, financed entirely via equity and long-term debt raised from savers aware of the risk they were taking. Indeed, this is the model favoured by neo-classical economists harking back to the ideas of Irving Fisher.

A second option would be to attract Fedcoin deposits by providing services such as verification for know-your-customer and anti-money-laundering rules or secure digital wallets or even just the most user-friendly apps. Banks could compete for Fedcoin deposits by issuing their own blockchains, at par with Fedcoin. Deutsche Bank, for example, could issue dbCoin, which customers use to settle transactions with any counterparty, much like a digital chequebook. Banks would guarantee convertibility of their digital currencies into Fedcoin, and central banks offer clearing and settlement facilities.

This brings us full circle back to today's system, but with a couple of important exceptions. For starters, the difference between the monetary base and bank-created, branded money would be considerably clearer. More important, perhaps, the technological obsolescence of deposit-taking institutions engenders greater economic competitiveness. The banking sector would no longer be rewarded for processing payments or managing current accounts. It would have to compete for deposits by offering better services and ultimately greater responsibility for the money it creates.

Fedcoin remains a thought experiment. The humbling conclusion for banks is that neither customers nor central banks necessarily have to depend on their oldest services much longer. Although hard to imagine in the current low-interest rate environment, technological change may structurally raise banks' funding costs. If banks are to compete with the emerging fintech and shadow-banking industries for household savings, they will need to offer far more than in the past. ●

1 The idea of a government cryptocurrency has been discussed by others including David Andolfatto, a researcher at the Federal Reserve of St Louis.

Online video—the revolution will still be televised

The rise of online video has demonstrated Dornbusch's law on financial crises perfectly: it took longer than many expected but happened faster than anybody thought it could. From being an irrelevance to the European market, online video use has accelerated in the last twelve months. In Britain and France the average person now spends nearly 20 minutes a day watching online video, a tenth of the time spent on traditional television. That has pressured ad spending. In fact, last year was the first time European cable television networks saw a drop in these revenues. Meanwhile, video is driving data growth on fixed and mobile networks. Video makes up 60 per cent and rising of peak US traffic on fixed networks.

The rise of online video was always supposed to shake things up. The industry had long reasoned that consumers would 'cord cut' traditional television bundles and embrace so-called 'over the top' services. In this brave new world, traditional linear television, with its fixed programming schedules, would become an anachronism. Major franchises such as live sporting events and hit shows would be the big winners as they became more accessible; filler content would lose value with viewers no longer restricted by a television schedule. Pay-television bundles charging for hundreds of channels would see massive cord cutting as consumers moved to à la carte consumption.

Another overriding assumption was that barriers to entry in video provision would collapse. Data compression would ensure broadcast-quality video was no longer the preserve of license-based terrestrial networks and mobile usage would trump all. Content owners, therefore, would go straight to the consumer, offsetting the added costs of customer service by pocketing the revenues that



used to go to platform providers. The biggest losers would be the industry's gatekeepers, be they satellite operators, free-to-air channels, or pay-TV platforms. Most figured they would have little value once rights owners could go directly to consumers.

It has not turned out that way. Viewers have not abandoned linear television. Over 90 per cent of viewing outside the US and the UK still involves fixed schedules. Oddly, the shift to downloading and streaming has been slower in film than in music or even print. (In the UK, two-thirds of video spending is still on physical media, with a staggering £85 per person per year spent on DVDs. The Blockbuster rental chain may have died, but supermarkets, not streaming, have taken over.) People seem unwilling to give up passive watching in favour of proactively picking their own schedules. And while consumers do demand mobility, it is in addition to existing services not in lieu of them. Indeed, the revealed preference for consumers so far has been to want 'all of the above' through quad-play bundles (mobile, fixed telecommunications, broadband and pay-tv). As a result, the major content rights holders have largely stuck with the established pay-TV operators and ad-funded channels.

The big platforms have held their own for a whole host of reasons, most notably the challenge of monetising content via online channels. Essentially, content can be monetised either through ad-funded or subscription/

Laurie Davison

pay-based platforms. In both models, online video pales in comparison with television on viewing numbers. For ad-funded platforms, the largest viewing event on YouTube, the Red Bull Stratos Skydive had eight million concurrent viewers versus the 111m tuned into Fox for the Superbowl. Meanwhile, among subscription-based online video services, Netflix's success with 46m subscribers remains an anomaly. In Europe, Free and Neuf, the largest internet protocol television providers (delivering content over a local area network or internet) are still under half the size of the major satellite operators Canal, Sky or Kabel Deutschland. In America, AT&T U-Verse's six million subscribers are dwarfed by the 22m at Comcast and DirecTV. Moreover, traditional platforms can still charge substantially more than even successful providers like Netflix (\$78 per month for Comcast or \$102 for DirecTV versus \$9 for Netflix).

Why don't content holders skip the platforms and go it alone? The one example of a major rights holder going directly to consumers has not been a roaring success. World Wrestling Entertainment launched an over-the-top subscription service in 2013 and withdrew rights to traditional pay-TV providers for pay-per-view. However, consumer uptake for the WWE network at 700,000 was well short of the targeted one million subscribers by the end of 2014. Operating income before depreciation and amortisation plummeted and the company has made efforts to return as a premium cable service in Canada.

Apart from monetisation, reliability and scalability also remain issues for content providers looking to move online. High-profile streaming collapses this year include HBOGo's season finales of True Detective and Game of Thrones; or Sky's NowTV service failure during the final day of the Premier League season which prompted refunds. Scalability is another barrier. Netflix and YouTube can serve events with eight million concurrent viewers because their scale ensures preferential treatment from internet service providers, which smaller content providers do not enjoy. That may not last forever. Net neutrality proposals would end their ability to buy 'special lanes', encouraging further fragmentation of the online video market.

Another barrier to content holders going online is the difficulty of customer relationship management. Most content producers want to manage creativity, not customer contact centres, credit checking, billing and CRM systems. The complexity of effective subscriber management should not be underestimated. At Sky, for instance, it costs around £700m, or a quarter of non-programming operating expenses.

Piracy too remains a major concern. HBO's Game of Thrones finale in June set the dubious record of having an all-time high level of pirated views. Piracy monitoring site Torrentfreak reported 1.5m downloads from Torrent sites within 12 hours of screening. Linear television viewing for the same episode was 7m. This is not an isolated incident; BitTorrent remains a greater generator of downstream internet traffic than Netflix or iTunes in both the US and Europe. In such a larcenous world, closed satellite and cable systems still hold a strong appeal for content providers.

As a result, any online service provider seeking to challenge the incumbents would need to offer internet-connected set-top boxes for on-demand services, wi-fi preloading to tablets and smartphones, in-home satellite cable delivery, out-of-home mobile network access, and expensive sports content. This is not an online free-for-all, but a business with rising barriers to entry.

To the extent that platforms must adapt, European pay television operators are in better shape than their US peers. Netflix, for instance, has made big inroads into the US because it competes against expensive packages, which often cost 80 per cent more than equivalent UK packages. Moreover, pay television has largely been sold in big bundles in the US, making the operators more vulnerable to 'skinny' packages, whereas less than half of Sky's UK subscribers buy big bundles.

Investors remain concerned about the detrimental impact of online video on the prospects for pay television. In Europe, the de-rating of Sky, continued questions on cord-cutting, and worries about the impact of Netflix underscores significant market fear. However, across many regions there is little evidence of cannibalisation, cord-cutting or even cord-shaving. In the US, for instance, subscription growth has slowed, but average revenue per user growth has remained strong at over four per cent. That makes pay television that rare thing, a media area that is likely to continue to grow despite the online disruption. ●

European bank mergers—now is the time

Cast your mind back to 2007 when Royal Bank of Scotland emerged triumphant from the raging boardroom battle to acquire ABN Amro, buying the Dutch bank for an astonishing \$100bn price tag. Scarcely a year later, strained by the acquisition and the subsequent financial crisis, RBS itself had to be rescued from near-collapse by British taxpayers. While the RBS-ABN deal remains the totem pole for the banking sector's pre-crisis exuberance, the period is littered with other deals that left shareholders short-changed and management teams shamefaced.

Indeed, data compiled by Deutsche Bank Research reveal the full extent of the profligacy. In the decade leading up to 2009, European banks spent €700bn on mergers and acquisitions. Unfortunately, the returns on this gargantuan spend turned out to be a quarter below the sector's estimated cost of equity, destroying nearly €175bn of shareholder value in the process. Chastised by this track record and the regulatory upheaval that followed the financial crisis, deal activity has since plummeted. The aggregate value of all European bank deals in the last six years is well below that single RBS-ABN transaction.

Given this backdrop, a call for more deals in the sector sounds rather ill-advised. However, as detailed below, the case for more deals, especially in Italy and Spain, is merited on each of the following four criteria: economic cycle timing, industry dynamics, company fundamentals and regulatory environment.

First and rather intuitively, when it comes to value creation from mergers and acquisitions, timing matters. Ignoring the oft used financial market maxim of 'buy-low sell-high', nearly 80 per cent of all bank deals take place late in the cycle when valuations are stretched and expectations of future growth are unjustifiably rosy. For instance, the wave of Italian bank mergers in 2006-07 was transacted at an average 2.2 times book value. Goodwill write-downs since then have already accounted for nearly a quarter of the price paid.

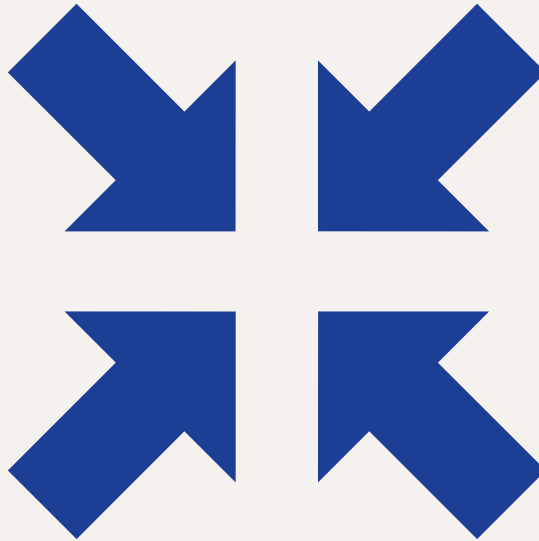
But 2015 is a world away from 2006. Italian banks now trade at 1.2 times book. There are also tentative signs of lending growth returning to Europe after five years as well as cheap central bank liquidity continuing for the foreseeable future. Hence today more likely represents the 'post-recession, pre-lending boom' early cycle timing that can potentially deliver strong returns on deals.

If now is the right time for European banking deals, Italy and Spain, as two of the most fragmented banking markets in the continent, are just the right places to start. In fact, after being forced to consolidate due to the perilous financial state of its Cajas in 2011, the Spanish banking industry now shows the scope for consolidation that exists in the Italian banking sector with its Popolari banks. With the number of Cajas down from 45 to two and the exit of many foreign banks from the country, the top eight banks in Spain have increased their deposit market share from 60 to 80 per cent since 2011. The number of bank branches in the country is down by one-third from its peak whereas in Italy the branch network is down by just one-tenth. And despite this consolidation Spain still remains a relatively low concentration banking market.

Apart from the market timing and industry dynamic, the fundamentals of Italian and Spanish banks also provide a strong incentive to engage in deals. Revenues of the Italian banking sector last year were still a tenth below their 2007 levels. Under the eurozone's most likely macroeconomic scenario of positive but weak output growth and low interest rates for the foreseeable future, banks will at best enjoy annual top-line growth rates in the low single-digits.

Struggling to deliver returns that match their cost of equity, banks have countered anaemic revenue growth by cutting costs. For instance, Italian banks have managed to cut

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operating costs by about one-tenth from pre-crisis levels. However, finding further organic cost cutting opportunities to boost returns is becoming harder. Therefore, combining businesses with significant operational and geographic overlap offers an attractive alternative. Historically, for instance, deals between European banks operating in the same country have led to cost synergies of one-third the target's cost base. In contrast, cost synergies in cross-border transactions were only half as much.

Even if mergers and acquisitions make business sense, a common investor misperception is that the regulatory stance remains unfavourable towards banking sector consolidation on account of the systemic risk posed by large banks. While that may well hold true for any proposed combination of two large banks, it does not necessarily preclude the consolidation of very fragmented banking markets. For sure, even small deals will have to jump through many hoops to satisfy regulators that the combined entity meets adequate capital, leverage and liquidity requirements. However, this should also allay investor concerns as, unlike the past, fragile combinations will be blocked.

In some ways the rigorous regulatory scrutiny of the banking sector even aids the consolidation process. At a European level, the completion of the Asset Quality Review provides greater confidence in the target banks' balance sheets for potential buyers. In some

cases the AQR explicitly recommends that some weaker banks seek partners. In addition, the ECB will likely conduct annual stress tests on European banks, imposing discipline regarding the adequacy and quality of capital, liquidity and assets. Furthermore, the ongoing process of regulatory harmonisation across European countries should aid cross-border deals.

In addition to the Europe-wide changes, national-level reforms being instituted in Italy will spur deal activity there. For instance, the ongoing reform of the Popolari banks which requires them to convert to joint stock companies makes buying them easier. Similarly, changes in the bankruptcy and foreclosure reforms should boost the non-performing loan market over time and reduce the cost of a non-performing loan portfolio that accompanies the purchase of a weaker bank.

European banks have a track record of destroying shareholder value through mergers and acquisitions. Even if doing something over and over again and expecting a different result is the very definition of insanity, we argue that the current environment offers rich opportunities for banking consolidation in Italy and Spain with the regulatory environment, company fundamentals and, above all, the economic cycle all aligned. ●

➤ Please go to gm.db.com or contact us for our in-depth report: "M&A: Poor track record, rich opportunities"



Confidence accounting— precision is overrated

It is the biggest activist fight of the year. In one corner is Noble Group, the global commodities broker based in Hong Kong. In the other is an outfit that calls itself Iceberg Research. So far, Iceberg has landed the big punches. Its claims of manipulated profits and assets have battered Noble's share price over the past twelve months. Iceberg has even gone to great lengths to compare Noble with Enron, which collapsed spectacularly in 2001.

At its heart the dispute is about how to value a contract. Specifically, how to estimate the future income on a long-term contract and how much to call profit now. There is nothing wrong with booking paper profits based on future contracted earnings. It has been common practice since ancient Babylonian times. Iceberg, though, thinks Noble's assumptions about its multi-decade contracts are too aggressive, for example, overestimating the future production of a mine or the expected price of a commodity. If that is the case, Noble's profits would never actually turn into cash. To Noble's credit, it asked one of the Big Four accounting firms to check things over and in August, the company received a stamp of approval.

The problem is that mark-to-market (and mark-to-model) accounting methods, as well as others that grace the textbooks, assume a 'correct' value actually exists. But when subjective forecasts are involved there can be no such thing. Hans Hoogervorst, chairman of the International Accounting Standards Board,

said as much in a speech in June when he declared he has no preference for either historical cost or fair value accounting. Many saw this admission as scandalous given an accountant's *raison d'être* is to 'figure out the numbers'.

Step forward 'Confidence Accounting'.¹

Among the more obscure proposals for reforming mark-to-market accounting, this approach does not put an exact figure on a company's profits or assets. Instead, management presents a range within which it is 95 per cent confident the true figure lies. Ever so neatly, debates over precise numbers disappear.

As a complete replacement to the current system, though, Confidence Accounting is a tough sell. For starters, investors may perceive it as a way for executives to hide failings, especially if the confidence intervals are very wide. Indeed, if the top-end of the confidence interval grows each year, a chief executive could claim success even if true profits are falling. And creditors might be reluctant to lend to a company that cannot say whether or not it is making money.

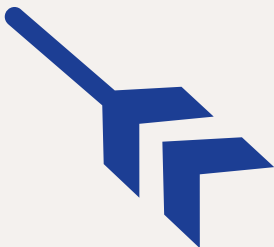
Despite these shortcomings, the idea may come in handy in helping answer the biggest questions investors have, namely, whether the assumptions behind a company's valuation models are reasonable and what happens when they change. Companies could be required to present, in the notes to their accounts, what their overall balance sheet would look like over time if some of the most important assumptions

that straddle the company's models moved by, say, five or ten per cent. For example, changes in base interest rates (and derivations such as discount rates) or, in Noble's case, consumption forecasts for different commodities. Of course, forcing managers to make private information public will not be popular. But any talk of 'proprietary models' or 'excessive burden' is nonsense. Disclosing the logic that underpins a company's financial position is surely in the interests of investors and the public.

Such disclosures would improve the status quo immeasurably. Currently, sensitivity analysis barely exists in financial reports. International rules only require it for 'non-observable inputs' in models that value illiquid assets. For example, an office building may be valued by estimating a capitalisation rate. The firm would then show how the building's value varies as the assumption changes. Alas, this is one of the world's most abused disclosure rules. Weak presentation guidelines mean the numbers are frequently massaged until they become useless. The picture is similar in America where sensitivity and risk commentaries in 10K regulatory filings can be so generic that investors can wonder if they are transplanted from one company's report to another with just the name changed.

In the absence of a new approach, such as Confidence Accounting, that lets investors openly assess a company's assumptions, mark-to-market accounting rules will remain a convenient scapegoat. In the aftermath of the 2008 crash, politicians, bankers, fund managers and regulators have all claimed these rules forced firms into dangerous yo-yo revaluations where profits and assets soared or plunged repeatedly, putting the fate of entire companies at the whim of the market. Fears of a repeat have changed business models. Since the crisis, US banks have increased their holdings of fair-valued securities by just two-fifths while those held at historic cost have more than tripled.

Along with its criticism have come plenty of suggestions for fixing mark-to-market accounting. Apart from an outright suspension, proposals include changing the definition of trading assets to make it easier to keep values at historical cost. Others postulate that companies should disclose two different sets of earnings figures, one based on historical cost and the other on mark-to-market values. Another idea is to create a new financial statement that reconciles net cash flow to net income. Yet another proposal argues for 'mark-to-funding' where an asset is only 'fair valued' if it is funded by short-term, market sensitive instruments. All these methods, though, still assume a 'correct' valuation figure exists.



It is true that Confidence Accounting is not without its own difficulties. For example, calculating the simultaneous effect of rising volumes of two commodities that are countercyclical is clearly illogical. But companies for which this matters should already have models that take this into account (if they do not, investors should be worried). And the benefits could be enormous. Imagine if, in 2006, companies with housing market exposure were required to scientifically state what their balance sheets would look like if there was a one-tenth correction in house prices. That one-page disclosure (or just an admission that 'we can't work it out') would have been more useful than the vast tomes currently pumped out. This is the point of the stress tests conducted by various regulators, but these are only carried out on a select group of institutions.

Confidence Accounting would also make it easier for auditors to stamp a company's financial statements. The reason why is neatly illustrated in the Noble/Iceberg fight. After Noble had its accounting methods reviewed and approved in August, it seemed logical that its share price would jump. But it barely budged. A quick look at the accountant's report showed why. From the cover page to the fine print it was flush with caveats. Those caveats do not necessarily mean anything is wrong. They exist because the accountant was acutely aware that what Noble's investors really want is assurance that the assumptions behind the valuation models are reasonable.

But auditors are not economists or research analysts. They rely heavily on the external industry experts who provide estimates and sign-off valuation assumptions. But these experts are usually employed by management who, in turn, auditors deem ultimately responsible for the company's accounts. Investors, meanwhile, rely on the auditors. Hence the underlying problem with mark-to-market accounting – everyone and no one is responsible. Unsurprisingly, when something goes wrong, fingers are pointed in

many directions. Anyone involved with Enron, Lehman Brothers, or AIG knows how this feels.

A variant of Confidence Accounting could change this by delineating roles and responsibilities. Figures produced by external experts could be assessed independently of a company's model, management could be better held accountable for subsequent decisions it makes, and auditors could write reports with fewer caveats. Investors would then be better equipped to take responsibility for their stock decisions. All round, such an approach would reduce the potential to shift blame when something does go wrong. And surely that is desirable. ●

1 For further reading, please see the joint paper from ACCA, the Chartered Institute for Securities & Investment, and Long Finance, "Confidence Accounting: A Proposal" from July 2012.

US home- ownership —renting the American dream

Steve Abrahams

For most of the last century Americans have attached a vaguely mythic aura to owning their home. It has become shorthand in public conversation for the American dream – testament in bricks and mortar to opportunity and hard work. The public has embraced it. Business has embraced it. Politicians and policymakers have, too. But lately myth has given way to a more complicated reality.

Homeownership in the US has been declining for more than a decade. From an historical peak when around 70 per cent of households owned their homes a decade ago, homeownership has dropped to 63 per cent recently, the largest fall since the great depression. With this decline has come change. Investors have replaced homeowners. Construction of apartment buildings has outpaced single-family homes. Rents have continued rising. Almost seven million households that might have owned homes a decade ago have instead become renters.

And the shift in the landscape of homeownership looks almost certain to continue, bringing more fundamental change to American communities and markets. If permanence is measured in decades, then it is a permanent rather than a temporary shift. The full effects are still unfolding and investors, businesses and policymakers would do well to start thinking about them now.

This historic turnaround in US homeownership arguably sprang from one seed but has been cultivated by circumstance. Losses from the housing crash during the last decade set things in motion; recession, tighter mortgage credit, demographics and possibly even changing preferences for owning a home have kept it going. It will be hard to stop.

It is no coincidence that the decline started with the first national decline in home prices since the great depression. According to the Federal Reserve, the 27 per cent drop in home values from 2006 through 2011 wiped out nearly seven trillion dollars in homeowner equity. If all of those homeowners had been able to ride out the crash, then maybe it would have had a modest effect on homeownership. Homeowners might have upped their savings to offset the crash, and slower growth and higher unemployment might have kept some buyers on the sidelines. But things got much worse than that.

The housing crash dragged along broad parts of the financial system, magnifying the effect on the rest of the economy. Recession and unemployment created millions of homeowners with less income for covering mortgage payments and nothing to gain from selling. From late 2007 through 2014, according to Hope Now, a US non-profit agency that counsels homeowners, more than 7.5m owners lost their homes and an equal number had their loans modified. That left a mix of homeowners with damaged credit or no equity as they walked out the front door and no way to come back into the housing market as a buyer without a good run of savings. The Urban Institute estimates that these double-trigger

events – loss of equity and income – reduced homeownership by almost five percentage points.

Tighter mortgage credit has since shut the door to homeownership for many. Since 2006, the median credit score on loans for buying a new home has jumped from around 700 to 744. The average cost of getting a guarantee from Fannie Mae or Freddie Mac, the US mortgage finance giants, has gone from 20 basis points a year to more than 60. In addition, the cost of a guarantee from the Federal Housing Administration jumped from the equivalent of 70 basis points a year to 160, before coming down this year to 110. A wide range of loans – interest only loans, those with balloon payments or carrying high fees, among others – have become illegal under rules set in motion by the Dodd-Frank financial reform legislation.

These echoes from the housing crash have mixed with demographic trends that also point to lower homeownership. The US Census Bureau projects that a rising share of the adult population over the next 15 years will fall into younger age groups that own homes at a relatively low rate. Ethnicity will also shift toward groups that traditionally own homes at lower-than-average rates. Many analysts further argue that rising student debt will dent the ability of younger households to buy, although that is likely most true for students that took out loans and then failed to finish a degree.

To top things off, studies by Fannie Mae have found that even today's prime candidates for owning homes – couples in their early thirties with a child and plenty of income – show declining interest in owning a home. Perhaps the housing crash is just too fresh.

All of these moving parts will interact over the next few decades to reshape homeownership. Home prices have already rebounded sharply. Homeowner equity and credit scores will steadily get repaired. Mortgage credit standards may loosen a little bit but will probably never return to pre-crash levels. Demographics march on. In all, the Urban Institute has projected that homeownership between 2010 and 2030 will drop by four percentage points. With three-quarters of that projected decline realised in just the last five years, the estimate looks conservative.

Public policy has to recognise these changes in the market. One immediate impact has been a surge of investors buying up homes that have come to market through foreclosure or similar avenues. In 2006, the distressed share of home sales stood at three per cent, but by 2009 it had jumped to 25 per cent and stayed there for three years before dropping back below ten per cent recently. John Burns Real Estate Consulting estimates that one-in-ten households now live in single-family homes owned by investors. These investors have helped home prices rebound and have effectively replaced much of the capital that homeowners lost in the crash.

The drop in US homeownership rate means almost seven million households that might have owned their homes a decade ago have instead become renters. Investors have replaced homeowners.

Today's prime candidates for owning homes – couples in their early thirties with a child and plenty of income – show declining interest in buying. Perhaps the housing crash is just too fresh.

The surge in investors has created new businesses to rent out those homes. Households' ability to buy homes may have fallen, but the demand for shelter has not. Most of these businesses are small operations of less than ten homes each, but some – Blackstone, Colony, American Residential and others – have bought thousands of homes. These larger efforts have created specialised operating companies and financed some of their operations through securitisation. Other businesses, such as FirstKey Holdings, have sprung up to lend to small investors who want to buy single-family homes.

While homeownership has declined, the number of households has continued to grow and fuel a boom in the construction of apartment buildings. Even though since 2011 builders have broken ground on new apartments faster than they finish existing projects, vacancies keep falling and rents keep rising. The 2.4 per cent vacancy rate on apartments at the end of 2014 stood at its lowest level since the bursting of the dot-com bubble at the start of the millennium. As vacancies fell rents for the five years ending in 2014 rose by a fifth, according to data provider REIS, the fastest pace since 2002. Higher rents have helped push up the value of apartment buildings, too, with Real Capital Analytics, a research firm, estimating a jump of 15 per cent so far this year.

The boom in apartment buildings has flowed into the debt markets as growth in securities backed by loans on these buildings. Loans on apartment buildings are often guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae, the government mortgage agencies. The agency share of all new commercial mortgage-backed securities has jumped from four per cent in 2006 to 35 per cent last year.

The shift from owning to renting homes and from single – to multi-family building should give an extra lift to the builders, lenders, real estate brokers and other suppliers that specialise in the faster-growing side of this equation. Although absolute numbers of homeowners should still rise as the number of households increases, the faster growth in renting should still favour some businesses more than others.

The shift should also soften the value of land in general since apartment buildings require less of it to house the same number of people. But location will matter. Rural or distant suburban locations where renters are less likely to live should see land value soften the most.

For policymakers, the shift toward renting also has more subtle implications. At the national level, the focus of an important set of agencies may need to change. The Federal Housing Administration and the Veterans Affairs along with Fannie Mae, Freddie Mac, Ginnie Mae and the Federal Home Loan Bank system have all tended to focus on lowering the cost and expanding access to single-family mortgages. While almost all

of these agencies have programs that support multi-family lending too, they have tended to be the poor stepchild to the single-family programs. The multi-family programs will need to receive more resources.

The US tax code also favours owning rather than renting, and that may come under pressure. While proposals to eliminate the tax deduction for mortgage interest probably would go nowhere fast, subsidies for renting might have a better chance. That could come through the federal mortgage agencies, tax policy, other transfers or a combination of these.

At the local level, a shift to renting should force city planners to pull out their erasers. More multi-family housing creates a denser city. Roads will have to handle more traffic, schools more students, parks more people looking for a place to rest or play. And cities used to growing their single-family neighbourhoods may have to draft plans for shrinking them.

A population that rents may also be more mobile since moving will no longer bear the high transaction costs of selling real estate. The investor capital that increasingly supports housing may be able to stay in place longer and avoid those costs.

The rush of investors to fill the homeowner equity gap and the boom in multi-family building has created not just more capital for American housing, it has created a new voice in local discussions of real estate. Local taxes and services flow right into the operating models of these investors, and they are likely to be organised and active.

The American public and policymakers have long believed that homeownership somehow created special benefits for the whole community. Owners might fix leaky faucets, mow lawns, paint fences and vote for the better schools and services that kept up the value of their property. As homeownership ebbs, the belief in its special benefits will be put to the test. If the new wave of renters and the investors behind them step smoothly into the role of good citizen, then the great recession may leave in its wake yet another version of the American dream, this one rented rather than owned. ●



German rent
caps—paved with
good intentions

An argumentative bunch by training, economists disagree on most of the fundamental questions facing their profession: is quantitative easing inflationary, does fiscal austerity work, are capital controls desirable? However, for the most part, economists coalesce around the view that rent controls do more harm than good. Paul Krugman wrote fifteen years ago that rent control is one of the best-understood and least controversial topics among economists. More memorably, the Swedish economist Assar Lindbeck quipped, rent control is the most efficient way to destroy a city next to carpet bombing. ➤

Unfortunately, an idea that draws near-universal scorn from economists is garnering increasing popularity among politicians on both sides of the Atlantic. Frothy property markets in London, Paris and New York are leading to concerns about affordability and gentrification and worries that those on lower incomes are unable to find living spaces in these cities. But what about Germany, where urban real estate is among the cheapest in the developed world with price-to-incomes and price-to-rents a tenth lower than the country's long-term average? Even here, the relatively strong recent house price momentum has drawn a political response with Berlin signing new rent cap legislation earlier this year.

However, the supposedly torrid price rises of the last three years across urban Germany merely amounted to five per cent per annum, much lower than cities in many English-speaking countries. Even in relation to Germany's past, there does not appear to be anything resembling a crisis. Nominal rents only grew by one per cent per annum over the past 15 years versus more than four per cent prior to the 1990s or even seven per cent in the 1960s. Indeed in real terms, rents have declined over the past two decades.

Even if affordability was spiralling out of control, it is worth pointing out Germany already has some of the strictest tenant protections among the OECD member states. Rental contracts are open-ended and evictions are rare, even to requisition the apartment for one's own use. Yet the fears of a betongold or a property gold rush, have risen due to the strong performance of the German economy, rising wages and the low interest rate environment. Alongside a new grand coalition government in place since 2013, rising property prices have made everyone more sensitive to the social impact of tighter rental markets – hence the political momentum towards this rental cap. It is, therefore, worth considering whether the policy will prove workable over the medium term.

Before the recent legislation, new leases could be freely set but increases on existing leases were constrained in two ways. First, their growth rate was tied to comparable rents, most commonly estimated using the Mietspiegel, which are rent indices laboriously compiled by local authorities and adjusted for similar areas in similar quality apartments. Modernisation by landlords offered additional upside from passing on costs. The new rent cap, or Mietpreisbremse, adds to the panoply of legislation by affecting what landlords can charge on new leases. These will be constrained at ten per cent above comparable rents. The legislation will apply on a case by case basis and only in housing markets deemed tight, subject to approval from both federal states and municipal governments, and only for a maximum of five years. In Berlin it came into effect on June 1st.

The rent cap is a game-changer. Tying increases in existing rents to increases in comparable rents was fine even if the index was backward-looking, not updated frequently enough, and therefore strongly lagged a rising market (indeed the gap between the Mietspiegel and rents on new leases is 23 per cent in big cities.) It was also tolerated because re-letting a unit provided the bulk of the upside for landlords. However, tying the level of new rents to comparable rents risks removing any incentive for landlords to rent a place out altogether. Moreover, it threatens to incentivise a housing market that further benefits the wealthy and leans against the poor. As if this were not enough, the legislation is nearly unenforceable.

Faced with a rent cap, an existing landlord has the following four choices: withhold their flat from the market, rent it out at a lower rate, illegally rent it at a market rate or seek additional payment in the black market, which amounts to the same thing, or finally sell the flat. Most of these choices will drive demand further away from supply and have a significant impact on the market.

Take the withdrawal of flats as one possible reaction to regulation. Lowered returns mean the expense and hassle of renting may be higher than the benefits. If, at the margin, rental units are withdrawn from the market, vacancies are likely to become more pronounced. This is not just rank speculation. In Spain, the introduction of a rent cap policy in 1950 caused vacancies to increase to 16 per cent from 3 per cent over the following three decades. For existing tenancies, evictions may also rise as landlords seek alternatives to rent; this is what occurred in Finland in the 1960s following the introduction of rent control, though it is less likely in Germany given the strong tenancy laws. It is also the case that poorer households will suffer disproportionately from the cap, as the existing stock of housing is allocated to wealthier households, which are more likely to be selected as tenants due to their lower default risk. The outcome of withholding flats and evicting tenants is to make it harder for some parts of the population to rent and to push supply and demand in the market further apart.

Alternatively, if the landlord decides to rent at a lower rate, he is accepting lower returns in the future and as a result is likely to spend less on the upkeep of property. As maintenance spend is slashed to the bare minimum the quality of existing housing stock deteriorates. This is the idea behind the Assar Lindbeck observation mentioned earlier, and it is borne out anecdotally and empirically. For instance, the OECD has shown the incidence of leaky roofs as a percentage of rental housing is the highest in countries with the tightest housing market regulation (seven to nine per cent in Germany and the Netherlands versus one to three per cent in Britain and Poland).

The rent cap also incentivises illegal activities. Landlords could, for instance, ignore the cap (for which there is no penalty as yet). As such, a landlord may simply continue to charge the market rent unless a tenant takes them to court, at which point the rent may need to be lowered. A landlord could also stretch the law beyond its intent, charging exorbitant fees, such as for kitchen appliances.

Even if the landlord is blameless, black-market based compensation mechanisms would likely emerge in order to match supply and demand. In central Stockholm, for instance, aspiring tenants of rent-controlled flats often pay 'key money', or a one-time top-up payment, to the existing tenant for the privilege of living in a below-market rent flat. Key money in 2013 amounted to anywhere from 40,000 to 900,000 kronor (\$5,000 to \$100,000) and it is difficult to ban because the old renter and the new renter have an incentive not to rock the boat; everyone needs a place to live, after all. Other forms of illegal activities to circumvent regulation include bribes, exorbitant brokerage fees, tenant harassment and illegal subletting. A law that encourages the transgression of other laws is a paradox. It rewards rule-breakers and insiders over rule-followers and those less familiar with the technicalities. This is certainly a bad thing.

Finally, a landlord can also decide to sell. Indeed, as rental returns become less attractive, selling becomes the only viable option to realise market returns, and many property developers are likely to move to an asset-trading model. This could eventually lead to the end of a system that has served Germany reasonably well. Because the lower returns inherent in the new model will sometimes not satisfy a given cost of capital, many landlords will need a new operating model. In the short-run they can move to an asset-trading model in which the existing stock of assets can be monetised.

However, in the long-run, we are likely to see a de-emphasis of the large build-to-let sector. This would dampen new housing supply given these landlords accounted for a substantial amount of fresh supply in recent years. It is an irony that just as policymakers in places such as Britain are moving to the German model of corporate residential landlords, with their high quality provision, Germany is making it harder to maintain that model. It is also odd that Germany is reducing the profitability of the build-to-let sector even as the need for it has become ever greater. Net migration into the country was running at around 450,000 per annum, the second highest in the OECD after the United States, even before the recent migrant crisis saw Germany accept much larger numbers.

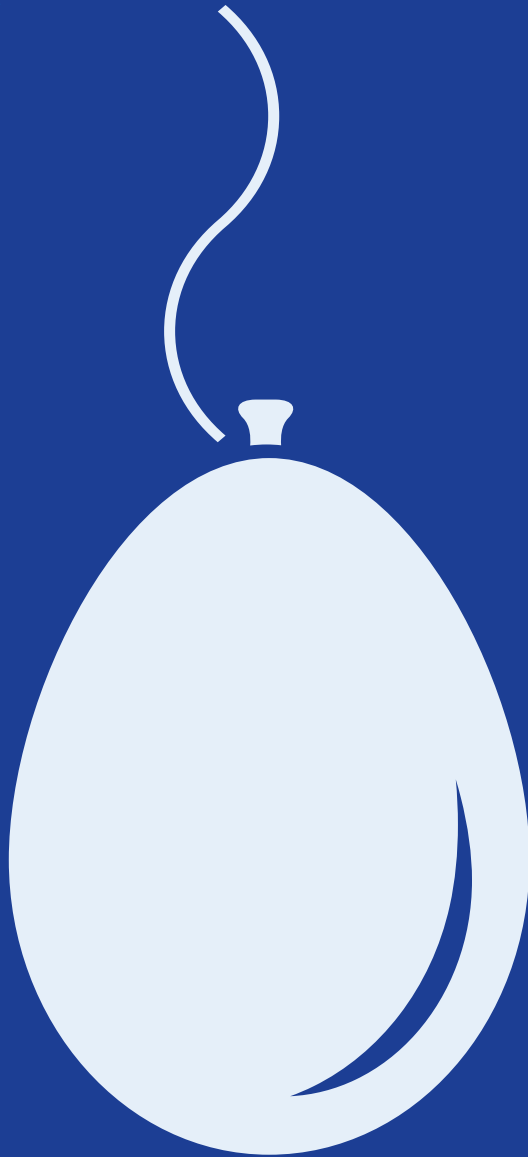
Another effect of making renting less attractive to both landlords and renters (due to lower quality housing provision) is that homeownership is likely to rise. In Finland, after the introduction of

rent controls it rose from 61 per cent to 73 per cent in the twenty years to 1990. In Germany, homeownership is currently only 46 per cent versus the European average of over 70 per cent. Low financing rates (on average about two per cent for a ten-year fixed rate mortgage) along with rent caps are likely to drive that upward. Homeownership has often been a cherished policy goal in English-speaking countries but has come in for a rethink in the wake of the 2008 crash as detractors point out that it restricts labour mobility and encourages unsustainable debt among households.

It will not be just new home-owners that pile in. As housing becomes more expensive, the government is likely to buy homes and convert them into social housing. Another way of saying this is that as return-sensitive buyers exit the housing market, non-income sensitive buyers will be lured into it. As return considerations no longer determine investment decisions, and amid a permissive financing environment, a bubble could form in already-tight housing markets. Depending on the narrative and psychology of the markets, Germany could be pushed into a housing boom. In our view, house prices in cities subject to the cap could increase by 40 per cent over the next three years.

Overall, the introduction of a rent cap will likely have consequences diametrically opposite to the stated objectives of policymakers. If the aim is to make life easier for price-sensitive renters, its unintended consequences will instead drive evictions and remove quality flats from the market, reducing overall supply and therefore making it harder for more price-sensitive renters to find housing. If the social goal is to maintain the existing vitality and quality housing stock of a city, this will do the opposite. If the point was to discourage questionable behaviour like top-up payments or key money, this will reward risk-takers, law-breakers and insiders while penalising others. It will also hurt the German residential landlord sector over time and could lead to a property bubble in major German cities. This is a policy change that will reverberate for years to come. ●





London property
—calling time on
the party

Owning a house on Pepys Road, the fictional London street in John Lanchester's novel *Capital*, "was like being in a casino in which you were guaranteed to be a winner." Property prices in the city's well-heeled districts today suggest the great lotto of London property has continued unfettered, to the point that even such fictional accounts seem understated. Prime London real estate has been going up for so long that new peaks are no longer news. In fact, any decline is a buying opportunity – or so everyone has come to believe. ➤

The dinner-party perception that prices for prime London property¹ have always gone up is potentially a reason to worry. That everyone strongly believes they will continue to go up further is a cause for anxiety. Still, timing any turn is hard and it has long been a losing battle to call an end to the froth in this market. But perhaps we are close to the turning point.

With the average asking price of a London residential unit now at £620,000 (\$1m) the returns from property ownership over the past quarter of a century have undoubtedly been stellar. Every one pound invested in London bricks and mortar in 1990 has grown five-fold by now, double the performance of the FTSE 100. Lever up these returns using mortgage debt, add in a few tax sweeteners for buy-to-let investors and the true returns are tastier still. The rise was as relentless as it was spectacular. In the last sixty years, the Volcker recession of the early-1980s, the sterling crisis of 1992 and the 2009 financial crash, are the only three instances of nominal price declines for London housing.

There are many arguments for the rise and rise in prices. Most, however, are plain wrong. The economist Kristian Niemietz demolished the commonest explanations in a 2012 paper. Rising population densities in an overcrowded southeast? (The region is not particularly dense relative to continental Europe.) Housing benefit spending? (A symptom not a cause.) Thatcher's decimation of social housing stock? (A fifth of total dwelling stock is still social housing, among the highest in rich countries, much of it in London.) Too-low property taxes? (As a percentage of total tax revenues it is the highest among rich countries – think stamp duty.) Smaller households? (No different elsewhere.) Under-occupation? (again, a symptom).

Having cast aside these arguments, Mr Niemietz cites just one factor as credible: poor planning that has led to an inelastic supply of homes amid fast-growing demand. Hence to solve what we have come to know as 'the housing crisis', London must build, build, build. This supply-side view has become the standard diagnosis among regular commentators on property prices, such as the Economist, Financial Times, Institute of Economic Affairs and the Royal Institute of Chartered Surveyors.

However, the impact of this supply-demand mismatch is perhaps exaggerated. For one thing, rents and house prices, theoretically subject to similar physical supply-demand dynamics, have diverged over the last decade with prices having risen by 35 percentage points more. In any case, physical supply and demand mismatches are often a poor indicator for future house price moves. This follows from the fact that housing is not only a durable consumption good but also a financial asset, and is therefore influenced by future price expectations and financing, as much as by physical supply.

These can change rapidly. Hong Kong property prices in 1997 dropped 40 per cent over just 12 months. Like London, it was also densely populated with inadequate land and housing supply. Moreover, the approaching handover to China was spurring a return of optimistic and moneyed émigré residents, with mainlanders also eager to buy Hong Kong assets.

Despite this the property market endured a six-year downturn. Why? A Hong Kong Monetary Authority economic survey in May 1998 wrote: “coupled with the announcement of the government’s policy in October 1997 to increase the supply of housing units, the interest rate hike resulting from Asian financial turmoil sent property prices down by 20 to 30 per cent in the last few months.” A stark reminder of the role financing and expectations play in the property market.

Of course, blaming interest rates looks obvious. Financing became more expensive as capital outflows raised the interbank borrowing rate, which compelled banks to increase the best lending rate, on which mortgages were based, by 150 basis points in the space of four months. Nevertheless, delinquencies were low by international standards. Despite property accounting for half of total banking system assets, the main problems for Hong Kong banks were trade finance and corporate loans. Most homeowners made their payments and had plenty of equity because loan-to-value ratios were usually capped at 70 per cent. While homeowners coped with higher rates, house prices still plummeted.

A shift in expectations about future supply was much more instrumental in bringing about the downturn. The post-handover government had made it known that it would welcome a decline in property prices and would increase supply by 85,000 units a year. In retrospect, at no point during the next five years did housing completions reach 35,000 annually. Yet because the decision had credibility, it changed expectations and the 85,000 figure is still cited today as a reason for the market decline. The government announcement precipitated a change in psychology that diminished the speculative increment in the market.

Hong Kong is not the sole example either. Japan famously endured a monster asset price bubble in the 1980s, with the vast portion of new debt and capitalisation secured by ever rising land values. There is the apocryphal story about the Imperial Palace and California but few also remember that the cash value of Chiyoda-ku, that same ward in downtown Tokyo, could by 1988 purchase all of Canada. The bubble ended two years later as the Bank of Japan raised rates by 350 basis points and the ministry of finance introduced the soryo-kisei restrictions on real-estate lending, which caused an immediate and dramatic drop in the availability of credit. As financing conditions and future price expectations changed, Tokyo residential land prices fell two-thirds from their peak in 1990.

Surely if raising interest rates threatens to be cataclysmic, the Bank of England will simply not do so. Yet borrowers in large open economies are not insulated from global events raising the cost of credit.

There is growing political risk embedded in prime London housing. It is not that prices cannot rise further. It is that the more they rise the greater the chance of a political backlash against further gains.

Much like London today, the physical supply shortage argument was also advanced to justify Japan's boom. Japan's industrious and high-saving population was shoehorned into narrow coastal plains – only 14 per cent of the country was flat and suitable for building. Investors duly pushed average prices of condominiums in the nine square kilometres around central Tokyo to 16 times average gross incomes. Compare this to the 13 times using conservative estimates for London today and Tokyo-on-Thames seems a plausible scenario.

So, if expectations are too buoyant, what will cause them to normalise? Even though price rises in prime London property have moderated this year, there are multiple catalysts to suggest that 2015 is the turning point. The most significant are: impending higher interest rates, tighter macroprudential policies and a deepening politicisation of the housing issue. Again, all that needs to happen is for investors to think price outcomes are asymmetric, with low upside and large downside.

Take interest rates first. Just under half of the UK's £1.3tn mortgage debt is on variable rates and most of the remaining is effectively variable anyway given the fixed rate period typically lasts only two years. London residential mortgage debt amounts to a quarter of the country's total. Given British households' penchant for making huge interest rate bets, borrowers have enjoyed the post-2008 falling interest rate environment but things could get ugly when rates rise. Moreover, over a third of those with mortgages have interest-only loans, with the first sizeable wave of principal repayments due in 2017-2018. With affordability already stretched, a few rate rises can easily reshape consumption decisions for housing and the broader economy.

But surely if raising interest rates threatens to be so cataclysmic, the Bank of England will simply not do so. Yet borrowers in large open economies are not insulated from global events raising the cost of credit. Bank of England economists have pointed out that UK swap rates, a key input into commercial banks' own cost of borrowing, are highly correlated with those in the US. On average, quoted UK mortgage rates increase by around 50 basis points in response to a 100 basis point increase in US swaps. Counterintuitively, the US tightening cycle will hurt British households more than their American counterparts that rely on long-term fixed rate mortgages.

Macroprudential policies have also gained currency under current Bank of England Governor Mark Carney who views them as a way to tame house prices without hurting the overall economy. Under previous governor Mervyn King, the central bank avoided them for fear of political blowback but Mr Carney has called housing the "biggest risk to financial stability" in Britain. In February 2015, the central bank was granted direct powers to

control loan-to-value and debt-to-income ratios where previously, they could only recommend changes. Lending requirements for owner-occupier mortgages were already raised in 2014, with no more than 15 per cent of banks' new mortgages to exceed a loan-to-income ratio of 4.5 times. Tighter controls on fast-growing buy-to-let lending appear likely to follow given this sector is disproportionately leveraged and two-thirds of all such mortgages are interest-only.

There is plenty of scope to do more on this front. The most advanced practitioners of macroprudential policy are Hong Kong and Singapore where loan-to-values for buy-to-let properties are capped at 50 per cent, foreign purchases of property are hit with 15 per cent stamp duty and second and third home buyers face differentiated, punitive treatment. In this approach, housing becomes more like a utility and less like a financial asset. The Bank of England appears to be moving in this direction.

The final catalyst that could well push prime property prices over the edge this year is politics. The prevailing political attitude to housing, in particular buy-to-let, seems to be changing fast. The UK chancellor said in his summer budget: "we will create a more level playing-field between those buying a home to let and those who are buying a home to live in." His budget proposals included a phased reduction in the tax relief on mortgage interest payments for buy-to-let landlords from the 40 per cent to 20 per cent tax rate over the next six years. Moreover, landlords also lose the right to automatically claim ten per cent of the rent against wear-and-tear costs. These are serious blows to levered buy-to-let portfolios.

To see why, imagine a buy-to-let flat worth £500,000 earning a four per cent rental yield and financed with a 75 per cent loan-to-value mortgage on a four per cent interest rate. Under the current rules, the net cash income of £5,000 (£20,000 rent less £15,000 mortgage interest) incurs a tax liability of £1,200 for a landlord paying the 40 per cent rate of income tax. However, following the full implementation of all the budget changes by 2021, the entire £5,000 income will go towards taxes. Sure, London's housing demand also includes relatively non-return-sensitive buyers such as owner-occupiers and foreign safe-haven seekers. But these changes threaten to dent the demand from the highly return sensitive buy-to-let landlords.

Other recent tax changes also signal the UK government's willingness to extract more revenue from the booming real estate sector. A major overhaul of stamp duty last year increased the cost of buying homes worth more than a £1m, putting disproportionate pressure on the prime end of the London market. Moreover, permanent non-domicile status, which benefits some 100,000 people, will be abolished, while foreign owners of property who were previously exempt from capital gains tax will have to pay it.

These tax changes are occurring as public discussion about foreign buyers of high-end London property has turned toxic. For instance, after a television documentary exposé on money-laundering at real estate agencies, Prime Minister David Cameron was compelled to speak on the issue, stating “London is not a place to stash your dodgy cash.”² This rhetoric itself is new and unusual, even if serious action is still awaited.

Changes are afoot on the spending side of fiscal policy as well. In an effort to slash the £25bn annual housing benefit bill, the government plans to lower the ceiling on the total benefits any household can receive by £3,000 to £23,000 for London. Since payments such as child benefits and tax credits are fixed sums, housing benefit will likely bear the brunt, putting substantial downward pressure on rents from social housing tenants to private landlords.

Meanwhile, the housing issue continues to move up the political agenda. The home ownership rate in Britain peaked at 70 per cent in 2002 and has since dropped well below two-thirds. Conservative party policymakers are aware that this precipitous fall needs to be stemmed, if not reversed, to secure the next generation of Conservative voters, given the propensity of homeowners to vote for the party in the past. Unsurprisingly, the centrepiece of David Cameron’s speech at the Conservative party conference earlier this month involved policies aimed at “turning generation rent into generation buy”.

Housing is fast becoming the rallying point for the younger generation. Only 40 per cent of today’s 25-34 year olds own homes compared with two-thirds of those in 1991. A 35-year old born in 1981 carries twice as much debt as those born in 1951 at the same point in their lives, even though their weekly income is the same in real terms. That suggests Burke’s notion of a social contract between the generations has been broken.

This disgruntled younger generation was instrumental in the surprise election of Jeremy Corbyn as the new Labour party leader in September. Mr Corbyn has said that housing is a top-three priority, ensuring political oxygen for the issue. In the Lanchester novel, the inhabitants of Pepys Road begin to receive postcards of their houses with the menacing message “We Want What You Have.” With that sort of sentiment rising, the fate of house prices may well be decided in the political face-off between younger voters and the elderly harnessing their political power to prevent price declines to their house-cum-pensions.

All of which points to the growing political risk embedded in prime London housing. Perhaps a turning point has been reached in which the marginal policy intervention will favour stabilising or reducing prices. It is not that prices cannot rise further. It is that the more they rise the greater the chance of a political backlash against further gains. Certainly it is hard to imagine, as one consultancy has, a doubling of prices in the next

fifteen years without explaining how this would not sow the seeds of its own correction given the increasingly febrile politics of housing in the capital and the country.

London, of course, remains a growing and attractive city with substantial planning barriers, high population growth, rising number of single person households, global cultural and business links, currency stability, low political risk, and no anticipation of a significant increase in supply. But as in financial market jargon – all that is already in the price, and then some.

There are bigger forces at work here too, with London just one part of a global housing boom. Indeed, despite frequent observations that all real estate is local, one of the oddities of the global economy since 1970 has been the persistence of synchronised global housing cycles. This has arguably been driven by two factors.

First, the intellectual victory of financial liberalisation in the 1980s, which led to increased household borrowing domestically and freer cross-border flows internationally. Second, a decline in global real interest rates due to a global “savings glut”, linked variously to an increase in demographic dependency ratios, a structural decline in inflation due to technology and globalisation of manufacturing, and mercantilist foreign exchange reserve policies of current account surplus countries. These factors have caused four successive housing booms since the end of the gold standard in 1971, the most recent since 2008. From this perspective, prime London’s boom is merely at the more extreme end of a generalised global trend. The boom here does not truly end until it ends elsewhere.

No one knows when these long-term trends will turn. Perhaps other trends will work in the opposite direction, with new technologies such as autonomous vehicles increasing the willingness to live further away or virtual reality devices reducing the premium on physical interaction. Either way, what investors can hold on to is the limited upside in this market. Valuations are high relative to history, falling interest rates cannot provide further support, and given current affordability home ownership cannot rise materially.³ London’s property is unlikely to enjoy the next thirty years as it did the last. ●

1 The estate agent Savills defines prime central London as the areas of Knightsbridge, Mayfair, Kensington, Chelsea, Marylebone and Notting Hill

2 For an estimate of the unaccounted foreign money, especially from Russia, flowing into London’s property market see Oliver Harvey and Robin Winkler’s analysis of the balance of payments anomalies in the Deutsche Bank report “Dark Matter: the hidden capital flows that drive G10 exchange rates,” published March 2015.

3 For further reading, with emphasis on both upside and downside risks in UK housing, please see Deutsche Bank research reports by George Buckley, “UK Housing: London versus the rest” from July 2014 and “How affordable is UK housing?” from April 2014. For a primer on the financial position of UK housebuilders, see Glynis Johnson and Priyal Mulji’s “Strategic Land: Driving better returns for longer,” published in June 2015.

Japan property— faster, higher, bubblier



Real estate in Japan should never see another bubble. Having witnessed three in the last half a century, the second one a Godzilla-sized boom in the 1980s, investors would surely be wary and vigilant against another developing. And with commercial and residential land prices still four-fifths and two-thirds below their 1990 peak respectively, talk of another bubble may seem absurd. However, as unlikely as it seems, a confluence of factors is contributing towards a nascent real estate bubble in the country once again. ➤

This new bubble's genesis was in 2013, when the award of the 2020 summer Olympics to Tokyo created a plausible scenario for rising real estate prices. Since then, growing tourist numbers and the prospect of more visitors has buoyed anyone in the business of offering accommodation. In addition, infrastructure investment, both large-scale by the government, and small-scale by individuals and corporates, is seen to be propelling the economy forward.

Adding to the Olympic inspired enthusiasm is the recently agreed Trans-Pacific Partnership, one of the biggest trade deals of all time, involving Japan, the US and ten other countries. The TPP will likely result in all real estate contracts being written in English, thereby encouraging foreign investment in the Japanese market. This could even act as a prod to Chinese and Middle Eastern buyers who currently prefer buying property in English-speaking countries such as the US, UK, Australia, and Canada.

Even if the Olympics and TPP get Mr and Mrs Watanabe excited about property once more, by themselves they are not enough to cause the Japanese property market to overheat. The belief that asset prices will rise is merely the first of three preconditions necessary for an asset bubble. The second is aggressive bank lending. Ominously, Japanese bank lending to the real estate sector hit Y10tn last year, the same level as in 2007 just before the financial crisis. The stock of outstanding loans to the sector reached an all-time high of Y64tn earlier this year.

The third requirement for a bubble is encouragement from the tax system. This has, ironically, come in the form of a tax increase rather than a tax cut. Last year, the government passed new laws that lower exemptions and increase the rates of inheritance tax. Whereas paying inheritance tax used to be the exclusive domain of the wealthy, even the middle classes are now falling into this net. Real estate offers an escape. For the many asset-rich but cash-poor Japanese, particularly those who bought their property before the 1980s boom, the value of the land for inheritance tax purposes will be reduced by 80 per cent, substantially more than the 50 per cent discount previously on offer. In addition, in most cases the tax will not apply if one of the heirs lives in the property.

Hence children have been moving in with their elderly parents thereby creating multi-generation homes that allow owners to take advantage of the 'shared house' exemption. In addition, those who have become freshly liable for inheritance tax are incentivised to buy property to take advantage of all the exemptions. One example is the Brillia Towers Meguro in the Meguro-ku ward of Tokyo. The first phase of almost 500 apartments was offered for sale in mid-July. Less than one month later, the entire batch was sold out. Over half the apartments cost more than Y100m and the most popular were 40 times over-subscribed. Tellingly, almost two-thirds of the properties were

purchased by people over the age of 50. This age group also accounted for four-fifths of the purchases at the Branz Tower in Yokohama's Minato Mirai waterfront area.

If all this points to a developing bubble in Japanese real estate, it will just add to the three bubble-like rises in real estate prices that Japan has experienced over the last 45 years. The first occurred in the early 1970s after Prime Minister Kakuei Tanaka announced his 'Plan for Remodelling the Japanese Archipelago'. At a time when the Japanese population was growing, this was the catalyst for residential land price rises of over 40 per cent a year, although growth swiftly reversed and prices were falling by the middle of the decade.

The second real estate bubble that occurred in the late 1980s was perhaps the most famous. It came in a period marked by the 'Japan as number one' mentality and was fed by the astonishing wealth that was made by some on the stock market. There seemed to be no limit to how high Japanese property prices could climb. In the major cities, annual growth rates hit almost 50 per cent leading to comparisons in the value of Tokyo's Imperial Palace with the whole of California. What happened next is well documented.

Even then, a third real estate bubble reared its head between 2003 and 2007 although this one was less pronounced than the first two. This episode was sparked by several legal changes that allowed for the expansion of securitised real estate. In turn, this prompted foreign buyers to sink money into big-ticket commercial properties in a country where prices lagged other developed markets. Two examples during this period are the purchase by US banks of the Tiffany Building in Ginza for ¥38bn and the Shinagawa Mitsubishi Building in Minato-ku for ¥140bn.

The lesson from these three bubbles is in identifying the preconditions. In each, there was first a plausible scenario, a qualitative backdrop that made people assume real estate prices would rise in the future (economic expansion, continuous stock market wealth, increased foreign buyers). Second was growth in bank credit. Only twice in the last 45 years has the annual growth in bank lending exceeded 20 per cent. Both these occasions in the early 1970s and the late 1980s coincided with property bubbles. The mid-2000s also experienced sharp increases in bank lending growth albeit to a lesser extent.

Today's real estate environment is already flashing some warning signs. The first come from falling capitalisation rates, which indicate the annual rent a property can expect to yield. As these rates fall, a property becomes more expensive relative to the income that can be earned. In Tokyo, small studio apartments all the way up to high-end family properties are valued at about five per cent, a figure in line with levels at the top of the mini-bubble in 2007. To a lesser extent, similar trends can be seen in regional cities like Sapporo, Sendai, and Nagoya.

Capitalisation rates for commercial property have also fallen, down to just four per cent for retailers in the fanciest shopping districts, a level they dabbled with in 2007. Meanwhile, shopping centres in Tokyo's suburbs have seen capitalisation rates drop below six per cent and are closing in on their pre-crisis low of 5.5 per cent. What is more, these rising valuations are occurring in an environment of falling absolute rents. Tokyo residential rents, for example, have fallen continuously since their peak in the late 1990s and are now about five per cent lower than they were pre-crisis. Office rents, meanwhile, have experienced a sharp contraction since the peak in the early 1990s and are now almost 15 per cent below their level in the mid-2000s.

After all, there is no shortage of office space. During the mini-bubble in the last decade, vacant office space in central Tokyo amounted to less than 20,000 tsubo (a standard Japanese measure of area equating to about 3.3 square metres). Currently, the amount of office space available is closer to 80,000 tsubo. In addition, new buildings mean that supply is expected to increase by up to 180,000 tsubo over the next three years despite the fact that the number of office workers in the Tokyo city centre area is expected to remain the same as it has been for the past quarter century.

Indeed, Japan's demographic statistics are on a worrying trend all around as the country is becoming older and poorer. The population is decreasing from its peak at the beginning of the decade and by 2040 is projected to be one-fifth smaller than today. The number of people in the prime working age of 25-44 is also falling fast. In the past decade this age group has shrunk by about seven per cent. And even if migration policies are relaxed, they would have to change significantly in order to affect the housing market as immigrants are only likely to consider buying a property if they are assured permanent residence, something that is far from the current political agenda.

Compounding the demographic problem is deflation and falling incomes. In 1996, just before the first rise in consumption tax, the country's average household income was about ¥6.6m. Today, it is about one-fifth lower. Indeed, even though timing the market is hard and past experience shows bubbles can last many years, the next planned rise in the consumption tax in 2017 will be a big challenge for real estate prices. It risks dampening market exuberance just enough to expose the underlying fundamentals.

Governments in most of the rich world have a poor history of deflating financial bubbles before they pop and cause widespread mayhem. But they tend to go into overdrive to limit the damage once a bubble has popped. The Japanese government's reaction to the 2008 events is therefore worth noting for two reasons. Firstly, it provides a template for its likely reaction after the next property crash and second, because its apparent success has created the preconditions for a wider confidence, one that is likely to encourage greater risk taking.

In the aftermath of the 2008 financial crisis that sent Japanese property into a tailspin, policymakers implemented a measure whereby loans to small businesses were guaranteed up to a value of ¥80m with no collateral. This intervention, which helped cushion the market, was very similar to a policy introduced after the financial crisis of 1998-2001 when firms such as Yamaichi Securities and Long-Term Credit Bank met their demise. During that period, the loan guarantee was limited to ¥50m but it was still effective in providing confidence to the market.

In mid-2009, the government went further in addressing bank lending. New measures were introduced that encouraged lenders to renegotiate loan terms with distressed clients. Over the course of the next three years, about three million of these applications were made to banks and nine in ten were approved even though some commentators criticised the policy which they believed encouraged banks to 'extend and pretend' with bad quality loans.

The final piece of economic stimulus was the establishment of the Real Estate Market Stability Fund, known colloquially as the Kanmin Fund, which was designed to support the market for real estate investment trusts, otherwise known as J-Reits. These vehicles are required by law to distribute to investors nearly all the rental income they derive. As a result, they do not have the potential to accumulate internal reserves and thus rely on bank funding. If this is withdrawn, the J-Reit may be left with a cashflow problem. The Kanmin Fund offered J-Reits liquidity which, in turn, incentivised banks to continue to keep their funding channels open. The fund appears to be a success. Since it was established in mid-2009, there have not been any J-Reit failures.

Success with policy during a crisis is certainly a good thing. However, if the market takes for granted that regulators and the government will implement emergency support measures to combat a falling market, it may encourage even greater future risk taking. That would ratchet up the consequences for the wider economy when the next crash eventually hits. ●



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Book review— the scandal of sleep

A review of Jonathan Crary's *24/7*

Aleksandar Kocic

Throughout human history, the most important technological advances (ships, cars, planes, the assembly line) were about using time more efficiently. Recent innovations, however, seem more concerned with fusing work and leisure times or consumption and family times together. Television, fast food, smartphones and the internet all enhance the possibilities of multitasking and, as such, directly affect how we manage our time. We can now easily work and consume away from the workplace or the shopping mall, blurring the boundary between work and private life.

In the west this has given rise to an entrepreneurial culture of the individual, with a pressure to be constantly engaged. Not being switched on equates to falling behind, being out of step and thus losing a competitive edge. In that paradigm, “sleeping is for losers.” Unlike other irreducible activities, which have been successfully commoditised, sleep remains the last frontier resisting colonisation by the engines of profitability.

Jonathan Crary addresses this in his book “*24/7 – Terminal Capitalism and the Ends of Sleep*”. In his view: “sleep sticks out as an irrational and intolerable affirmation that there might be limits to the compatibility of living beings with the allegedly irresistible forces of modernisation... The troubling reality is that nothing of value can be extracted from it.” But if sleep cannot yet be eliminated, it can be wrecked, and efforts towards this are fully in place. Mr Crary argues if this trend of sleep contamination continues, quite possibly sleep “will have to be bought like bottled water”.

The book opens by showing that scientific research on sleep is an unusually active terrain, attracting considerable attention and funding. One example is a study of white crowned sparrows that during their migration along America’s west coast show unusual capacity for staying awake for as long as seven days. This ability has made them a particularly interesting

subject for the army – there is an obvious benefit of engineering a sleepless soldier that could engage in combat for unspecified duration of time while maintaining alertness.

As with other inventions that spread from military to civilian life—for instance penicillin, microwaves, nylon—the next logical step would be to produce sleepless workers and sleepless consumers. Merging humans with machines is the obvious way to achieve this. And while this transformation from crown sparrow to sleepless soldiers to sleepless workers and consumers might not have immediate dystopian repercussions, the book suggests such a trend enhances the idea of human disposability. After all upgrading someone to a more efficient version is an implicit recognition that their earlier version was less valuable. The book elaborates on the consequences of these developments and outlines the contours of a society where these trends are fully developed.

On some level, the book is homage to Paul Virilio, the theorist of accidents and grand maître of cultural theory. In Mr Virilio’s words: “Invention of a ship is invention of a shipwreck... progress and disaster are two sides of the same coin. And, the more powerful the invention, the more dramatic its consequences. So, it is inevitable to reach a point when progress and knowledge become unbearable.”¹ The power of his explanation of causality is it can be applied to almost any context, including Mr Crary’s warning of threats to sleep. When it comes to rationality, when set free and unchecked, it eventually demands the removal of any obstacle to profit maximisation. Instead of working for living, we risk living for work – our efforts no longer serve to subsidise the enjoyment of our free time, but we use our free time to become more productive workers.

1 Paul Virilio, *The original accident*, London: Polity 2007, pp 21-33.

Ideas lab—motivation at work

Charlotte Leysen

Talk to company managers about how to improve employee motivation and productivity and monetary reward are among the first things to be mentioned. The truth, however, is that motivation is more complicated than just paying more money. Adrian Furnham, Professor of Psychology at University College London, spoke to Ideas Lab about how money is a powerful de-motivator. There are better ways to increase worker productivity, he argues.

He started by explaining the two types of motivation: intrinsic and extrinsic. The former is when you do something for pleasure. For example, fishing as a hobby is done purely for the joy of fishing. Extrinsic motivation is when you do something for some specific reward, such as money. The more a job is intrinsically satisfying, Professor Furnham argues, the more people are motivated and happy with it. He makes the observation that potters, people who make and paint pots, earn an average of just £20,000 a year but have one of the highest levels of job satisfaction. They do what they love.

Money, on the other hand, is a de-motivator. Studies show the gratifying effect of a salary rise does not last long and you soon recalibrate to a higher level of income. Monetary rewards are shown to make workers ignore the fundamental or intrinsic reasons why they are in a job. Contrary to regulatory fears, money can often discourage risk taking while making people feel bribed.

A study of 15,000 individuals conducted five years ago showed there is almost no correlation (less than two per cent) between job satisfaction and a high salary. An insightful example of the negative effects of money is blood donation. Donations are said to be much higher in the UK than in America because people give blood for free in the UK whereas donors get paid in the US. Clearly, money changes the nature of the relationship and causes big motivational changes.

Professor Furnham went on to explain that money is also demotivating because it is human nature to strive for fair distribution of wealth or assets among peers. Therefore, it is common to ask: is it fair what I'm being asked to do, given what I receive in return? Is it fair in comparison to what the people around me receive? We are all sensitive to perceptions of fairness. Hence the returns from paying more are low when firms are prone to lying or hypocrisy, or where distrust is common and rules are enforced with intrusive techniques such as cameras. Broken promises, around salary for example, can lead to workers being disenchanted and unhappy.

The presentation concluded that a carrot and stick form of motivation does not work anymore. Others, such as Daniel Pink, author of bestselling business and management book "Drive", have also proposed that businesses should adopt a new approach to motivation. Humans have an innate drive to be autonomous, self determined and connected to one another. Professor Furnham references professors as an example – they are not highly paid, but have a great deal of autonomy. It does not matter where or when they do their work (research), the output or final piece is all that matters.

The lesson from this Ideas Lab lecture is organisations should focus on these alternative drivers of motivation and productivity when managing their human capital. They should create settings that focus on employees' innate need to direct their own lives, learn, create and work.

Conference spy— slumping commodities

Notes from Deutsche Bank
conferences on Metals & Mining
and Oil & Gas

Sahil Mahtani, Luke Templeman

Truth in forecasts: Nobody knows anything. William Goldman's quip about Hollywood applies to mining too, as one old hand wondered whether all forecasts were bunk. For instance, at the turn of the millennium, China's annual steel production was expected to double to 200m tonnes by 2010. Instead, it was 700m. Go back further and a mining industry survey in the mid-1980s did not mention China at all in its "next thirty years" chapter. Similarly in 2000, Rio Tinto was criticised for its lucrative North acquisition on grounds that iron ore was unexciting. All these examples relate to China but will there be another China? Today feels like the mid-1980s, said a bearish analyst, when miners had not realised that Japanese steel consumption had peaked and hung on to capacity while droning on about "making assets sweat."

Mining technology: Like boys with their toys, miners are prone to awe-struck comparisons. The Norilsk-Talnakh mines in Siberia were "without question the finest iron ore body in the world." Also particularly fêted were Rio's Pilbara mines in Western Australia, far to the left of the cost curve and still falling. Lower energy costs, a weaker Australian dollar, and automation initiatives have pushed cash costs down a third since 2012. When Rio first pursued automation initiatives, it reckoned it had a two year head start over competitors. It now reckons it has ten years. Today 60 per cent of trucking is automated – with better mine mapping all of it can be – and every automated truck replaces four expensive drivers. And don't get Rio started on its automated trains.

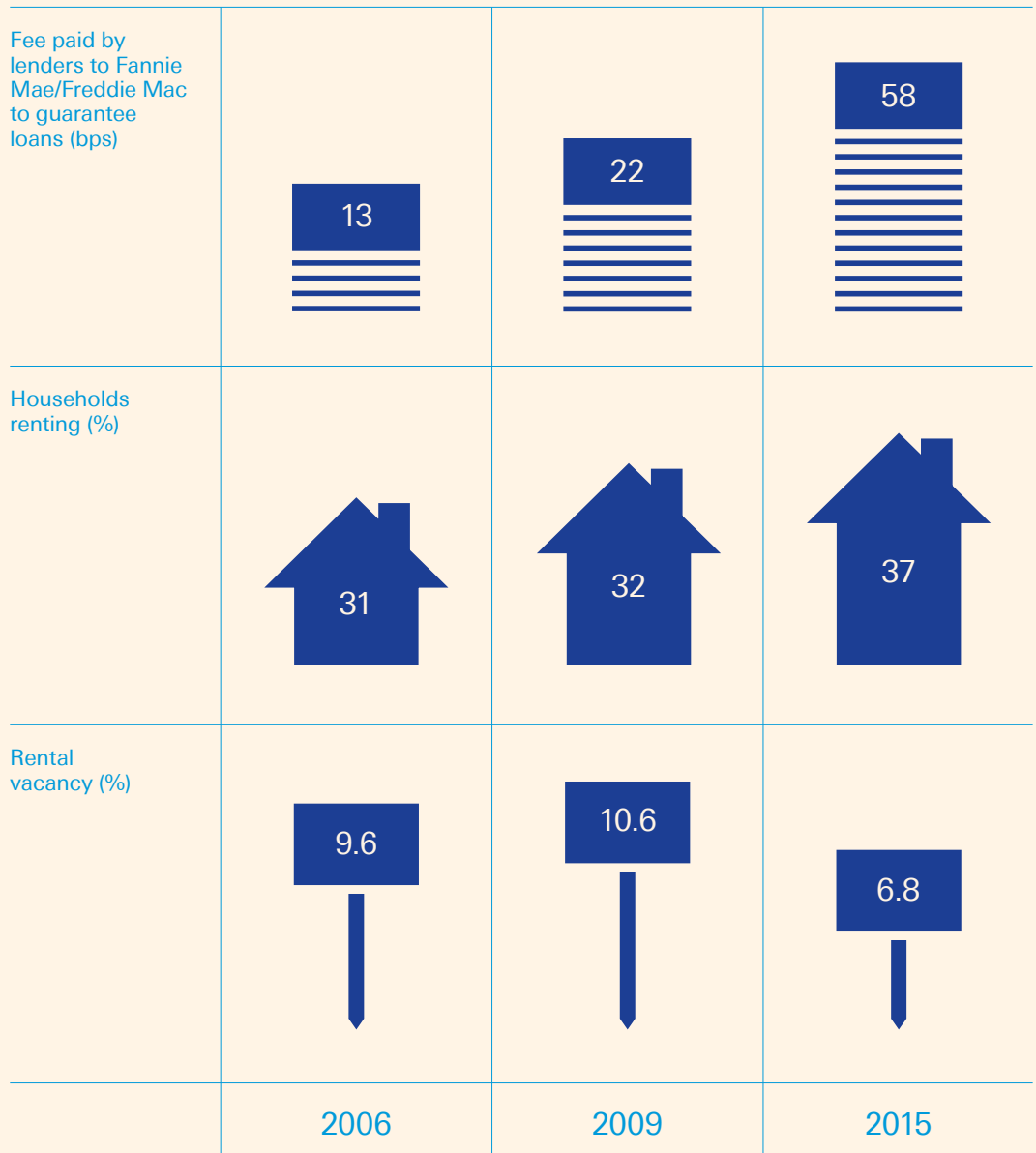
Cost deflation: Pumping a barrel of oil may cost single digit dollars for some Middle Eastern oil companies but they are outliers. In fact, only one-third of the world's oil and gas resources break even at \$50 a barrel. That was fine when oil was at \$100 and producers pumped relentlessly. Now, restoring profitability is the order of the day. Ironically, higher cost projects may be the biggest beneficiaries. The rush to pump in deep water, for instance, left bloated cost bases now

primed for streamlining. Producers are also locking in long-term contracts with services companies, with some prices one-third lower. Cost cutting was a theme shared by miners, with one projecting a 15 per cent cut in equipment costs. But a nearby capital goods analyst noted his firms had yet to see those cuts.

Saudi Arabia/Iran: Saudi Arabia may dominate the world's oil supply but life is becoming tougher. Costs on existing projects have doubled over the last decade and meaningful new ones are scarce. Indeed, the \$6bn spent exploring in the Red Sea and the country's north yielded disappointing results. However, just across the gulf, Iran is gearing up. Assuming sanctions are lifted, foreign capital can replace aging infrastructure and boost recovery factors which at 25 per cent are under half those in Saudi. Furthermore, less than one-tenth of Iran's gas reserves are currently being exploited. Bureaucracy and regulation continue to be bugbears (only Chinese companies have an established presence) but much of Iran's resources are on-shore or in shallow water making them cheap to extract.

US tight oil: America may not produce the world's marginal barrel of oil but it does produce the most flexible one. That was the message from consultants Wood Mackenzie on the US tight oil industry. This flexibility is a necessary by-product of the cost curve. While only one-eighth of projects break even at \$45 oil, many make sense at \$55-\$60. The problem, though, is that it takes five times longer to ramp up capacity as to slow it down. As a rule of thumb, an oil crew that sees limited work for six months will go elsewhere or leave the industry altogether. As tight oil producers wait out low prices, crews have been offered contracts as short as three weeks to keep them close. If oil prices stay low, the famed flexibility may stiffen considerably.

Infographic—US homeownership



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