June 21, 2016

A HISTORY LESSON: WHAT NEGATIVE INTEREST RATES TELL US ABOUT THE COMING INFLATION TAX

Quantitative Easing (QE) and negative interest rates—until recently—seemed to be impossible phenomena, but this is not the first time Quantitative Easing has been brought into action. A practically identical structure was used in the 18th century in France, when the government was hopelessly mired in debt. The French QE had two purposes: assessing an inflation tax on capital and ensuring low interest rates.

For governments, the only way to solve a chronic debt problem without causing a strong negative reaction in society is by assessing an inflation tax—by printing new money, the state imposes a ***tax on capital owners***.

The popularity of the inflation tax is due to its unobtrusiveness. For example, originally, one British pound equaled one pound of silver (sterling). Today, one British pound buys only 1/177 pounds of silver. Thus, in the past century, the state has confiscated 176/177 of the population's savings using the inflation tax, but capital owners have barely noticed it.

In 1718, the French government invented ***a revolutionary inflation tax solution—the Mississippi System***, which became the world's first financial innovation. The plan was to create a company with monopolistic trading rights in the gold-rich Mississippi colony and then swap government debt for the company's shares.

But how could the French government persuade creditors to convert the "risk-free" government debt into shares of the private Mississippi Company? ***The state gave the Mississippi Company the right to print paper money***, which was used to purchase shares of the company itself, thereby leading to a rapid increase in the share price from 140 to 10,100 livres. Before long, creditors were lining up to exchange the government debt (billets d'état) for the skyrocketing shares.

The system was based on the people's tendency to automatically copy others' behaviors. Seth Klarman named this phenomenon "***trading sardines***," based on an event in Monterey Bay, when sardines stopped coming to spawn in the area. The prices for canned sardines suddenly rose, and cans were passed back and forth from person to person at an increasing price as a form of trade. People started blindly copying the behaviors of others, and nobody paid attention to the prices anymore, as ***the next day's prices would certainly be even higher than today's***. But when one of the buyers opened a can and found that the fish had long become inedible, he got a tough rebuke: "You shouldn't have opened these sardines. They are not for eating; they are for trading. "

Resisting the temptation to trade "sardines" is very difficult. For example, Sir Isaac Newton was one of the initial investors in the British analog of the Mississippi

System. Having pocketed a 2-fold profit, he sold shares and publicly exposed the nature of the system. However, when the price increased further by 400%, even Newton—one of the best minds in history—could not resist and bought it again, this time losing everything.

The official goal of the Mississippi Company was interest rate reduction, as the high cost of capital was commonly considered the major reason of the economic crisis. Because the Mississippi shares paid fixed dividends—in fact, interest payments—higher share prices caused a reduction in interest rates (as the price of the debt security increases, its interest rate falls). At the peak of the system, interest rates were as low as 2%.

At the time, only the government knew that the Mississippi colony didn't have gold. ***The actual purpose of the Mississippi Company was to print money and impose the inflation tax on capital by creating a speculative demand for the government's debt. Record low interest rates were a by-product of this debt-engineering mechanism.***

Now history is repeating itself. In the beginning of the 21st century, the US faced an acute public debt problem as well.

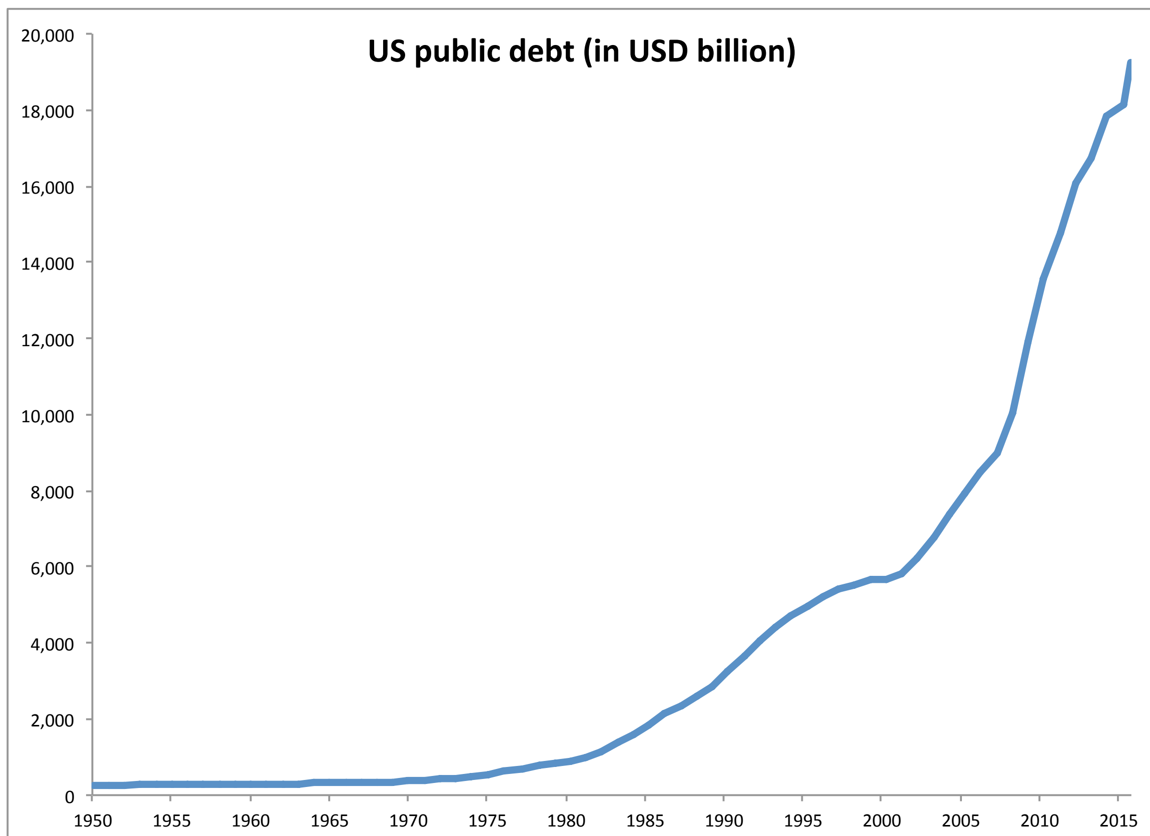

Chart 1: The US public debt (US$ billion). Source: St. Louis Fed.

Similar to France, America didn't have any choice but to start printing money and preparing the inflation tax. However, it was necessary to find some sound justification for turning on the printing press. The French Mississippi System has become useful, with its hypothesis of lower interest rates as the main remedy to fight unemployment. Thus, ***the issuance of an enormous amount of new money was explained not by the highly unpopular inflation tax, but by anti-crisis measures.***

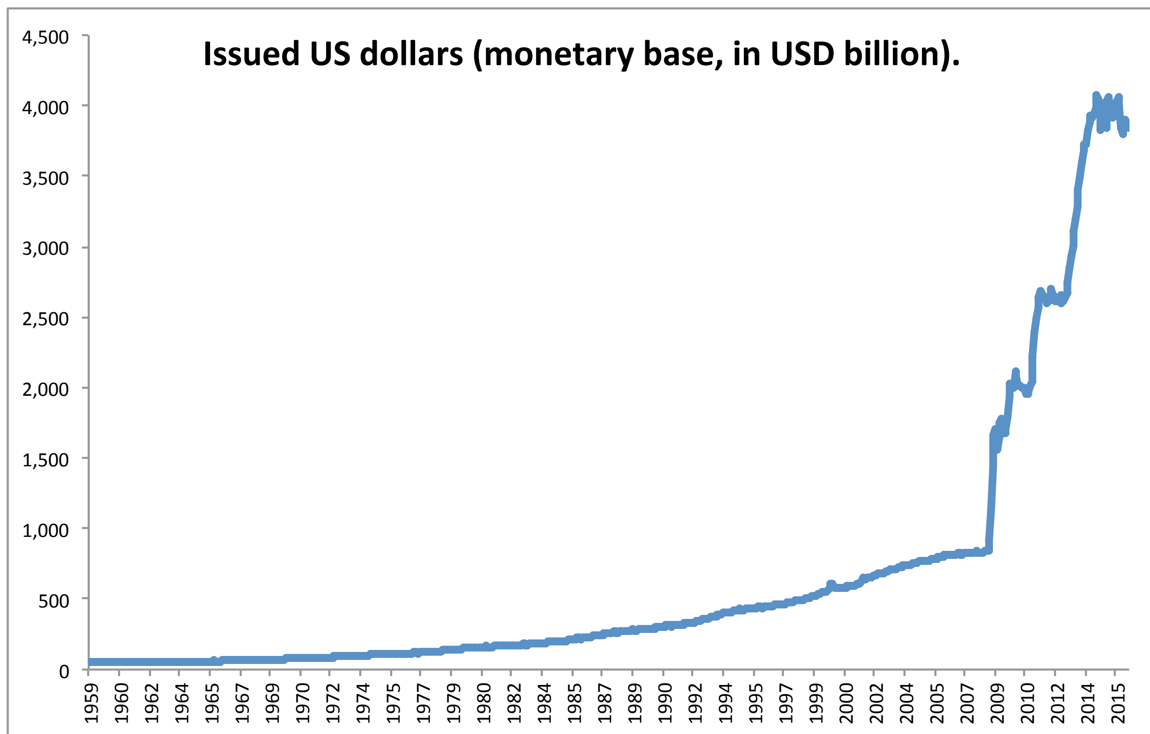

Chart 2: Money issued (Monetary Base). Source: Federal Reserve Bank of St. Louis.

The design of the Quantitative Easing was largely copied from the Mississippi System: ***The state used a significant part of the printed money to buy government debt securities (treasuries), which led to an increase in their prices and ignited a classic spiral of speculative "sardine" trade.*** The only substantial difference in the structure of the modern QE system was that the government was buying its debt directly, not through an intermediary company.

As the demand for treasuries increased, interest rates fell dramatically. Currently, long-term rates are approaching the negative benchmark while short-term rates are already practically zero.

On the one hand, zero and negative rates are meaningless. Indeed, who would loan capital if they were guaranteed to get back the same amount or even less at maturity?

But this phenomenon can be explained by the simple fact that buyers of the treasuries have ceased to look at what these securities would return at maturity. Just like the Mississippi System, today's buyers are focusing exclusively on tomorrow's prices. ***We are witnessing the standard sardine-trade cycle***. If the price of a debt security is even higher tomorrow, what difference does it make if the interest rate has become zero or negative? ***Buyers no longer plan to open these "sardine cans."***

Three hundred years ago, the Mississippi System wrote off the French public debt at the cost of colossal ensuing inflation. Today, if history repeats itself, we can also ***expect a period of intense capital inflation tax.***

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