The Cost of Safety

Author Stephen Marchant August 2019

As greed turns to fear the herd search for safety. This applies to those particularly heavily invested in financial products and even those who are passive investors with substantial savings. The perceived safety of Govt bonds is anything but safe as interest rates are driven to zero and below. At what point does fear turn to panic as even Govt bonds are defaulted upon – first slowly and then a final crash.

The reason for this is that we are in a monetary fantasia where fiat currencies have no hard benchmark and we are all in a game of pass the debt parcel. The problem of maintaining that growing debt parcel relies on driving interest rates ever lower and into negative territory. From a layman's perspective this is madness. With a rate of -0.5% you could loan me $1m and pay me $5k per anum to keep hold of the money – nice work if you can get it! Better still loan me $1bn and I can live like a king on $5m per anum. In fact there is a Danish bank now offering mortgages of -0.5%.

From a savers perspective this is the worst possible situation as even without a sudden default a 30 year bond at -0.5% would lose 15% of its principal without taking account a sudden default or a de-facto default through compounded annual inflation. With a modest annual inflation of 3% the purchasing power of the bond would be reduced by two thirds at the end of its term. This would wipe out pension funds or at least cause actuaries to substantially reduce pension payments.

From a business perspective there would be no opportunity cost of depositing cash with a bank at a negative rate. It would encourage companies to stockpile to the point where warehousing exceeded the cost of loaning the bank surplus cash. For businesses using non-perishable commodities such as coal, oil, gas, metals etc this would be likely but for supermarkets with much perishable stock it would be problematic however they may use cash to buy futures options for commodities rather than depositing cash in a bank. This action in itself would increase prices as surplus cash would be chasing assets. You see my thinking, the very negative rates could lead to a stagflationary environment rather than investment in productive capacity.

From a consumer's perspective what would be the point of saving when I see the nominal savings dwindle and the added problem of inflation reducing its purchasing power. If one had limited savings better to hoard non-perishables and no doubt larders would be filled with long dated tinned products. Those with a substantial amount of spare cash may keep it under the mattress, the tech savvy may invest in crypto such as bitcoin and others might buy physical gold or other precious commodities.

Some might say that negative bonds are not a problem as long as rates keep falling because one can sell on the older less negative bond and take a profit. This is nothing more than a ponzi scheme and at what point do interest rates go too far into negative territory? We are already seeing a large upward movement in the price of gold which is reflecting this debasement of fiat currency. There will come a point where the only money going into negative yielding bonds are the pension funds that are forced through Govt regulation to buy them so that ordinary workers will be paying the price of default through reduced purchasing power of their pensions. Even this will eventually break down as those with pensions and even deferred pensions realise they are being cheated.

Government spending is likely to increase as they are paid to run any deficits as in the case of Germany and Japan. With the global economy slowing and individual nations such as Germany heading for recession there is political pressure for Govts to cut taxes and increase their share of GDP spending. This in itself may lead to stagflation as politicians seek quick fixes of firing up consumer demand for short-term political gain.

Mortgagees stand to gain if we have a period of stagflation on the scale of the UK in the 1970s. Official inflation peaked at about 25% in 1975 and remained in the high teens until the early 1980s. Those workers with strong wage bargaining power faired best but businesses with weak pricing power, pensioners and those on fixed returns suffered badly. Whilst house prices stagnated the salary/mortgage ratio dramatically improved albeit with pain of fluctuating mortgage interest payments.

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The IMF recently published papers advising member Govts on how central banks may implement negative interest rates:

1) Abolishing all cash

2) Discounting cash as retail banks make withdrawals and deposits from the window of central banks.

3) Maintaining zero rates for small deposits and fully negative rates for large deposits.

4) A lottery where cash with certain serial numbers are made obsolete on a regular basis.

Whichever way the central banks coordinate their policies they are faced with two choices, neither of which is safe:

1) Allowing the debt bubble to burst as interest return to normal levels. This would inevitably mean mass bankruptcies and a severe recession, nay depression with huge political risks.
2) To continue money printing and low rates but to funnel the money to Main Street rather than Wall Street. If done over a long period of time with careful targeting to infrastructure and production capacity it need not be too inflationary. However, there is likely to be a panicked reaction from our political class which will lead to quick fixes to fuel the consumption and hence stagflation would be the result.

As ordinary citizens we should not fear the future but equally not anaesthetise ourselves to the dangers of the current monetary system. We can do small things by keeping savings in gold, silver and holding the minimum of fiat currency for day to day living costs. We can build stronger local communities and even try bartering for services and produce. The less we rely on the corporate money machine the stronger we are as individuals, families, neighbourhoods and local communities. The greatest danger we face is that stagflation pits one group of workers against another as society is riven by industrial unrest, business failures and those who are left behind. The elites will not care so long as they have a peaceful haven in which to enjoy the wealth that has been extracted from our debt fuelled economies. The greatest danger to them are capital controls that will prevent them from fully escaping the stagflation.

“Your Comfort Zone Will Kill You” is the graffiti I recently saw on a wall in France. How long before that safety blanket of ‘cheap money’ and easy credit is ignited with stagflation?

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