Little by little, we went insane

“Are we finished? The answer is no.”

- Mario Draghi, President of the European Central Bank, 5th June 2014, having just cut ECB deposit rates to minus 0.1 percent.

“The first panacea for a mismanaged nation is inflation of the currency; the second is war. Both bring a temporary prosperity; both bring a permanent ruin. But both are the refuge of political and economic opportunists.”

- Ernest Hemingway.

“The way to crush the bourgeoisie is to grind them between the millstones of taxation and inflation.”

- Vladimir Lenin.

“Mr Draghi did more than expected and promises still more if necessary. Interest rates could be made even more negative if the ECB thought fit. It might also agree to make large-scale asset purchases. Yet the ECB is battling disturbingly sluggish demand. It would be remarkable if what it has done so far proved enough. If it did it would be because, as was true of the OMT, Mr Draghi has pulled off a benign confidence trick. If he convinced enough people, he might have already achieved his aim. If not, more must come. The will to act is now clear.”


“Unfortunately this rabbit is not going to put up a brave fight, unlike the one in Monty Python’s Holy Grail. Speaking for Italy, which is the sick lady of the euro zone, the problem is neither the availability of financing, nor the cost of it. I can assure you that, at this moment, any half decent company in the country has the opposite problem; we are under the constant soliciting of banks offering us an almost unlimited supply of money at a cost which may very well be at a historical low. So why is Italy's GDP in permanent contraction? Because nobody sane wants to invest in the
country. Italian manufacturers are investing in Eastern Europe, in Asia and even in Latin America, basically anywhere as long as it is not in Italy. Rightly so I may add, as the Italian government (yes even Renzi’s) is the sworn enemy of the private sector economy, the sworn enemy of capital and the best friend of a paralyzing bureaucracy, whose only reason of existence is to bleed money out of the country’s companies. Unless there are massive and revolutionary pro-business measures, much like the ones taken by ex-communist states redeeming to capitalism, there is nothing that the ECB can do. We need a killer rabbit, this one is just an optical illusion.”

- Harry Haller on the FT website, in response to Martin Wolf.

“Everyone loves an early inflation. The effects at the beginning of inflation are all good. There is steepened money expansion, rising government spending, increased government budget deficits, booming stock markets, and spectacular general prosperity, all in the midst of temporarily stable prices. Everyone benefits, and no one pays. That is the early part of the cycle. In the later inflation, on the other hand, the effects are all bad. The government may steadily increase the money inflation in order to stave off the latter effects, but the latter effects patiently wait. In the terminal inflation, there is faltering prosperity, tightness of money, falling stock markets, rising taxes, still larger government deficits, and still roaring money expansion, now accompanied by soaring prices and ineffectiveness of all traditional remedies. Everyone pays and no one benefits. That is the full cycle of every inflation.”

- Jens O. Parsson, ‘Dying of money: Lessons of the great German and American inflations’.

“Facts do not cease to exist because they are ignored.”

- Aldous Huxley.

**If it looks** like insanity, smells like insanity, tastes like insanity, feels like insanity and struts about barking, “This is insanity”, then perhaps it might just be insanity. Consider those three little words from the FT’s resident inflationist-in-chief: interest rates could be made “even more negative” if the ECB thought fit. We are truly through the looking glass.

“We were in the jungle. We had too much money. We had too much equipment. And little by little, we went insane.”

Not the words of Mario Draghi – yet. They are the words of film director Francis Ford Coppola in relation to his *magnum opus*, ‘Apocalypse Now’, a film that so outrageously exploded beyond its budget and beyond any reasonable compass that during its making it started being referred to as ‘Apocalypse Later’. Coppola’s unique vision came at a price. What was expected to be a 14-week shoot in the Philippines ended up taking more than a year. Coppola fired his leading man, Harvey Keitel, after just two weeks. His replacement, Martin Sheen, turned out to be fighting alcohol addiction and suffered a heart attack on set. Numerous members of the crew went down with tropical diseases. At key points, helicopters hired for pivotal action sequences were suddenly redirected to quell a revolt in the southern Philippines. Then a typhoon hit, the set was destroyed and the production was shut down.

Throughout all of it, Coppola was dealing with increasingly worried money men back in Hollywood as the film’s budget ran dry. As the film’s scriptwriter, John Milius, pointed out: “Studio executives, you know, are not noted for their social courage”.
And then Marlon Brando arrived on set, so hugely overweight as to be almost unrecognisable. He didn’t have the barest knowledge of the script. And there were actual dead bodies on the set, bought to add some ‘atmosphere’ from a local who turned out to be a grave-robber. Then Brando shaved all his hair off and insisted on improvising all of his scenes.

Coppola had sunk his own life savings into the film. He faced financial ruin if he couldn’t finish it. He suffered a nervous breakdown and on at least three separate occasions allegedly threatened to commit suicide. “My movie is not about Vietnam,” he once explained, “my movie is Vietnam.”

The markets are not about Vietnam. They are Vietnam. There’s a difference, of course. When a film studio runs out of capital, the production gets shut down. Corporate resources can only ever be finite. But when a government runs out of capital, it simply borrows more. Or taxes more. Or both. At least for as long as it has access to credit by way of maintaining the confidence of the bond market.

Practically every western government has got its finances into a desperate mess. In the words of US fund manager Paul Singer of Elliott Management,

“America is deeply insolvent, and for that matter, so are most of continental Europe, the UK and Japan.”

For as long as governments can perpetuate the illusion of solvency, they can continue to borrow, and therefore also to spend. But once the illusion is broken.

The chart above, courtesy of Incrementum AG and Ronald Stoeferle, shows the extent of the problem. We all know that Japan is drowning in debt, which makes Japanese Government Bonds about the most dangerous asset in the world right now, especially given the Bank of Japan’s pledge to double its monetary base, ensuring that holders of JGBs will be paid back in ever less valuable currency. But the vulnerability of the UK’s creditworthiness is less widely appreciated. Pimco’s Bill Gross, still clinging on to the $229 billion remaining in his Total Return bond fund, referred to UK Gilts as “resting on a bed of nitroglycerine” as far back as 2010. The UK is hardly alone in running its national treasury on empty. Not one single major western government possesses a stable balance sheet. Everybody has thrown caution to the winds, in the illusory hope that ultimately somebody will pay. If you hold western government bonds, that somebody is likely to be you.
Actions have consequences. Governments are no different from individuals or corporations or film studios in this respect – they can merely perpetuate the myth of solvency for longer, given the credulity of global capital markets and of agency investors with no real skin in the game in their bond portfolios. But at some point, the piper must be paid. Which is why every major western government is determined to inflate, and pay the piper (bondholders) in ever more worthless paper money. And this is why Mario Draghi has now driven interest rates to below zero. The natural corollary to universal currency debasement is to own a currency and durable store of value that cannot be printed on demand. If only we could find one.

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