

July 20, 2012

"Only the government can take perfectly good paper, cover it with perfectly good ink and make the combination worthless."

-MILTON FRIEDMAN

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The Taylor House Rules. Numerous past EVAs have highlighted the famous, at least to monetary authorities and economists, "Taylor Principle" (aka, the Taylor Rule), named after John B. Taylor, currently professor of economics at Stanford University. Remarkably, for someone who has never been a member of the Fed, his Taylor Principle has had a powerful impact on central bankers worldwide—at least until the last few years.

Simply put, one of the key elements of the Taylor Principle is that interest rates should rise more than 1% for each 1% increase in inflation. Other aspects of the Taylor Principle itself take into account how far above or below full capacity the economy is at a given point in time. It also includes determining what interest rate level is consistent with attempting to maintain the ever-elusive condition of full employment.

Although the Federal Reserve never explicitly endorsed the Taylor Principle, or admitted to following its tenets, the reality is that for many years Fed policies roughly tracked it. But, as with so many other reliable parameters of finance prior to the credit cataclysm, this rulebook has apparently been ripped up, or at least forgotten on a dusty shelf somewhere in Ben Bernanke's attic.

Thus, it was no surprise that in a July 4th *Wall Street Journal* op-ed piece, Dr. Taylor took the Fed, and other central banks, to task. In essence, he accused the Fed's long-running zero interest rate policy of creating a series of unintended consequences, many of a most negative nature.

This leads me to this week's guest EVA, written by one of my favorite observers of most things financial and economic, Charles Gave. In his essay, *Obsessed by Negative Real Rates*, Charles is responding to his long-time partner, Anatole Kaletsky (the Kal in GaveKal).

As you will read, Anatole has accused him of having an unnatural fascination with interest rates below inflation which, in geek speak, means "negative real interest rates." In case you think this is an arcane and irrelevant topic, Charles plausibly argues that the Fed's disregard for a reasonable cost of money has caused planet Earth to shell out \$2.2 trillion more than it should have for its annual oil bill alone. In other words, we've all paid dearly for the Fed's vain attempt to eliminate the normal ups and downs of the business cycle.

In fact, it's Charles' contention, one with which I concur, that the Fed's ultra easy money policies have been the prime factor in the serial bubbles and busts we've seen around the world over the last decade. Sound a bit too much like Ron Paul? It's time for you to be the judge of that...

David_Hay_Signature

Obsessed By Negative Real Rates
By Charles Gave

While we were debating the policy mix in the US, my good friend and partner Anatole recently told me that I was "obsessed by negative real rates in the US." This is absolutely true, and led me to begin thinking about why. While I have done plenty of research on how counterproductive negative real rates are for individual economies (see [Ricardian Growth](#), [Schumpeterian Growth & The Cost Of Capital](#)), I have done less direct work on how Keynesian excess in the US affects the rest of the world. This is a gross lack of due diligence. As the world's reserve currency, US monetary policy is felt around the world.

Stage 1—Bubbles and taxes

Abnormally low or negative real rates in the US are initially exported to the rest of the world in the form of bubbles and increased "taxes" in the form of higher commodity prices; later comes the reckoning in the form of dollar shortages, sub-par growth and private sector crowd-out.

We shall start by looking at the trade-weighted dollar. The green shaded areas below correspond to periods during which three-month Treasury bill yields are lower than the 12-month inflation rate. These green periods have been pushed forward by a year. The grey shaded areas correspond to the US recessions, while the red line is simply the trade weighted US dollar index. It is no surprise that negative real rates dilutes the value of the dollar. What is interesting is the timing; the US dollar starts falling one year after rates go negative. It seems the markets do not much mind if real rates are negative for a year or less when a recession has struck US and/or if a temporary shock is hitting (first Gulf war). A full year of negative rates, however, smacks of a policy error and the punishment comes.

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This decline in the US dollar has many consequences, including a massive rise in the prices of certain assets which can be considered as alternative reserves of value, such as oil or gold. Gold does not matter much except as a sign that the monetary policy is wrong. Oil is very important.

In the chart below, the periods of negative real rates have been pushed forward not by one year,

as in the previous chart, but by two. Each such period is followed, eventually, with oil and gold prices moving up massively, and roughly in the same proportion. It seems safe to assume that negative real interest rates are at least partly responsible for the US\$100 increase in oil prices per barrel since 2002.

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So negative real US rates create a tax for the world's consumers—while at the same time enriching the oil-producing countries, which in general are non-democratic and have a pretty poor track record of allocating capital properly. Oil today is about \$75 more per barrel than it was a decade ago. So a rough estimate shows that with 80mn barrels a day consumed globally, the annual global bill for oil is US\$2.2trn more than it was before the US Federal Reserve launched an aggressively Keynesian monetary policy. This make the fiscal cliff look small in comparison. Meanwhile, much of this is being paid into the coffers of great people such as the Russians, the Venezuelans or the Iranians.

It would be silly to say that the Fed is fully responsible for such a tax increase, given the emergence of Chinese demand as a major swing factor. But what can be said is that the Fed has *monetized* this increase in oil prices, as it did during the first oil shock in the 70s, and that this monetization has exacerbated the rise in oil prices. The proof can be found in the observation that both gold and oil fell in the 1980s after the Fed, under Paul Volcker, stopped the monetizing.

Stage 2—Deflation and crisis

Consumption bubbles fuelled by negative real rates always contain the seeds of their own destruction. Debt levels get too high and force household deleveraging; meanwhile the currency falls, which improves competitiveness in the global marketplace. The combined effect is a narrowing of the current account deficit. When the world's reserve currency nation experiences such a narrowing, the supply of dollars outside of the US falls, and inevitably catches some countries out (see [The Unfolding Liquidity Crisis](#)).

The best way to look at global dollar supply is to remove China and oil from the US current account balance; this is because of the incredible competitiveness of China, and the scarcity-value of oil producers. Excluding oil and China, the annualized US current account has moved from a deficit of 3% of GDP in 2003 to a recent surplus of 1% of GDP.

This improvement in the current account position has taken place despite the fact that most of the world is growing well below its potential. In effect, the US economy has exercised an immense deflationary pressure on the margins of companies outside of the US, and in so doing has managed to "recover" roughly 4 % of its GDP.

This turnaround underlines just how low the value of the US dollar fell after years of dilutive monetary policy. Moreover, the pressure of a cheap dollar has been compounded by mercantilist China's de facto peg to the US dollar. No wonder so many current account crises are percolating around the world—countries from Egypt to Italy to India have had to deal simultaneously with a hypercompetitive dollar, an undervalued renminbi and higher oil prices:

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While the oil producers and China may still be sitting on a ton of US dollars—which they are recycling into USTs and thus keeping US government borrowing costs at bargain-basement levels—the dollar supply elsewhere in the world has fallen sharply. The countries which have no access to the US currency have to start using their foreign exchange reserves to meet their payments (very often to oil producers and China), thus amplifying the problem. When a country is forced to sell reserves, then it has to follow restrictive monetary and budget policies to depress domestic demand and recreate a current account surplus. The cost of capital rises sharply for the private sector. India today offers a prime example of a country stuck in this corner (see [The RBI Does What It Can: Very Little](#)).

In the chart below, I am showing the 12-month variations of foreign central bank reserves deposited at Fed—this is excluding China (I would also exclude the oil producers, but could not find a way of estimating their forex reserves). **Past periods of rundowns in global forex reserves always have been associated with crises.**

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When the US current account deficit starts closing, the dwindling supply of dollars eventually leads to a panicked rush for dollars. Non-US companies that binged on dollars when the money was cheap and the dollar was forever going down, now find themselves caught out. **Every entity with a negative cash flow in dollars scrambles for dollars — even though selling local assets and converting the proceeds — depressing risk assets everywhere.**

The US dollar and USTs outperform everything, including industrial metals (see chart overleaf). And of course equities are not spared (see chart overleaf).

Needless to say, if one has to be invested in equities in these periods, stay in the US stock market (as US companies will not have such troubles) and avoid non-US equities except when they become extraordinarily cheap versus the US market (e.g., a ratio below 1.2x).

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I could go on and on with other examples, but let's just get to the point: **one cannot operate a capitalist system if the state can borrow at a negative cost.** Years of irresponsibly loose monetary policy in the US has led to cheap funding for the US (and other) governments, but difficult credit conditions for the private sector all around the world. As I underlined in [How The World Works](#), negative real rates leads to misallocation of capital which ends in asset deflation, while simultaneously limiting the capacity for recovery by driving out the private sector.

The Fed has been managed by a bunch of Keynesians who care nothing about the role of the dollar as a reserve currency and who probably believed they were managing the central bank of Belorussia or Zimbabwe!

So what's an investor to do?

Now at this point, the reader may feel I am about to suggest buying a ranch in Oklahoma, a few guns and some nuggets of gold. This is not my recommendation—at least not yet. In fact, for more than a year now, we have been recommending assets with a positive cash flow in US dollars. We see no reason to change the portfolio yet. Indeed, because the US bond market has absorbed so much of the world's "panic liquidity," a number of US assets are still reasonably priced (corporate bonds) or even cheap (e.g., platform companies, or good quality residential real estate).

The big question is whether there is scope for more sane central banking, and an improvement in liquidity conditions. In some ways I feel hope:

- Oil prices have come down a lot, and the US dollar is rising (despite the Fed's frenetic distribution of swaps).
- China is internationalizing the RMB (it's currency) and increasingly widening its capital account, to provide another source of liquidity.
- If non-US assets become cheap enough, then more risk capital will start flowing in that direction (a break-down of the euro would be very useful here in so far as it would instantly create a lot of very cheap assets in Italy, Spain, France, etc.)

In an ideal world, central banks would stop manipulating prices and would return to the Wicksellian rule which worked so well from 1983 to 2002—i.e., they would decide to put short rates gradually back at a level consistent with the growth in the local private sector GDP. I know full well that allowing short rates to go up at this time flies against the current Keynesian orthodoxy at the Fed. A few Fed officials have already acknowledged that with the Fed balance sheet as enormously large as it, future QE action will simply have much less bang for the buck. Unfortunately, with yesterday's FOMC announcement on additional funds for Operation Twist, it is clear that any voice of reason in that organisation will be drowned out the by Keynesians on board.

I can only take solace from the fact that political winds also do not seem to be blowing in the Fed's direction. We may have to wait for November—to see if the voters fire the Fed. Such an outcome would be very bullish for global risk assets.

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