February 2016

Tax Talk 2016 ©

Economic Forecast for 2016

In 2016 it is the banks, not the IRS or the French Fisc directly, that should worry taxpayers. Without any historical precedents, a handful of European countries have, since the middle of 2015, issued bonds at negative nominal rates, in a deliberate policy of formal financial repression. Believing that the current economic malaise is the result of a “savings glut” and “secular stagnation,” policy makers in Germany, France, Denmark, and Switzerland have gone beyond selling bonds at *real* negative interest rates (i.e. negative *after* inflation) to selling bonds which are *nominally* demarcated at negative rates on the day they are sold. This literally involves the sale of IOUs with no intent to repay them in full, and/or which require that those buying them pay regular fees for the privilege of continuing to own them; standing in stark contrast to the historical practice of rewarding bond owners with regular interest payments. The main buyers of these bonds are the central banks of the respective counties where they are issued and thus the taxpayers whose money they use for this purpose. Major financial institutions are second, and amongst them American purchasers comprise the largest non-European contingent either for reasons of hedging against Euro/Dollar currency volatility, or to obtain cheaper finance for American corporate operations outside the United States.

There are a number of possibilities why creditors might be interested in lending money to a government which is upfront about never paying them back fully, but the underlying assumption is that as an asset class, these negative assets will still be more valuable than other assets which will decline more steeply or simply default. This is as dark an outlook as they get and it's based on market expectations, not the ruminations of analysts.

The ability of any asset to decrease in price is by definition deflationary when the asset is understood to serve as a store of value in the general economy. The purpose of this deliberate financial repression is to fight general price declines in the economy. To fight the “deflationary threat," blamed for destroying profitability and employment, high-saving rates associated with "secular stagnation" or the "saving's glut" need to be lowered. In Denmark, Germany, and Switzerland, nominal negative rates intentionally impose direct costs on savers. It's no longer the bank that pays out interest on a deposit; it is the client paying the bank to hold their money. The policy has so far been limited to large corporate accounts as a matter of both prudence and hesitation. Policy advocates rule out the possibility of this trickling down to small account holders for fear of a bank panic, but are simultaneously obsessed with eliminating paper and metal moneys, to which they attribute the power of being able to cause a run on the banks. What appeared to be a mere rumor spread by conspiracy theorists, is in fact a not so public consensus amongst promoters of nominal negative interest rates, that paper currencies are to be eliminated if their policy is to stand a chance of success. Money which exists in a uniquely electronic format will be subject to greater and more absolute central bank control than paper and coins, which are said to be redundant.

Hardly anyone bothers, or feels qualified enough to inquire about the end-game of such repressive financial policies. So far, a canton in Switzerland requested that its citizens delay 2016 tax payments until December, in order to avoid a 2.5 CHF million bank charge on its deposits. In Denmark, families enjoy mortgages where payments are made only on the principle *minus* the monthly interest, which being negative, reduces the principle. In Germany, in less than eight months after the introduction of nominally negative interest rate bonds, nearly three quarters of all German bonds traded on exchanges resulting in negative yields. If experts are correct, where banks cannot see themselves passing on the lost revenue of negative mortgages to clients via explicit interest rates on small deposits, then banks will have to increase their own borrowing from counterparty and non-banking institutions. Taken to the extreme, an explicit policy of financial repression not only destroys savings, but what exactly does it do, if not destroy capital formation at all levels of the credit creation chain?

On the one hand, negative interest rates may herald an era of decline so fast and unexpected as to be the equivalent to falling off a precipice. Years of stagnation finally reach a breaking point, and the fall is rapid, astonishing, and final. On the other hand, policy makers need tools to withdraw easy money from the economy, and degrading the velocity and quantity of it in circulation by breaking down capital formation, and encouraging loans rather than savings is an audacious, even if not entirely convincing, strategy.

For those who hold that the world's present economic malaise is the result of an overabundance of savings and a lack of investment and consumption, even if the destruction of savings sound like a palatable approach, why not simply let poorly managed economic entities declare bankruptcy? Why not let capital be destroyed where it was mismanaged? In 1998? In 2001? In 2008? Why push the fallout down to the lowest level at every turn? Why socialize costs? Why formalize financial repression? Why transform poor business acumen at the top into socialized burdens, and a business problem into a monetary and fiscal one which impacts everyone from small debtors to mom and pop stores, including school savings and pension funds? From a business point of view, it is difficult to fully grasp how one could run a ledger with *negative receipts* and *positive expenditures*, but the monetary world may not be a case of straightforward double-entry book-keeping.

Unlike previous years, 2016 is no longer about government treasuries ratcheting up tax collection to meet their continuously overextended budgetary commitments. It is the year when the precedent of Cyprus and the now legalized form of *bail-in* which the tiny island nation sneaked into EU legislation, is likely to cause considerably more problems for tax collection than mistakes on individual tax returns. Virtually everything we've predicted for the last 5 years has come to pass, and no underlying problem has witnessed any solution of note in the economic realm. China, India, Europe, appear capable of little else than reaching into people's savings to make ends meet, or beggaring their neighbors via devaluations and aggressive export policies. America is the consumer of last resort, and it is tired, angry, and agonizing over the sacrifices it has had to make in order to accommodate global growth for the last two decades in the form of deindustrialization, negative or low savings, and skill/job mismatches spelling an increase in the population of the permanently unemployed and a quadrupling of the precariously employed.

For all its declarations of rebalancing the economy towards consumption, China has done nothing of the sort. The EU's answer is being played out before our very eyes. Goading citizens into greater consumption by extending negative loans on Monday, European banks will then have to raise customer fees on Tuesday in order to balance the loss from Monday's faux generosity. Just as it beggars belief that tax authorities prefer delayed, rather than earlier receipts, so too it beggars belief that banks can get away with negative interest loan legerdemains. What, if any, net effect on the economy can result from accounting shenanigans?

When a single sector, like energy, can see 5 trillion dollars in value evaporate in the span of ten months, while commodities another 5 trillion, one has to wonder how it is possible that banks whose lifeblood depended on financing such exorbitant trades, are not defaulting as a result of the bad loans, since their collateral consists in no small part of assets linked to commodities and energy. What is the natural negative interest rate at which depositors' savings have to be destroyed, to offset the decline of commodities and energy, so a bank may pronounce itself sound, once it has liquidated non-performing loans linked to both sectors? With a policy of negative interest rates, is the actual intention to literally incur as great a debt as possible in order to avoid all fees associated with positive balance sheets in negative interest rate environments?

As impossible as it is to explain negative interest rates using common sense, it has become impossible to predict economic developments with any trace of common sensibility. Taxpayers are no longer to expect a nasty tax collector knocking on their door as their only problem. In 2016 money has come under attack directly in its home, the bank account, and when it's central banks doing the buying of the bonds denominated at negative interest rates, it's taxpayers' savings that are directly subsidizing the destruction of taxpayers' money via their accounts in banks. Short of better options or asset classes to invest in, taxpayers have no choice but to come to grips with a world in which financial repression is the order of the day and to hope that there are limits to how low nominally denominated negative interest rate bonds can go, so that the increases in costs for bank services and inverse rates on savings do not surprise with their speed nor temporal duration. The effects could be beyond anything expected.

SIMONARD SOREL S.E.L.A.R.L. au capital de 7.622 €- Toque L0184 - N° de TVA : FR82391172764
12 Rue Lincoln, 75008 Paris, France - R.S.C. Paris: 39117276400048 A.P.E. 6910Z
Telephone: +33 1 53 23 94 20 - Fax: +33 1 40 70 16 08 - contact@simonardsorel.com