Soros's Secret Weapon: the Impossible Trinity

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Yesterday we looked into how tightening monetary policy is just stimulus in disguise. Even if central banks raise interest rates, as they did in the US recently, they're still spiking the economic punch bowl. We're practically a bunch of drunks!

The investment opportunities out of this were covered yesterday too. Today we look at what it means for the economy you live in. And how the famous speculator George Soros plans to make his next buck…

As long as they've existed, politicians and economists have sought to fiddle with the economy. They want to use it to fund an empire. They want to fine tune it to stay elected. They want to control it to make their campaign donors happy. At the heart of this is the belief that the economy can be influenced in a predictable way.

But the economy is not a machine. When you push buttons and levers, the results are not consistent or predictable. They aren't linear, meaning that if you do the same thing twice, you don't get the same result.

Then there are the unintended consequences. Governments focus on the seen consequences of their policies. But there are unseen ones as well. Usually they outweigh the seen ones and end up causing more of a problem.

You've probably heard about those two issues. But there's an even deeper problem. As soon as governments and central bankers fix their attention on a particular economic indicator they'd like to control, that indicator becomes useless and misleading. Its relationship with the rest of the economy goes haywire. And that defeats the purpose of trying to influence it in the first place.

Economic indicators like unemployment, inflation and the interest rate are information. They're signposts guiding people how to behave in an economy. If unemployment is high, people need to accept lower wages to get a job. That's what returns the employment market to an equilibrium. If interest rates are high, people borrow less. All of these sorts of indicators guide people to behaving in the most economically rational way given the state of things around them.

But then governments come along and start to meddle. They see these indicators as a way to control things – levers instead of signposts. For example, lower wages sounds bad, so politicians introduced the minimum wage. The result is unemployment.

If a central bank controls the interest rate instead of the supply and demand for loans, then we lose the guidance of that price. People are misled instead of guided. And the results are mistakes. The interest rate is the price of debt, so those mistakes are made in the world of debt.

At first, those mistakes might change things to look "better". Higher interest rates might bring down inflation and lower rates might improve unemployment. But at the expense of what?

Let's look at a very similar example to answer that question.

The Impossible Trinity

Governments used to use exchange rates to try and control their economies. By moving exchange rates up and down, they'd stimulate exports and imports to try and keep the economy rolling at the pace they want.

But that lead to problems. One of the laws of economics is called the Impossible Trinity. Governments can only ever control two of the following three indicators: interest rates, exchange rates or capital flows. Whenever a country tries all three, it leads to economic disaster. One of the three has to be a valve for the pressure created by manipulating the other two.

George Soros understood this when he bet against the pound in 1992. His name always includes the mention of his one billion pound profit as a result. Eventually the British gave up on maintaining their exchange rate.

Every time currency pegs collapse, it's terribly embarrassing for governments. And incredibly profitable for investors who understand and predict the results of such meddling.

Because of the embarrassment, most governments gave up on exchange rates as a tool for economic meddling. Now they use interest rates in the same way instead. But the same pressure is building too.

As you know, the idea is to stimulate the economy by lowering interest rates when it's moribund. And to slow the economy by raising rates when it's out of control and inflation heats up. Just about everyone in the country is familiar with this.

The problem is that they're meddling with the price of debt – the interest rate. And this creates the same problems in the world of debt as it did in the world of exchange rates. If supply and demand aren't allowed to find an equilibrium, something will eventually snap.

The results of using interest rates as a tool instead of leaving it as an indicator are very predictable. When interest rates are too low, you get a debt boom. When they're too high, you get a recession or depression.

Just look at Germany versus Greece. They have the same interest rates, but completely different levels of unemployment, inflation and GDP growth. The result is a continued boom in one and a continued malaise in the other.

Soros is on to this trade again, by the way. The basic message is that we've relied on debt growth to keep the economy chugging along. Interest rates were our tool. Every time the economy slowed, central banks goosed it with lower rates that increased borrowing. But we've reached a limit when it comes to how well that works. Debt can't grow infinitely. Central bankers are flogging the dead debt goose.

But without something to replace debt, what happens next? How do we stimulate our economy now? And what happens to the companies that rely on debt growth even more than the rest of us do? Their share prices will go down, for a start…

The Italian crisis

Over indebtedness and a stagnant economy leads to one of the few problems governments still have trouble papering over. Non-performing loans and the trouble they cause for banks.

Tim Price is on to this specifically at *The London Investment Alert*. He reckons European banks are in deep trouble. And we know from 2008 how interconnected the banking world is.

Tim's also explained why UK banks are not as stable as they and their politicians claim. That's where his intriguing investment ideas come in.

Until next time,

Nick Hubble