# John Bull and Two Percent

By John Mauldin | July 9, 2022

Bagehot and Bull
Impossible Tulips and Other Manias
More Risk, Please
Dallas, Puerto Rico, Family, and New York

The economics profession has long had a vigorous academic argument over "natural" interest rates. What would rates be if we could somehow remove all the subjective actors—central banks, commercial lenders, government agencies—that conspire to set them? What would nature do if we left it alone?

It's an academic argument because, in the real world, we can't do the kind of experiments that would produce a definitive answer. Guesses are all over the board. History, however, suggests that rates below 2% are neither natural nor sustainable. Worse, bad things happen when they get that low.

This isn't a new revelation. People noticed centuries ago how low interest rates led to speculative bubbles that always ended badly. We are at the end stage of one such bubble right now. Some expect a soft landing. I hope they're right, but it would be the first time.

Today I'll continue discussing Edward Chancellor's remarkable forthcoming book on the history of interest rates, *The Price of Time: The Real Story of Interest*. Most of this letter will be an extended quote from the book, which I hope will entice you to read the rest. It is truly a must-read as we enter a volatile and possibly dangerous economic era.

## Bagehot and Bull

Before reading Chancellor, you need a little setup. Much of this passage refers to Walter Bagehot, a 19th-century British journalist and editor of *The Economist*. (His surname, incidentally, is pronounced "Badge-it." One of those delightful English quirks.)

Bagehot lived in interesting economic times, observing the Bank of England develop into what we now know as modern central banking. He believed central banks were necessary as lenders of last resort but should lend only to *solvent institutions against sound collateral* and at *high interest rates*. That advice, known today as "Bagehot's Dictum," is now widely ignored.

You'll also see references to "John Bull." This was not an actual person, but a colloquialism used to describe everyday Englishmen—a bit like when modern commentators talk about "Joe Sixpack."

John Bull, as used here, is an investor whom Bagehot said, "cannot stand two percent." Earning such a low return was simply unacceptable. If that's all he could earn from a bank deposit or government bonds, John Bull (and others far outside England) would look elsewhere. Chancellor describes how this quest for higher returns helped generate some now-infamous investment crazes: the Tulip Bubble, the South Sea Bubble, and others.

As you read, I think you'll recognize similarities to our own time, with years of low rates (often well below that 2% level John Bull couldn't stand) pushing investors to take excessive risk in search of more and higher returns.

Now, on with the quote.

## Impossible Tulips and Other Manias (Excerpt from *The Price of Time* by Edward Chancellor)

As a banker and financial journalist, Bagehot observed that outbreaks of financial recklessness did not occur at random. Rather, they tended to appear at times when money was easy and interest rates low. He expressed this insight in his own inimitable fashion: 'John Bull can stand many things, but he cannot stand two per cent.' When interest rates fell to such a low level, investors reacted to the loss of income by taking greater risks. In modern language, they engage in 'yield- chasing'. John Bull – that personification of English common sense – made his first appearance in Bagehot's writings in an article for the *Inquirer* published on 31 July 1852:

> 'John Bull', says someone, 'can stand a great deal, but he cannot stand two per cent . . .' Here the moral obligation arises. People won't take 2 per cent; they won't bear a loss of income. Instead of that dreadful event, they invest their careful savings in something impossible – a canal to Kamchatka, a railway to Watchet, a plan for animating the Dead Sea, a corporation for shipping skates to the Torrid Zone. A century or two ago, the Dutch burgomasters, of all people in the world, invented the most imaginative occupation. They speculated in *impossible tulips*.

Bagehot's claim that 2 per cent interest represented the tipping point into financial folly was borrowed from John Fullarton, a former East India Company doctor turned banker. In his 1844 book *On the Regulation of Currencies* Fullarton observed that at times of low interest, 'everything in the nature of value puts on an aspect of bloated magnitude', and every article becomes an object of speculation. Long periods of easy money, wrote Fullarton, engender 'a wild spirit of speculation and adventure'. Fullarton noted that financial euphoria occurred after a period of falling interest rates: 'From the Bubble year [i.e. the South Sea Bubble of 1720] downwards, I question much if an instance could be shown of any great or concurrent speculative movement on the part of capitalists, which had not been preceded by a marked decline of the current rate of interest.'

Bagehot intuitively understood how people were habituated to a certain return on their investments and how, when the accustomed income was not available, investors were inclined to take more risk: 'The fact is, that the owners of savings not finding, in adequate quantities, their usual kind of investments, rush into anything that promises speciously.' In the *Saturday Review* (August 1856), he elaborated on this theme:

> [W]henever money becomes very cheap, experience teaches us to expect that it will be misspent. John Bull, as it has been wisely observed, can stand a good deal, but he cannot stand two per cent. The particular form of mania differs in various years; but when the common and tried employments of money yield but a low profit, recourse will be had to new and untried ones, some of which will be unprofitable, and a few of which will be absurd. It is only at the outset of such manias that warning is of the least use – when they attain a certain growth, advice is thrown away. Everybody is seen speculating; and what everyone does must be judicious. Foolish person No. II. imitates foolish person No. I.

Bagehot himself never made that connection between John Law's Mississippi Bubble and the 2 per cent interest rate that he introduced into France in 1719. Nevertheless, when we consider the speculative episodes he mentions, the link with easy money is soon apparent. For instance, Bagehot was correct to point out that 'money was plenty' in the Dutch Republic of the mid-1630s when the burgomasters started speculating in 'impossible tulips'. Earlier in the decade Holland experienced large capital inflows from foreigners, who found the notes of the Bank of Amsterdam (founded in 1609) most convenient for trade. The bank's balance sheet increased by nearly two-thirds between 1633 and 1638.

Dutch interest rates fell from around 8 per cent at the beginning of the century to around half that level by the mid-century. This was the age when 'modern "easy money" was discovered', according to Sidney Homer and Richard Sylla. The search for yield turns out to be as old as capitalism itself. Later in the century, Joseph de la Vega in his book *Confusion de Confusiones*, the earliest account of stock market activity, reported that,

> [E]very day . . . the revenue from investments at fixed interest becomes less, inasmuch as it is difficult to find ways of investing money. The rate of interest on ordinary loans amounts . . . to only 2½ per cent. Therefore, even the wealthiest men are forced to buy stocks, and there are people who do not sell them when the prices have fallen, in order to avoid a loss. But they do not sell at rising prices either, because they do not know a more secure investment for their capital.

Bagehot's claim that speculation is spurred by low interest rates is confirmed by the second episode that he mentions (relisted in chronological order), namely a 'plan for animating the Dead Sea'. No such plan ever existed, of course. Bagehot is alluding to the bubble companies that appeared during the South Sea Bubble of 1720. In his book *Lombard Street*, he lists both genuine promotions, for example 'Insurance of Horses and Cattle' and 'For improving of Malt Liquors', and several spoofs, for example 'For importing a large number of Jack Asses from Spain', 'For a Wheel of Perpetual Motion' and, most famously, 'For an Undertaking which shall in due time be revealed'.

Britain's South Sea Bubble of 1720 was a shoddy imitation of the Mississippi Scheme. Like John Law, the company's directors sought to lower the cost of government debt, then largely consisting of expensive annuities, by converting the debt into shares. As with Law's ill-fated project, the bubble occurred at a time of easy money. The yield on the country's long- term government debt fell from 8 per cent in 1710 to around 4 per cent in the early 1720s. As in France, the decline in interest rates encouraged government creditors to exchange their annuities for South Sea shares, whose price soared nearly tenfold during the first half of 1720. By the end of that year, however, the share price had collapsed and nearly all the bubble companies were swept away.

There never was a 'canal to Kamchatka', any more than there was a plan for animating the Dead Sea. A canal construction mania, however, did take place in England in the early 1790s. Canals were capital-intensive projects that took years to complete and even longer to pay back. Such long-dated investments are inevitably sensitive to changes in the discount rate. It is no surprise, therefore, to discover that canal-projecting was most intense when interest rates reached a low point. The economist and statistician Thomas Tooke considered the fall in interest rates, which dipped below 3 per cent in the 1790s, as 'both a cause and an effect of the great extension of the country bank system which about that time took place'. The canal mania ended with a banking crisis in 1793 after war broke out with Revolutionary France.

In February 1797, a small French force landed near Fishgard in Pembrokeshire, Wales, and immediately surrendered to British troops. The main consequence of this invasion of British soil was to trigger a financial panic, followed by an Order in Council permitting the Bank of England to suspend gold payments. The country's first experience of a pure paper currency was accompanied by another bout of easy money. Throughout the Napoleonic wars, the Bank's lending rate remained at 5 per cent – the maximum level permitted by law. The banker Henry Thornton considered the rate of interest in the early 1800s to be 'unnaturally low'. The real (post- inflation) yield on Consols turned negative for the first time.

Between 1800 and 1807, the amount of commercial paper discounted by the Bank of England more than doubled. The commercial world erupted in ‘an almost universal excitement’. Hundreds of banks were established and dozens of stock-jobbing speculations came to the market – including ‘seven breweries; five wine companies; four distilleries; several insurance companies . . . and miscellaneous trading companies’. Commodities were caught up in the whirlwind. Shares in the Bank of England and the East India Company, together with Consols, experienced a ‘sharp speculative advance’. Shut out of the European market by Napoleon’s

Continental Blockade, English merchants turned with an eager eye towards the South American trade. According to a contemporary account,

> [T]he exportations consequent on the first opening of the trade to Buenos Ayres, Brazil, and the Caraccas were most extraordinary. Speculation was then carried beyond the boundaries within which even gambling is usually confined, and was pushed to an extent and into channels that could hardly have been deemed practicable. We are informed by Mr. Mawe, an intelligent traveller, resident at Rio Janeiro, at the period in question, that more Manchester goods were sent out in the course of a few weeks, than had been consumed in the twenty years preceding . . . Elegant services of cut-glass and china were offered to persons whose most splendid drinking-vessels consisted of a horn, or the shell of a cocoa nut . . . and some speculators actually went so far as to send out *[ice] skates* to Rio Janeiro.

The story that ice skates had been shipped south of the Equator entered City legend. When Bagehot alluded to this episode nearly half a century later his readers would have understood the reference. The speculative frenzy subsided in the summer of 1810, after which around a third of the country banks failed. Lord Liverpool later reflected on these events in a speech to the House of Lords: ‘The tendency of an inconvertible paper money is to create fictitious wealth, bubbles, which by their bursting, produce inconvenience.’

The British railway mania of the 1840s took place while the young Bagehot was reading mathematics at University College London. The whole nation was transfixed by the potential of rail travel and an index of British railway shares more than doubled between 1840 and 1845. Among the speculators was the journalist Charles Mackay, an acquaintance of Charles Dickens and author of *Extraordinary Popular Delusions and the Madness of Crowds* – the first popular account of early speculative manias, published in 1841. The book’s warnings about the dangers of speculation were lost not only on the British public but also on Mackay himself.

Promoters planned the construction of around 4,500 miles of rail track, a greater mileage than Britain’s existing network of toll roads. By October 1845, around 1,200 railways were being promoted, at a projected cost of £560 million – a sum exceeding the country’s national income. Railways were built, or at least proposed, to faraway places that could never repay the cost of investment. As for ‘a railway to Watchet’, a seaport in Somerset not far from Bagehot’s home town of Langport, in 1845 there were, in fact, three different plans on the drawing board.

The railway mania coincided with yet another period of easy money. Discount rates on bills of exchange had fallen below 3 per cent by mid-1842 and touched 2 per cent in the following year. The Bank of England had started to lend at longer maturities and against a broader range of collateral, and even dabbled in railway debentures, thereby providing ‘a high sanction and an effective stimulus’ to the stock market boom. *The Times* reported on 28 April 1842 that,

> [T]he ill effects of the Bank of England lowering the rate of discount to 4 per cent are now universally felt and acknowledged. Money is so very abundant that dealers in it have literally no employment for it, apart from the public securities and shares, which in some branches of business would not be a fitting employment of capital.

By 1844, Bank rate was at 2 per cent, at which point the banker Fullarton warned that such a low rate typically excites speculative spirits. *The Economist*, founded and edited by James Wilson, also blamed the mania on easy money: ‘there is no doubt that the “secondary” speculation, and the actual railway building, were very largely fostered, if not literally created, by the ease with which accommodation could be obtained at the Bank and in Lombard Street.’ Bagehot, Wilson’s future son-in-law, agreed, writing several years later:

> Some [railways], no doubt, were required, but money was abundant. In consequence, every place was to have a railway; every railway was to pay twenty per cent, ‘as safe as the Bank of England’; scrip in schemes as visionary as the most imaginative tulip were daily bought and sold. There was no toleration for secure gain for quiet pursuits, for ordinary industry; *people could not stand two per cent*.

**(End of Chancellor excerpt)**

## More Risk, Please

John here again. I think Chancellor’s core point is spot on: Low interest rates drive investors into riskier assets than most are prepared to handle. But what is “low?”

Bagehot drew the line at 2% but that was in the context of a specific time and place. Inflation is a key variable. Nowadays, a 2% *real* return isn’t so bad. A patient investor who starts young and saves diligently can build a nice nest egg at that rate. But even that has been unattainable for a long time unless one is willing to take substantial risks.

If taking more risk is the only way to make a real return on your money, then most investors will take more risk. We see it today in stocks, junk bonds, real estate, private equity, venture capital, and commodities. We have invented entire new asset classes like crypto for the sole purpose of helping people take more risks in search of higher returns.

None of this is new. It’s happened many times before, going back centuries, and never ended well. This time is unlikely to be different.

We will see in future letters how Greenspan, Bernanke, Yellen, and now Powell all distorted the markets and created bubbles, as did the ECB and other major central banks. Zero-interest-rate policies inspired wild speculative bubbles as investors “reached for yield.”

## Dallas, Puerto Rico, Family, and New York

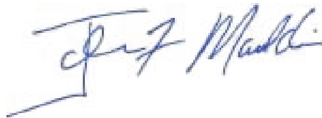
I write the end of this letter from an Admirals Club in Dallas before the long 5+-hour flight back to Puerto Rico. Tomorrow night my twins along with their husbands and (more importantly) three of my granddaughters show up for a few days where I am sure we will get some water park time. This is going to be so much fun.

I plan to visit NYC July 17 and leave the next Thursday. Lots of meeting and dinners and good time with friends. Then hopefully some time in Cleveland for my long-delayed checkup. My body is telling me I need it.

We are making progress on putting together an oil and gas drilling fund with Jay Young and his team. It will be a new way to give investors the full benefit of drilling, actually getting a part of the field as the drilling increases its value.

And with that I will hit the send button. Have a great week and spend some time with family and friends. And follow me on Twitter for some fun!

Your really thinking about how this experiment with low rates will end analyst,



John Mauldin
subscribers@mauldineconomics.com

http://www.mauldineconomics.com/members

© 2022 Mauldin Economics. All Rights Reserved.

Thoughts from the Frontline is a free weekly economic e-letter by best-selling author and renowned financial expert, John Mauldin. You can learn more and get your free subscription by visiting www.MauldinEconomics.com.

Any full reproduction of Thoughts from the Frontline is prohibited without express written permission. If you would like to quote brief portions only, please reference www.MauldinEconomics.com, keep all links within the portion being used fully active and intact, and include a link to www.mauldineconomics.com/important-disclosures. You can contact affiliates@mauldineconomics.com for more information about our content use policy.

To subscribe to John Mauldin's Mauldin Economics e-letter, please click here: http://www.mauldineconomics.com/subscribe

To change your email address, please click here: http://www.mauldineconomics.com/change-address

Thoughts From the Frontline and MauldinEconomics.com is not an offering for any investment. It represents only the opinions of John Mauldin and those that he interviews. Any views expressed are provided for information purposes only and should not be construed in any way as an offer, an endorsement, or inducement to invest and is not in any way a testimony of, or associated with, Mauldin's other firms. John Mauldin is the co-founder of Mauldin Economics, LLC. He also is the President and investment advisory representative of Mauldin Solutions, LLC, which is an investment advisory firm registered with multiple states, President and registered Principle of Mauldin Securities, LLC, a FINRA and SIPC, registered broker-dealer. Mauldin Securities LLC is registered with the NFA/CFTC, as an Introducing Broker (IB) and Commodity Trading Advisor (CTA).

This message may contain information that is confidential or privileged and is intended only for the individual or entity named above and does not constitute an offer for or advice about any alternative investment product. Such advice can only be made when accompanied by a prospectus or similar offering document. Past performance is not indicative of future performance. Please make sure to review important disclosures at the end of each article. Mauldin companies may have a marketing relationship with products and services mentioned in this letter for a fee.

PAST RESULTS ARE NOT INDICATIVE OF FUTURE RESULTS. THERE IS RISK OF LOSS AS WELL AS THE OPPORTUNITY FOR GAIN WHEN INVESTING IN MANAGED FUNDS. WHEN CONSIDERING ALTERNATIVE INVESTMENTS, INCLUDING HEDGE FUNDS, YOU SHOULD CONSIDER VARIOUS RISKS INCLUDING THE FACT THAT SOME PRODUCTS: OFTEN ENGAGE IN LEVERAGING AND OTHER SPECULATIVE INVESTMENT PRACTICES THAT MAY INCREASE THE RISK OF INVESTMENT LOSS, CAN BE ILLIQUID, ARE NOT REQUIRED TO PROVIDE PERIODIC PRICING OR VALUATION INFORMATION TO INVESTORS, MAY INVOLVE COMPLEX TAX STRUCTURES AND DELAYS IN DISTRIBUTING IMPORTANT TAX INFORMATION, ARE NOT SUBJECT TO THE SAME REGULATORY REQUIREMENTS AS MUTUAL FUNDS, OFTEN CHARGE HIGH FEES, AND IN MANY CASES THE UNDERLYING INVESTMENTS ARE NOT TRANSPARENT AND ARE KNOWN ONLY TO THE INVESTMENT MANAGER. Alternative investment performance can be volatile. An investor could lose all or a substantial amount of his or her investment. Often, alternative investment fund and account managers have total trading authority over their funds or accounts; the use of a single advisor applying generally similar trading programs could mean lack of diversification and, consequently, higher risk. There is often no secondary market for an investor's interest in alternative investments, and none is expected to develop. You are advised to discuss with your financial advisers your investment options and whether any investment is suitable for your specific needs prior to making any investments.

All material presented herein is believed to be reliable but we cannot attest to its accuracy. Opinions expressed in these reports may change without prior notice. John Mauldin and/or the staffs may or may not have investments in any funds cited above as well as economic interest. John Mauldin can be reached at 800-829-7273.