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Market Memo

Research and Insights

Perissos Investment Management

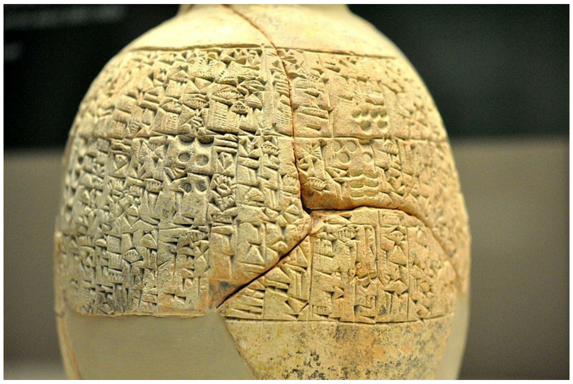
Part I History of Interest Rates

Over the last couple of years, small talk has gone from, "What do you think of this weather?" to "Can you believe how expensive groceries are?" or "Can you believe mortgage rates are 7%?" We humans are myopic and expect the future to be somewhat similar to the recent past. Most of the time, we are surprised when things turn out drastically different. Throughout history, we see this theme play out over and over. Today, for example, most market participants believe things will go back to how they were before Covid. Interest rates will go back down, and inflation will be a non-issue in a couple of years, which may come to pass, but a study of history and interest rates suggests it may not be that simple.

Wanting to understand the cyclical nature of interest rates took me on a journey back some 2000 years. The question I wanted to answer was what happens when rates are low for long periods of time, and then suddenly, they must be raised to combat inflation. There are many books on economic history, and a really good one on interest rates is "The Price of Time," by Edward Chancellor. Others include "Dying of Money," "The Forgotten Man," and "Lords of Finance," to name a few.

As many of you know, I like to write about what I research to help me remember and understand it more deeply. So, let's start from the beginning.

Interest on loans has been around since before coined money. In fact, the Mesopotamians charged interest before they invented the wheel. Today, we borrow money to buy a car or a house, but before the eighth century, most loans were for seeds or livestock. The Greek word for interest is "Tokos," meaning a calf. The Sumerian word for interest, "Mas," means a lamb, and the Hebrew word, "Marbit," means to increase and multiply. Many historians believe that these loans were used for productive purposes. The seeds planted would yield an increase and, at harvest, could be paid back with additional seeds from the harvest (interest). Even in the U.S., in the 19th century, "cows were commonly sold on trust with the terms being double the number transferred being returned in four of five years" (Price of Time).



The charging of interest first showed up in Mesopotamia in the third millennium BC. A cuneiform inscribed clay cone (right) records the dispute between two South Mesopotamian cities, Lagash and Umma. Umma was using Lagash's land for agriculture, with Umma making payments to Lagash annually equal to 300 liters of barley. When Umma stopped making payments, Lagash took back the land and demanded back payments of the grain. Lagash demanded 33.33% interest for the past years, bringing the total payment to roughly 4.5 trillion liters of barley. When Umma failed to pay, the result was war. Keep in mind this was in the year 2400 BC. (Picture source: Wikimedia Commons)

When the war was over, Lagash was riddled with debt, and Enmetena, the ruler of Lagash, was the first ruler to order the cancellation of debt. After the first debt cancellation, another followed roughly 50 years later. If you read the Bible, you know that fifty-year debt jubilees or debt cancellations were ordered every 50 years in the Book of Leviticus.

Even in ancient times, we see that empires/countries would get overindebted and have to lower interest rates or consider debt restructurings. Then came coined money, and interest rates were charged when people borrowed money instead of just seeds or livestock. But what would cause interest rates to go up or go down? People have been trying to figure out how interest rate levels are determined for centuries. To this day, economists argue about how market rates are determined. Some say it's tied to money; others say it's tied to economic activity. While a mix of both real and monetary economic activity may cause the rise or fall of interest rates, history does show that money supply and interest rates are correlated.

In the year 33 AD, when Tiberius became emperor after Augustus' death, he hoarded the Roman Empire's coined money. A series of events took place as interest rates rose and a banking crisis followed. (yes, there were merchant banks in the Roman Empire days)

Tiberius then decided to loan out, interest-free, the kingdom's hoarded treasure. The result was an almost immediate decline in interest rates and an end to the banking crisis. **This was the world's first-ever experiment with Quantitative Easing.**

What is interesting about the ancient empires such as Babylon, Greece, and Rome is that interest rates followed a "U" shaped pattern over centuries. As the empire became established and prospered, interest rates declined. As the empire began to decline and eventually fall, interest rates would rise sharply. For example, in Babylon, interest rates on silver fell to a low of around 8% from 700 BC to 650 BC. However, roughly 100 years later, around 500 BC, interest rates spiked to over 40% when Babylon fell to the Persians.

For most of these empires, there is a correlation between lower interest rates and higher debt levels. As an empire/country grows prosperous, they sometimes become overindebted, and having too much debt requires lower rates to continue to meet debt obligations, especially if the economy slows. As the empire/country's debt burden increases, interest rates tend to rise as people lose confidence that they will be repaid.

I will break this research memo into a few parts to keep it from getting too lengthy and requiring an evening to finish. In the following memos, I will discuss the parallels between interest rates, the Great Depression, The Japanese housing Bubble, and where we currently stand in the U.S.

All my best,

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