March 9, 2012

"Somehow, with QE everything, with a zero percent funds rate, with monetary 'mastery' from the people in Washington, I think the current system is leeching dynamism from this economy…"
-JAMES GRANT OF GRANT'S INTEREST RATE OBSERVER

POINTS TO PONDER

Papering over our problems. What is money? While it might not be up there with "What is the meaning of life?" or "Is there a God?" this is, nonetheless, a profound and perplexing query. These days, with central bank printing presses running like perpetual motion machines, it's a particularly germane (if not German) question.

For years now, our Fed has been throwing monetary caution to the wind by conjuring up, with apparently magical powers, one and half trillion or so of "presto chango" money. Initially, the Fed was viewed by its overseas peers as a reckless renegade. This was especially true in Europe where, until recently, Germany's Bundesbank, with its genetic abhorrence of inflation, kept the European Central Bank (ECB) in check. But lately, now that the ECB is under Italian management, the floodgates have opened as wide as the entrance to hell (which is where several members of the Bundesbank seem to think the eurozone is headed).

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Even in Japan, long home to chronic deflation and a timid central bank, things are a changin'. The soaring yen, severely crippling Japan's export machine, has caused the Bank of Japan to get in touch with its inner Ben—as in Bernanke. Thus, we have three of the world's most important economies involved in an unprecedented monetary proliferation.

There is simply no debate that all of this has significant implications for the future of "fiat" money (no, that doesn't refer to the down payment on an Italian car of questionable quality, but rather money that is backed merely by government edict). When I think of the handful of people who have the credibility and intellectual bandwidth to tackle the momentous "What is money?" question, Charles Gave is in that select group. Therefore, I am pleased to share his recent treatise on this topic with all of our loyal EVA readers.

Every time I read Charles' essays I am struck by his clarity of logic and his remarkable depth of knowledge. This issue is no exception. In just five pages, he relevantly incorporates philosophers like Aristotle and Plato on this subject as well as legendary economists such as Wicksell (Sweden), von Mises (Austria), Fisher (US), Keynes (UK), Marx (Germany), and, of course, another American, the mythic Milton Friedman. Even Jesus Christ's unique views of money are included.

For more than 30 years, I've been a believer, correctly as it turned out, that inflation was largely a non-event. In fact, my team and I have effectively used the periodic bouts of inflation paranoia we've experienced as opportunities to buy yield instruments for our clients when they've been "on sale" during these episodes. Now, however, my conviction level in subdued inflation is ebbing, at least a bit.

2012 is likely to be exceedingly important in this regard. If we don't soon see a shift away from deleterious fiscal and monetary policies, it's Evergreen's view that we will need to divert more of our clients' funds into countries with sounder foundations. Charles highlights several nations that still view their money as an asset to be protected at all costs.

For those who are time-pressed, and I know that applies to many, if not most, of you, I'd suggest you read the opening couple of pages and then skip to the conclusion. Let me warn you, however, that you are likely to become hooked and want to read the full piece. This might be one to print out, read at your leisure, and possibly refer to the next time you're tempted to think our travails of the last few years have been cured by all the money that central banks have manufactured. As Milton Friedman famously observed, there's no free lunch. Never was, never will be.

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Blind Men Looking At Money

Over the past year, we have published a number of debates on the euro, which generated vigorous client feedback, from the logical *"isn't it obvious that, if the euro continues as presently constructed, then it won't",* to the somewhat tasteless *"I was at Disney World this weekend and saw the Euro wearing a Make-A-Wish T-Shirt".* But at the heart of every one of these debates was a simple question—namely, **what is money?**

This is a question we actively danced around but failed to address. Because we could not really write a think piece which would have a beginning, a middle and an end; a piece "on what money is" would struggle to present a cohesive thesis. At best, like blind men describing an elephant by touching it (small tail—so must be small, big ears—so must be big, huge belly—so must be ferocious, long tusks—so must scrape the ground?..), we may approach different facets of what money is and, in the process hope to get a complete picture.

At the request of a few clients, this is what we propose to do in the following paper. But be forewarned, the question of money is a vexing philosophical one which has divided thinkers for centuries. After all, every one uses money to measure value, to store wealth, and to exchange goods, but no-one really knows why money has any value at all.

The original philosophical difference

The greatest minds in Western civilization have struggled with the concept of why money has any value at all. Aristotle expressed the view that money had to have a high cost of production in order to make it valuable and to allow it to represent a lot of value in a small physical format. He also argued that everybody had to accept money as a means of payment, as a store of value or as a standard of value. This drew Aristotle, the first famous gold-bug of sorts, to the conclusion that only gold and silver could be accepted as money.

Unfortunately, this still leaves us with the farmer selling his wheat for something essentially useless. Aristotle also does not explain why it would make sense, and generate wealth, for people to spend resources and time to dig up holes in mountains, and then take the proceeds of their efforts to bury them in another hole somewhere else. But most importantly, it seems that the core of the Aristotelian argument is that gold/silver have value because it takes a lot of effort to extract; in other words, at another time, Aristotle might have been a paid-up subscriber to the Marxist theory that what gives value to goods is the amount of work that goes into producing those goods. However, as the Austrian school amply demonstrated, the labor theory of value is definitely not worth the amount of time that Marx took in formulating it. Incidentally, this makes it ironic that so many people who claim themselves to be "Austrian economists" are gold bugs. Indeed, one can be a disciple of Aristotle, Ricardo or Marx and be a gold bug; but one cannot claim to be a follower of von Mises and argue that gold is the answer. Indeed, the founding stone of Austrian economics is that value is totally subjective. So how can we have a world in which all values are subjective—except one, gold, which would be objective?

The Aristotelian explanation thus falls short. **The reality is that gold and silver do not have a value because of the time, resources and cost involved in producing them. Instead, gold and silver have value because everybody believes they do.** This is not at all the same thing and leads us to the second view, namely that of Plato.

For Plato, money is just a social convention and has no intrinsic value except the one that the people are giving it. This is a lot more acceptable, and very close to the marginal theory of value (which stands at the center of Austrian economics).

Thus, for Plato, money is little more than a social convention and money itself need not have value, except the one that people wish it to have.

Now the other great Western philosopher who never bothered to write anything down was Jesus Christ; though that did not stop Him from being the most influential thinker to ever walk the face of the earth. And, as one might expect, Christ actually had a lot to say about money (See *Charles*' book—"Jesus, the Unknown Economist," *for more details on this.*). Christ only emphasized Plato's marginal theory of value (the story of the poor widow whose lonely small coin offering is worth a lot more than the large gifts of the Pharisees) and highlighted that burying one's money in unproductive means was harmful (the parable of the talents) **but Christ went one step further than Plato by stating that the entity enforcing the value of money was the state** (the state had the monopoly of putting Caesar's face on a coin, and it was the duty of the state to make sure that the coins could be used to buy cherries, pears, or pay taxes). For Christ, if money is going to work, it needs to have a state backing it. And this makes ample sense for the following reasons.

Does money need political backing?

If money is a "social convention" then it follows that this convention will need to take place in a social "something". In our modern times, this social something has tended to be more often than not a nation. But what is a nation? Renan, a 19th century French philosopher wrote that the main characteristic of a nation was *"the willingness of the citizens to live together".* Implicit in the idea of a nation is thus that of a social contract exists with two important elements: a) solidarity among the citizens, and b) a state to help organize the defense of life, freedom and property. And if this is the case, then money is nothing but a necessary tool for this social contract between citizens to be expressed in the economic and legal life of the nation. *It is through "money" that the citizens can organize themselves economically and establish legally the contracts that bind them.*

Behind every contract, behind every legal act, behind every transaction, in the background, unnoticed, we always find the notion of money. This implies a same set of "values" which correspond to this "willingness" to live together and usually this has corresponded in modern times to a nation, a polis, to use the Greek word. In turn, this raises the question of whether each nation has its currency and each currency its nation?

Money as a common good

For a nation to emerge and prosper, we thus need a) the willingness to live together and b) two tools, namely a money and a state, the last one being defined as the entity having the monopoly of legal violence, delegated by the population. Money, by construction, being one of the two tools necessary for a nation to exist is however a "common good," a little bit like the internet, clean air or individual freedom. Common goods—for example, "justice"—are strange notions and sometimes hard to define. **Everybody should enjoy them, but they must not be owned by anybody and especially not by the state.**

However, the temptation for the individuals working for the state to capture the control of money to serve their own goals has historically proven to be almost irresistible. The relationship between money and the state operates through the tax system. Money to a certain extent is a claim on the future tax receipts but is also needed to pay current expenditures. When the government cannot finance its current expenditures through taxes, it can issue bonds, which are nothing but deferred taxes. When nobody in the free market wants to buy these bonds, the solution is either to reduce government expenditures (always a good idea in theory, but never right now) or to ask the authority in charge of the production of money to buy the debt issued by the bankrupt government. But then money stops being a common good.

When those who control the state move to "capture" money and subject it to state whims, the general well-being of the population tends to decline. When the heavy-hand of the state supplants the invisible hand of the market, a vicious circle ensues. The size of the government's weight in the economy goes up, which at first can provide a burst of growth; but over time, the marginal rate of return on capital goes down, and with it the growth rate of the economy. Unemployment rises, inviting more intervention (see How the World Works).

Money is thus a common good which should not be owned and/or operated by those ruling the state; and one of the great battles in democratic systems has always been to prevent this nefarious "capture". There are various means to achieve this:

1. Give the control of this common good to a bunch of independent wise men and women (a little bit like what the US did for justice when it created the Supreme Court—to sit separately from other branches of government). This has been the solution chosen by the Swiss, Australians, Canadians, Norwegians, Swedes, etc.
2. Takeaway the possibility for the political rulers to steal the currency by moving to the gold exchange standard.
3. Abandon the national characteristics that money should keep (Argentina, Eurozone). Historically, this has been a terrible decision since this move tends to destroy the "willingness to live together" (more on that later).

Money as an information system

We all know that money is a means of exchange, a standard of value and a reserve of value, but this hides the most important fact: **money is the system through which information about the current and future values of goods and services is transmitted. This is transmitted through its price(s). The problems is that money at any given point in time has itself not one but two prices:**

1. The first price, the exchange rate, allows the nation to specialize in her comparative advantage and thereby maximize the well-being of the population over the short and the long term.
2. The second price, the interest rate, optimizes the choices that the local consumers/savers have to make between consumption and investments (between the present and the future).

The first price deals with the nation's specialization in a geographical world, the second with how the nation can rationally integrate present value discounting mechanisms into the decision-making processes of its citizens.

The history of economics is almost all about attempts by policymakers to tamper with either one of these two prices. And each attempt, starting with Diocletian's Edict on Maximum Prices all the way to the current crisis on the Euro has led to untold disasters. For what is the Euro but an attempt to impose the same exchange rate, and interest rate, for different nations who have no willingness to live together? Since all the prices derive one way or the other from exchange rates and interest rates, political powers should never (except perhaps in times of an acute crisis such as a total war) interfere with these prices.

Differentiating between money and credit

In a fiat monetary system, central banks can create base money from nothing. In turn, commercial can multiply this base money by extending credit. This simple reality brings us back to Irving Fisher's equation of **MV=PQ to which we would very immodestly propose a small alteration as the equation may be better expressed as (Government Money + Credit Money) * V= P * Q (nominal GDP).

Now the "credit" comes from the Latin "credo" meaning, "I believe" or "I trust." So how does "trust" prevail? History has shown that "trust" expands when the "system of credit" is privately owned (for the creative destruction to take place), extremely fragmented (to avoid the too-big-to-fail syndrome in the credit system with its resulting moral hazards) and above all when it is tightly regulated. In that regards, the provision of credit is different to that of most other goods and services.

Indeed, for capitalism to function, it usually makes sense to make sure the production of goods and services are as deregulated as possible. But the same logic does not apply to the production of money for a simple reason; *namely that the marginal cost of producing one more dollar of credit is zero in the short term though it can be very high in the long term.* As the past few years have shown, those benefiting from the deregulation may not be those paying for its failures.

***MV = PQ is defined as money times velocity = price times quantity, i.e., money supply times its turnover rate equals total economic output.*

This will happen every time if the managers/owners of the credit system have their bonuses/profits tied to the short-term distribution of credit, and no penalty for the non-repayment of the loans. In such a system, we witness an excessive growth of credit, followed by a bust. In such a situation we first witness a huge rise in the value of the assets bought on credit, followed by a collapse on these values later on. This then leads to a huge contraction in the credit part of our money equation (see Irving Fisher's Debt Deflation Theory of Great Depressions); which triggers either a depression (1930s) or the present situation with the central bank forced to replace with *money* the *credit* which has been destroyed with consequences that are difficult to fathom.

Our next point is thus that **credit is not money, but *money* borrowed**. As such the creation of new credits must be in the hands of the private sector (to avoid the ownership of money by the public sector) but must also be tightly regulated by an independent body, preferably the central bank; with the best regulation being that commercial banks remain small, with a capital base equal to a minimum of 12% of the size of their balance sheets (which have to include off-balance sheets positions and the net positions in derivatives, and with derivatives priced on an open market).

The costs of money

Wicksell explained that, at any given point in time there are two costs of money: the "market rate" (short rates as determined by the supply of demand of money/credit) and the "natural rate" equal to the variations in the working age population to which must be added the growth rate of productivity (i.e., the structural growth rate). For Wicksell, economic booms and busts usually come from the differences between these two rates. If short rates are below the natural rate, and since profits tend to have a structural growth rate equal to the natural rate, it pays to borrow to invest (the cost of money is below the return on capital). This leads to the boom phase. Since everybody borrows, the cost of money rises and eventually moves above the growth rate. The bust then ensues.

If Wicksell was right (and as our more faithful readers will have guessed by the number of times we quote him, we tend to believe that he was) then the bigger the spreads between the market rate and the natural rate, the bigger the booms and bust cycles, and the higher the volatility of economic activity and the risks of financial accidents.

For an illustration: from 1983 to 2001, the US followed a perfect Wicksellian policy which led to the so-called period of "great moderation". Then (because of the TMT Bust, or maybe 9/11, or a fear of "repeating Japan"?) the US central bank moved back to a Keynesian policy of negative real rates, which of course puts market rates way below the natural rate. This led to a massive misallocation of capital and a financial crisis.

Incidentally, any Wicksellian disciple would quickly conclude that the euro is doomed since the natural rates are very different from one country to the next. We will thus always have massive divergences between the different natural rates and a common market rate. And over time, this will lead to ever bigger, and uncontrollable booms and busts, across the Euroland.

The external price for money—or the exchange rate

For Milton Friedman, the best system when it came to the determination of the exchange rate between different nations was the freely floating exchange rates, the exogenous shocks (changes in economic policies, oil, wars, tsunamis, droughts, etc…) being absorbed by the exchange rate, minimizing every time the damage to the international and domestic economic systems. This is what we broadly had in the 1980s and at the beginning of the 1990s and it led to one of the strongest growth periods in history. Then came the German reunification leading to the creation of the euro, together with the emergence of China as a major player in world trade, but while maintaining a closed capital account and a quasi-fixed and undervalued exchange rate against the US Dollar. These two events broke the back of the Friedmanian system (as it was known by the Washington consensus) and led to massive trade surpluses for Germany and China, increasing dramatically their "perceived" political power, and from there to the re-emergence of the mercantilist view that a current account surplus is a "good" thing and a current account deficit a "bad" thing.

Since the countries with surplus present themselves as "virtuous" and do not want to expand, while the countries with deficits, the "sinners," have to follow deflationary policies, we are led inevitably into a deflationary bust. Nowhere is this more visible than in Euroland today. As a matter of fact, this belief encourages political interventions into economy through the manipulation of prices which have an influence on the external competitiveness, such as interest rates or exchange rates. From this point we often get the emergence or reemergence of protectionism.

So there is a double-point here: interest rates should be maintained as close as possible to the structural growth rate of the economy all the time (i.e., the natural rate, or where they would probably be if the central banks did not intervene constantly) without any attempt to fine-tune the economy. And the exchange rate should be left alone, since over time, the exchange rate between two countries with similar levels of development will always return to purchasing parity.

Money in a non-democratic society

The first thing that a non-democratic government wants to do is to control information. Since money is an information system, it comes to reason that the first goal of a non-democratic government is to control money. In such societies, we will typically have foreign exchange controls, price controls, and a closed capital account—together with control of the media and the absence of an independent judicial system. In such a world money is of course *owned* and operated by the non-democratic government.

We have "good money" only in democracies (this is not the same thing as saying that all democracies have good money). In fact, we could go as far as saying that it could go both ways: in a democratic country if a bunch of appointed or unelected guys take control of the money creation/credit system, then democracy might be in danger (see the Euroland today for an example). "Money" in a non-democratic society is thus nothing but a way for the government to express its preferences and force the citizens to do things that they would not do otherwise. It may be a means of exchange (not always the only one, for example the dollar could be used for important transactions, or the black market could flourish), but it is not a standard of value, and certainly not a reserve of value. To put it bluntly, bank notes issued by a non-democratic country do not represent "a willingness to live together" but most of the time a dysfunctional political system maintained through a police state.

This takes us to the next link in the chain: in a non-democratic system, there is no money to speak of. We may have banking systems, monetary signs, bank notes, etc... but we do not have a money in which the citizens recognize their willingness to live together.

The gold standard

In the gold standard, the monetary base component of the M in the MV=PQ equation is determined by the inventory of gold at the central bank (or the country if there is no central bank). It does not mean that the credit part of M cannot explode for whatever reason; but when the downside cycle of the credit market occurs, then we have no choice but to move into a depression since money cannot compensate for credit. The depressions in the 19th century and at the beginning of the 20th century were created by "implosions" of M that were fierce and led to long periods during which the economies operated well below their long term potential. Moreover, the gold exchange led to policies aimed at accumulating the maximum amount of gold as a sign of virtue—the best way being of course to compress domestic demand and undervalue the exchange rate, and when gold flew in, to refuse to let the local money supply go up (France in the 1930s, which accumulated half of the world's gold and refused to expand under the wise guidance of Rueff).

In fact, as the 1930 proved, a gold standard system invites and almost forces the intervention of the political system in the economic system, since the survival of the nation is at stake if there is not enough gold in the vaults of the central bank. **The gold standard thus leads naturally to protectionism.**

Another key problem of gold standards is that there is absolutely no reason why there should be any relationship over the long term between the demand for money and the inventory of gold. If too much gold is found, we have inflation (which is what happened in Europe after the discovery of Peru and other New World gold production centers). If growth outpaces the supply of gold, we face structurally falling prices, which massively favor the rentier over the entrepreneur and thus may lead to economic stagnation (the end of the 19th century).

What emerges is thus very simple: Gold as a substitute for money is only adequate when the authorities in charge of issuing money fail in their duties. When democracy does not work, there is always a part of the population clamoring for the return of some kind of automatic dictator. Gold is the brain-dead dictator when it comes to money. And this leads us to our final point: **Gold is not money, but a daily assessment of the way money is managed by those who have that responsibility in the major countries.**

Conclusion

The ongoing financial crisis is ultimately a crisis of the fiat monetary system. A fiat system only works when certain inviolable rules are followed. The rules have been broken in most (though not all) of the world's economically important countries.

The euro does not actually constitute a form of money at all, since there is no state to back it—i.e., there is no taxation power behind it and it is not an expression of a willingness to live together. As we have written before (see Was the Demise of the Soviet Union An Negative Event?), Europe is a civilization, not a nation. The illegitimacy of this currency is to blame for much of the recent global financial uncertainty.

The US dollar, because of the misguided attempt to deregulate the US credit system at the end of the 1990s, does not constitute what we define as "good money". The money creation system in the US was long ago captured by the political system. The same can be said of the British pound and the yen.

In the past few years, many investors have taken refuge in emerging market currencies as they waited for monetary sanity to return to the West. This strategy is unfortunately looking more vulnerable by the day. Indonesia, India and Brazil, for instance, have lately started to embark on policies that are either inflationary or increasingly interventionist. China of course is one of the great masters of currency intervention, but because the renminbi is so undervalued, it will remain on an appreciation path as the capital account gradually liberalizes (as reflected, for example, in its renminbi internationalization program).

The following countries have operated also more comparatively sound monetary policies in the past few years: Switzerland, Sweden, Canada, Australia, Denmark, Norway, New Zealand, Singapore, South Korea and Poland. As a result, their currencies have by and large already been re-rated aggressively (in part due to marginal improvements from heavily-manipulated starting points). Out of this bunch, we tend to prefer Singapore, South Korea, Poland, Sweden, Denmark and Canada, mostly for valuation reasons.

David_Hay_Signature

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