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The end of the long con

“Around 2002, a developing country defaulted on its debt. Following protracted negotiations, agreement was reached that the *bad* debt would be replaced with a smaller amount of new *good* debt, with all investors losing around half their original investment. The country’s finance minister, accompanied by a vast retinue of assistants and bankers, embarked on a road show to sell the deal.

“In Tokyo, the meeting attracted a vast throng of aged Japanese retirees, who had invested their savings in the defaulted securities, on the recommendations of financial advisers to earn interest rates higher than those available in Japan. At the end of the minister’s presentation, a frail, ancient Japanese woman stood up and spoke. In a quiet steady voice, she explained the hardships that the loss had caused. She wanted to know “whether there was any chance she would see any of her money before her life ended.”

- From ‘Extreme Money’ by Satyajit Das.

In July 2008, a bank in Zimbabwe cashed a cheque for \$1,072,418,003,000,000 (one quadrillion, seventy-two trillion, four hundred and eighteen billion, three million Zimbabwe dollars). It had taken 28 years from independence for the former colony of Rhodesia to become an economic basket case.

“Inflation in Zimbabwe was 516 quintillion percent (516 followed by 18 zeroes). Prices doubled every 1.3 days. The record for hyperinflation is Hungary where in 1946 monthly inflation reached 12,950,000,000,000,000 percent – prices doubled every 15.6 hours. In 1923, Weimar Germany experienced inflation of 29,525 percent a month, with prices doubling every 3.7 days. People burned Marks for heat in the cold Northern German winter. It was cheaper than firewood. The butter standard was a more reliable form of value than the Mark. The German government took over newspaper presses to print money, such was the demand for bank notes. The abiding image of the Weimar Republic remains of ordinary Germans in search of food pushing wheelbarrows filled with wads of worthless money.”

The quotation is from Satyajit Das’ just published ‘Extreme Money – Masters of the Universe and the Cult of Risk’ (FT Press). This investor’s heart initially sank when offered the chance to review a copy – four years, and counting, of financial crisis have spawned all sorts of crisis porn – but ‘Extreme Money’ rewards the effort. The tone isn’t exactly gleeful (*just look at the mess we’re in !*) but the book fairly scampers across the financial landscape, scattering juicy quotes a-plenty in its wake. Das cites Tom Wolfe, for example, quoting Austrian economist Joseph Schumpeter:

““Stocks and bonds are what he called evaporated property. People completely lose touch of the underlying assets. It’s all paper – these esoteric devices. So it has become evaporated property squared. I call it evaporated property cubed.” Extreme money is eviscerated reality – the monetary shadow of real things.”

Our own external investment panellist, Guy Fraser-Sampson, has described the situation nicely. If humans vanished tomorrow, the likes of economics, financial markets, and money (of any meaning) would vanish with them – but the world would still turn. Finance is a demon of our own design, and we now inhabit an acutely over-financialised world.

So what is money ?

Something “universally accepted as payment, a claim on other things.. a medium of exchange, a measure of the market value of real goods and services, a standard unit of value, and a store of wealth that can be saved and retrieved in the safe knowledge that it will be exchangeable into real things when retrieved”.

But there is also *commodity money*: anything that is simultaneously money but also a desired tradeable commodity in its own right, money that is good enough to eat. Over history mankind has experimented with dried fish, almonds, corn, coconuts, tea and rice. As Das points out, the ancient Aztecs used cocoa. “The large green-yellow pods of the cacao tree produce a white pulp that, when dried, roasted and ground, becomes chocolate. Some European pirates seized a ship full of cocoa beans – a true El Dorado worth more than galleons filled with gold doubloons. Unaware of the value of the cargo and mistaking it for rabbit dung, the pirates dumped the cocoa into the ocean.”

And as Das ominously observes, in economic chaos, war or collapse, commodity money reappears.

One alternative is *fiat* or *paper money*, a promise by the state to pay you whatever it says on the paper – usually in the form of more paper. “It relies on acceptance – the trust of everyone to exchange often dog-eared and toxic notes into real things.”

Our current money is almost magically insubstantial:

“Less than 8 percent of all dollars are in the form of paper money or coins. The vast majority of dollars exists in the form of entries in the accounts of borrowers or lenders. Paper money is an abstraction or, as most of it does not exist physically, the abstraction of an abstraction. Its sole reason for existence is as a medium of exchange. **There are no limits to the amount of money that can be created.**” [Emphasis mine.]

And there are reasons to believe that these ‘non-existent’ limits to money creation will soon be existentially tested, because the nature of the overarching financial crisis still facing the politicians and investors of the West stems from the confluence of bad money and bad debt. The title of the relevant chapter in Das’ book: ‘Nowhere to Run, Nowhere to Hide’.

David Bowers of Absolute Strategy Research calls it the last game of ‘pass the parcel’:

““When the tech bubble burst, balance sheet problems were passed to the household sector [through mortgages]. This time they are being passed to the public sector [through governments’

assumption of banks' debts]. There's nobody left to pass it to in the future." It was the grifter's *long con*, great if it works but difficult to pull off."

And the figures for the US' own debt crisis are appalling. As economist David Rosenberg observes,

"In the past three years.. the US public debt exploded by \$5 trillion – the country is 244 years old and over one-third of the national debt has been created in just the past three years.. The US government now spends \$1.60 in goods and services for every dollar it is taking in with respect to revenues which is unheard of – this ratio never got much above \$1.20, not even during the previous severe economic setbacks in the early 1980s and early 1990s."

The open-minded, or plain sceptical, are justified to ask which will outlast the other: the US dollar as global reserve currency, or the US Treasury market as reference rate for international debt. The status quo is evidently unsustainable. The only question is whether the current system ultimately ends in a deflationary ice-age or an inflationary firestorm. Judging by the political climate in the United States, and the apparent unwillingness of US politicians to make hard choices, the inflationary outcome would seem to be the more urgent fear. This would seem to be the message that gold is trying to send out, to anyone willing to listen.

Satyajit Das advocates his own remedy to the current malaise. But it is not a message that politicians or consumers are likely to welcome.

"There is no simple, painless solution. The world has to reduce debt, shrink the financial part of the economy, and change the destructive incentive structures in finance. Individuals in developed countries have to save more and spend less. Companies have to go back to real engineering. Governments have to balance their books better. Banking must become a mechanism for matching savers and borrowers, financing real things. Banks cannot be larger than nations, countries in themselves. Countries cannot rely on debt and speculation for prosperity. The world must live within its means."

Satyajit Das' 'Extreme Money – Masters of the Universe and the Cult of Risk' was published by FT Press on 7 August 2011.

Tim Price
Director of Investment
PFP Wealth Management
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Email: tim.price@pfp.co.uk

Weblog: <http://thepriceofeverything.typepad.com>

Group homepage: <http://www.pfp.co.uk>

Bloomberg homepage: PFPG <GO>

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