CARTWRIGHT
PENSION TRUSTS

A final word on the nature of money today

Following the success of the first nine articles in our series on the topic of money,, this time we complete the series with the last instalment on the nature of modern money and the far-reaching implications it has for society, the economy and our economic wellbeing.

As we noted in the first instalment, "What is Money and why it Matters", the two vital questions of what money is and where it comes from rarely garner the attention they deserve, whether among senior lawmakers in Westminster or the general public, whose interests they are supposed to serve. Even many economists don't give it much thought. One exception was the late economist Bernard Lietaer, who once likened humans' relationship to money to fishes' to water:

"Fish are born in water, live their entire lives in water, die in water and have no clue what water is. That is how we live with money."

"The First Panacea for a Mismanaged Nation..."

Understanding the nature of money is particularly important today. We are living through an era of extreme economic and financial uncertainty and upheaval, as the 50-year global experiment with 100% fiat currencies could be drawing to a close. This is one of the main reasons why, as you may have noticed, we are experiencing decades-high inflation. As Ernest Hemmingway once wrote, "The first panacea for a mismanaged nation is inflation of the currency; the second is war. Both bring a temporary prosperity; both bring a permanent ruin."

This, unfortunately, is more or less the situation we find ourselves in today. Debt is at an historic high, and interest rates are their highest level for more than 15 years. The unprecedented rout in UK treasury gilts in September 2022 was a timely reminder of just how fragile the multi-decade global bond bubble has become. Since then, a number of large banks have collapsed in both the US and Europe, including Credit Suisse, a global systemically important bank (G-SIB) whose only possible salvation in the end was a shotgun merger with its domestic rival, UBS.

Central banks are still struggling to get to grips with the inflation they themselves helped to unleash by "printing" unprecedented sums of money. The US broad money supply, or M2, increased more than 70-fold between 1960 and 2020. After the Global Financial Crisis of 2008, many global central banks, following the US Federal Reserve's lead, kept interest rates far too low for far too long. Now, they are trying to undo the damage and have hiked rates at the fastest pace in decades, which is piling yet more stress on an already buckling financial system.

The galloping inflation of the past three years has made it harder and harder for people to pay for basic goods and services. Better off households are struggling to save for the future. As we warned in the second article in this series, "The Insidious Impact of Persistent High Inflation on Personal Savings", the only way to have any chance of preserving the purchasing power of the money you earn and the savings you accumulate over the course of your working life is to take ever larger risks with it. That turns you into an investor, not a saver.

Why Money is Never Neutral

Even more insidious is the Cantillon Effect, which was the focus of our third article, "Why Money is Never Neutral: The Timeless Relevance of the Cantillon Effect." In that piece we showed how unfettered money creation, by central and commercial banks, not only deprives people of the fruits of their labour through currency debasement and inflation; it also vastly exacerbates income and wealth inequality.

As the 18th-century Irish-French economist, Richard Cantillon observed, the individuals and institutions closest to the source of the money supply are able to use newly "printed" money to buy up assets at low prices, before inflation takes hold. This gives them unparalleled financial advantages and privileges at the cost of those least connected to the financial system. In Cantillon's day, it was the kings and queens and their courtiers who were closest to the money source. Today, it is large banks, hedge funds and private equity firms.

In our fourth article, titled "The Inflation Debate", we cleared up some of the myths and misconceptions around inflation. We explained how the benefits of technological price deflation have been more than nullified by the effects of central bank monetary inflation as well as how the meaning of the word "inflation" has changed over time.

In the past few years, we have seen more money created than at any time in history – and what's more, at a time of unprecedented low economic activity and global supply chain shocks. The inevitable result has been surging price inflation. This inflation is essentially a discreet form of taxation – so discreet that most people don't realise it is happening, as we explained in our fifth article, "Why Inflation is a Hidden Tax, and Why Brits are Feeling the Effects Particularly Hard":

"As with any taxation, the end result is that people have less money and governments more. But it is done, not by transferring money from taxpayers' pockets to government coffers, as with normal above-the-board taxes, but by printing money and in the process eroding the value of the underlying currency. "

Inflation is not just a covert form of taxation; it is one that is sharply regressive, disproportionately affecting low-income groups and the middle classes.

In the last three articles, we looked at some of the institutions responsible for our current economic malaise. The sixth instalment explored the legacy of the International Monetary Fund (IMF) and the World Bank. These were two Bretton Woods institutions set up in 1944 with the initial aim of helping rebuild Europe and Japan after the devastation of World War 2. However, once they achieved this task, they took on a new role: to extract raw materials and cheap labour from the recently decolonised developing world. This they have done with ruthless aplomb, allowing the US and Western Europe (especially France) to continue draining the resources of their former colonies without having to use military force.

Our seventh article explored how modern banking works in an article entitled "Understanding Modern Banking". We looked at how, despite common misconceptions, central banks are not the primary creators of money in the economy. We clarified this misunderstanding by explaining that banks are more than mere intermediaries between depositors and borrowers. Instead, they actively create money through the process of issuing new loans, and that this then results in the fact that most of the money in circulation, in the form of bank deposits, is created as new loans are sanctioned.

We then explored how in a fractional reserve model of banking, almost all the money we use is virtual credit – or debt – and is conjured into existence whenever a bank loans out money. This differs starkly from the general public's perception of banking, and it holds significant ramifications for the nature of money, our relationship with it and the way the broader economy functions.

We also pointed out how in reality, not even fractional reserve banking actually exists today; and how we have moved even beyond that. We explained that what we have instead is a banking system based on no reserves. The UK, for example, hasn't had a reserve requirement since 1981, when the minimum reserve ratio of 1.5% was abolished. In other words, there is almost no limit to how much banks can lend to their customers, in the process increasing the money supply, apart from one thing: interest rates.

The Ultimate Bubble

That brought us to our eighth article in the series, "How Central Banks Distort the Price of Money (and with it, Everything Else) in Today's Boom-Bust Economy", which explored how interest rates were all but neutered in the wake of the 2008 Global Financial Crisis. Left to their own devices, interest rates used to rise and fall depending on the volume of savings, or capital, available at any given time. Not anymore. Instead, they are largely determined by central banks, who believe that artificially lowering rates is enough to finance investment, allowing consumers and businesses to access new credit without having to forgo consumption – in other words, to have their cake and eat it.

The result has been a sharp intensification of the boom-bust cycle. There are plenty of recent examples of bubbles created by central bank stimulus, including artificially low rates. The nascent tech sector during the dotcom bubble, the housing market in the years leading up to the Global Financial Crisis and just about everything during the "Everything Bubble" of the 2010s, when nearly all asset classes surged in value – all made possible by loose monetary policy.

But as we've already seen in 2000 and 2008, all bubbles eventually burst. This normally happens when the central bank in question begins to worry about the consequences of the huge bubble(s) it has stoked, including surging inflation. Their response, usually years too late, involves rapidly reversing the same policies that helped create the bubble, including the artificially low interest rates. This is what is happening today.

In our penultimate article "why time is so important for our economic health" we explained how the nature of the monetary system in a country's economy can dramatically affect the time preference of both individuals and companies. We explained that because the nature of our money leads people to have a high time preference, people save less for the future, society accumulates less capital, or even begins to consume its capital, and worker productivity stagnates or even begins to decline. We explained that people consume more of their income and borrow more against the future and that the resulting debt

crises grow in scale and severity, as we are seeing now. We explained that just as centuries of capital formation helped to fuel unprecedented advances in labour productivity, economic development and quality of life, decades of capital destruction threatens to do the opposite, and why therefore the nature of our money and time preference is so important for our economic health.

So What Does All This Mean for Pension Trustees and Members?

The analysis we've shared across this series underscores a pivotal reality for pension trustees and members: the traditional mechanisms and assumptions about money, savings, and investments are increasingly precarious in today's economic climate. As stewards of retirement funds, trustees must navigate a landscape where monetary instability can erode the real value of saved capital, and where the rules of finance are not as firm as they once seemed. This calls for a heightened diligence and perhaps a reconsideration of traditional asset allocations and the exploration of new asset classes, in particular hard assets, not subject to monetary debasements. Understanding the inherent risks and potential instabilities of our current monetary system is crucial, as is exploring hedges and resilient strategies that safeguard long-term value against the backdrop of these challenges.

If you would like to discuss any of these matters further, please get in touch with your usual contact at Cartwright.

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