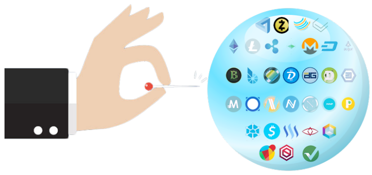
LOBNEK
WEALTH MANAGEMENT

A Brief History Of Money



Newsletter, August 2021

*"*Money is the most universal and most efficient system of mutual trust ever devised.*"*

Yuval Noah Harari (1976 –), Israeli Historian

Ever since our forebearers came to the realization that we cannot all possibly be "experts" in everything, that being a "jack of all trades" also meant that you would be "master of none", and that creating a platform in which trading one's skills in producing a particular good or service in exchange for those of others made so much more economic sense than any other conceivable setup, our lives were to be transformed forever. All efforts from then on went into optimizing and refining the process of transacting, the special lubricant between the cogs that provided economies with the necessary means to develop to a scale that would otherwise have never been possible. The barter economies of centuries ago were certainly a better solution than the alternative of the time, which consisted in going to war and plundering, but bartering was also highly inefficient and cumbersome and no match to what would come after[1].

It didn't take long to realize that what was really needed to get the ball rolling was an intermediary type of instrument through which to conduct transactions, an asset that would be entirely fungible. For that to work, a substantial number of people would have to be convinced that the intermediary itself had a value of its own[2]. Because this was a relatively novel idea and nation states did not have anywhere near the influence and reach that they do in the present, the instrument tended to be forged from a precious metal such as gold or silver, providing it with intrinsic value independent from the issuer[3]. As economies continued to grow and prosper, and as trade between nations expanded well beyond their borders, governments, for all practical purposes, switched their currencies into notes and coins that did not carry any intrinsic value in themselves. To pull this one off, the authorities promised to exchange the notes and coins against gold at a fixed rate.

This important change ushered the world into the era of the "gold standard" where the money supply ended up being entirely determined by the size of a country's gold reserves. It meant that the monetary authorities could not create anywhere near the levels of indebtedness that we see in the present (a desirable trait), which also meant that the amplitude of economic cycles were far more pronounced than those that we observe in the present (an undesirable trait). It is therefore not too surprising that the eventual demise of the gold standard came about as a result of a series of crisis situations. The first such crisis occurred as a result of World War One, when the U.S. and Europe had to suspend the gold

[1] With bartering, not only did you have to find the right person to trade with, you also had to ensure that what you had in your possession was desirable enough to your counterparty that they would be willing to go ahead with the trade.

[2] This is the network effect. Your latest mobile phone with all its bells and whistles would be not much more useful than a paper weight if it wasn't for the network to which it connects.

[3] The earliest such use of gold coins can be traced back to 600 B.C. in Lydia, which is in present day Turkey.

standard so that they could print enough money to finance their military involvement. That seemed to work very well and although it did trigger a lot of inflation, the 1920's was a period of unparalleled wealth creation.

The second one came with the great depression of the 1930's, creating a negative feedback loop where the unprecedented scale of the crisis led to a series of high-profile bankruptcies, bringing public trust in financial institutions to an all-time low which triggered a run on the banks, as customers began hoarding gold instead. In order to avert a total collapse of the financial system, the U.S. government decided to prohibit the private ownership of gold, and over time it ended up accumulating the largest gold reserves in the world. This is how the U.S. dollar became the world's de facto reserve currency and although the gold standard continued, its days seemed numbered. The third and final crisis happened in the 1970's. The rapid economic expansion in the U.S. led to a growing current account deficit which was followed by a double-digit rise in inflation as a result of the oil shocks and the Vietnam war.

As trust began to erode, banks across the globe that had accumulated large dollar reserves began to redeem them for gold, diminishing the U.S. stockpile to an extent where the Fed could no longer honor its obligation, putting an official end to the gold standard and ushering in the era of fiat money. The gold standard may have brought monetary discipline, but it also put countries with low gold reserves at a substantial disadvantage to those with comparatively larger ones. The post gold-standard monetary system provides far greater monetary flexibility, which has proven to be invaluable in times of crisis. It is reasonable to argue that the outcomes of both the sub-prime crisis of the last decade and the more recent pandemic-driven one (which is still ongoing) would have likely ended up being far worse, had monetary authorities been constrained by the gold-standard.

It could also be argued that the gold standard was bound to failure from inception, it was just a question of time with each new crisis causing it to disentangle further. As we enter an increasingly digitized economy, money in its current form is once again being challenged, optimized and likely redefined. The emergence of digital currencies and the advent of block chain are signs that the processes of creative destruction are very much alive and kicking. Governments are being pitted against the private sectors as they battle for supremacy on the mediums of exchange. Even if we can say with confidence that fiat money is here to stay, it is also true that cryptocurrencies won't be disappearing anytime soon[4].

Where Do We Go From Here?

The double whammy effects of inflationary pressures across sectors and the seemingly rapid spread in the Delta variant of the virus around the globe spooked investors enough to cause a sharp drop in values, bringing on a sense of "déjà vu" of the sharp corrections in March of last year. Sentiment turned sour on fears that we could be facing recession or at the least a form of stagflation, as the surge in prices may force the hand of central banks, right when another round of lockdowns appears to be brewing on the horizon. That sentiment didn't last very long, however, as robust earnings results from a broad range of sectors continued to pour in, validating a growing sense that the economy had somehow become more resilient to such onslaughts.

That sense was to be further reinforced with the recent U.S. National Bureau of Economic Research announcement that the economy had been in a recession for just two months since the start of the pandemic, making it the shortest-lived U.S. recession on record[5]. The unusual circumstances surrounding the current recovery is evident from the seemingly lack of consensus on the way in which it is expected to unfold. A constant tug of war between bulls and bears is creating conflicting signals for the markets. Unusually low bond yields suggest a recession ahead and that inflation shouldn't be much of a concern, whilst stocks continue to surge ahead, breaking new records and stretching multiples to well beyond their historical averages, which can only mean that strong growth is expected to remain over the longer term.

---

[4] https://www.wsj.com/articles/ransomware-is-the-irs-of-bitcoin-11625346129
[5] https://www.nber.org/news/business-cycle-dating-committee-announcement-july-19-2021

Another reason for continued uncertainty regarding the markets is the still very unpredictable way in which the pandemic is likely to unravel. The surge in new variant cases combined with a marked slowdown in vaccination rates, just when lockdown restrictions have been softening across the globe is cause for concern, but for which there won't be much more clarity until we approach the fall. Then there is the source of inflation to worry about, mainly because this time around it is being fueled by both demand and supply, which means that the monetary authorities with tools geared more towards demand driven inflation will be having a harder time managing it. If supply driven inflation gains the upper hand, central banks could raise rates, nipping demand which risks dragging the economy into recession.

Supply constraints are currently especially acute in the real estate and automobile sectors, caused by a protracted shortage in building materials and microprocessors that are likely to extend over the coming months. Manufacturers are more likely to pass on a rise in input prices to the consumer than when the cause is a surge in demand, in which case it is typically absorbed until either supply is ramped up or demand subsides. There are signs that wages are also on the rise in certain segments, but that won't amount to much if prices of goods and services are also increasing over the same period. The real danger with inflation is when it lingers on, because that is when it risks seeping into the future inflation expectations of both households and businesses, triggering a wage-price spiral that becomes much more difficult to control afterwards.

As we enter the second half of the year with diminishing tailwinds and a flurry of headwinds to contend with, there are chances that the newfound vigor fizzles out prematurely, but there is also a greater likelihood that given the unusual resilience of economies, those headwinds amount to not much more than a dent on the expansion, moderating it to an extent where comprehensive intervention becomes unnecessary. We are not out of the woods yet, far from it, the pandemic does not appear to be anywhere near its last throes and the recent catastrophic flood across Europe is clearly a precursor to the threats from climate change (i.e. the more frequent occurrence of such substantial disasters). So, there is reason to fret and be hopeful at the same time. I think it's called cautious optimism, but I may be wrong.

Altug Ulkumen, CFA

Independent Contributor
aulkumen@gmail.com