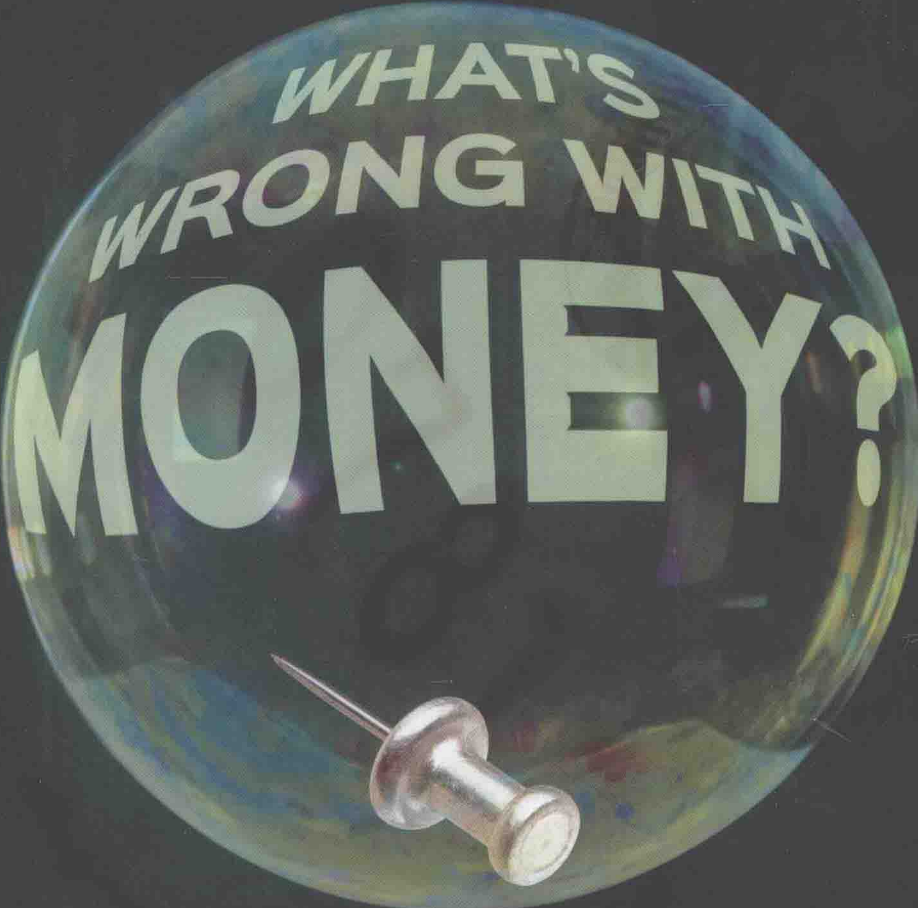
WHAT'S WRONG WITH MONEY?



THE BIGGEST BUBBLE OF ALL

MICHAEL ASHTON

WILEY

What's Wrong with Money?

The Biggest Bubble of All

MICHAEL ASHTON

WILEY

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.
Published simultaneously in Canada.

Library of Congress Cataloging-in-Publication Data:

ISBN 9781119191018 (Hardcover)
ISBN 9781119191179 (ePDF)
ISBN 9781119191162 (ePub)

Cover Images: Soap bubble © rusm/iStockphoto;
US one hundred dollar bill © burakpekakcan/iStockphoto;
Pushpin © rimglow/iStockphoto
Cover Design: Wiley

Printed in the United States of America
10 9 8 7 6 5 4 3 2 1

Preface

Every person in authority, whether at the Federal Reserve (Fed) or the European Central Bank (ECB), in the White House or at 10 Downing Street, on Capitol Hill or in Parliament, says that we should not worry. Sure, there are holdouts—people who worry, like we do—but they are marginalized as cranks or backbenchers.

What are we worried about? In 2000, we had a bursting stock market bubble that produced a fairly brief but painful recession. Central banks and legislators sprang into action by drastically cutting interest rates and extending jobless benefits, among other things. "Don't worry! It's Greenspan to the rescue!" we were told. For a while, it seemed as if they were right. The economy recovered, although we now realize that the actions of the authorities set up another, bigger bubble.

In 2007, the second bubble within a single decade started to come undone; it popped in 2008. The ensuing recession was deeper, and longer, and the response from monetary and fiscal authorities was more dramatic. The scale of the response was an order of magnitude larger, with trillions of dollars of deficit spending and the implementation of quantitative easing (QE) on a massive scale. The breadth of the response was also impressive, with every major central bank not only dropping interest rates but also implementing its own version of QE. Dramatic? The response was desperate. Certain central banks pursued policies that drew criticism at the time, not because they were of limited effectiveness but because they were of questionable legality under the central bank's authorizing legislation. But it was a classic case of the ends being taken to justify the means: In the end, the world was saved from financial immolation and if you have to break a few eggs to make an omelet, who cares? After the fact, even some of the original critics begrudgingly recanted, saying that in the heat of the moment clearly something had to be done, and any alternative proposal would have to be tested against a policy that, ultimately, worked.

In the United States, the unemployment rate is below 6 percent again. Banks are lending. The hyperinflation predicted by the hyperventilated never, in fact, happened. Budget deficits are coming back down. Japan and the Eurozone have seemingly averted deflationary collapses as well, and although many bank depositors in Cyprus were "bailed in" (in other words, their money on deposit was confiscated), the European currency union has so far proven inviolate. Although, to be fair, we haven't heard the last of Greece.

Winning!

So why are we worried? The crisis is over! Disaster averted. And soon—although we have to use our imagination about what "soon" is—the Federal Reserve will begin increasing interest rates to put monetary policy on a more normal footing. All of the worst predictions have failed to materialize. Game, set, and match to the financial interventionists. Right?

We are worried because this doesn't feel right. We see a perpetual motion machine, and although we can't write down the physics equations for why it shouldn't be working, we have intuition that tells us it shouldn't. If the seemingly insane scope and scale of the policy response was successful in doing what it is purported to have done—to have added millions of jobs, saved thousands of banks and put the stock market on the moon—with no evident side effects, then why the heck haven't central banks and legislatures been doing this forever? Eat all the chocolate you want, and don't gain weight! It sounds like a great deal.

But we know something is amiss. This book describes what that is. The unfortunate fact is that each subsequent crisis has only been repaired by weakening a more fundamental layer of our financial lives. The crumbling equity market edifice was repaired, at the cost of the housing and credit markets. The housing and credit markets have been repaired, but at what cost?

This book is about the most fundamental layer of all: the structure of money itself. Over the last century, our concept of what money is, at its very root, has gradually changed. What backs money today is simply this: trust. There is nothing else behind our dollars, our euros, our sterling, our yen, our francs . . . but trust that someone else will accept it at a reasonably predictable level in exchange for stuff we need. And this is why it matters so much that policymaker responses to the last few crises have whittled away at that trust. This is why it is so disturbing that these policymakers say "trust us" while they monkey with money.

Never before has so much ridden on trust. And never before has that trust been so abused, and so stretched. What's wrong with money? Nothing, and everything.

What's Wrong with Money: The Biggest Bubble of All is structured thus:

In Part I of the book I explain what money is, how it differs from related concepts of wealth and currency, and why we need money in the first place. How has money evolved from being backed by something to being backed by only trust? What is *fiat* money, and why is it any better or worse than non-fiat types? What can we learn from the experience of bitcoin? One of the things we can learn from history is how fiat money regimes tend to end. Perhaps that will help us figure out where we are going.

In Part II, I tackle the current circumstance. It is key to understand how the actions of fiscal and monetary agents in response to the global credit crisis have impacted us today, and how those actions narrow the set of potential future outcomes. And I will tell you how I personally think this whole episode is likely to end. Spoiler alert: There is no perpetual motion machine.

In Part III, I tell you how this should affect the way you arrange your investments, today.

Acknowledgments

I can't believe I wrote the whole thing.

This book was the surprising (to me) result of an inspiring conversation I had with my good friend Karl Strobl, who admonished me to warn the countryside about the perils of relying on a system of money whose edifice is built on the shifting sands of trust. From the moment that Karl suggested the title *What's Wrong with Money*, the book came alive in my head and in a few short months it was reality.

The whole team at Wiley is terrific, but I must single out Executive Editor Bill Falloon. Bill has rejected (kindly) so many of my ideas in the past that when he said he liked this one I knew that it must really be a good idea. Also special thanks to Meg Freeborn, who quarterbacked the project and was so encouraging throughout.

My wonderful family deserves special mention, and not simply because of their boundless love and support. I was tasked with this manuscript only a few days before we began a month-long road trip, complete with dog—and deadline. My family tolerated my sneaking away to write a thousand words here, a thousand words there, and never complained. Words cannot express my appreciation. A road trip with a dog is stressful enough already!

About the Author

Michael Ashton is managing principal at Enduring Investments LLC, an independently owned investment management company that offers focused inflation-market expertise.

Prior to founding Enduring Investments, Mr. Ashton worked as a trader, strategist, and salesman at some of the most prestigious financial institutions in the world, including Deutsche Bank, Bankers Trust, Barclays Capital, and J.P. Morgan.

Mr. Ashton is a pioneer in the U.S. inflation derivatives market, a proven innovator in inflation markets, and an outspoken advocate of the need to provide effective client inflation solutions that are unique, transparent, liquid, scalable, and inexpensive. While at Barclays, he traded the first interbank U.S. CPI swaps. He was a driving force in the creation of the CPI Futures contract that the Chicago Mercantile Exchange listed in February 2004 and was the lead market maker for that contract. Mr. Ashton has written extensively about the use of inflation-indexed products for hedging real exposures.

Mr. Ashton graduated summa cum laude with a BA in Economics (1990) from Trinity University in San Antonio, Texas. He earned his CFA designation in 2001. He is married with two children and lives in Morristown, New Jersey. This is his second book: *Maestro, My Ass!* was published in 2009.

Contents

PART I

How Money Lives and Dies

CHAPTER 1

What Is Money, and Why Do We Need It?

Stop for a minute and think about that dollar (or euro or yen) in your pocket or in your bank account. What does it mean? Before you read further, think about that question. What is the *significance* of saying, "I have a dollar"? What does a dollar represent?

The meaning of a dollar—and, henceforth, I will often use "dollar" for ease of exposition, but you understand that I mean *your currency unit*—is best understood by thinking of the two endpoints of the period of time during which I possess it.

I *receive* a dollar in exchange for something—very often, my labor. In fact, that is how most of us receive our dollars. In the United States (in 2015), about 51 percent of total personal income was received in the form of wages and salaries. Another 12 percent was in "employer contributions for employee pension and insurance funds" and "employer contributions for government social insurance," though to be honest neither of those sounds like the kind of income that puts dollars in my pocket today. (For those readers who are curious: 14 percent is from Social Security, Medicare, and Medicaid; 14 percent is from wages and dividends; the balance is from a variety of sources.)[1]

So the dollar in my pocket is most likely the result of my labor. And where does it go? About 42 percent goes to Girl

Scout cookies . . . wait, that's just me. Your answers here will vary, but the salient point is that those dollars are in our possession temporarily until they go to buy goods and services. For you, for your family, or for your heirs—ultimately, a dollar is just a placeholder for "what I will buy, someday."

That greenback is to your labor what a battery is to electricity: It holds the input (labor) in a form that is easy to hold, until it is ready to be used.

This is an important function for money, and you can see this by thinking about a primitive society that doesn't have money.

A Pre-Money Society

Consider Elmer the farmer. Elmer grows corn and raises chickens. This works for him because the chickens will eat surplus corn, so he has a decent diet of chicken, eggs, and corn. Nicely done, Elmer.

Elmer's neighbor, Margo, raises cows and wheat. This doesn't work *quite* as well as Elmer's setup, but the cows eat the chaff from the wheat and graze on her fallow acres, so Margo enjoys beef, milk, and bread. She, like Elmer, is also fairly self-sufficient.

Both Elmer and Margo can easily improve their positions. Elmer can offer three eggs in exchange for a quart of milk, for example, or swap chickens for cows. This is called a barter economy, and you can easily imagine how this economy can be enlarged with more of Margo's and Elmer's neighbors producing and trading vegetables, sheep, fish, and so on. This little commune could lead a bucolic existence, even without money. Consider, though, three potential problems with this setup.

First Problem: Slippery Standards of Exchange

What happens to this little vignette if Margo complains that Elmer always gives her the three *smallest* eggs in exchange for a quart of milk? In a barter economy, our two actors would resolve this issue by reaching some agreement on the size of the eggs that need to be exchanged for one quart of milk at a three-to-one ratio. The eggs must be just *so* big, but (for Elmer's protection) no larger than *this*. But what if Elmer has already traded all of his eggs of that size, and only has small eggs left? Moreover, *every* exchange of goods (or services! Margo's neighbor Olaf builds fences for food!) will have a set of standards to ensure a fair exchange. These standards may be established and maintained at a trading post or just developed organically (no pun intended) by the society, as a series of bilateral exchanges serves to establish not only the price but what we would call the *contract grade*;[2] but these details need to be agreed for each transaction.

Second Problem: Long-Term Storage

How does a system like this deal with a circumstance like Margo's Milk Miracle, the memorable year when Margo's cows doubled milk production for reasons no one ever figured out. (Was Margo's milking more aggressive? Was the grass that year especially lush? Who knows? Milk is mysterious.) Margo tried to trade away her milk by pre-paying this year's milk for next year's eggs. She had Olaf build fences to nowhere, threw milk parties, and so on. She would have liked to save some for next year, or put some toward her retirement (or for the retirement of Bessie, her bell cow); but in the end, a lot of the milk spoiled. Milk doesn't store well.

Third Problem: Different Trading Interests

Barter depends critically on an intersection of interests. If I have A and want B, and you have B and want A, then barter is feasible. But there is complexity when Margo needs a fence but Olaf—who is on a very restrictive gluten-free vegan diet—doesn't eat beef, milk, or wheat. How does Margo get her fence, if she has nothing to exchange for Olaf's services? Margo needs to do some additional work: Olaf needs a new fireplace, which the mason can provide. But Minnie the mason is lactose-intolerant and has all the beef and wheat she needs for the next month already laid in. However, Minnie needs shoes, which Carlos the cobbler can provide. Carlos needs leather, which Tessa the tanner has; Tessa, fortunately, can use a cow for not only beef but for the hide as well.[3] *So*, all that Margo needs to do is to give a cow to Tessa in exchange for leather; trade the leather to Carlos for shoes; swap the shoes to Minnie in exchange for a fireplace for Olaf; and then Olaf can build a fence for Margo. *If*, that is, one cow equals the right amount of leather to get the right number of pairs of shoes to persuade Minnie to build a fireplace. Building a fireplace is a lot of work, so Minnie might require *not only* shoes but also salsa, which Margo can get from Sadie the chef, who needs . . .

Maybe it would be easier to invent money. Money can resolve each of these problems and make the economic system of the whole community work more smoothly.

Money as a Unit of Account

You may have heard that money serves as a *unit of account*. This function is useful for solving the problem of slippery standards of exchange. If Elmer doesn't trade eggs for milk, but rather, eggs for money, which he then uses to buy milk, then we don't need a list of standards of exchanging eggs for milk, because Margo knows one unit of currency is worth three eggs of a certain size. We can adjust more easily for deviations from "contract grade" by, for example, paying more money for bigger eggs rather than having a whole different set of exchange