

Money Illusion

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Money is a more slippery concept than you might imagine. The story goes that money was invented to replace barter. It's clearly very hard to make an estimate of how many shoes are equal to a bushel of wheat although I was once offered "two camels for my wife" on a trip to Egypt. On reflection...

In his book the "First 5000 years of Debt," the financial anthropologist, David Graeber pointed out that there is absolutely no evidence for that story at all. In fact, it's a story concocted by economists as a kind of foundation myth. What is true is that everything from iron bars to cowrie shells have been used as units of exchange through history but money as a unit of exchange, store of value and unit of account, is a very modern phenomenon.

Of course, in a modern monetary system we are used to placing a value on goods and services in terms of its price. We think in terms of money value. So much so, it led Oscar Wilde to describe a cynic, perhaps he meant an economist, as someone "who knows the price of everything and the value of nothing."

More properly we should think about money in terms of the quantity of goods and services into which it can be exchanged. Paradoxically, money has no intrinsic value of its own.

It is well known that the developed world economy is still suffering from the overhang of the global financial crisis which is now seen as fundamentally a banking and debt crisis. One of the reasons for the duration of this hangover is that there are two profoundly different interpretations of the role of money in a modern economy fighting for supremacy.

There is the Anglo-Saxon view that places primacy on money as a means of exchange and motor of economic activity. Opposing that view is the German "ordo-liberal" perspective that money is primarily a unit of value and that prices should adjust to meet the quantity of money, not the other way around which sees a lack of money in circulation as an impediment to growth. It's easy to see why the German economic establishment led by Jens Weidmann is so bitterly opposed to the policy of Mario Draghi at the ECB. This is the real fault-line dividing Europe.

It turns out that money is quite a dangerous concept particularly in a fiat currency regime where the volume of money is literally controlled by the stroke of a keyboard. It's also alarming that the notion of earning a return on deposited money at the bank is being eroded. Interest returns on cash are negative in over twelve countries and close to zero in many more.

If governments retain the power to deflate or inflate the value of their money what should investors do to maintain the real purchasing power of their, usually, very hard-earned wealth?

This was a question posed to us at the very depth of the financial crisis. The same answer still applies; owning part of the productive wealth of an economy seems more rational to us than holding paper claims on the financial institutions.

There is a debate currently being held at the highest levels of business and government as to what is the role of business? The stock answer for decades has been to "maximise shareholder value."

However, thinking about money in terms of what it can be exchanged into leads to the realisation that you are really talking about people's demand for leisure, entertainment, medicine, security, healthcare, travel and food.

Therefore, in addition to securing shareholder returns, businesses exist to meet all the disparate needs of the people that constitute the economy. The real money illusion is to think that money is productive: it is not.

So, investors should be looking for opportunities to create value. That is the real role of the businesses into which they invest. Value-creation not money illusion is at the heart of what we do at Tacit Investment Management.

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