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EDITORIAL

Perspectives on Money, Finance and Debt

Simon Davies, Managing Director, The Blackstone Group International Limited, London, UK

We are in a war for economic recovery, but we haven't worked out how to win it.

In a search for safety and security, with investment asset values bouncing around like a yo-yo, prospects unclear and economic growth uncertain, 'cash' has become an attractive asset, even if the returns on it are paltry due to almost zero interest rates available. But what is cash, and is it a valuable thing to hold?

People believe that cash is the number that shows in their bank account – which, to an extent, is true. However, I was more than a little perturbed to learn that, in a recent UK survey, 74 percent of people polled believed that, when they deposited money with their bank, the money remained legally theirs. Either people are not listening to proper disclosure of risks of depositing money in a bank account, or they are not being properly informed. I do not expect any of us have even started to look at the terms and conditions of our bank account. There's just that inherent feeling that putting your money in a bank is sae – it's your cash, they are just looking after it for you, right?.

Given the outcome of the survey, it is clear that the vast majority of us believe that when people put money in the bank, they own cash. The unfortunate reality – that they have a claim as an unsecured creditor against the bank to which they have just lent money, with the first loss amount of that claim of up to GBP 50,000 insured by the UK Government – is probably not quite what they expect, given the outcome of the survey.

However, all is not lost and, for so long as a person maintains a bank account with GBP 50,000 or less in it, then the Government will pay out if things go wrong and the bank can't pay me cash. And the Government has plenty of cash, right?

As we have started to learn, the answer to that question is 'not necessarily'. Like any other person or company, if the Government wants to make a payment, then it must have the funds available to it – which it 'earns' through taxation and raises by borrowing from others.

The UK Government is not alone in being a Government which, on a net basis, currently needs to increase the amount of money it has borrowed in order to balance its books – it is spending more than it earns and is running a forecast budget 'deficit' for the medium-term. It has raised taxes and is cutting costs, but the books are still not balanced unless it borrows more. For so long as the financial markets have confidence that the UK can, and will, pay it debts as they fall due, they will probably continue to lend the money it requires. However, as Greece has found, once confidence wanes, the deterioration is a steep and unpleasant one.

Therefore, as the rules are currently written (remember they were rewritten for Northern Rock for a time, but that was before the Government bailed out the whole banking sector), you'll probably get your first GBP 50,000 back and a claim against the bank for the rest. Not quite the outcome that 74 percent of us are expecting.

Before you empty your bank account and start stuffing mattresses with cash, it's worth considering what you are actually stuffing into the mattress. Once upon a time, currency was an asset-backed security – it was an actual 'claim to gold' and your notes and coins meant that, theoretically, there was a small lump of gold somewhere with your name on it. Its downfall came about as a result of the last global financial melt-down in the 1930s when the 'gold standard' was shown to be an inflexible mechanism for currency as a medium of exchange at a time when countries needed to devalue their currencies to make their economies relatively more competitive.

Today's currencies are not linked to a fixed asset – there is no claim to gold and they are 'fiat' currencies. They exist as a medium of exchange to allow for business to be done and things bought and sold without requiring that we do everything by way of barter. Their relative value – the amount of any goods that they can buy and their traded value against other currencies – is a matter of confidence that the central bank will maintain a 'sensible' monetary policy, controlling the supply and cost of money so that it is maintained as a stable medium of exchange. As Zimbabwe showed, if all confidence in a currency's role as that medium is gone, the currency is of no practical use and mattress stuffing becomes a value destructive hobby.

The Zimbabwe problem – which is one of the biggest risks to actually hoarding cash – illustrates most clearly the fact that cash is devalued over time in an inflationary environment. The rate of change of prices was so great that any cash retained was worthless within days.

In a 'normal' world scenario, where the central bank is targeting an inflation rate of, say, two percent, the rate of loss of value on cash is slow as prices for goods and services are rising at a relatively steady pace. In that 'normal' world, you would not be afraid to place cash on deposit at a bank and, if carefully selected, your bank deposit would earn a rate of interest on that cash that more than compensates for the loss of value through inflation. You are lending to that bank, after all, so it pays you interest to reflect the risk to the safety of your money being returned by them.

The 'normal' world scenario was suspended in late 2008 and has not returned. The current situation – relatively stubborn positive inflation and zero or near-zero interest rate policies – means that the individual who has savings at a bank is watching those savings erode over time as the bank offers below inflation interest on accounts.

However, for the indebted individual – those with mortgages, loans and credit card debts – the real value of that debt is reducing over time. This intuitively feels like a good thing, as the problem faced by Japan, where a consistently deflationary environment has meant that the real amount of borrowing actually increases over time, should not come to pass. But the value attached to a reduction in the real value of debt is only effective for a person if the corresponding income of that person is improved when compared with the cost to repay those debts.

Mortgage rates are very low and there is a limit to how much lower they can go, being 'not very much'. This has reduced the debt service cost of the interest charged to a person but that is now relatively static. Unemployment is stubbornly high and will likely remain there for some time to come – the public services are suffering cuts and the private businesses are making relatively little investment for growth, so job creation will be limited and, on a net basis, potentially negative in the near future.

High unemployment will create competition for jobs, driving down the wages as supply outstrips demand. This, combined with increase in a person's tax burden will mean that there is less income available to the individual, so even while debt is being 'inflated away', a relatively greater impact may be felt by the reduced net income earned. Welcome to austerity, my friends – a situation where you are being made better off – eventually – very slowly and potentially painfully.

It is fascinating at the moment to see such massively opposed views as to risk. For any one economist who preaches inflationary risk from ultra-loose monetary policy, there is another who preaches deflationary risk due to the output gap. For everyone who preaches austerity, there is another who will preach profligacy. Should I save my money and repay my debts or should I spend it and try to 'keep the economy going'? The question at a personal level is identical to that at a government level – spend and be damned or save and be equally damned. Thus the default position of save at a government level and spend at a central bank level.

The one absolute requirement of this period of global finance – whether it is austerity versus spending or any other policy – is the need for a coordinated approach to fixing the global financial system. Many good things were said in the early period of the 'credit crunch' about needing to act in a consistent manner in re-regulating the financial industry and setting fiscal and monetary aims. We must remain open to free trade. We must appreciate that pulling together as a global unit is required to fix global finance.

Positive talk has not become positive deeds. Governments are impatient to be rid of the monkey on their back, to be freed of the financial problem and are suffering the same from the same short-termism of which they accuse investors, financial institutions and markets. They are also suffering from something worse – short-sightedness. They are looking no further than their own borders as they try to define what constitutes a 'solution' to the crisis.

History tells us (and we can choose to believe or discount as we see fit) that periods of financial crisis are prolonged through inflexibility or inability to institute change (the gold standard, labour market 'stickiness' – the euro today?) and protectionist measures. History also tells us that times of such massive Government deficit and debt only generally occur as a precursor to, or a result of, a large war.

We are in a war now, just one without guns. And we are all losing it in the long run, though it will look like there are some victors in the short run.

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International Corporate Rescue

International Corporate Rescue addresses the most relevant issues in the topical area of insolvency and corporate rescue law and practice. The journal encompasses within its scope banking and financial services, company and insolvency law from an international perspective. It is broad enough to cover industry perspectives, yet specialized enough to provide in-depth analysis to practitioners facing these issues on a day-to-day basis. The coverage and analysis published in the journal is truly international and reaches the key jurisdictions where there is corporate rescue activity within core regions of North and South America, UK, Europe Austral Asia and Asia.

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