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Digital tulips and the spectre of inflation

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The history of money is as fascinating as the history of civilisation. So much that the two are closely linked and share a constant pattern: financial innovation generates prosperity, while political decadence foreshadows monetary crises. Today we are living in yet another era of significant political swings, hence the reason for going back to history and seeing what might happen with our money.

The first study of money was published in China in the 7th century BC (yes, a long time ago) and was known as the *Guanzi*. Already back then, Chinese scholars concluded that money need not have an intrinsic value. Money was debt issued by the sovereign and, as such, it was a key tool to exercise power. If the sovereign issued too much debt it stimulated economic activity, but if the money in circulation exceeded the amount of goods being produced it would lead to a rise in prices and a certain degree of instability. Thus, the sovereign occasionally had to limit spending to alleviate prices: a delicate balance.

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Another lesson they learnt was that money has a redistributive component. Deflation benefits creditors, while inflation aids debtors. This creates friction. On the other hand, since money need not have any value, the sovereign could create it at his discretion and, every time he did, he redistributed the wealth of his subjects to the state's coffers. This notion led the Chinese scholars to one last discovery: the sovereign must have the monopoly over money creation if he wants to ensure social and political stability.

Thanks to these early studies, China was well ahead of Europe in monetary matters. The first paper money (or 'flying paper', because it was light and easy to carry) was established during the Tang dynasty in the 7th century and perfected in the Song dynasty in the 11th century. Therefore, when Marco Polo reached China in the 13th century, paper money was well established across the empire of the Great Khan. Europe, in contrast, issued the first paper bill in Sweden during the 17th century.

It is also true that across the centuries many Chinese leaders did the opposite of what the *Guanzi* prescribed, leading to periods of hyperinflation. Such was the extent of the problem that in 1455 the Chinese authorities banned paper money and turned towards an obsession with silver, which lasted until the Communist Party took power in the second half of the 20th century.

These painful experiences in China and its equivalents in Europe –for example, the hyperinflation of the *assignat* following the French Revolution and in the Weimar Republic– explain why until 1971, when Nixon broke away from the gold standard, the monetary anchoring to a precious metal was the prevailing norm.

In this half century of fiduciary money we have assimilated a few lessons from the *Guanzi*. Money does not have an intrinsic value, and after the 'stagflation' of the 70s, the inflation rate has been low. Nonetheless, what we have not done is leave the monopoly of money-creation in the hands of the sovereign. Today, commercial banks create money through the fractional-reserve system and, as expected, credit has exploded. On the other hand, we have also realised that the quantity theory of money is questionable: we have seen an enormous rise in the monetary base (particularly since the Great Financial Crisis), which has not translated into a rise in inflation.

But the lessons of history suggest this might change. After the Great Recession and the war against COVID-19, the world's debt (both public and private) has reached an astonishing 365% of global GDP, a historic record. Only last year the US Federal Reserve issued a fifth of all dollars currently in circulation. It is no surprise that the US stock market has skyrocketed, and last year both gold and the Dow Jones reached record highs, something remarkable given that they usually move in opposite directions. This anomaly suggests that the liquidity is creating bubbles and distorting the discovery of prices by economic agents.

This has sparked fears of inflation, suggested by the rise in the price of bitcoin. The cryptocurrency reflects a nostalgia for the gold standard. Its appeal lies in the fact that supply is limited, as there will only be 21 million bitcoins 'printed'. But that is exactly why it will never be a currency, much less money. As demand increases and supply is limited, the price of bitcoin rises. But let us not fool ourselves, bitcoin is neither a medium of exchange (few will buy their Tesla with bitcoins) nor a unit of account (its value is measured in dollars or euros) and is too volatile as a store of value. We are facing a digital tulip nurtured by a speculative frenzy.

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But the bitcoin-mania must make us reflect. Historically, the emergence of private near-money has suggested that political power is losing legitimacy. The detachment of broad layers of society from the democratic system and the liberal international order is unquestionable: the assault on the US capitol being the most evident example. Traditionally, political and monetary stability feed each other, and 50 years of fiduciary money is a brief instant in the long history of finance.

What does the future hold for us? For the moment cheap money will continue to flow because we need to win the war against COVID-19 and because the Fed cannot afford a collapse in the stock market if half the US population have their savings there. But it is precisely after wars when inflation appears. We may live a new 'Roaring 20s', but the debt levels will have to decrease at some point and to do that it is useful to think about four different scenarios.

(1) Growth: this is the ideal; using the cheap money from today to invest and increase our productivity. But we may end up with too little growth and too much inflation.

(2) Adjustment: central banks keep their independence, increase rates when prices start increasing, the cost of debt rises and we head into a deep recession. Let us hope that by then inequality has decreased, otherwise social tensions will increase.

(3) Inflation: the political class captures central banks with 'fiscal dominance' and opts to reduce debt thanks to the rise in prices. It may work, but it is a risky strategy: inflation is hard to tame once unleashed.

(4) Debt restructuring: Thomas Piketty and 100 more signatories have recently proposed it. Naturally, they have met head-on resistance from the establishment.

Sovereign debt restructuring at the heart of our international monetary system must be the last resort. But, maybe, if the other three do not work, it could be our last option. The Jubilee in the Old Testament already considered debt cancellation every 50 years, and that document is even older than the *Guanzi*.