The Greatest Global Financial Risk

A hazard that we all touch every day freezes chief risk officers and blinds central bankers.

Money itself is the greatest global financial risk. More specifically, I nominate the "fiat money" of every developed country as the hydrogen bomb awaiting the trigger event.

Important note here to all my readers: please don't abandon this article! For reasons unknown to me, our collective eyes and brains glaze over when we hear warnings of "money printing" and monetary policy! Please bear with me, for I shall treat this topic in few words and in a different manner than the standard disquisition.

Fiat Money Relies on Confidence and Much More

The definition of "fiat money" is simply money consisting of paper, electronic record or any other conceivable form that has no intrinsic value. It is "money" by virtue of government decree and society custom.

The terms "paper money" and "fiat money" are *not* synonymous. Paper money originally possessed intrinsic value as a receipt that the holder could exchange for goods or other tangible substances in safekeeping.

Defenders of our modern banking system explain that the people must "have confidence" in the banks for the system to work. Fiat money has the same confidence requirement. If and when the people lose faith that society's agreed value of one dollar or euro or pound, *et cetera*, will have the same value tomorrow, the money will crash.

Some motivational speakers will tell you "hope is not a plan" to coerce you to take strong steps in the present to improve your life. I'll adapt that statement to "confidence is not a plan" for banks and money. When an engineer designs and builds a bridge, he or she doesn't tell pedestrians they must "have confidence in the bridge" for it to provide safe passage.

Possibly much more important, fiat money relies on governments not to behave in a manner that debases or destroys the nation's money. One of the inspirational themes of financial history is that central banks exist to be independent of their governments and to protect the currency from every government's natural desire and tendency to diminish it. Unfortunately, inspiration has never met the reality. Governments did not create central banks to tether themselves.

Let's Think Like Risk Professionals

As risk professionals, we seek to encode every risk position of our firms into databases that are highly accessible, transparent, accurate and complete. With models, user interfaces, data feeds, judgment and ingenuity, we strive to remain acutely aware of both the current state of the firm's aggregate risk and the extent of change in value and risk with conceivable market and world events.

As part of this second activity, we go well beyond the simple modeling of parallel yield curve shifts, FX rate jumps, and so on. We challenge as many implicit assumptions as we can identify. For example, we stress the prices at which we might liquidate assets. We discard the model element that simply rolls all the repo funding. We insist on having liquidity to fund all the collateral agreements that a hypothetical rating downgrade would trigger for the firm.

In this spirit, let's ponder what could go wrong with fiat money. Imagine a significant developed country with large debt. Since it has kept interest rates artificially low for years (or even decades), this country can pay the interest on its debt – but just barely. Yet the country continues to run an intentional fiscal deficit ostensibly to help the citizens in various ways.

Let's also assume that the central bank holds much of the country's debt and keeps buying more. The government understands that it cannot let interest rates rise due to the increased cost of servicing its own debt. Though it sees its own currency depreciating relative to that of other countries, our hypothetical country actually perceives an advantage in its own weakness!

The politicians may believe the weaker currency will strengthen the economy through greater exports.

Does this scenario strike you as feasible? Or just a tail event? Or even completely impossible? I'd say this is the current world situation! Several countries fit this description.

We continue this "stress test" by imagining that "Country B" is watching our previously described "Country A," and eventually decides that Country A's deliberately weakened currency is harmful to Country B. Whether we call it "currency wars" or "competitive devaluation" or "a race to the bottom," this supreme systemic risk is a distinct possibility with fiat money.

I don't ask readers to agree that this global failure outcome is "likely." Rather, I ask only that we consider the outcome to be "possible" and well worth preventing, if the cost of prevention is acceptable.

Alternative to Fiat Money

Proceeding from the definition of the term, any system of money that employs a substance or goods or services of intrinsic value is an alternative to fiat money. History's most prominent candidate for "a substance of intrinsic value" is gold.

In the interest of space and my attempt to deviate from the standard disquisition, as I called it, I omit discussion of the fortuitous chemical and physical properties of gold. I will mention, though, the fascination and adoration that human beings have had for gold for all of recorded history.

No, "you can't eat gold," as some critics say. But gold does have intrinsic value. You'll find many people you meet during the day wearing gold.

Everyday Life under a Gold Standard

I sometimes wonder why the typical sophisticated, intelligent person is dismissive of gold-backed money. Perhaps it's because most people alive today cannot remember an era of the pseudo-gold standard that expired in the early 1970s. Or it may be the famous quip of John Maynard Keynes, the legendary economist, about the gold standard being a "barbarous relic." (We will make “barabarous relic” a hot link using the following link: http://barbarousrelic.net/) My guess is that there may be misunderstanding of what the gold standard is and how it works. So let’s provide some explanation.

First, life under a gold standard would look much like life today. There’s no big change *on the surface*. We will still use paper money. We’ll still have money at banks and other places in electronic form. We’ll write checks and send wires.

Money will still be electronic when that is most convenient. People will not find it necessary to carry gold coins or hold physical gold in any form. The only evident change is that people will have *the option*, not an obligation, to exchange their money for gold (or gold for money) with the central bank at a fixed price. That’s it. For the typical person, then, life does not change.

There are anti-gold standard arguments based on the difficulty of finding the correct “fixed price” for gold. Actually, there exists a simple, straightforward and ultimately accurate method for determining this fixed price. I’ll not publish it here. It is true that one cannot arbitrarily choose this “fixed price,” as several nations have learned through history.

Nations need not coordinate among themselves to adopt gold standards in their respective currencies. Thus, there’s no need for international negotiations or treaties. How fortunate! In fact, there’s an “early mover” advantage to instituting a gold standard in advance of other countries.

Madison vs. Keynes

Keynes’ legendary antipathy to gold has a pithy, logical basis. A true gold standard is inflexible. When a country runs out of money, it runs out of money. There’s no “printing of gold” or “priming the pump.”

The Keynes view is that government, rather than a fixed volume of gold, should control the nation’s money because government could, in theory, supervise a flexible money supply by adding and deleting money at strategic times in a manner that outperforms a gold standard.

However, the gulf between theory and practice is immense. To side with the Keynes fiat money view of the world, one must believe that government experts (economists? politicians?) have the skill, experience, judgment and motivation to achieve best results for *all citizens* as opposed to favored sectors or the government itself.

James Madison, the fourth U.S. president and a renowned author of the U.S. Constitution of the 18th century, held a diametrically opposing view. In *The Federalist No. 51* (1788), (We will make "The Federalist No. 51" a hot link using the following link:http://www.constitution.org/fed/federa51.htm) though not writing of monetary policy, Madison stated:

> "In framing a government which is to be administered by men over men, the great difficulty lies in this; you must first enable the government to control the governed; and in the next place oblige it to control itself. A dependence on the people is, no doubt, the primary control on the government; but experience has taught mankind the necessity of auxiliary precautions."

The government of the U.S. Constitution employed gold and silver rather than fiat money. Though I do not presume to speak for James Madison, I expect he would have viewed the gold/silver standard as an appropriate "auxiliary precaution" to bind the monetary policy of government. During the Revolutionary War that ended only five years earlier, the nation had a disastrous experience with fiat money.

A Path to Systemic Disaster

The greatest global financial risk is the correlated collapse of numerous fiat currencies. Fiat money relies on both the confidence of the people and the discipline of governments to refrain from debasement.

Debasement, however, "works" in the short-term to reduce effective debt levels, placate some citizens with printed money and allegedly boost exports. Consequently,with fiat money, there is clearly an imaginable path to systemic disaster, as one country's lack of discipline weakens whatever discipline remains in other countries.

Joe Pimbley (FRM) is a financial consultant in his role as Principal of Maxwell Consulting, LLC. His expertise includes enterprise risk management, structured products, derivatives, investment underwriting, training, and quantitative modeling. He is the co-author of "Banking on Failure – Fixing the Fiasco of Junk Banks, Government Bailouts, and Fiat Money."