Private Client Letter

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Sound Money, Unsound Money

Liquidity is an asset class, and not simply an account balance. Safe and stable money does not fall from the sky, but depends upon many factors. We should pay more attention to this, even when times are good.

It was a beautiful legacy from a grandmother: an artistically designed banknote for one hundred million marks, issued in Berlin on 22 August 1923, signed by a dozen members of the Reichsbank directorate. On the day of its issue, it could have been used to post over two thousand letters in Germany. A little more than two months later, the same amount was just enough to post one letter, and by 9 November 1923, you would have needed ten of these artistic notes: a billion marks for one postage stamp. Such hyperinflation is rare and traumatic; today, we see it most often in developing and emerging economies such as Venezuela and Zimbabwe.

The quality of money is first measured by whether it is suitable as a unit of account for valuing goods and whether it is generally accepted as a medium of exchange. In addition, a third, key criterion is whether the money is stable in value, i.e. whether the same amount of goods can be bought later for the same amount of monetary units. In the extreme case of the German mark in 1923 described above, it is clear: worse money is virtually inconceivable. The economy crashed, the social situation was explosive, the political consequences far-reaching. Wages were practically worthless before they were even paid out, and those who had money in bank accounts lost their entire fortune.

In the industrialised countries of today, we can hardly recall what inflation is like. The last major spurts took place in the 1970s; the turbulence of 1923 dates from another era. Such conditions also seem unlikely in the near future, although the highly experimental monetary policy that has been pursued for years gives some observers a queasy feeling. At the same time, the conditions for stable money are by no means a matter of course: they must be constantly hammered out anew. Even in good times, it is worth keeping an eye on the quality of money; liquidity is the basis for all transactions. And should the tide turn, it would then be too late to react. More than ever, liquidity and the ability to act are «worth their weight in gold» in bad times.

Sound money is better money

So how do we recognise sound money? Lastingly low inflation rates and positive real interest rates, stable or strengthening exchange rates, generally low fluctuations in value, international acceptance, global use for reserves and investments, a high level of protection of privacy, low manipulability by state or private interests and, not least, the lowest possible counterparty risk – all these attributes suggest a high quality of money. The dominant form of money has long been the legally fixed currency of states; in Switzerland this has been the Swiss franc since 1850.

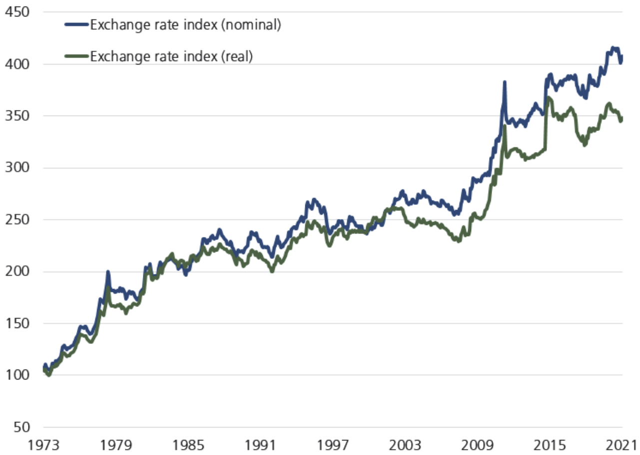
Private Client Bank AG
Alte Börse
Bleicherweg 5 – P.O.Box
8034 Zurich – Switzerland

T +41 44 253 73 00
F +41 44 253 73 20
info@privateclientbank.ch
privateclientbank.ch

Money is sound when it prevails in competition against alternatives. In an international comparison, the Swiss franc has been performing excellently on practically all criteria for decades, as Ernst Baltensperger convincingly pointed out a few years ago in his book «Der Schweizer Franken – Eine Erfolgsgeschichte» (The Swiss Franc – A Success Story). Our currency has appreciated considerably against all others since World War I, and inflation has been among the lowest in the world for decades. Real interest rates have also been mostly positive, in many cases even in times of negative interest rates. When it comes to maintaining purchasing power, the Swiss franc even beats the US dollar, whose wide distribution earns it international regard as a reserve currency. This makes it the most widely used currency around the world.

EFFECTIVE EXCHANGE RATE INDEX OF THE SWISS FRANC

Steadily stronger



Source: SNB. Exchange rate index of the Swiss franc against the currencies of Switzerland's main trading partners, 1973 = 100.

Safe and stable money does not fall from the sky and can only be planned to a limited extent. Influencing factors include the size of the economy, its growth and innovative strength, the diversification of sectors and industries, the soundness of public finances, but also the performance of the financial sector and the free convertibility of the currency. In particular, the independence of the central bank is also of vital importance, so that politicians are denied access to the money press. Such access is the primary cause of disastrous hyperinflation such as that of 1923 in Germany. Against the backdrop of a progressive softening of central bank independence in many industrialised countries and a renewed spike in national debt in the wake of the Covid-19 measures, it is quite understandable that some observers fear a grab for the printing press and a threatening return of inflation. Nonetheless, Switzerland has so far managed to stand out agreeably from the international mainstream in all the parameters relevant to sound money.

Most savers and investors today equate the term money with currency. Yet there are different forms of money even within the same currency. For example, Swiss francs in the form of banknotes and coins are issued directly by the Swiss National Bank – and this bank cannot in principle go bankrupt. A franc in a bank account, on the other hand, is a private claim against the commercial bank where it is deposited. If the bank becomes insolvent, the deposit guarantee takes effect up to a sum of CHF 100,000; anything above that could be lost entirely or at least in part. Under current conditions, private individuals cannot hold an account directly with the central bank and benefit from the correspondingly greater security; this is still reserved for the banks themselves and a handful of other institutions. For the time being, there will also be no possibility for private individuals and companies in Switzerland to hold digital money directly with the central bank. However, this will soon be the case in other countries, above all in China. The USA might then follow suit.

Are cryptocurrencies sound money?

In addition to state currencies, countless types of digital, private currencies have emerged in recent years, called «coins» or «tokens». In contrast to «tokens», «coins» aim to fulfil the function of money and act as a medium of exchange for a broader public. According to *The Economist*, there are currently around 800 such «coins», most of them with a market capitalisation of less than USD 100 million. The market is dominated by the two largest cryptocurrencies, Bitcoin (capitalisation as of 30.06.2021: USD 656 billion) and Ether (USD 265 billion). The two combined currently represent around two-thirds of the total market.

Our chart shows the performance of Bitcoin and Ether over the past five years. The high fluctuations in value alone suggest that neither cryptocurrency is sound money, at least not at the moment. In the case of Bitcoin in particular, it is also clear that the criteria for an efficient medium of exchange will probably not be met in the future either, due to slow processing times, high energy costs and problems with privacy.

PRICE DEVELOPMENT OF THE TWO LARGEST CRYPTOCURRENCIES

NOT EXACTLY STABLE IN VALUE

Source: https://coinmetrics.io. Own calculations, indexed to 24 June 2016 = 100, last price as of 24 June 2021.

The weaknesses of the market leaders have encouraged alternatives to spring up. Some of them, so-called «stablecoins», aim to reduce volatility by deriving their value from commodities or already existing currencies. The third largest cryptocurrency, Tether, with a capitalisation of USD 63 billion, is such a «stablecoin», which is based 1:1 on the US dollar. «Stablecoins» are basically nothing more than derivatives traded on the blockchain. They depend on whether the underlying assets meet the criteria for sound money, and must ensure that these exist. For example, Tether recently had to pay a fine because claimed US dollar reserves did not exist as reported.

Cash is important

In times of low interest rates, record highs on the stock markets and booming private market investments, the quality of cash enjoys little attention. It does not deserve this neglect: in the next crisis, its role as a stabiliser will be more important, especially since bonds would lose value when interest rates rise. Liquidity is an asset class, and not simply an account balance. Therefore, a few thoughts on this:

(1) The right proportion of liquidity in total assets depends on the investor's risk capacity and risk appetite. Liquidity should be available at least in the currency in which expenses and any obligations are incurred.

(2) The commercial bank where the (book) money is held must be carefully selected. In case of doubt and for larger amounts, spreading the money over several banks is sensible and advisable.

(3) Those who have their domicile in a currency area of poorer quality should diversify their liquidity into more stable, better currencies. If their «own» money is of high quality, on the other hand, cash diversification is less necessary.

(4) The best currently conceivable form of money globally is probably the Swiss franc in an account at the Swiss National Bank. However, this is not an option for everyone and has its price: it is no coincidence that negative interest rates in Switzerland are the highest in the world.

(5) Cryptocurrencies are intriguing and promising – but they are not sound money, at least as long as conventional currencies do not fail. Successful «coins» provoke harsh countermeasures, as illustrated by the Libra case, probably the most interesting cryptocurrency project of recent years. More recent examples are in China and Turkey.

And not least: sound money is historically and geographically an exception, while history is rife with a succession of bad money experiences. In 1923, salvation lay in real assets and diversification. This should be kept in mind, even if the world situation fortunately does not look as dramatic at present as it did a hundred years ago.

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IA, 30.06.2021

Private Client Bank AG
Alte Börse
Bleicherweg 5 – P.O. Box
8034 Zurich – Switzerland
T +41 44 253 73 00
F +41 44 253 73 20
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A SPECIAL BANK IN A SPECIAL COUNTRY

For the followers of any kind of international mainstream, the past weeks and months have been rather stressful where Switzerland is concerned. Three times our country behaved quite out of line. Beginning with the measures against the Corona pandemic, Switzerland dared to be the only country in Europe not only to let its skiers enjoy the snows of winter, but also to keep hotel accommodations (and the affiliated restaurants) open. Moreover, in some cantons skiers were even permitted to enjoy food and drink on sun terraces until the central authorities finally put a stop to this afternoon delight. No less a personage than the President of the German Bundestag, Wolfgang Schäuble, was scandalised by this and demanded what the Swiss were thinking, to be the only Europeans allowed on the slopes.

«Being different» has its price, and occasionally it is also foolish. But overall, our concept of diversification is not based on following one and the same mainstream or zeitgeist, but on diversity.

The next blow came at the end of May: the Swiss Federal Council announced to the European Union that it was withdrawing from negotiations on a cooperation agreement. What had been brewing domestically for a while then became an outward reality. A Brexit-like event, accompanied by all conceivable prophecies of doom and the eventual demise of the Alpine republic. Still, the government's move was probably inevitable. Otherwise, there would have been the threat of a referendum by the people and the cantons on the aforementioned treaty, with a presumably unmasking outcome for the supporters of an international mainstream of whatever kind, both here in Switzerland and there in Brussels.

As if that were not enough to be «different», the people then rejected the core of the parliament's and government's climate policy, the so-called CO_2 law, in a federal referendum. Among other things, it provided for an incentive tax on carbon emissions and the fiscal creation of a state fund for environmental projects. Scepticism about such zeitgeist-driven expansions of state power outweighed the arguments for an effective environmental policy.

In all three areas, from Covid measures to the right degree of European integration to climate measures, one can justifiably disagree. That is not the point here. Rather, it is about the signal that was sent with these decisions: the irrepressible will of the Swiss people to be able to decide independently and, under certain circumstances, to go against the grain with these decisions. Of course, «being different» has its price, and occasionally it is also foolish. But on the whole, our entire concept of diversification is based not on uniformity, not on following one and the same mainstream or zeitgeist, but on diversity. Diversity must always be fought for, diversity must be lived out. Diversity excludes absolute truths.

Private Client Bank is also different in many ways, at odds with the mainstream in the banking world. And it is no coincidence that it is located in this country, which not only allows diversity, but also celebrates it on occasion. The last few months have strengthened my belief that we are in the right place here.

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