New Money Podcast with Alex Gloy

Recorded May 3rd, 2023.

00:00:05 Paul Amery

Welcome to the New Money Review Podcast. I am Paul Amery, editor of the New Money Review. In this episode, I discuss money and markets with Alex Gloy, founder, and chief executive of Lighthouse Investment Management. Alex, welcome to the New Money Review Podcast. Please introduce yourself to the listeners.

00:00:34 Alex Gloy

Hi, my name is Alex Gloy. I'm the founder and CEO of Lighthouse Investment Management. I was born and raised in Germany, then moved to Switzerland and 1999 moved to New York City. I've worked in investment banking and private banking - mostly equities – for some bigger banks like Credit Suisse and some smaller private banks. I'm interested in cryptocurrencies from the perspective of the future of our monetary system.

00:01:14 Paul Amery

Let let's start with a very broad question then. What is money from your perspective?

00:01:20 Alex Gloy

That's the key question. What is money? According to the definition money is
1. A medium of exchange,

2. A store of value, and

3. A unit of account.

In theory, anything could serve as money, like the Rai Stones on the Island of Yap in Micronesia. Inhabitants used huge round wheels of rock, with a hole carved in the middle for easier transportation. The stones were mostly stationary due to their weight. Ownership was conveyed by verbal agreement. These stones serve as money. Bitcoin could serve as money. Of course, our monetary system is based on fiat money. It exists as public money issued by the Central Bank, like cash. And, of course, bank deposits, what we normally refer to as "money", next to cash.

00:02:34 Paul Amery

And in in the in our current Fiat system, most of the money in the system is issued by banks.

00:02:43 Alex Gloy

Bitcoin really taught me a lot of things about the fiat system because Bitcoin, like a gold coin, is nobody else's debt. And then you realize that in our Fiat system, it's impossible, and this is key, it's impossible to create money without creating debt at the same time. That means that your savings are somebody else's debt. What you think of your money in the bank is the bank's liability. Deposits show up as liabilities. Even cash that we hold in in hand is also a liability, the liability of the Central bank. It shows up as *their*

liabilities. If you want to create money, you also create more debt. And if somebody wants to save more, somebody else must go deeper into debt.

00:03:46 Paul Amery

Right, so what are the implications of this for the overall stability of the system?

00:03:52 Alex Gloy

That's also a very good question because you can already see that there is an inherent instability baked into the cake. The economy needs to increase money supply to grow because without credit there would be very few purchases of large ticket items possible, so you need to increase the amount of money and credit outstanding. Debt with interest is an exponential function. Interest on interest is exponential and our world is a world of finite resources. At some point his exponential growth will hit obstacles and that's usually the point when we hit a financial crisis.

00:04:52 Paul Amery

If we go back to Babylonian times or biblical times, one of the ways they dealt with that problem of exponential growth of debt was to have periodic resets, a period of debt jubilee where everything was written down to zero and then they would start again. But we don't. We don't have that in the current system - we have something different, I guess. How would you describe what we have now in comparison with earlier versions of debt-based monetary systems.

00:05:21 Alex Gloy

Or Islamic banking. No interest allowed. On the surface, that could be sustainable because there's no exponential growth involved. But there are ways around it - you issue debt at a discount and then the interest is hidden somewhere in there. Sorry, can you repeat your question?

00:05:48 Paul Amery

When you were talking about the instability of debt-based systems and the problem that interest on interest necessarily is exponential growth and that's a problem for a system that has finite resources, whether it's finite oil, finite commodities of other kinds, finite populations, other capacity constraints. In the old days, they would arbitrarily reset debts and write them off after a certain period. We had it happen in a chaotic way. People remember the lessons of the Great Depression of the 1930s. We seem to have reached a point in the financial system where the amount of debt created has become very large and difficult to manage.

00:06:53 Alex Gloy

The Institute of International Finance, IIF, tries to come up with the total amount of global debt, and according to them, it's currently above $300 trillion. Global GDP is something like $90 trillion. We are at a 350% debt to GDP ratio. If you slap just a 5% interest rate on that, our world economy, each year, has to come up with 17.5% of GDP for interest payments. 17.5% gets siphoned off. And that's that seems unsustainable. It could be sustainable if GDP also followed an exponential growth path. But unfortunately, debt outstanding grows faster than GDP and, with declining population growth, that means you have slower GDP growth. So yes, there will be resets. You mentioned we haven't experienced that yet. That's exactly right. But that is only true for countries in the Western World post World War

Two. In emerging countries monetary turmoil is a regular occurrence. Either you just cut a couple of three zeros from the value of money, or you have more chaotic outcomes.

It's only the Western world that has not experienced massive changes in the value of money. And this is why today's troubles shake our fundamental beliefs whenever there's a banking crisis or when, suddenly, inflation flares up.

00:08:55 Paul Amery

Like you, I got interested in cryptocurrency and specifically Bitcoin as an alternative to the current system. Bitcoin was launched with a nod to address the need for constant bailouts of bankers, searching for a better way of doing things. But a decade or more later, you've concluded that this cannot work as the basis for a new system. Why is that?

00:09:24 Alex Gloy

I went full circle. At first, I found the technology intriguing. My clients kept asking me "should I buy this coin or that coin. How does it work?" I had to really familiarize myself with the way Bitcoin works. Why can you not hack it? How secure is it? I found it very convincing at first. Limited issuance means no inflation. A real store of value. But when you think it through, I don't think a monetary system based on Bitcoin is workable. Why? The economy needs credit. Let's assume that when all Bitcoin are issued in the year 2140. There is a group of debtors who have taken out loans and they must pay them back with interest. Where does this interest come from when there is no more issuance? The system would just default.

Furthermore, who would want to have debt in Bitcoin – a currency that is (presumably) constantly appreciating due to its rarity and limited issue. It would be silly to have debt outstanding in something that constantly appreciates. Like a gold coin gold, Bitcoin is nobody else's debt. How would debt in Bitcoin even be possible? To which the proponents of Bitcoin say, well, there will be no debt. But how would a person ever buy a house without a mortgage? Most people would not accumulate enough savings during their lifetime to afford a home. To which Bitcoin proponents reply, well, prices would simply have to adjust downwards. Which would be a terrible, terrible deflation, and would lead to a collapse of the economic system.

My impression is that Bitcoin would be too hard of a currency for it to be used as a monetary system. It would be like a very strict gold standard and not work.

00:11:58 Paul Amery

Would it change your views if we made some radically different forecasts for the global economy, for the global population? Most people still assume that the economy is growing, the population is growing. But what if it isn't? What if we reached the peak? Population is starting to shrink in some countries. We've already seen some declines in life expectancy in some of the major economies, as well as birth rates in countries where they were previously very high. I know that's not the consensus for you, but if we were, let's say, if we were reaching peaks in some of those measures, would that make a difference to the way you view things?

00:12:38 Alex Gloy

That would make it even harder to keep the current system going. In the past, GDP somehow always grew to accommodate the already quite sizable debt. If GDP growth stalls, that makes it even harder. It would just pull forward the point when a reset needs to happen.

00:13:13 Paul Amery

Let's come back to the existing financial system and what's been going on over the last weeks and months. I'm connected with you on Linked-in and you've been writing some very interesting commentary on what's been going on in the US banking system and provided some interesting facts and figures. About a month ago federal authorities underwrote all the deposits of the failed Silicon Valley Bank. I think around 95% of their deposit base was uninsured. That was above the Federal Deposit Insurance limit of $250,000. In last week's failure of First Republic, they went to slightly different routes and got another bank to take it over, presumably because they're wary of expanding, of doing the same thing because the FDIC would probably not be able to take on more bailouts of that kind. What do you think? The people at the Fed, the Treasury, and the FDIC - where do you think they're trying to direct things?

00:14:31 Alex Gloy

Silicon Valley bank - the question is, did they do anything wrong? I mean they had no risk officer for a couple of months, and they didn't hedge their high-quality liquid assets (which they are encouraged to hold). The problem was this huge inflow of deposits during the technology boom. You always think that tons of deposit inflows are positive for a bank, but the bank needs to do something with those deposits. Deposits are a liability for the bank. Your liabilities go up and you must do something on the asset side.

Treasuries were yielding 5 bips (0.05%) and so management had to go into mortgage-backed securities and longer-duration securities. And then they got hit hard when the Fed hiked interest rates at the fastest pace since quite some time, from zero to five in 12 months.

If depositors would have stayed put it might have worked out.

But today, you don’t have to go to the branch office to withdraw your money in cash. You simply go to your app and you transfer your money. More than $40 billion left in a single day, which is unprecedented.

If the FDIC hadn't made all depositors whole, I think it would have triggered an even wider bank run. So, the FDIC, unfortunately, takes the brunt of a political decision. Since FDIC insurance began in 1934, no depositor has lost a single penny of insured funds due to bank failure. Of course, the FDIC would like to keep it this way, to prevent further banking panics. Politicians, wanting to be reelected, don’t want panics to happen either.

00:16:46 Paul Amery

But this was quite a controversial move, wasn't it? Because the whole point of deposit insurance is that you set a limit. You say we're insured up to 250k or whatever. In the UK it's £85,000, in the EU it's €100,000. If you leave your money on deposit at the bank above that limit, you're supposed to know you're taking a risk. You're effectively an unsecure unsecured creditor of that bank and if it goes bust, your deposit would be written down. Changing these rules, which have been put in place quite painstakingly over the last few decades, was seen by many people as a symptom of panic. It raised a lot

of broader questions which were then not really addressed by some quite contradictory statements from the Treasury Secretary in the in the succeeding days. Seeing what happened at FRC I can understand why they don't want to keep relying on the FDIC because it's funded by a levy on the surviving banks. So, if you allow another big failure, the whole thing could unravel quite quickly because [the rescue mechanism] could act as a transmission mechanism [of panic], right?

00:18:06 Alex Gloy

Absolutely. And what's interesting is that in Silicon Valley, the initial reports over the weekend were that up to $250,000, no questions asked, fully guaranteed. And above that amount, account holders would get an initial dividend payout…

00:18:28 Paul Amery

…They said they would get 30% or something and receive a paper or claim on the rest.

00:18:33 Alex Gloy

…And by Sunday evening, that had changed into "we are going to pay out everybody". There was clearly a fight going on. If there had been a haircut, I think it wouldn't have been that high. Depositors could have gotten as much as 85% on their claims. Still, it would have triggered a run on other big deposits. So I think it was probably the right decision. Even if it costs the FDIC a lot of money.

Think of bank deposits. I think of bank deposits as stablecoins (in crypto speak). Bank deposits is money issued by private institutions. It's not issued by a public institution. The only way we citizens can get hold of publicly issued money is through cash. As soon as you bring cash to a bank, you exchange a central bank liability against the liability of a private institution. It's a completely different animal. Bank deposits are stablecoins and the peg, the assurance that one dollar in the bank is equal to one dollar in cash, is guaranteed by the FDIC. Undermining that trust would have serious ramifications for the whole banking system. That's why it's such a sensitive issue.

00:20:22 Paul Amery

And it's still unresolved, isn't it? We had the take up of this weekend of FRC by JP Morgan.

And yet, yesterday, a lot of other regional bank share prices went down another quarter, another 30%. As bank share prices go down further, get closer to zero, it becomes a self-fulfilling prophecy. People basically think "well the equity is worthless - I better get my money out!"

00:20:57 Alex Gloy

If you're an equity or option trader, there's an asymmetry. You can just short regional banks. Few people are going to go against you and take the other side. Because if you go long a regional bank, and over the weekend it fails, you look stupid. And if you are short, and you are lucky, it fails, and you make a ton of money. So that's a self-reinforcing dynamic.

The question is how you stop that? The fixed income market and interest rate futures market assume the Fed will eventually be forced to lower interest rates significantly.

I mean the curve says – today we are May 3rd – today's FOMC meeting will be the last rate hike, probably 25 basis points, and that's it. First interest rate cuts are likely by September. And then significant cuts by next year. That would give some reprieve to the asset side of the banks that is currently underwater.

00:22:18 Paul Amery

These are probably the most dramatic events in the banking system since 2008. There's a great deal more. There are many more digital payments than there used to be. In some countries, it's completely digital. With the rise of cryptocurrencies came a lot of interest in, as you said, stable coins. Could this be an opportunity for central banks in some countries to fast track the introduction of Central Bank Digital Currency? Because if they did guarantee bank deposits to a higher amount, that would effectively be digital money, wouldn't it, underwritten by the state? Could that be happening by accident? Because central banks have been looking at this as a kind of academic exercise for a few years. And now suddenly they rushed. Having these market events taking place, there's an opportunity for them.

00:23:21 Alex Gloy

It's interesting. Globally, more than 100 central banks are working on central bank digital currencies. Among them, of course, are the Fed, and the ECB. The question is, why are central banks so keen on CBDC?

For the user it is not apparent why he needs CBDC. If you want instant money transfer, you can use Zelle or other privately offered solutions. In July FedNow goes live, allowing fast settlement even for smaller sums of money.

From the perspective of payment systems, CBDC is not needed. But what I learned is that Facebook's announcement of Libra, it's global coin, was a wake-up call for central banks.

Let's compare the amount of private and public money. We have $17 trillion bank deposits, and $2.3 trillion in cash. Most of the money in circulation is private money – only a small fraction has been created by the central bank. But no matter who created it – central bank or private bank – the money still sits on the ledger of the Central Bank.

For example: I'm with Citibank and you are with Chase Bank. I want to send you money from my bank account at Citi. Citi will deduct my account, and it will use its bank reserves at the Fed(eral Reserve Bank). The central bank moves that account balance over to Chase, and Chase credits your account.

The Fed controls the ledger and therefore they control money issued by the private banking sector.

However, private companies issuing stablecoins, that's not on the Fed's ledger anymore. The Fed loses control. That's why they want to counter that threat with their own digital coin – CBDC. But there's a second aspect to it, which might be even more important.

Cash is becoming less and less important. I know in Europe it's still used more. But here in the US – most people don't carry any cash anymore. It's almost a cashless society.

In a cashless society - how can a central bank reach its constituents with public money, with cash? Public money guarantees the value of privately issued money knowing we can convert private money into cash one for one. If there is no more cash, there is no guarantee. This is why CBDC is needed.

There was an interesting paper I saw this morning by Professor Peter Bofinger, University of Wuerzburg. It says you should be careful, because if you offer CBDC in unlimited quantities to constituents, that makes it even easier for a bank run, because if you are unhappy with your bank, have some doubts, you just switch everything over into CBDC. Within seconds it's all gone. CBDC has no counterparty risk, but a bank deposit has.

This means we will have to set upper limits on holdings of CBDC. It's going to be a tightrope walk between public money as a guarantee for privately issued money without putting the banking system into jeopardy at the same time.

00:28:00 Paul Amery

I guess privately issued money could carry a higher interest rate [than CBDC] as an incentive to stay rather than to switch out into public money.

00:28:10 Alex Gloy

I think the current idea is that CBDC would not carry any interest to not compete with bank deposits. The average bank deposit interest rate is still very, very low. Offering CBDC even at 2% might already attract a lot of transfers.

One of the advantages of CBDC is that it could be programmable. If the government wanted to issue stimulus checks you could make them expire in a month, so people would have to spend it or lose it. And that makes sense.

People are afraid CBDC could be programmed to destroy all your money or have huge negative interest rates. I don't think that is the intent here.

00:29:06 Paul Amery

It generates a lot of headlines. The idea of negative interest rates on certain types of government money. I don't think CBDC in itself is a bad idea. It could be used in many ways, as you've just described, for relief programs or particular kinds of stimulus, and to encourage short term spending.

00:29:32 Alex Gloy

But back to your question, what can be done? You could help banks liquidity wise with all kinds access to Fed money. But that access comes with certain interest rates on it and those are currently pretty high. Which eats away the interest margin, hurting profitability and depressing the stock price further.

I don’t see many other alternatives than massive interest rate cuts. That, of course, encroaches on the fight against inflation. You then realize we cannot have a stable banking system and bring inflation back down to 2%. We have to make a choice. The hope is that we have enough time to wait until inflation gets closer to 2%, but if not, we have to protect the banking system. Even at the cost of high inflation.

00:30:45 Paul Amery

People in charge of the system really have some very difficult choices ahead, some unpleasant choices to make between lesser and greater evils.

00:30:56 Alex Gloy

I would like to offer you a minority view. The Federal Reserve gets hammered with criticism and made fun of, because the only thing they know is to print money. What you have to realize is that all the money the Fed created amounts to $8.3 trillion – its liabilities. However, the amount of money in circulation, if you use the TCMDO, Total Credit Market Debt Outstanding, is more than $90 trillion. That's more than 10 times as much. $150 trillion if you include the euro dollar market (nobody knows exactly how big it is).

The Fed is responsible for the $8 trillion that they created or printed, but also for another multiple times more outstanding, some of which they do not even have jurisdiction over. And somehow, they are tasked with keeping all that stable and running smoothly for the benefit of the public.

00:32:13 Paul Amery

Let me ask you as a final question, Alex: you're an investor, you work with investment clients. What areas or asset classes or strategies are you recommending?

00:32:30 Alex Gloy

It all depends on the risk appetite and what investments you already have. But I'm always a proponent of being risk averse. I am currently focused on gold and gold related investments like gold mining stocks. I know hold hasn't done much in the last 12 years. We basically get it for the same price as in 2011. Which is amazing given the expansion of monetary aggregates in the meantime. And the miners have done even worse. I think it's so under-invested and some of the miners now offer decent dividend yields. You might as well park your money in there.

In general, the focus should be on real assets like stocks, real estate, and gold rather than nominal assets like bonds. I am afraid the fight against inflation will have to take a backseat versus keeping the system stable and running.

00:33:55 Paul Amery

Alex, thank you very much. It's been a fascinating chat. Great to have you on the podcast.

00:33:59 Alex Gloy

You're very welcome. Thanks for having me.

00:34:06 Paul Amery

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