

Credit, Money and Ordo-liberalism

Center for Financial Studies

Frankfurt, 26 February 2015

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Debts, nominal demand and resulting risks

Optimal rules with one Government and one currency

Deficiencies with Eurozone rules and responsibilities: and the need for radical reform

The Eurozone's *'Don't start from here'* problem: debts which will not be repaid – and the need for radical actions

Rules and trust: why Eurozone break-up may be unavoidable

Debt, Money and Mephistopheles: how do we get out of this mess?

CASS Business School

<http://www.group30.org/images/PDF/ReportPDFs/OP%2087.pdf>

* * *

Credit, Money and Leverage: what Wicksell, Hayek and Fisher knew and modern macroeconomics forgot

Stockholm School of Economics:

"Towards a Sustainable Financial System"

12 September 2013

<http://en.globalutmaning.se/?p=3328>

* * *

Escaping Debt Addiction: Monetary and Macro-Prudential Policy in the Post-crisis World

Center for Financial Studies

Frankfurt, 10 February 2014

<http://ineteconomics.org/blog/institute/adair-turner-escaping-addiction-private-debt-essential-long-term-economic-stability>

Debt, leverage and the crisis of 2008

The conundrum:

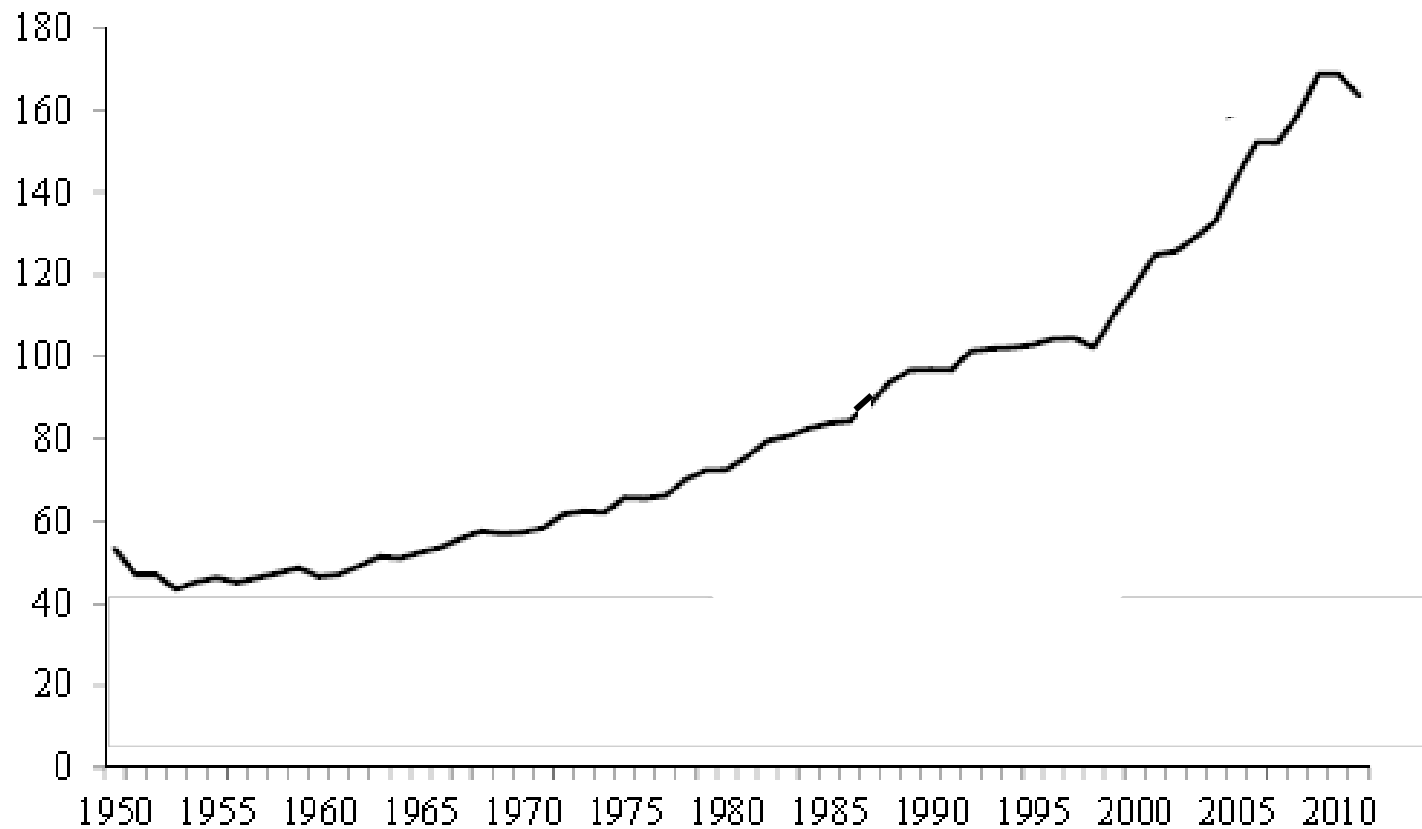
Credit growth apparently needed... but lead to crisis

Sources of nominal demand:

A choice of dangers

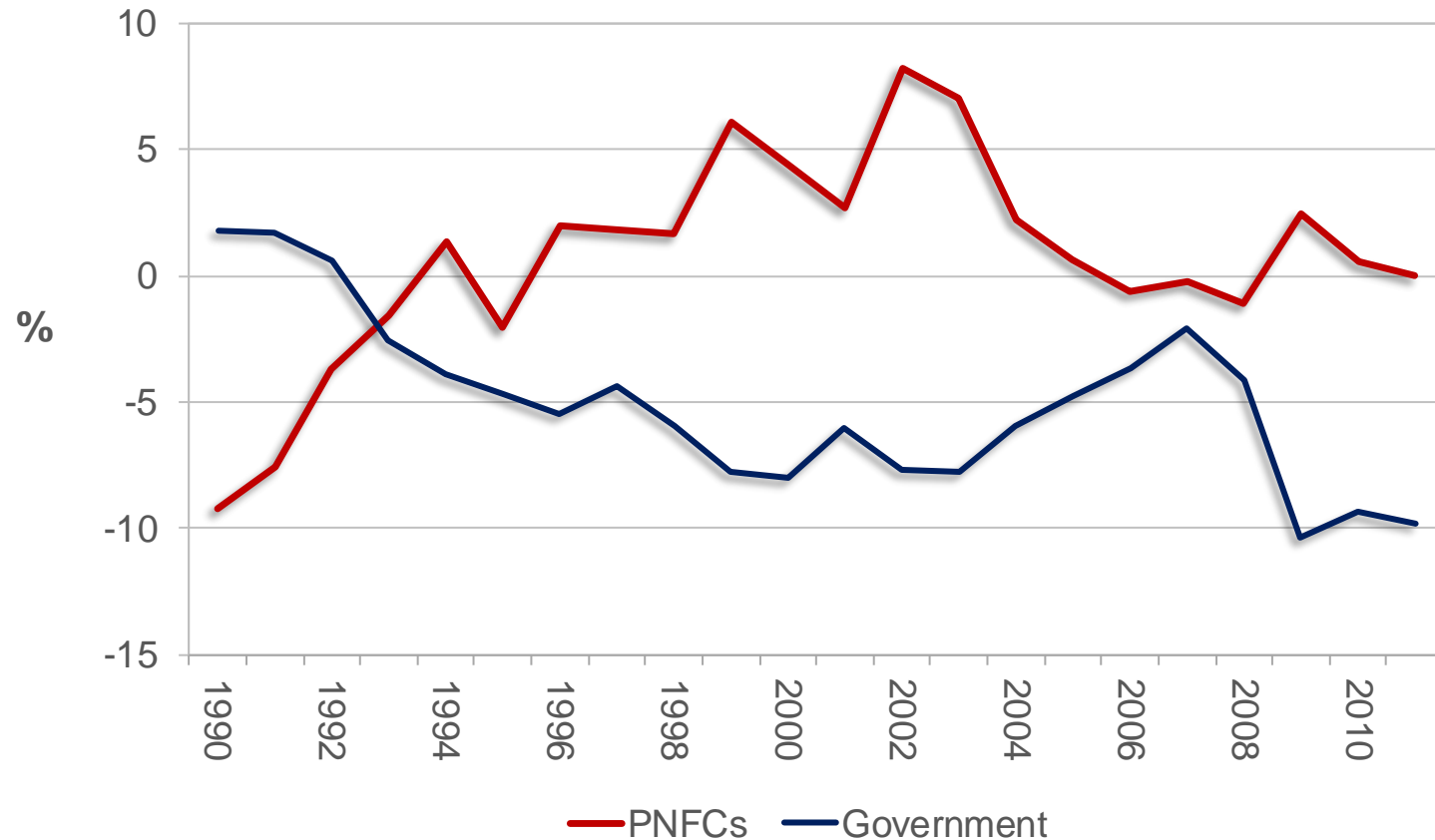
Private domestic credit as a % of GDP

Advanced economies 1950 – 2011



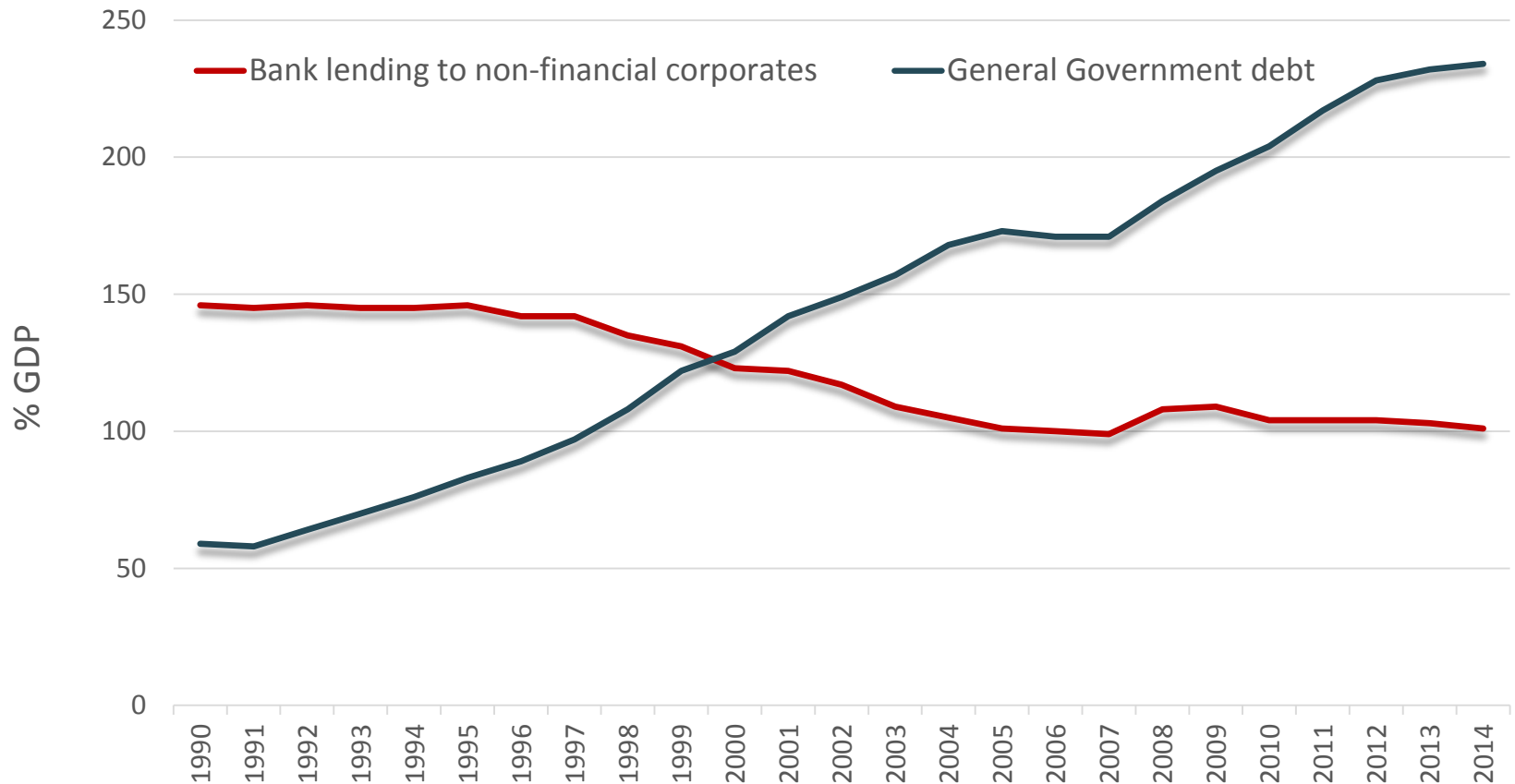
Source: *Financial and Sovereign Debt Crises: Some Lessons Learned and Those Forgotten*, C. Reinhart & K. Rogoff, 2013

Sectoral financial surpluses/deficits as % of GDP: Japan 1990 – 2012



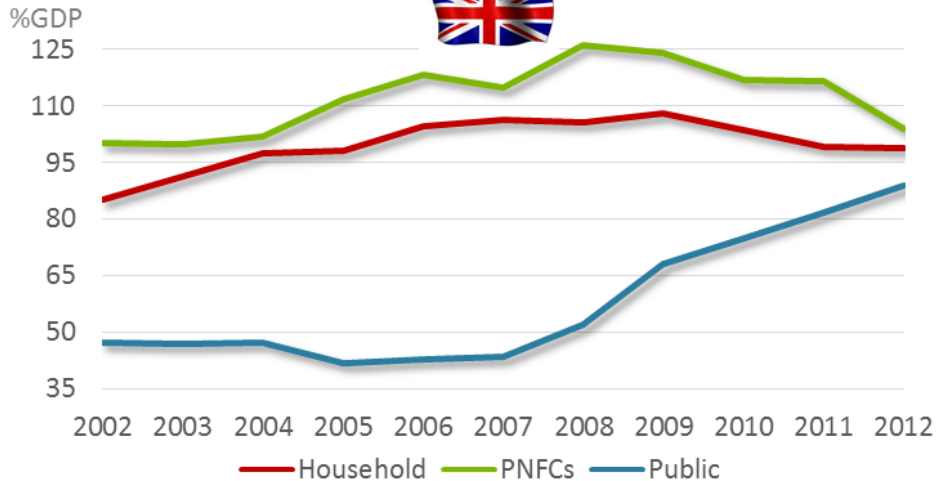
Source: IMF, Bank of Japan Flow of Funds Accounts

Japanese government and corporate debt: 1990 – 2010

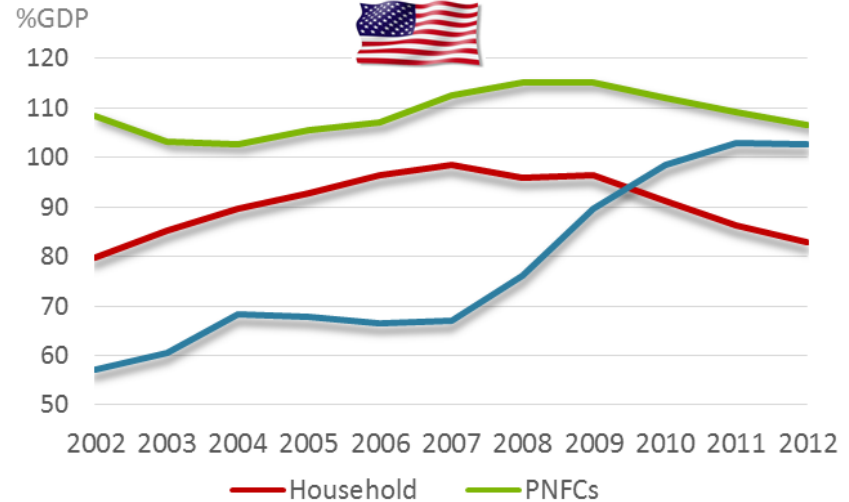


Source: BoJ Flow of Funds Accounts, IMF WEO database (April 2011), FSA calculations

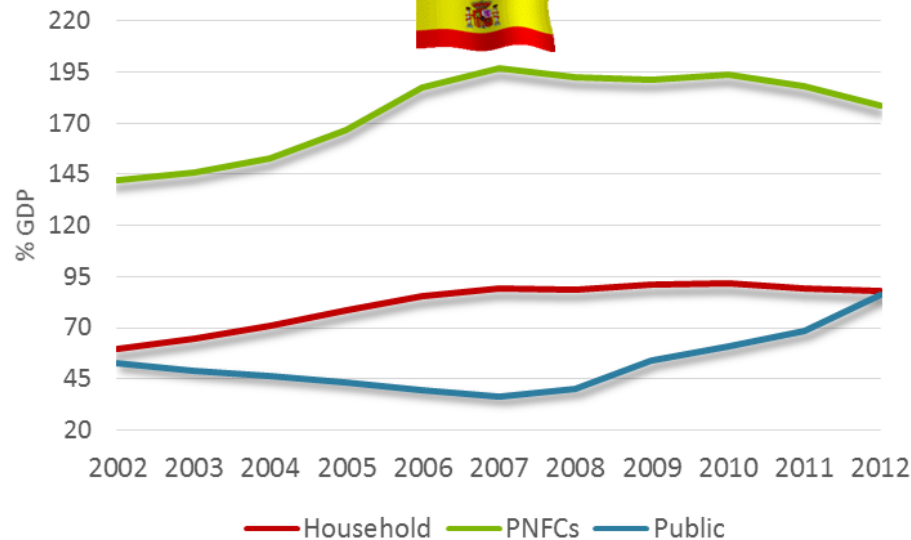
Shifting leverage: Private and public debt-to-GDP



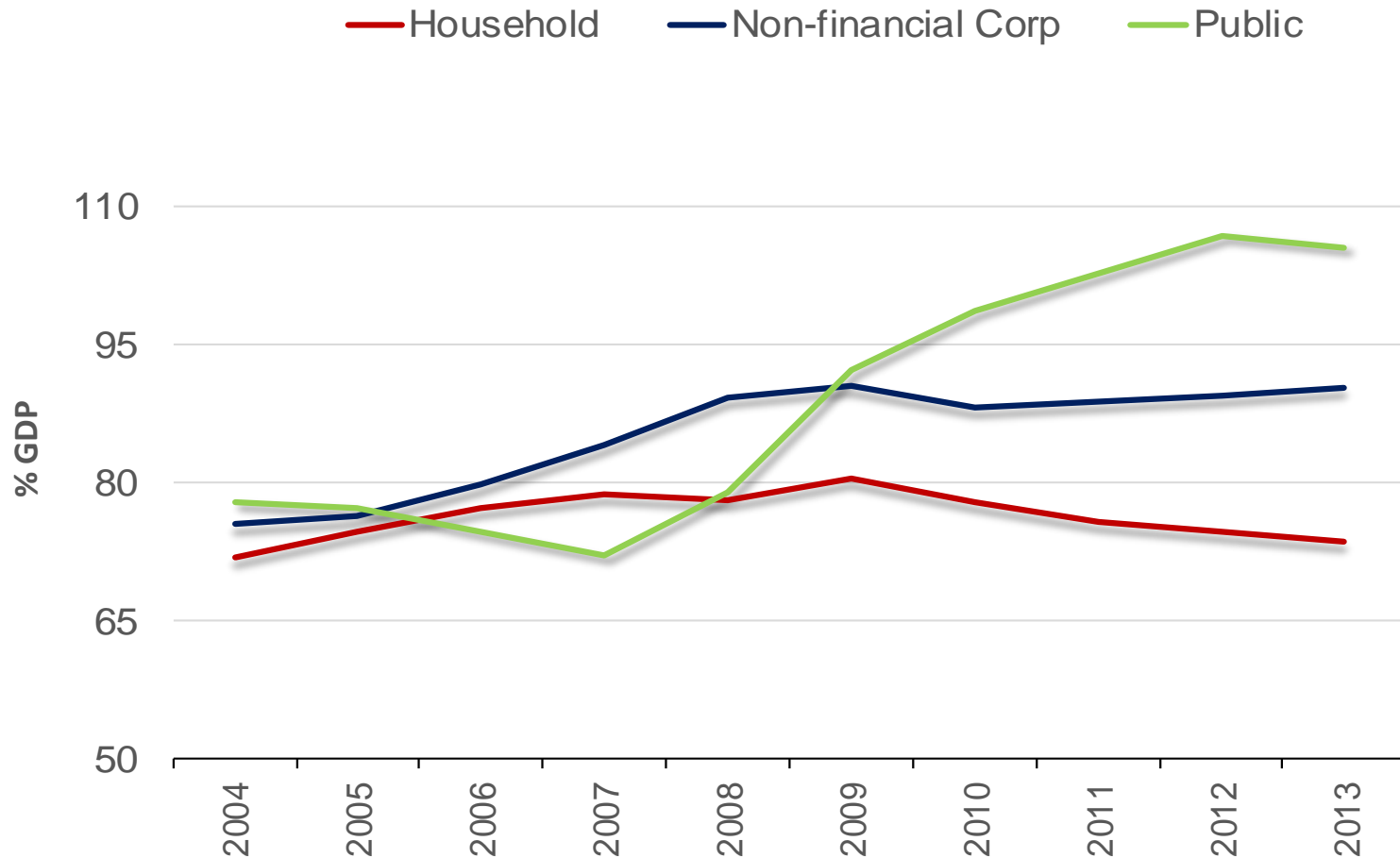
Source: OECD National Accounts



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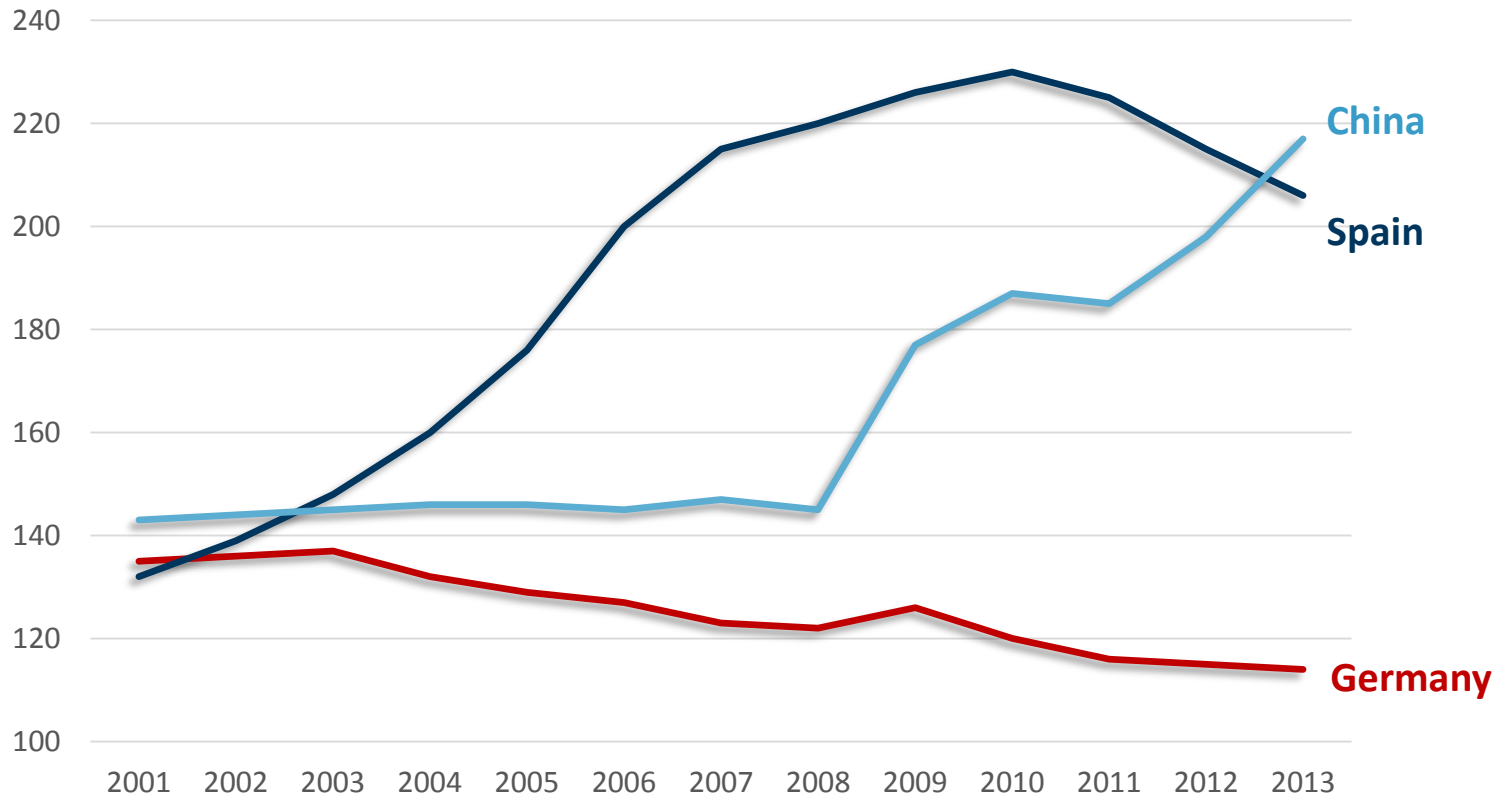


Developed economies – Debt to GDP



Source: Geneva Report No 16 *Deleveraging, What Deleveraging?* ICMB / CEPR September 2014

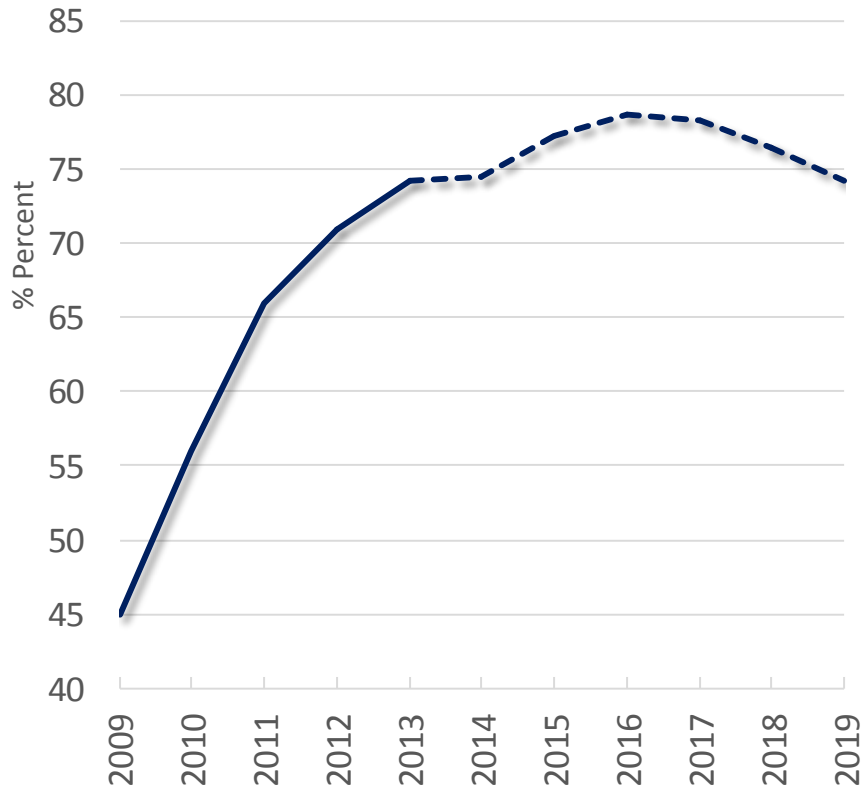
Shifting leverage: Germany credit-driven growth



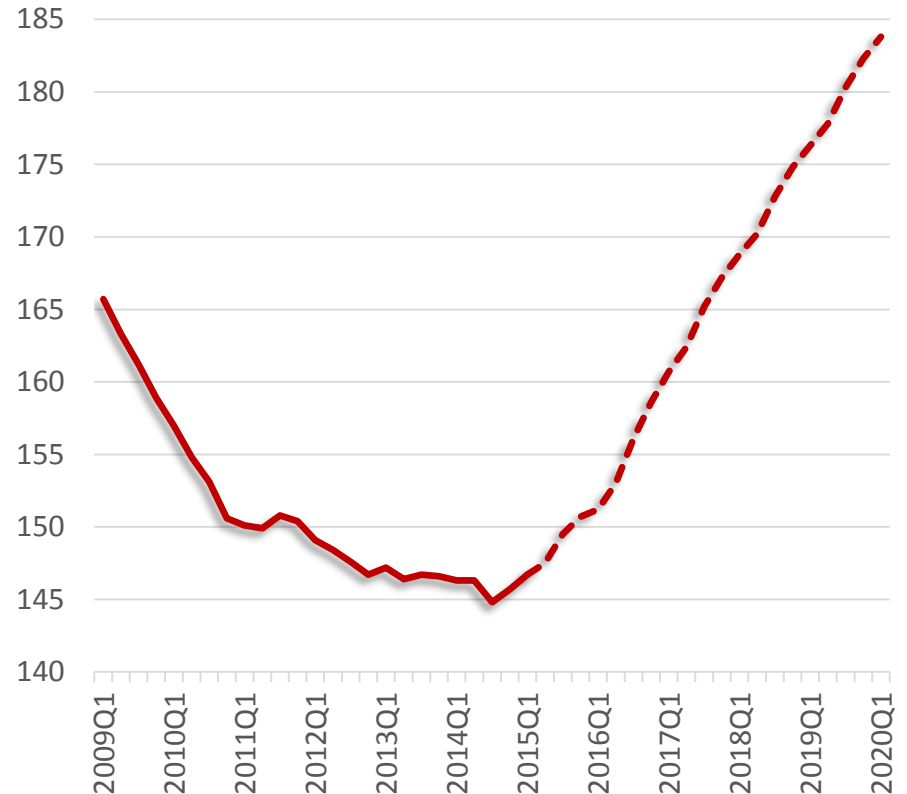
Source: *Deleveraging, What deleveraging*, The Geneva Report, 2014

Shifting leverage: back to private again

UK Public net debt as % of GDP: 2009 - 2019

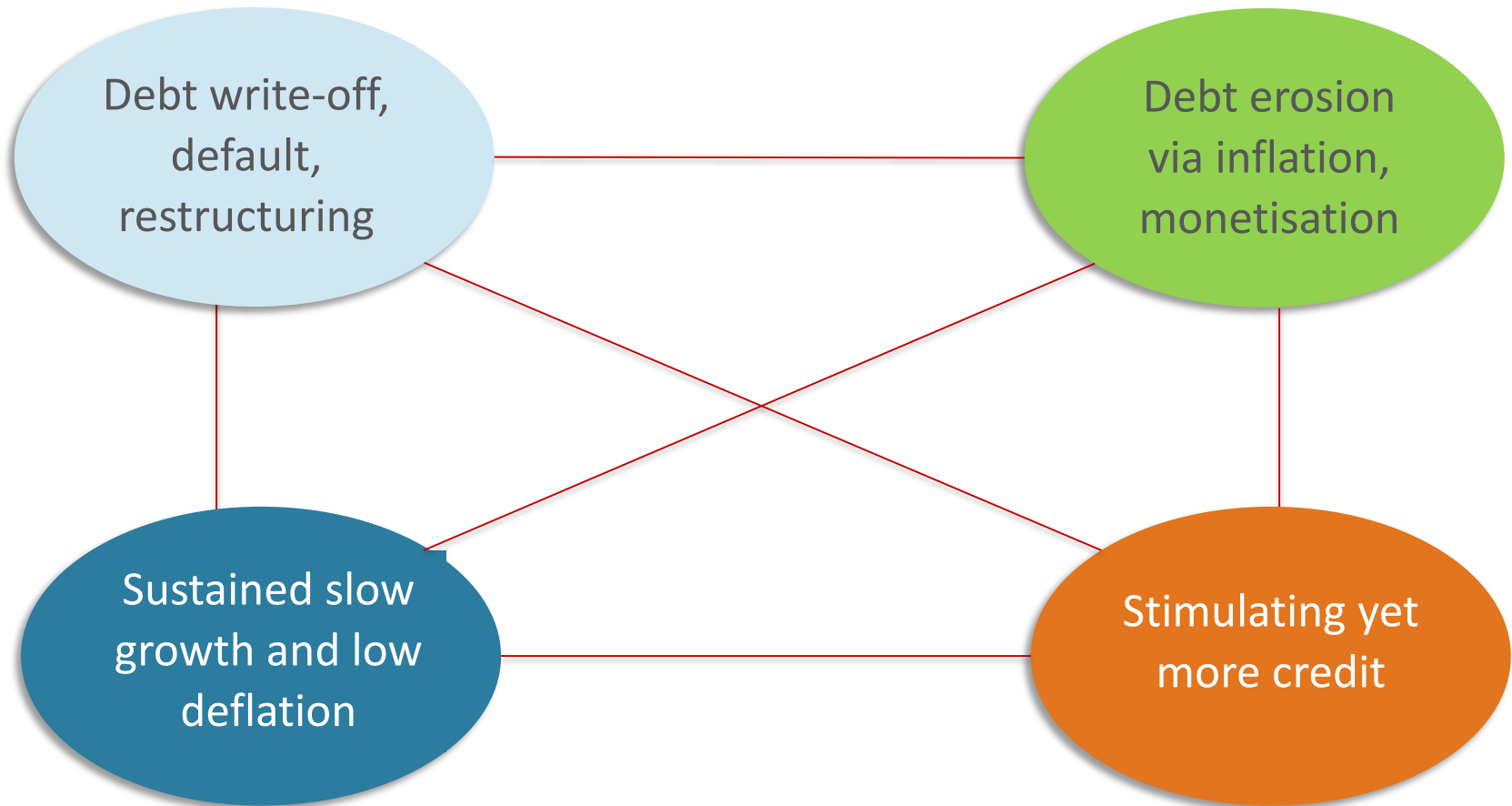


UK Household gross debt as % of income: 2009 - 2020

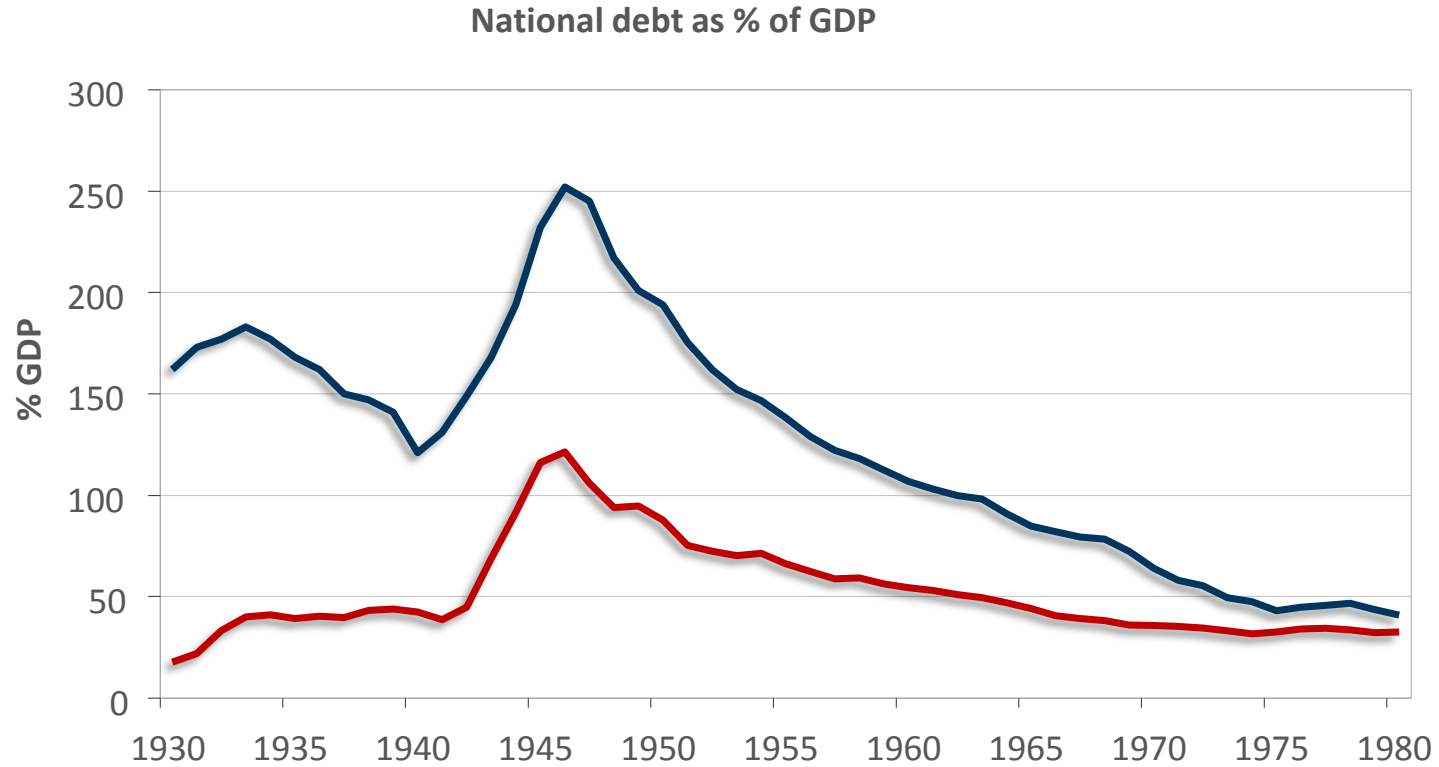


Source: Office of Budget Responsibility, Economic and Fiscal Outlook, December 2014

Debt overhang: the unavoidable choice



Public debt to GDP: US and UK



Source: DMO, ONS

The Dilemma

Pre-crisis path of nominal GDP growth	~ 4% - 5%	→	~ 2% real growth ~ 2% inflation
Pre-crisis path of credit growth	~ 10% - 15%		

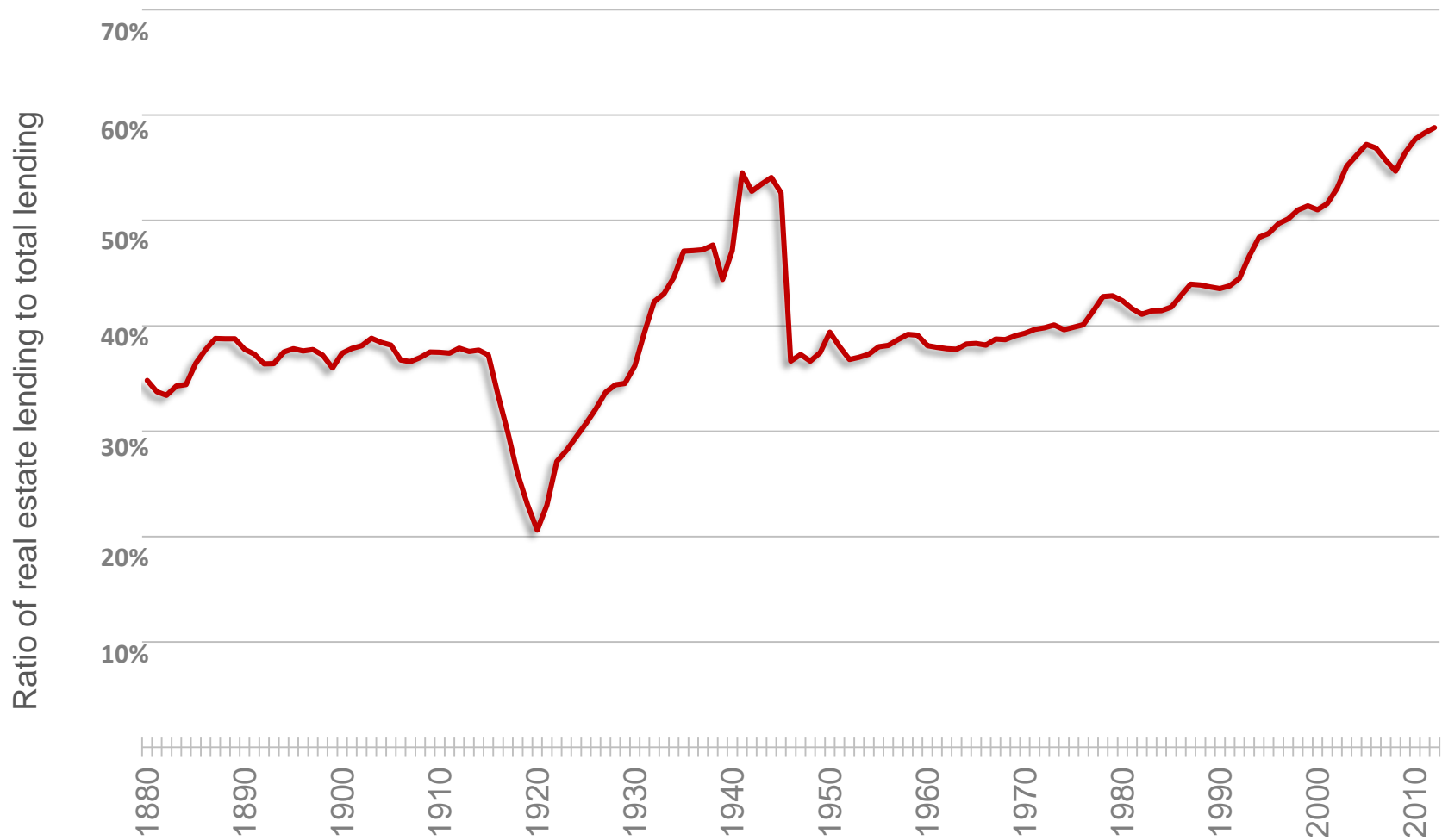
If central banks had raised interest rates to slow credit growth
.... this would presumably mean slower nominal GDP growth?

We seem to need $\dot{C} > \text{NGDP}$ to ensure adequate NGDP
... but this produces financial instability and post-crisis recession

The Dilemma

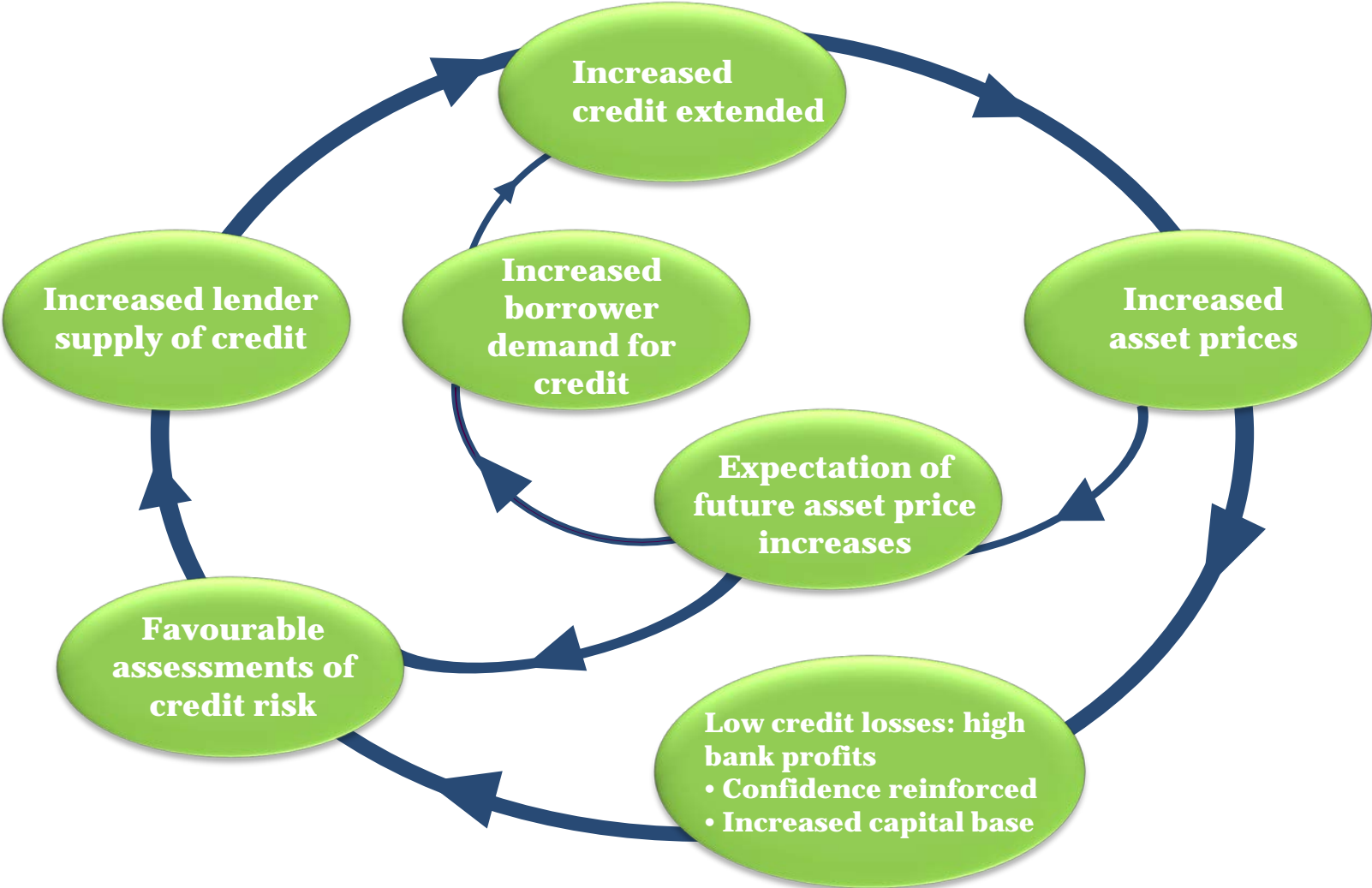
We seem to need credit growth faster than GDP growth to achieve an optimally growing economy, but that leads inevitably to crisis and post-crisis recession.

Share of real estate lending in total bank lending

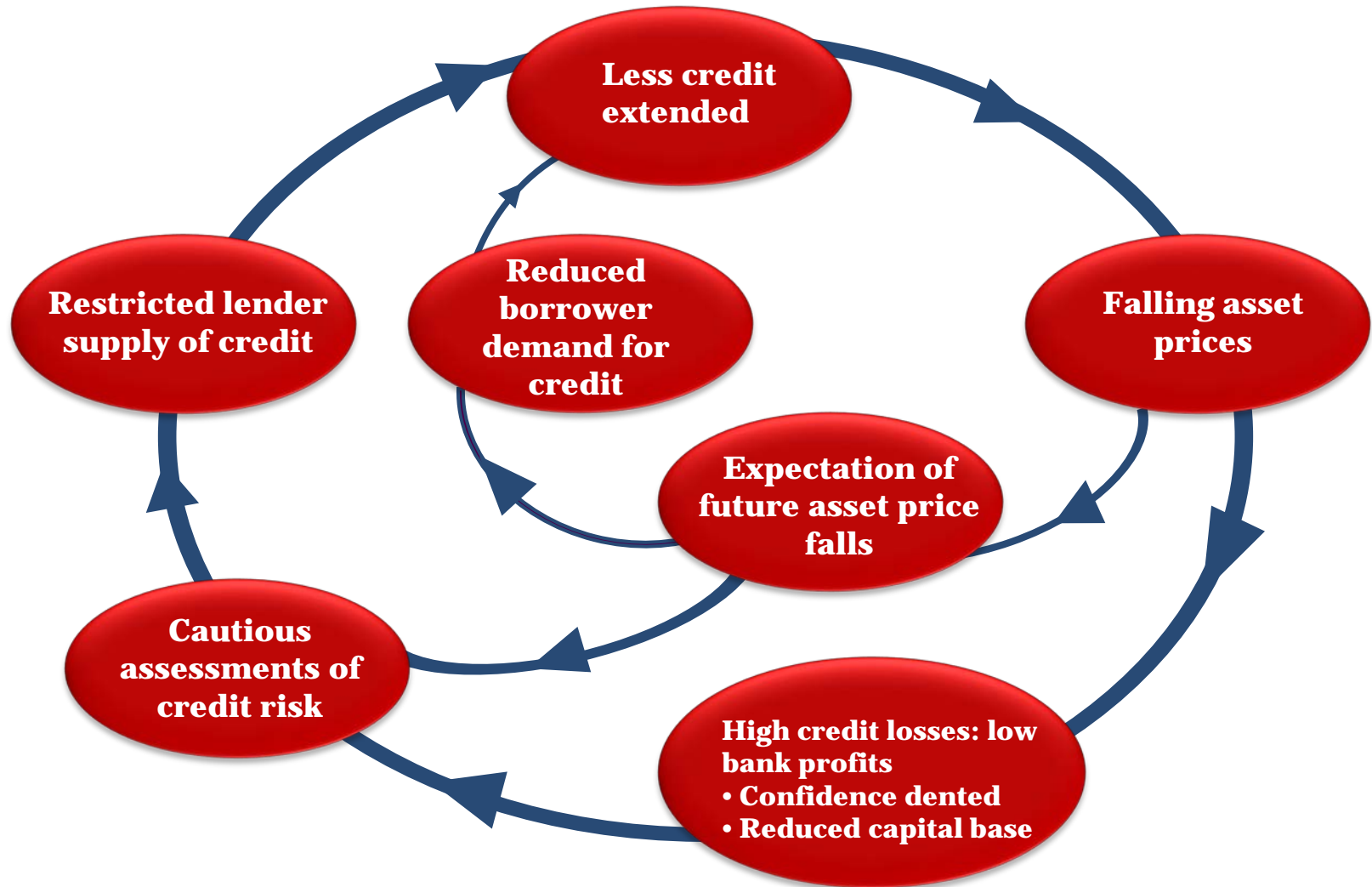


Source: The Great Mortgaging, Professor Alan Taylor, University of California, Davis

Credit and asset price cycles: upswing

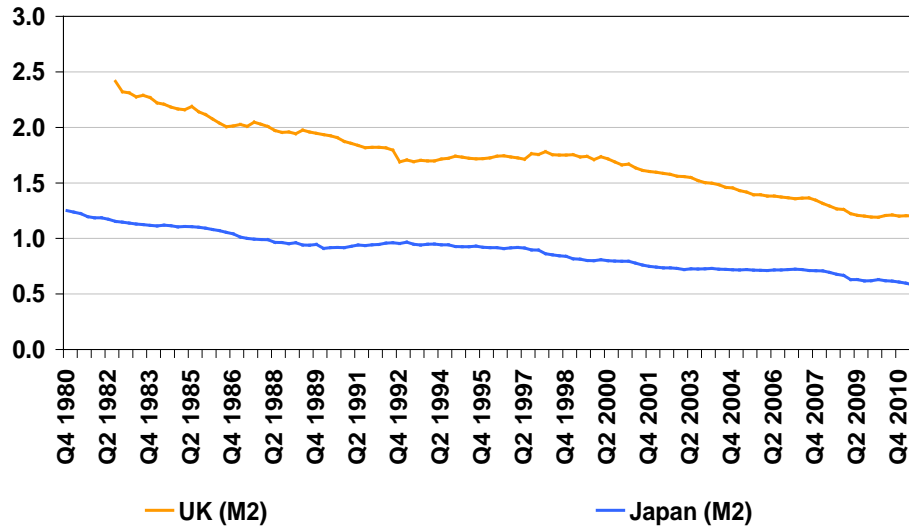


Credit and asset price cycles: downswing

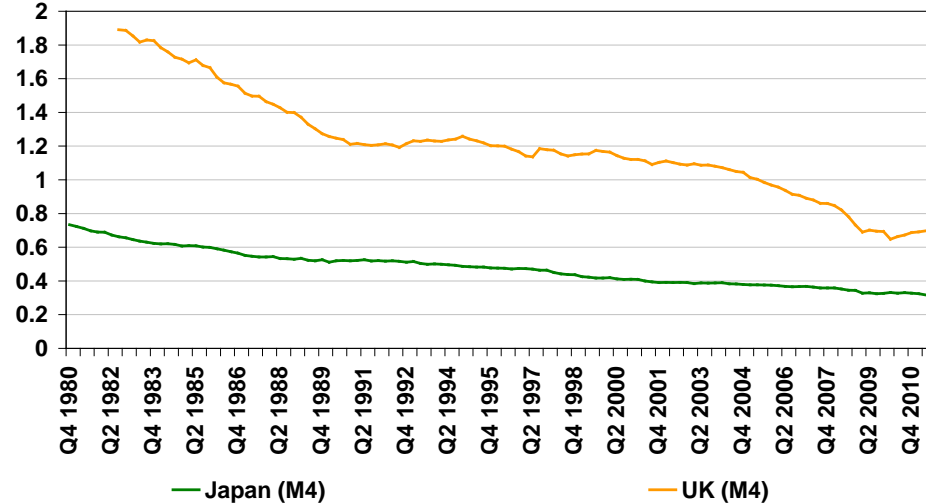


Velocity of money circulation

Velocity of Money
(Nominal GDP/M2)



Velocity of Money
(Nominal GDP/M4)



Source: BoE, BoJ, Datastream

“In the very nature of the system, banks will follow the economy with money substitutes during booms and precipitate future efforts at general liquidation thereafter ...

... private institutions have been allowed too much freedom in determining the character of our financial structure and in directing changes in the quantity of money and money substitutes.”

Henry Simons

‘Rules and Authorities in Monetary Policy’ (1936)

“Government expenditures should be financed exclusively by tax revenues or the creation of money.

... the chief function of the monetary authority [would be] the creation of money to meet government deficits and the retirement of money when the government has a surplus.”

(Milton Friedman, ‘A Monetary and Fiscal Framework for Economic Stability’, 1948)

Pre-crisis consensus

Modern economies work best with a low but positive rate of inflation: $\sim 2\%$ p.a.

Rational

- Facilitates flexibility of relative real wages
- Reduces danger that interest rate zero-lower bound will restrict stimulative policy when needed
- Facilitates resolution of debt overhang

Three sources of nominal demand growth

Private credit and money creation

- Banks create credit and money
- Maturity transformation creates purchasing power

Funded fiscal deficits

- Increases net private financial assets, but not money
- Ineffective if either/both
 - Ricardian Equivalence
 - Crowding out
- But Ricardian Equivalence may not apply
 - Myopia
 - Expectation of future monetisation

Money financed fiscal deficits – ‘helicopter money’

- Directly increases net private financial assets and money
- Enters directly “into the income stream”
- Will always increase nominal demand

Three categories of risk

Private credit and money creation

- Instability of the credit creation cycle
- Cannot be controlled by interest rate/inflation targeting alone

Funded fiscal deficits

- Build up of debt which in future requires either:
 - Fiscal consolidation even if private sector deleveraging
 - Monetisation on a harmfully large scale

Money financed fiscal deficits

- Political economy risk of excessive use

Successful use of money finance

Pennsylvania colony – 1720s

US Union Government in Civil War ('Greenbacks')

Japanese economy 1931-35
(Finance Minister Takehashi)

Unsuccessful

Weimar

Zimbabwe

Success of money creation in Pennsylvania was dependent *“upon the moderation with which it was used [whereas] the same expedient [...] was [...] deployed by several other American colonies but for want of this moderation [...] produced [...] much more disorder than conveniency.”*

(Adam Smith, The Wealth of the Nations, 1776)

Nominal demand creation: the modern orthodoxy

- Money funded fiscal deficits absolutely forbidden
 - Central banks must never monetise Government debt
- Funded fiscal deficits normally ineffective
 - And potentially dangerous because of long-term debt sustainability concerns
- Private credit and money creation optimal provided inflation in line with target

	Fiat money creation	Private credit and money creation	
Modern orthodoxy	<p>Dangerous</p> <p>Forbidden</p>	<p>Free market ensures optimal result</p>	<ul style="list-style-type: none"> • States fail because of short-term politics • Markets efficient and rational
Chicago Plan	<ul style="list-style-type: none"> • Essential to deliver some nominal demand growth • Can be contained by rules 	<p>So dangerous that banks should be abolished</p>	<ul style="list-style-type: none"> • Bank credit markets inherently inefficient and unstable • Political processes can be rational

Optimal rules to govern private credit creation

- Prudential and macro-prudential rules must:
 - Not only ensure stability of the financial risks
 - But constrain growth rate of private debt and the level of private sector leverage
 - Particularly when debt is extended to finance consumption or real estate
- Far stronger bank capital and liquidity rules than in Basel III
- Use of reserve requirements to constrain credit growth/money multipliers
- Loan-to-value and Loan-to-income constraints on real estate borrowers

Optimal rules to govern public debt/deficits

One country/one Government system

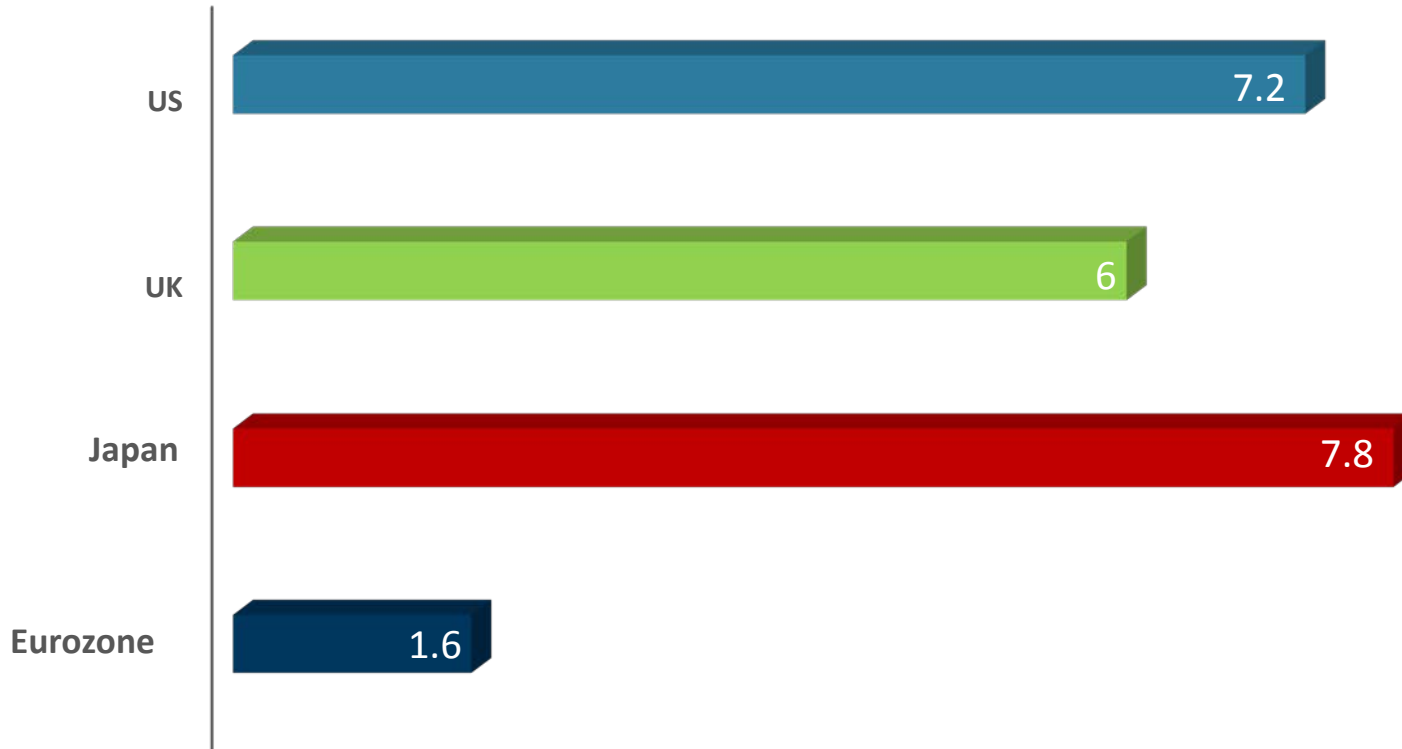
- Reality** Market discipline will always be ineffective given
- Market myopia
 - Rational expectation of future possible monetisation

But need to impose political discipline in order to prevent excessive debt accumulation

Ideal Rules Should not constrain too tightly annual deficits ('flows'), given need for automatic stabilisers and occasional discretionary stimulus

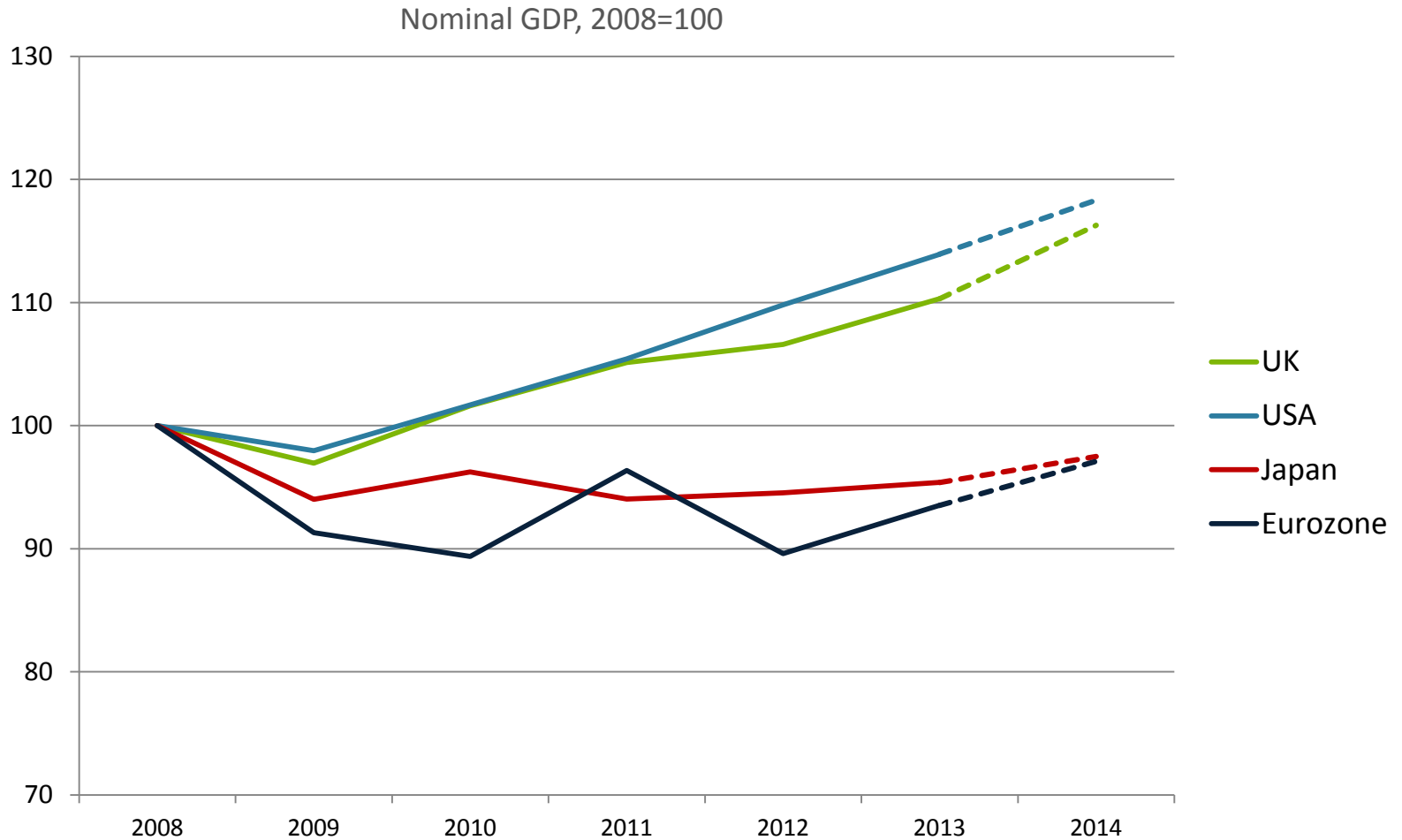
General Government primary deficit

% of GDP, average 2008- 2013



Source: International Monetary Fund Fiscal Monitor, October 2014

Nominal demand growth in major economies 2008 – 2013



Source: IMF, World Economic Outlook, 2014

Optimal rules to govern public debt/deficits

One country/one Government system

Reality Market discipline will always be ineffective given

- Market myopia
- Rational expectation of future possible monetisation

But need to impose political discipline in order to prevent excessive debt accumulation

Ideal Rules Should not constrain too tightly annual deficits ('flows'), given need for automatic stabilisers and occasional discretionary stimulus

But must constrain debt stock as % of GDP



Time consistency challenge

- No perfect answer
- Requires robust political processes, shared culture and trust

Optimal rules to govern money financed deficits

Current orthodoxy: totally forbidden

Technically possible and desirable policy could entail:

- Regular annual money financed deficits subject to:
 - Maximum constitutionally permissible amount, e.g. 2% of GDP
 - Central Bank agreement that each year deficit compatible with inflation target
- Exceptions| larger quantity to deal with debt overhang deflation (if constraints on private credit not strong enough in the past): subject to:
 - Central Bank agreement that compatible with inflation target

Three categories of structural reform

- Long-term fiscal sustainability
- Flexible labour markets for non traded sector job creation
- Competitiveness in traded sector labour cost

The structural reform delusion

Category of reform	Impact on short-term growth
Ensuring long-term public finance balance, e.g. increasing future retirement ages	NIL
Labour market flexibility to induce increasing non-traded sector job creation	Probably negative
Unit labour cost reduction in traded sectors – ‘internal devaluation’	<ul style="list-style-type: none">• Nil at Eurozone level<ul style="list-style-type: none">➤ Fallacy of composition• Potentially positive for individual nations• But increases debt burdens



Specific forms of structural reform desirable

- Different in different countries

But no substitute for adequate demand stimulus

Deficiencies of Eurozone structures and rules

- At the 'sub-sovereign' (i.e. nation state) level

- At the federal (i.e. Eurozone) level

Eurozone deficiencies at sub-sovereign level

Principle: Sub-sovereign debt can and should be disciplined by default risk as well as rules

Problems:

Very large public debts (e.g. 60% - 170% of GDP) at the sub-sovereign level

- Versus e.g. 10% - 20% of GDP in the states of the US



- Default or restructuring will be large shock to financial markets
- Fiscal consolidation (austerity) to avoid default will have major effect

Nationally focussed banks hold large undiversified portfolios of (sub-sovereign) government debt



- Wrong way correlated risk

Eurozone deficiencies at federal level

- No fiscal capacity to provide automatic or discretionary stabilisers if face reduction in private demand
- Absolute constraint on monetisation rather than rules to allow small or exceptional money finance if needed to maintain demand
- No undoubtedly safe asset for banking system to hold as liquidity

Optimal structure for Eurozone functions and rules

Sub-sovereign level

Can issue debt, but only to finance investment and/or within balanced budget constraints

Debt carries default/restructure risk

Absolute prohibition on banks holding sub-sovereign debt (and/or 100% capital weights)

Federal level

Most debt issued at federal level

Federal level surpluses/deficits provide automatic stabilisers

- with strongly pro-cyclical taxes and counter-cyclical expenditure items in federal budget

Banks hold federal level debt as undoubted risk-free asset

Rules on private credit, funded deficits and money finance as per one country/one currency model

The Eurozone position today:

Don't start from here

Italy & Greece



- Allowed into Eurozone with already excessive public debts (>100%)
- And in Greece's case with corrupt accounting, tax evasion, etc.
- Market myopia allowed public debt build up

Ireland & Spain



- Suffered private sector credit and real estate booms
- Reflecting inefficiency and instability of private debt creation

Levels of debt which cannot be reduced by pay back alone

Simultaneous attempted:

- Private deleveraging
- Public deleveraging (austerity)

... driving deficient demand

Japanese style 'lost decade' but greater social and political dangers

Repaying public debts

The Theory

- Eurozone countries to reduce public debts each year by 1/20th of excess over 60%
- Requires primary budget surpluses of around*
 - Spain: 4%
 - Ireland, Italy, Portugal: 5%
 - Greece: 7%
- Greek debt agreement requires 4% primary surplus

The historic reality

- Excessive public debt burdens have always been reduced by write-offs, restructuring, inflation or monetisation
- Attempt to repay will drive sustained deflation and slow growth

The walk away option

- Via political rejection/Eurozone exit
- Via physical migration

* Barry Eichengreen, *The Bond Markets Dance*, FT.com, 17 November 2014

Desirable responses to Eurozone's *'Don't start from here'* problem

- Significant restructuring / write-off of existing accumulated sub-sovereign debt burdens
- Significant demand stimulus at the federal level
- Moves towards a long-term structural sound system – with rebalance of sub-sovereign and federal roles

Optimal federal level demand stimulation

German concern:

QE is hidden monetisation, and reduces pressure for needed reforms and long-term fiscal consolidation

Reality:


Current QE risky because it is not permanent monetisation

Overt permanent monetisation – a Eurozone helicopter money drop – would be less likely to reduce pressure for needed reforms

Standard QE versus helicopter money


Standard QE

ECB buys bonds to depress yields and increase asset prices

- 
- May be ineffective in stimulating private activity with yields already very low
 - Only effective if re-stimulates private credit and leverage growth
 - Will stimulate financial speculation and potential instability (cf. IMF, GFSR)
 - Increases inequality

Eurozone Helicopter Money

- Indirect: e.g. via ECB purchasing of EIB bonds → investment
- Direct: agreed per capita distribution of newly created Eurozone money, or agreed equal one off tax cut (as per Tabellini and Gavazzi)

- 
- Puts aggregate nominal demand directly 'into the income stream'
 - Does not reduce interest rates
 - Does not remove pressure for medium term fiscal consolidation by sub-sovereign states – except in so far as stimulates growth

Optimal Eurozone arrangements: The problem of trust

Required Elements

Procyclical taxation (e.g. payroll taxes) and counter-cyclical expenditures (e.g. unemployment benefits) at Eurozone level

Sub-sovereign debt carries default risk

Eurozone deficits used only for necessary stabilisation purposes

Monetisation of Eurozone debt only in small amounts or exceptional and appropriate circumstances

The Trust Issue

Can German taxpayers trust that taxes are paid and benefits administered equally in Hamburg, Andalucía, Sicily, and Athens?

Will default actually be allowed – or will there be bail-out?

Will deficits and debts grow over time under political pressure?

Will monetisation grow over time under political pressure?