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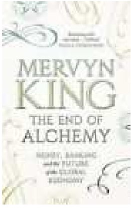
by Valerio Carnovale



King M. The End of Alchemy

The crisis was the failure of a system and of the ideas that underpinned it. There was a general misunderstanding of how the world economy was working. The economic failures of a modern capitalist economy stem from our monetary and banking system. New ideas will be needed to prevent a repetition of the Great Recession and to restore prosperity.

The crisis of 2007-9 was the latest manifestation of our collective failure to manage the relationship between finance and the capitalist system. Financial institution and investors started to take more and more risk. The saving glut and the banking glut combined, produced a toxic mix of a serious disequilibrium in the world economy. Low interest rates were encouraging household to bring forward spending from the future to the present. Adjustment was going to be necessary and the longer it was delayed the bigger the adjustment would be. The stock of credits and debits were building in an unsustainable way. No one player involved took action to change direction and the alchemy continued without any change in the fundamental structure of banking. We need a new theory, or narrative, to explain why global demand is so weak and real interest rates are so low. Correcting the internal and external imbalances will be a long process.

Money is not principally a means of buying “stuff”, but a way of coping with an uncertain future, maintaining a reserve of purchasing power to keep our options open. In a more complex world and in an unknowable future, money plays a special, indeed unique, role. Most money today is created by private sector. This is the most serious fault line, because the issue of money is a function of government, it belong to people.

Banks are at the heart of the alchemy of our financial system, the main source of money creation. They borrow short and lend long and are vulnerable to any crisis of confidence. Banks combine maturity and risk transformation. The transformation of bank deposits at safe value into illiquid risky investments is the alchemy of money and banking. Such a system is fragile and a run on the banks is self-fulfilling. So it is imperative that we find an answer to the question of how to make our banking system safer.

At the heart of modern macroeconomics there is the illusion that uncertainty can be confined to the mathematical manipulation of known probabilities, a belief that there is a “model” of the economy that will produce forecasts that are exactly right, a desire for certainty and control over our destiny that leads to irrational decisions (illusion of certainty). When things go wrong, the cause is not necessarily an irrational behavior, nor an external shock, but possibly a mismatch between the chosen heuristic and the environment. It extremely difficult, if not impossible, to judge how the riskiness of different assets will change in the future (ex. Basel III and Risk weighted capital requirements; it is better to use a measure of leverage, better at predicting which bank would fail; derivatives do not offer an insurance against radical uncertainty). The banking system should go back to its traditional role of accepting deposits and financing loans. Liquidity is not a permanent feature of financial market, it depends on psychological nervousness, or panic, among investors. Narratives about fundamentals play an important role. Money is the way of dealing with an uncertain future.

The advent of inflation targeting saw a move from the old central banking tradition of mystery and mystique, to openness and transparency. This guide expectations as to how the central bank will respond to the future events and explains past decisions. When the yield curve is completely flat, central banks may still create money by purchasing assets other than government bond, taking credit risk of a very different kind, which ultimately falls on taxpayers. Central banks was entering in the world of fiscal policy. Quantitative easing did not create inflation because the increase in the supply of money prevented the fall in total money supply and was matched by a sharp increase in the demand for highly liquid reserves. What has been missing was a broader and coherent vision, unifying framework within which to analyze policies in both good and bad times. Central banks have a role to play in changing the heuristic used by household and business when they see a serious disequilibrium building up.

No monetary union has survived unless it has also developed into a political union. It makes little sense to remain in a currency union with partners who do not share the same objectives and commitment for the management of money. Starting with differences in expected inflation rates, a single interest rate leads inexorably to divergences in competitiveness, surpluses and deficits in trade, differences in unemployment. The euro is no longer a means to an end but an end itself. Monetary union will come to great strain unless there is a high degree of mutual trust and willingness to make transfers to countries that have suffered major shocks. That require a deep political integration and transfer of power to European institutions, but democratic legitimacy remains in the hands of national governments.

For centuries, alchemy has been the basis of our monetary and banking system. Alchemy is the apparent transformation of risk into safety, the pretense that illiquid real assets of an economy can suddenly

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converted into money or liquidity. Liquidity is an illusion. The pretense that the deposits can be secure rests on the shift on to taxpayers of the risk of the assets of the banks. During crisis, regulators have been tightening up on the freedom given to banks on how they finance themselves (capital requirements has been raised, complex trading activities have been separated from basic operations, the largest banks have become smaller). However, it is extremely difficult to know the appropriate level of equity finance a bank should be required, in a world where the alchemy is still a characteristic. Two aspects of current regulation are difficult to reconcile with radical uncertainty: to estimate the riskiness of different assets on a bank's balance sheet; to define what assets are liquid (in a world of radical uncertainty, only central bank can create liquidity). Regulation has become extraordinarily complex and does not go to the heart of the problem of alchemy. Complexity feeds itself: it is a barrier to new small financial firms to enter the financial sector and brings the system into disrepute. We need ideas that are more radical. Some economist revives the Chicago plan to force banks to hold 100 percent liquid reserves against deposits. Reserves would include only safe assets; other assets must be financed by issuing equity or long-term debt, which would absorb any losses. The Chicago Plan breaks the link between the creation of money and the creation of credit. The prohibition on the creation of money by private banks is not likely to be sufficient to eliminate the alchemy in our financial system. It is time to replace the lender of last resort by the "pawnbroker for all seasons", prepared to lend to almost anyone who pledges collateral sufficient to cover the value of a loan. The idea is a natural extension of measures already introduced. Only a central bank can supply liquidity, or emergency money, against illiquid and risky assets. The aims are: to ensure that all deposits are backed by either actual cash or guaranteed by contingent claim on reserves at the central bank; to ensure that the provision of liquidity insurance is mandatory and paid upfront; to design a system that imposes a tax on the degree of alchemy in our financial system. Private financial intermediaries should bear the social costs of alchemy. The principle is to ensure that banks will always have sufficient access to cash to meet the demand of depositors. Each bank would decide how much of its assets it would posit in advance at central bank. For each type of collateral, the central bank would calculate the haircut. All asset had been pre-positioned, so that would be clear, well ahead of any crisis, how much central bank money that bank would be entitled to borrow at any instant. The effective liquid assets of the bank should exceed their effective liquid liabilities so that, in the event of crisis, a central bank would be free to lend on terms already agreed without any penalty rate. The idea: recognizes that in a real crisis the only source of liquidity is the central bank, provides a natural transition, allows the bank to choose for themselves the structure of the balance sheet solves the moral hazard problem associated with the conventional lender of last resort and simplifies drastically the regulation. The biggest problem of the central banks is to determine the appropriate haircuts. Bank resolution would be simpler. Alchemy can be squeezed out of the system by rising the amount of equity and keeping bank reserves at broadly their present level.

A world of radical uncertainty cannot be described by equations. The crisis raised deep questions about the foundation of the economic models. The problem is not just complexity but also the pretense of knowledge that leads you to select an optimal solution based on assumptions that are almost certainly false, the right answer to the wrong question. The narrative people use to estimate their view about economy, leads to disequilibrium that may appears stable but it is not sustainable indefinitely. It will persist until something happens to make people to revise their narrative. Mistakes are almost inevitable as are their corrections. In a world of radical uncertainty, they may lead to big mistakes in belief. Policy to boost demand do not alter the perceptions.

Without reforms of the financial system, another crisis is certain and the failure to tackle the disequilibrium in the world economy makes it likely that it will come sooner. Central banks are trapped into a policy of low interest rates that contributed to rise in asset prices and to increase in debt. Recovery has been anemic; sovereign debts are a big problem. It needs to postpone repayments until the debtor has achieved an export surplus or a debt forgiveness. Monetary union has created a conflict between centralized elite and the forces of democracy at the national level.