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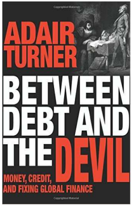
by Valerio Carnovale



Turner A. Between Debt and the Devil

We forged the new Basel III bank capital standard, but our reform failed to address the fundamental issues, and we were wrong to assume that the economies would recover if only we could restore confidence in the banking system. Radical policy implications follow. We need to question whether banks should exist at all. The bank should operate with leverage levels more like to five then the twenty-five or higher, that we allowed before the crisis.

The origins of the crisis were rooted in specific elements of an increased financial intensity: finance made much more money out of providing credit to the economy; the private sector became dramatically more leveraged; increasing borrowing explains rising asset management revenues; the financial system did too many and too complex activities; financial institutions did much more business with one another. This reflected two profound intellectual errors: the failure to recognize that financial markets are different from other markets; to recognize the crucial macroeconomic implications of credit and money creation of banks and shadow banks and of debt contracts in general and specific types of debt.

Financial markets left to free-market forces, can generate privately profitable but not socially useful activities (theoretical proposition Efficient Market Hypothesis – EMH and Rational Expectations Hypothesis - REH). Real-world evidences contradict both hypothesis. Realistic theories explain that: human decision-making is not entirely rational; the irrationality is highly correlated with unsophisticated investors tending to move as a herd; the theory that rational arbitrageurs bring back prices to efficient equilibrium level is valid only on individual stock or bond but is invalid in relation of level of prices in general; as a consequence, rational and thoughtful investors can, for a time, drive prices even further from rational equilibrium levels and to instable and irrational results; EMH and REH fail to recognize that the future is characterized by inherent irreducible uncertainty and not mathematically modelable risk.

Five features of debt contracts make them potentially dangerous: ignoring risk on the projects they finance with small probability of a very significant downsize; debt markets can be more susceptible then equity finance to sudden fall in confidence and sudden stops in new credit supply; debt contracts unsustainable do not adjust smoothly; asset price falls induced by sudden stop in confidence, can further depress both confidence and credit supply and impair solvency f banks; falling asset prices can produce a deflationary debt overhang effect. The quasi-fixed nature of debt contracts, the inherently imperfect markets and the potentially myopic human being can drive to financial and macroeconomic instability. So debt can be dangerous. Dangers are greatly increased by the fact that banks create credit, money and purchasing power.

Only when credit is used to finance useful new capital investment, it generates the additional income flows required to make the debt sustainable. In most of banking system most credit does not finance new capital investment, it funds the purchase of assets that already exist, above all real estate and consumption.

After the financial crisis of 2007-2008 and the credit crunch, the top priority seemed to fix the financial system and in particular the banks, but these policies were inappropriate because the biggest problem was the debt overhang in the real economy. Once the debt has grown to an excessive level, all the traditional levers appear blocked. Debt overhang became a trap from which there is not a clear escape. The cheap credit supply was not effective because the demand was not there, borrowers were already overleveraged. The attempts to deleverage have been ineffective, the leverage shifted from the private to the public sector. The quantitative easing stimulates the economy through rising asset prices and increased inequality. The policy should be focused on debt forgiveness.

We need credit growth faster than GDP to achieve adequate growth, but the resulting rise in leverage leads to crisis and post-crisis recession. Much of the credit growth played no necessary role in stimulating nominal demand growth but contributed to excessive leverage, speculation, debt overhang and inequality. The dramatic progress of information technology drives down hardware and software prices. The result is a massive wealth creation from minimal investment. Debt contracts can play a useful role in mobilizing and allocating capital investment, but most credit extension in modern economies is unrelated to capital investment. We can stimulate nominal demand without relying on private credit creation. We have to reject key tenets of pre-crisis orthodoxy and consent the government to stimulate demand through emission of fiat money.

Benefits of modern international capital flows depend on their type and tenor. Most of them don't flow from richer to poorer countries and don't finance sustainable capital investment.

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New ideas and principles should guide radical reform to manage the quantity and influence the allocation of credit in the real economy. Even good lending can generate bad aggregate effect (externalities). Sophisticated risk management techniques could advantage one bank relative to others but regulation and best practices, lead to excessive market liquidity, leverage, funding to purchase existing assets, asset trading (improved by technology) and to make overall system more unstable. Most money is not held for transactions purposes but arises as a by-product of credit creation. Too much credit leverage causes economic harm. The reforms must aim to manage credit creation, not to fix the banks. It is rational for the bank to maximize their own leverage, increase return on equity and be rescued with public money. We need to build economies that do not rely on rapid credit growth to achieve adequate demand, we need to manage the quantity and influence the allocation of credit that banks create.

The potential limitless supply of bank credit and the high inelastic supply of real estate and land are at the core of the financial instability. Capital requirement for real estate lending should be significantly increased and borrower constraints (loan to value, loan to income) imposed. Credit-intensive economy (credit has grown faster than GDP to finance consumption of the poorer and speculation of the richer) rises inequality and potential instability. Increase in inequality rests on globalization, information technology, financialization. They change social norms and incentives and reduce the relative position of less skilled workers. This requires redistribution of income and wealth trough tax and public expenditure. Large current-account imbalances should be reduced through global coordination of policies (reform of international monetary system and more extensive and flexible international liquidity facilities).

Let to itself, a free financial system will produce too much private credit. Structural reforms are needed such as: abolishing banks that create private credit, money and purchasing power, taxing debt pollution and encouraging equity contract through useful financial innovation. Banks should only hold money deposit for customer and make payment between accounts. All the deposits would be matched by deposit at central bank and the money supply would be equal to the monetary base. Debt contracts would function outside the banking system. The banks would no longer create new purchasing power, governments would run small fiscal deficits funded by creation of pure fiat money. Lending paid in full that looks good creates negative externalities. Taxation is the appropriate response, should be taxed the credit intermediation funded with short-term liabilities, since maturity transformation creates risks. Most tax regimes favor debt contract over equity. The debt contract gives apparently certain return, is less flexible, foster debt overhang and deflationary effects. The debt contract should be somewhat “contingent”, sharing some element of the risk they finance. Shared risk should have policy support, tax incentives.

The rapid credit growth is a strong indicator of potential financial crisis. Different types of debt perform different economic functions and create different risks. We need to constrain the quantity and influence of the mix of debt that banks and shadow banks create. That will require five sets of policies: banking regulation to constrain lending to real economy (reserve asset requirements should return to the central bank toolkit; tools should discriminate among different categories of credit), constraints on risky shadow banking (imposing capital requirements at the level of the contract and not the institutions, to constrain the scale and complexity of intrafinancial system links), constraints on borrowers’ access to credit (LTV, LTI), to put sand in the wheels of harmful short-term debt capital flows (to prevent commercial banks from engaging in proprietary trading – Volker Rule, to separate market-making and trading activities from traditional banking – Liikanen Group, the international banks should operate as subsidiaries rather than as branches), to ensure enough credit to fund required capital investments.

There are limits to our ability to use traditional stimulus to escape the debt trap. It Is crucial to constrain debt levels in good years and to restrict excessive private credit creation. The ultra-loose monetary policy generated faster nominal demand growth but it is insufficient, lowers interest rates encouraging risky and high leveraged financial speculation and asset mispricing. We need to stimulate nominal demand by printing fiat money and to rise bank reserves (an implicit tax on credit intermediation). We need to deleverage public and private balances by debt restructuring at a sustainable level, avoiding destructive bankruptcy and defaults. A sufficient private debt write-down can fix debt overhang problem; a public debt write-down plays a larger role by using money finance option and avoiding an excessive use.