

Institute For
New Economic Thinking

ESCAPING THE DEBT ADDICTION: Monetary and macro-prudential policy in the post-crisis world

Center for Financial Studies

Frankfurt, 10 February 2014

Adair Turner

Senior Fellow,

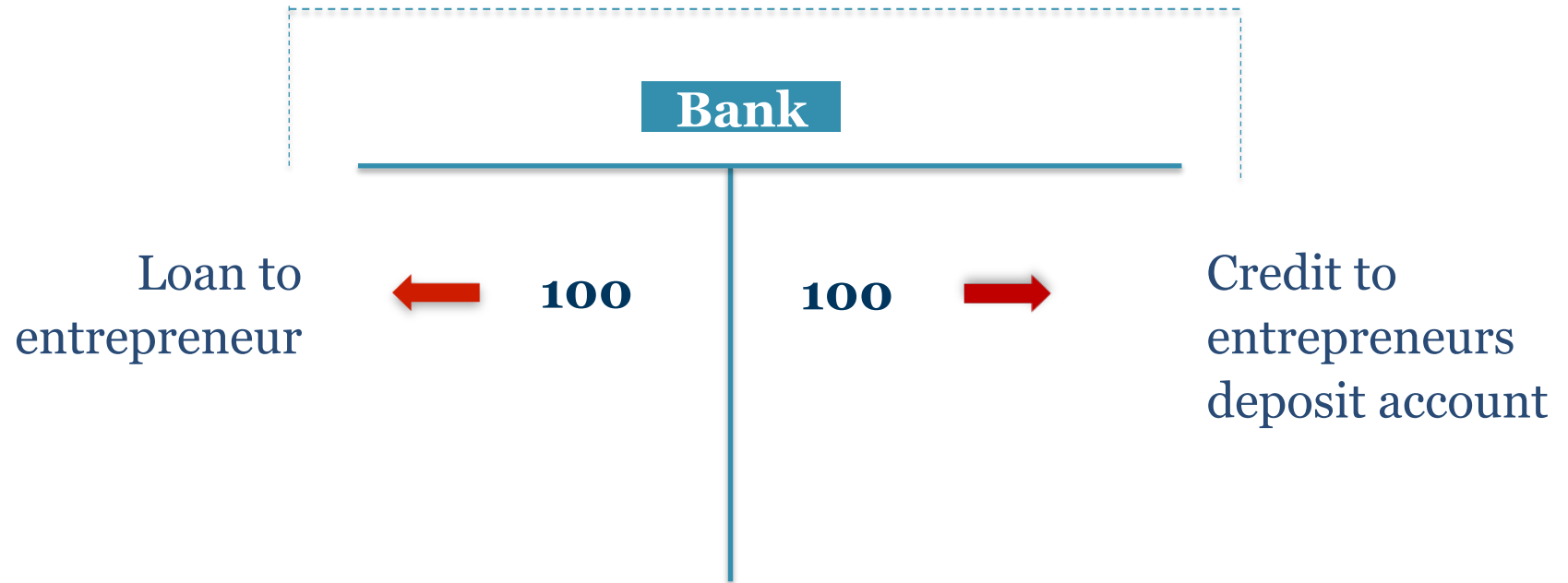
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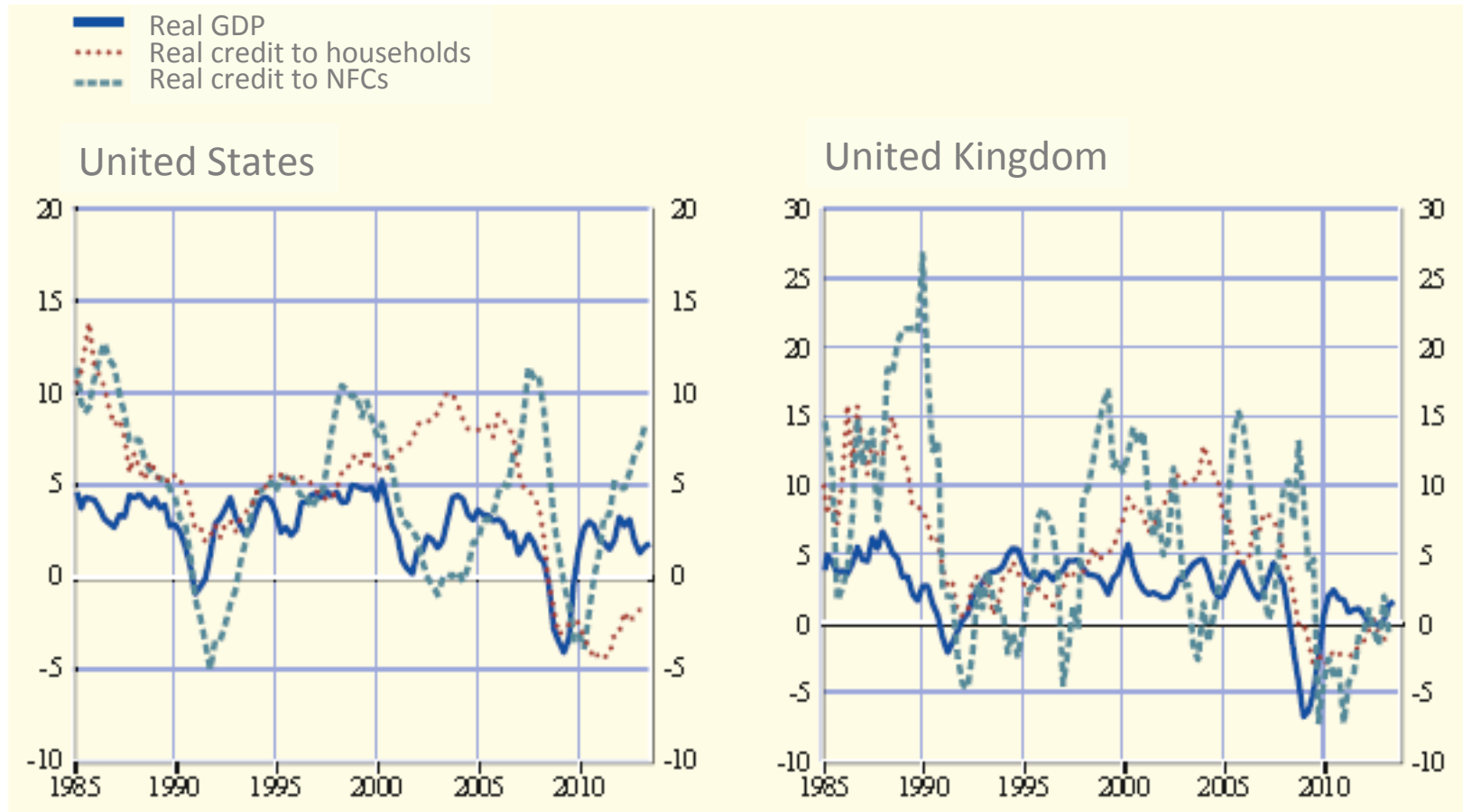
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Banks create credit, money and purchasing power

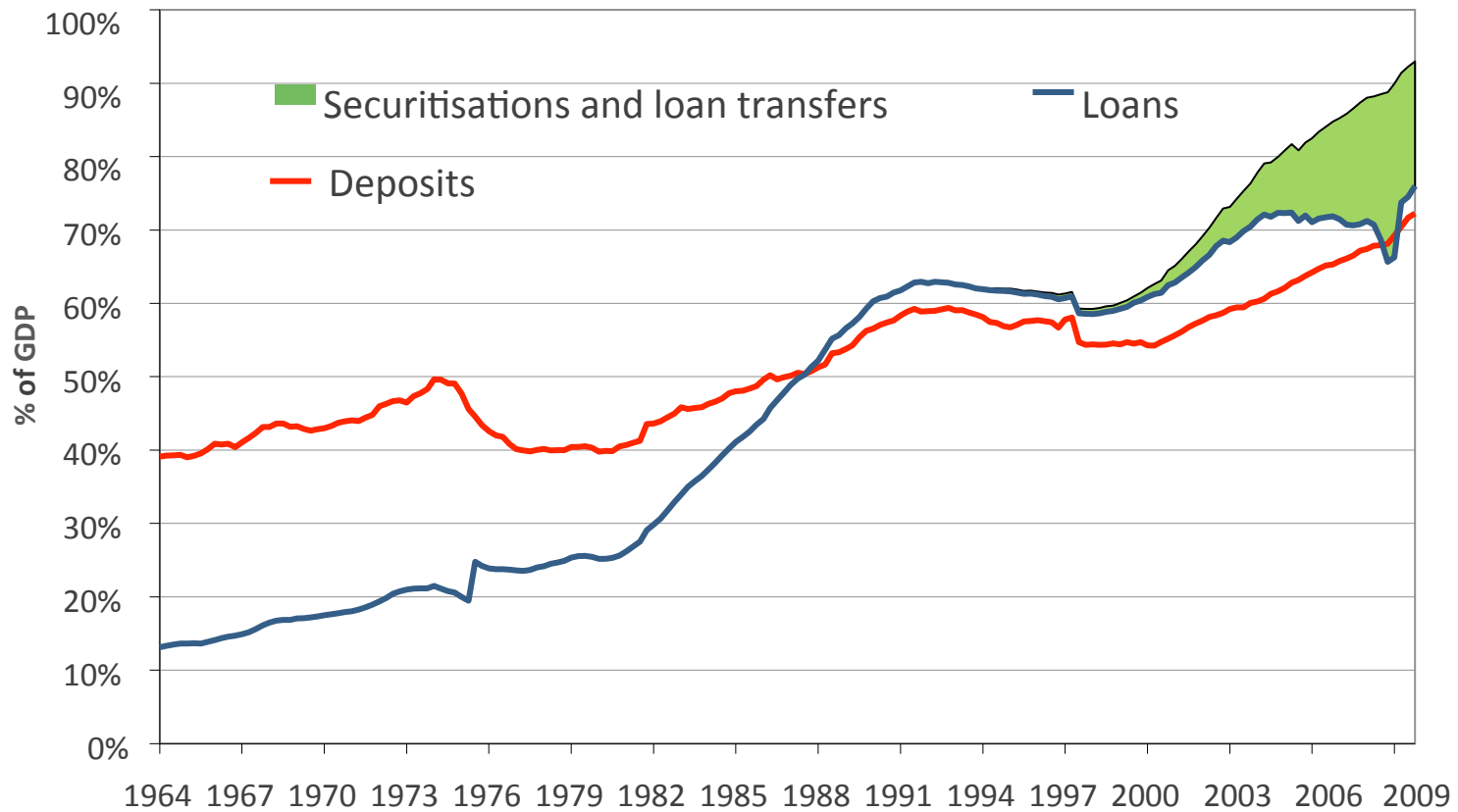


Dynamics of real GDP and credit (Year on year % change)



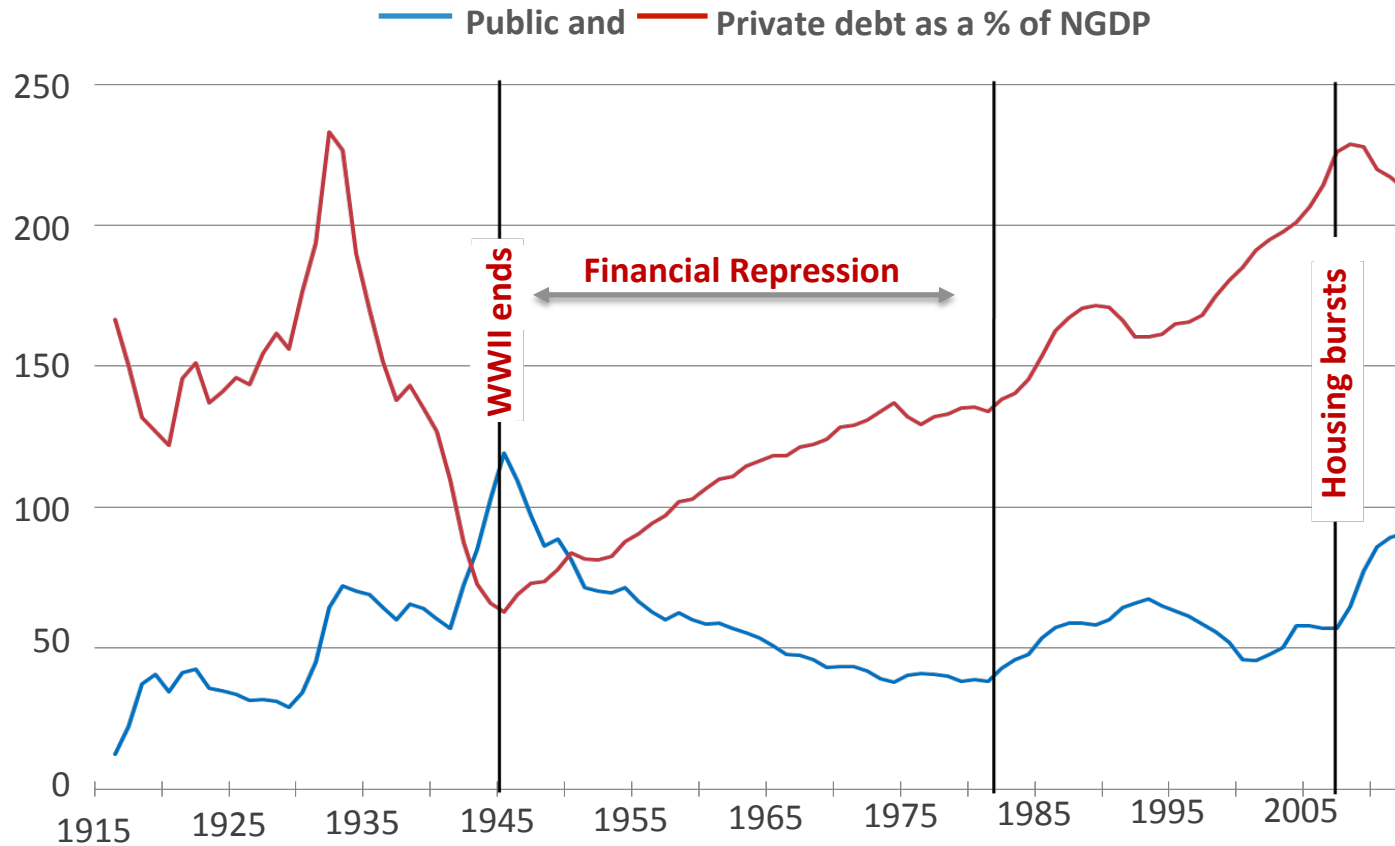
Source: Monthly Bulletin, European Central Bank, January 2014

Household deposits and loans: UK 1964 – 2009



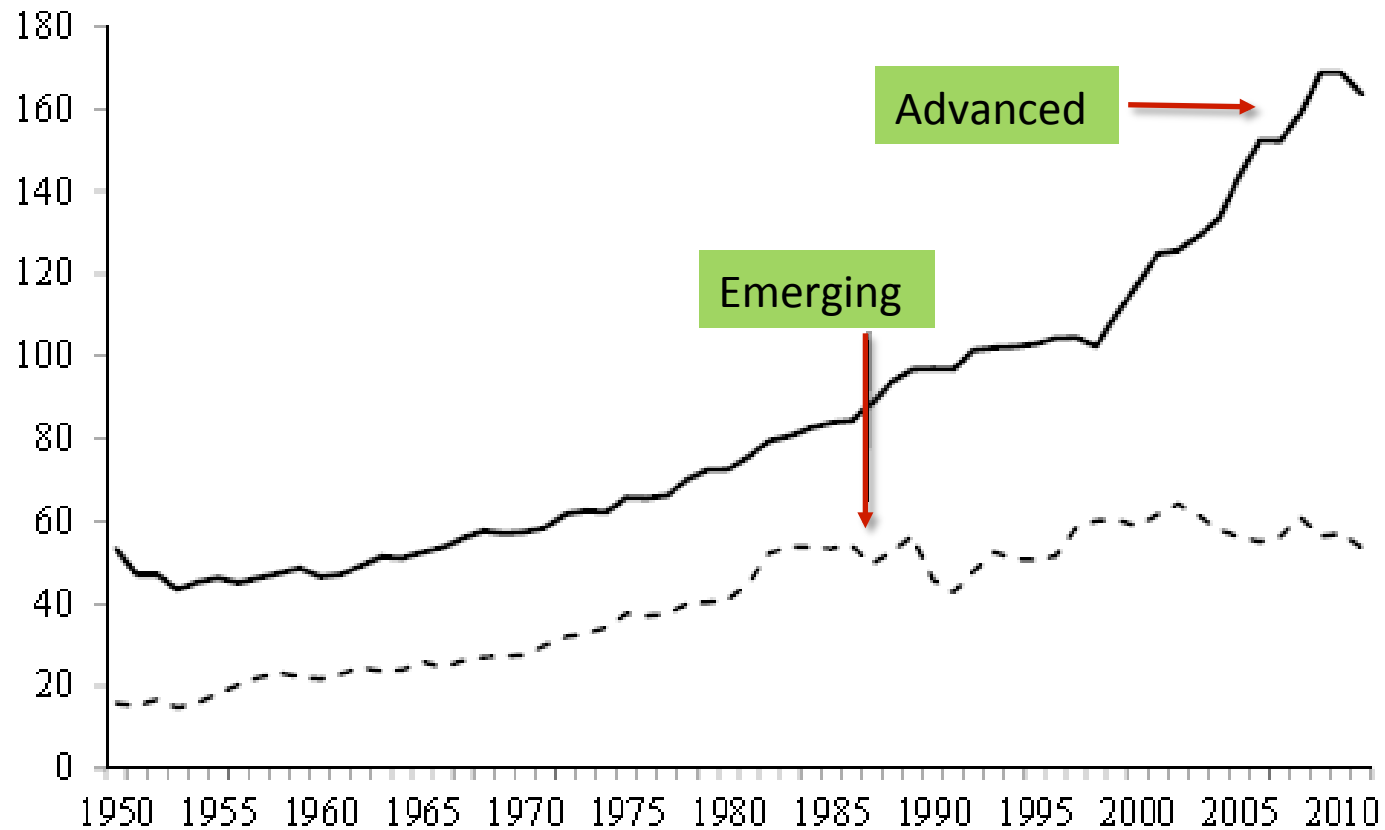
Source: Bank of England, Tables A4.3, A4.1

Private and public leverage cycles: US



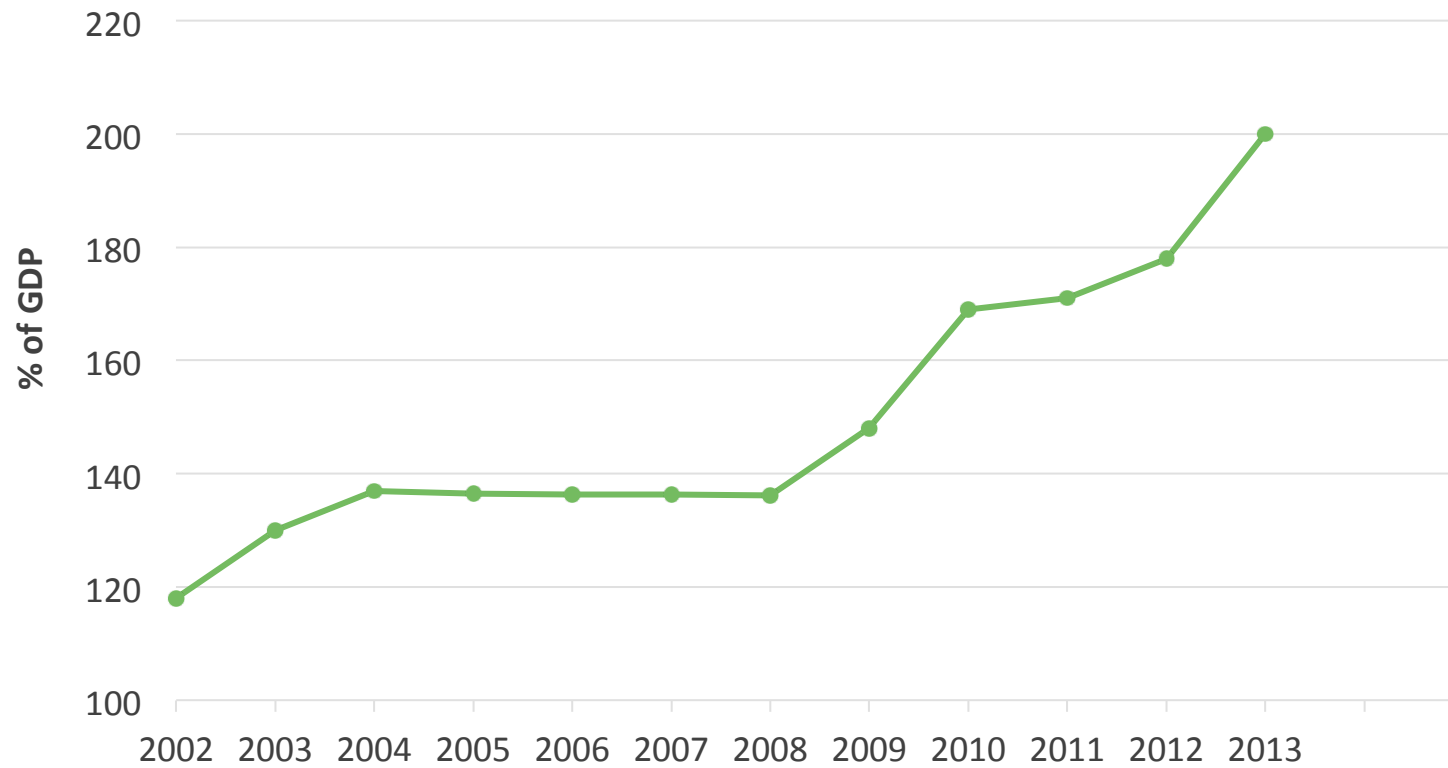
Source: McCulley and Pozsar

Private domestic credit as a % of GDP: 1950 – 2011

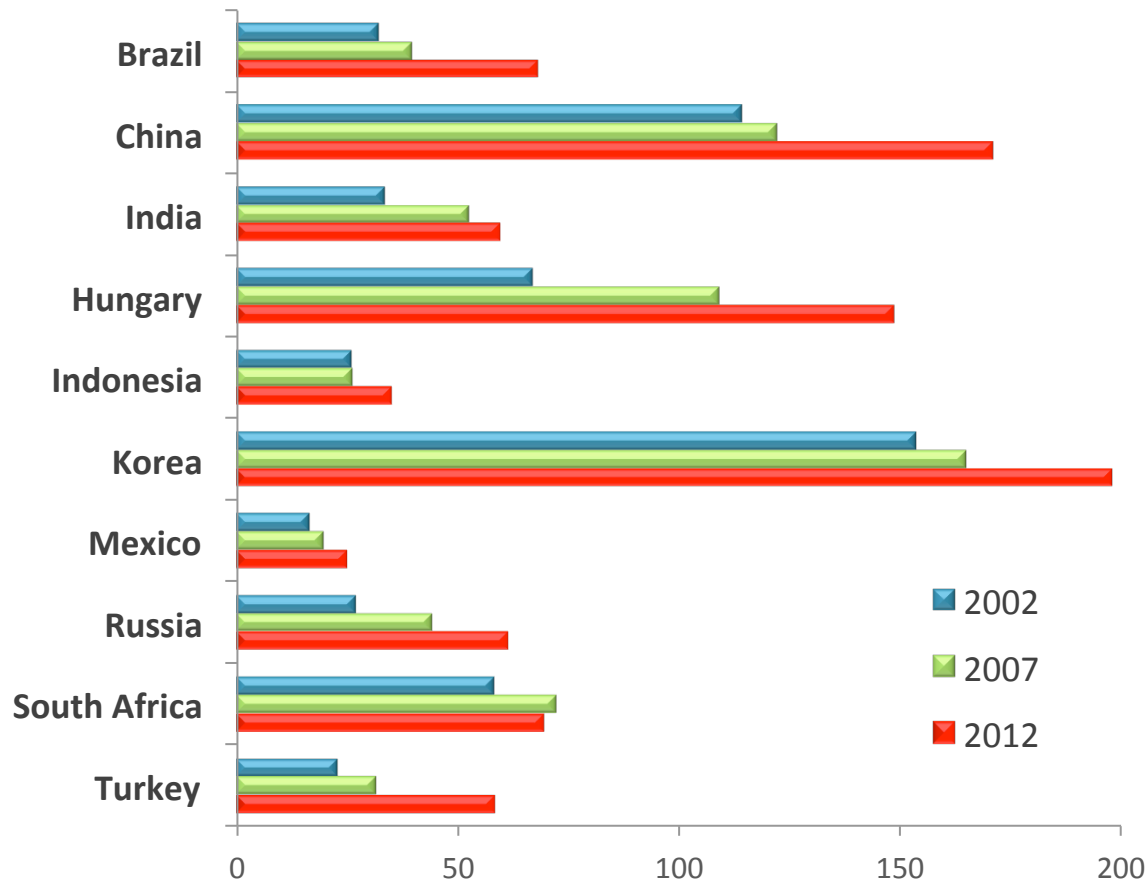


Source: *Financial and Sovereign Debt Crises: Some Lessons Learned and Those Forgotten*, C. Reinhart & K. Rogoff, 2013

China: total social finance to GDP

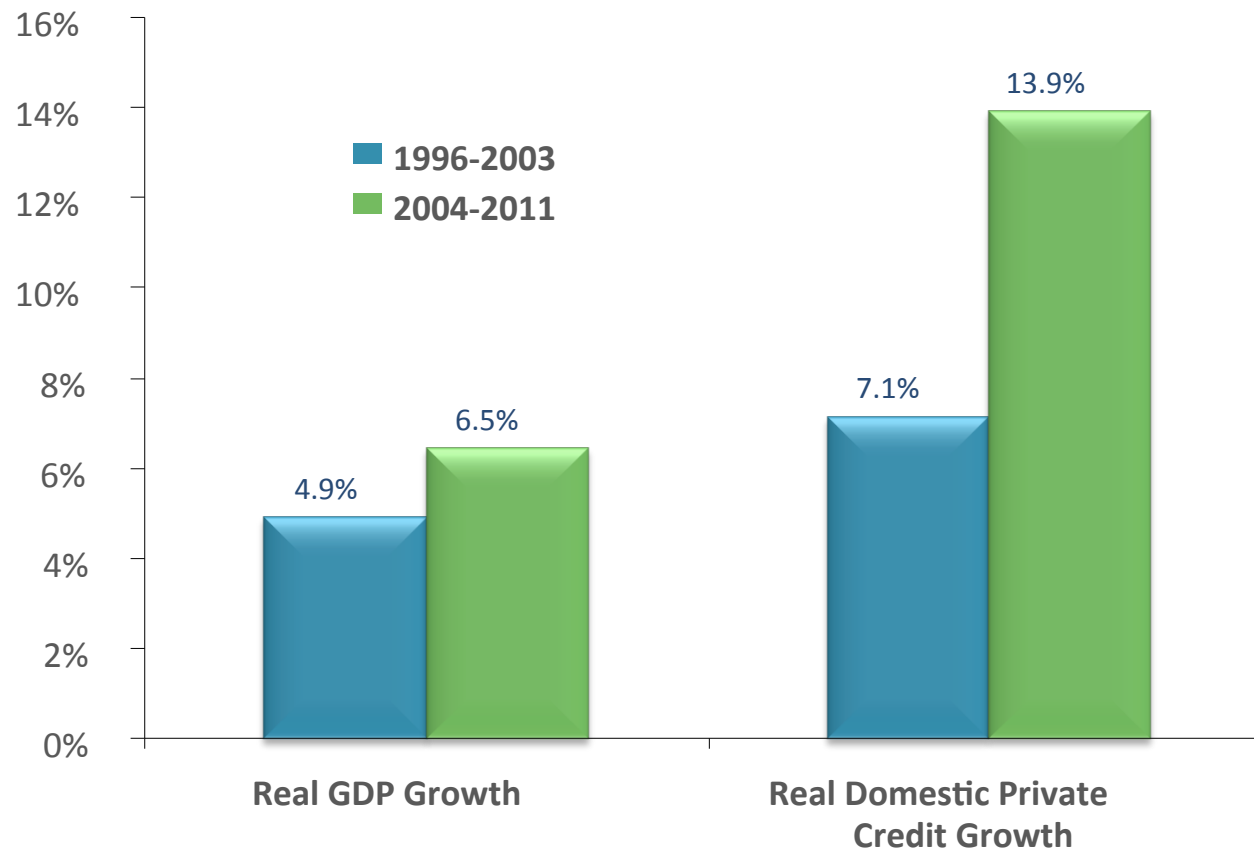


Non-financial private sector* credit outstanding: % of GDP



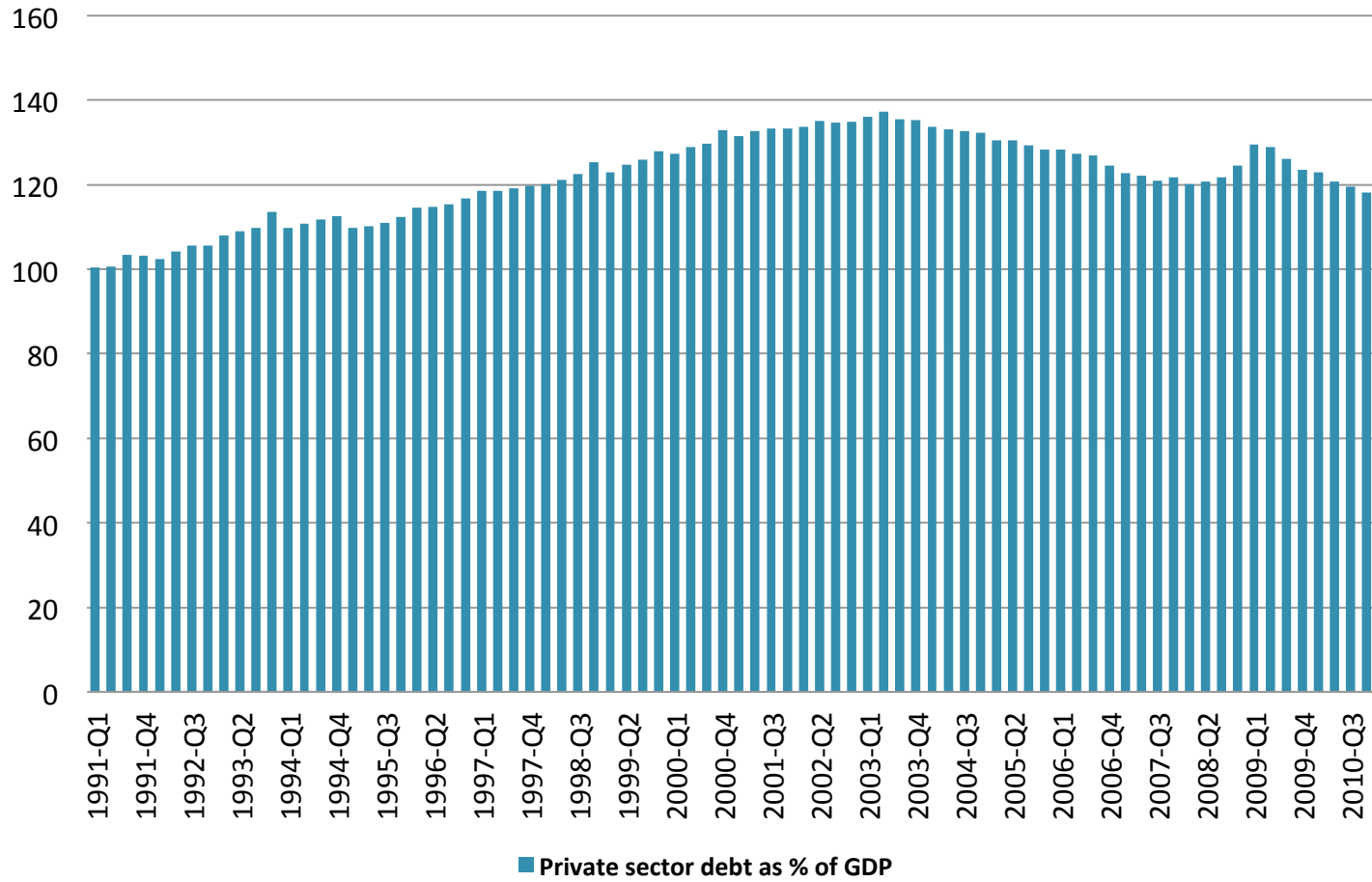
Source: BIS, Citi Research
*Households + corporates

Real annual credit and GDP growth in emerging markets: 1996-2011

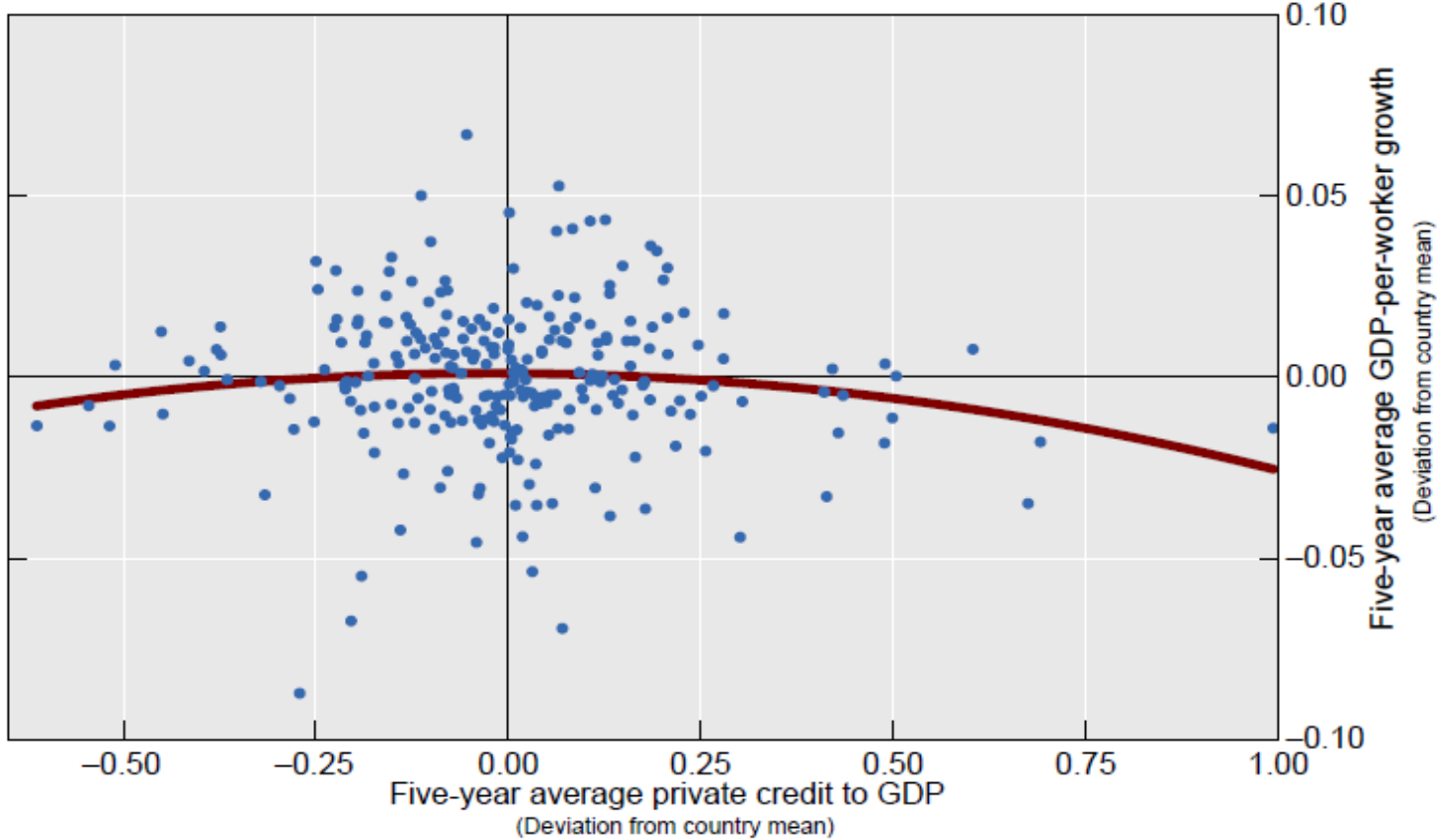


Source: IMF, Haver Analytics, Citi Research

Total German private sector leverage: 1991 - 2010

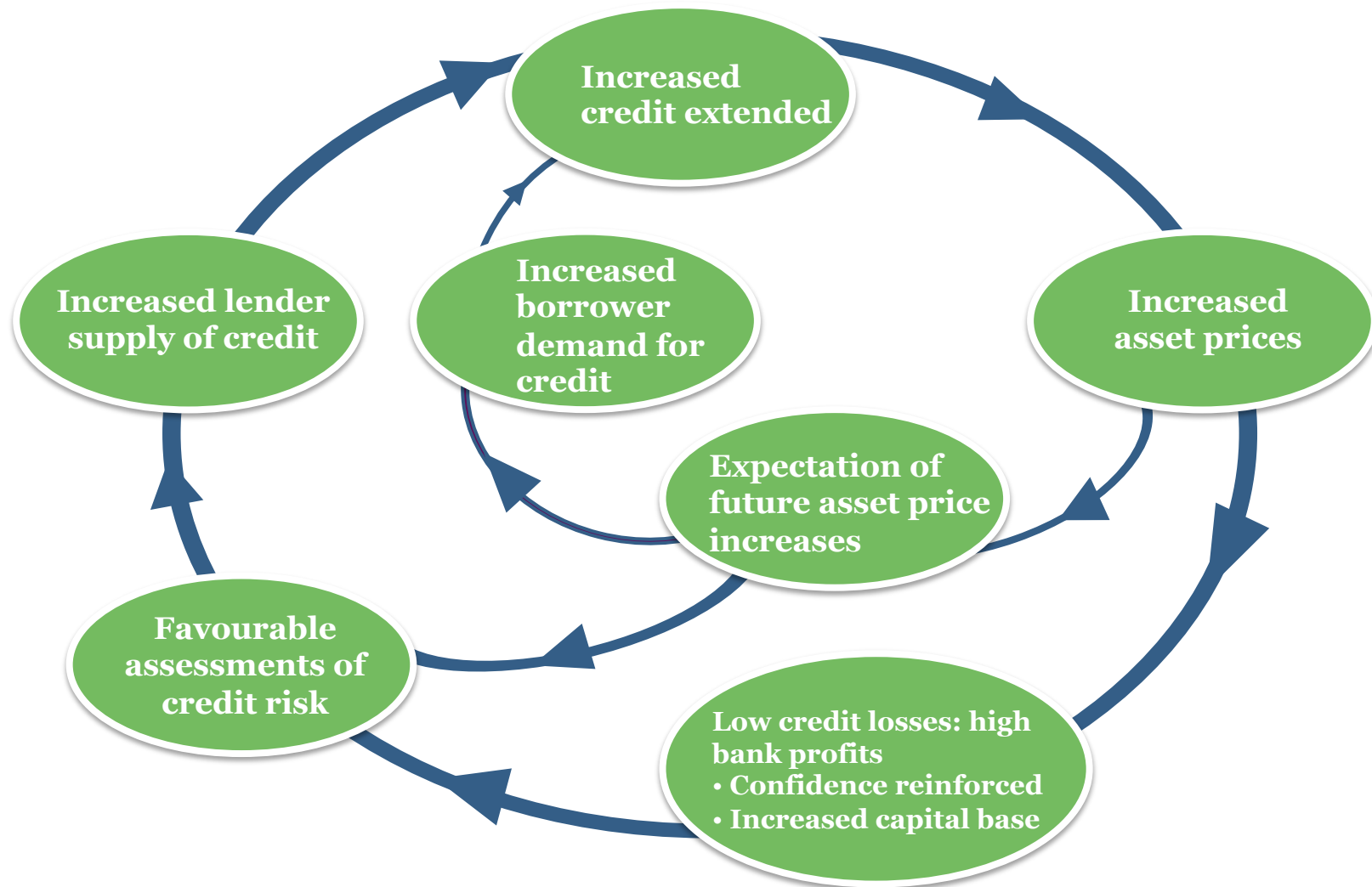


Private credit to GDP and growth



Source: "Reassessing the impact of finance and growth", S. Cecchetti and E. Kharroubi, BIS Working Paper No. 381

Credit and asset price cycles



The Dilemma



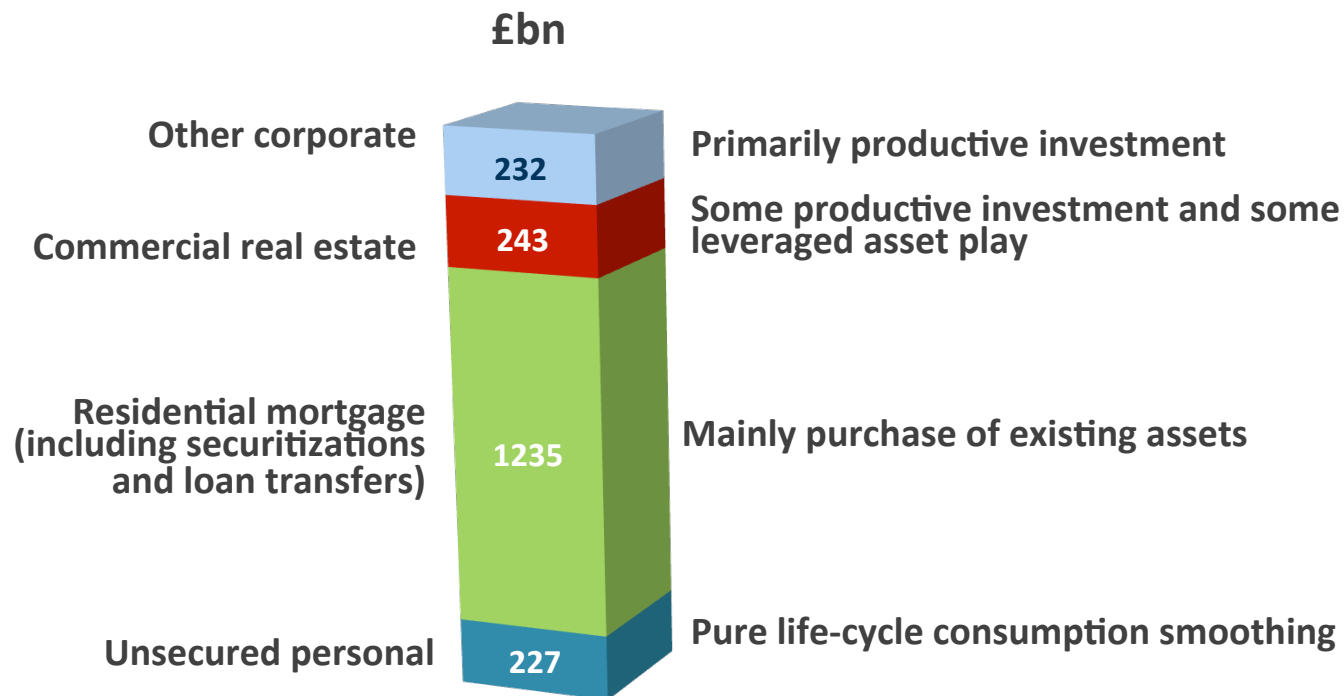
If central banks had raised interest rates to slow credit growth

... this would presumably mean slower nominal GDP growth?

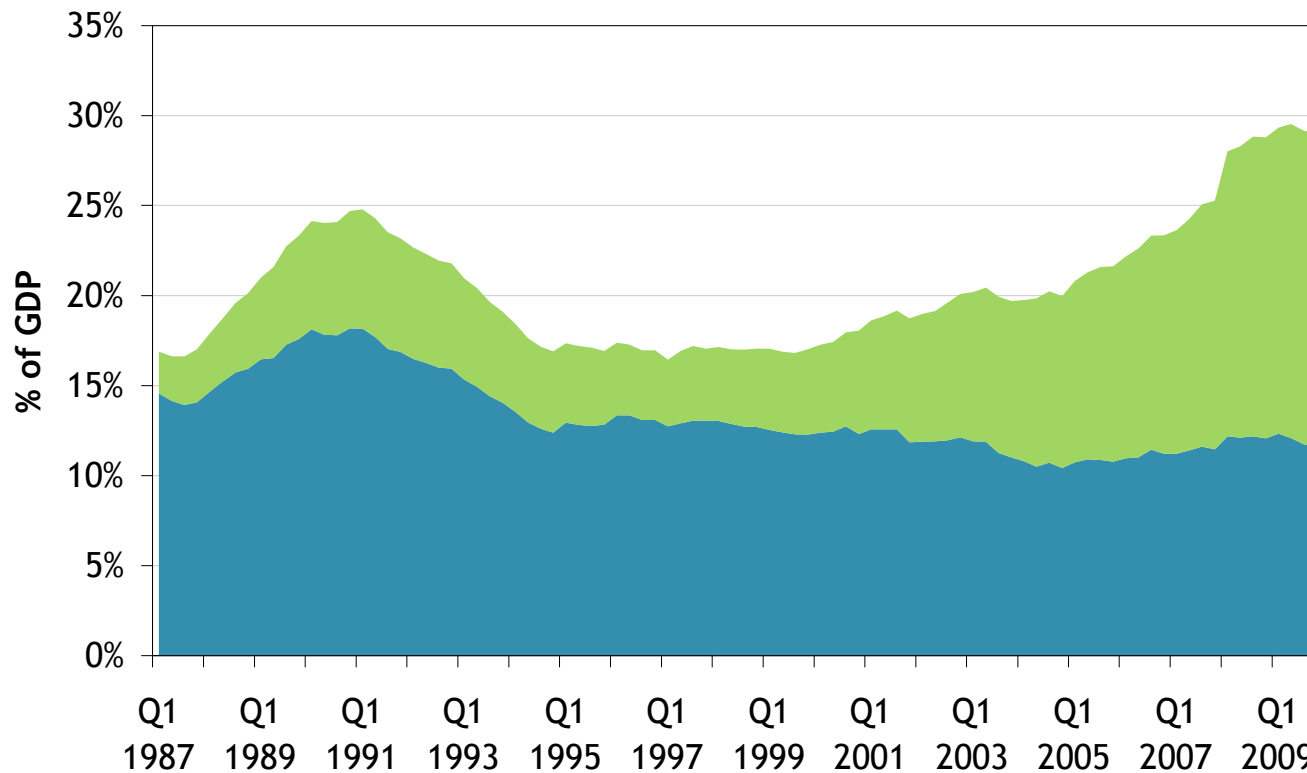
We seem to need $\dot{C} > \text{NGDP}$ to ensure adequate NGDP

... but this produces financial instability and post-crisis recession

Categories of debt: UK, 2009



Corporate loans by broad sector: 1987 – 2008



■ Non-commercial real estate PNFC lending ■ Commercial real estate lending

Note: Part of the increase in real estate lending may be due to re-categorisation of corporate lending following sale and lease-back of properties and PFI (public finance initiative) lending, but we do not think these elements are large enough to change the overall picture. Break in series from Q1 2008 due to inclusion of building society data. Sterling borrowing only.

The dominance of real estate in bank lending



(*Bank and non-bank combined)

	Total bank credit to domestic private sector	Mortgage credit	Mortgage credit as % of total
Australia	129%	74%	57%
Denmark	206%	131%	64%
Netherlands	155%	78%	50%
Spain	175%	101%	57%
Sweden	122%	78%	64%
USA	130%	91%	70%

+ Commercial real estate at typically around 20% - 25% of total lending

Source: Jordá, Schularick and Taylor, "Betting the Home", forthcoming 2014

Three conceptually distinct functions of lending

Finance of increased consumption

- Enabling inter-temporal shift of consumption within life time income

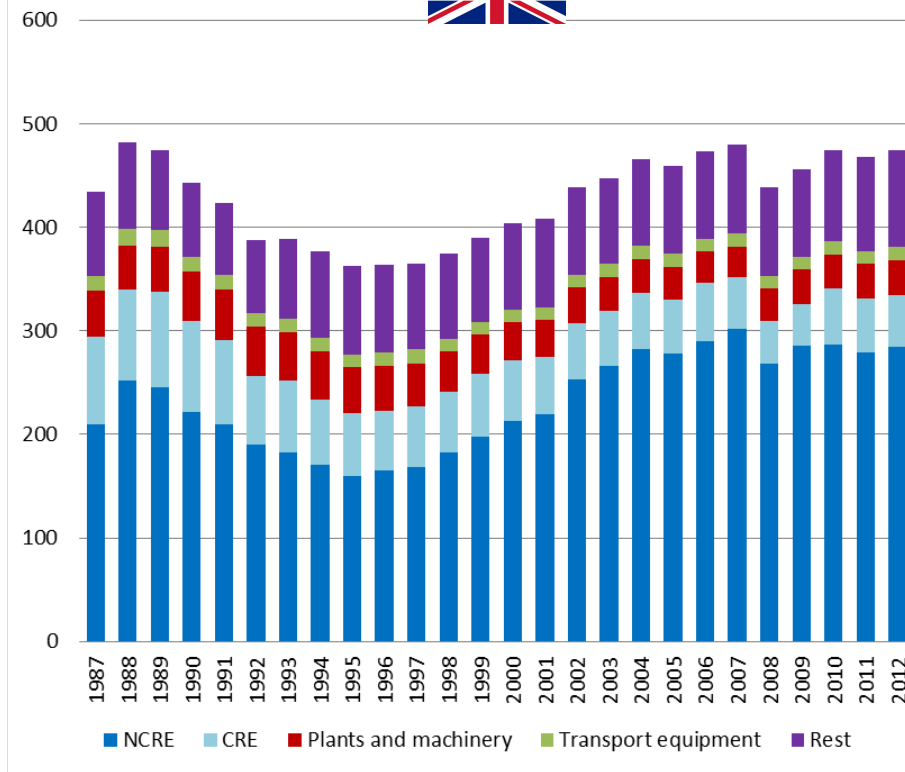
Finance of new capital investment

- Non-real estate
- Commercial real estate
- Residential real estate
- Human capital

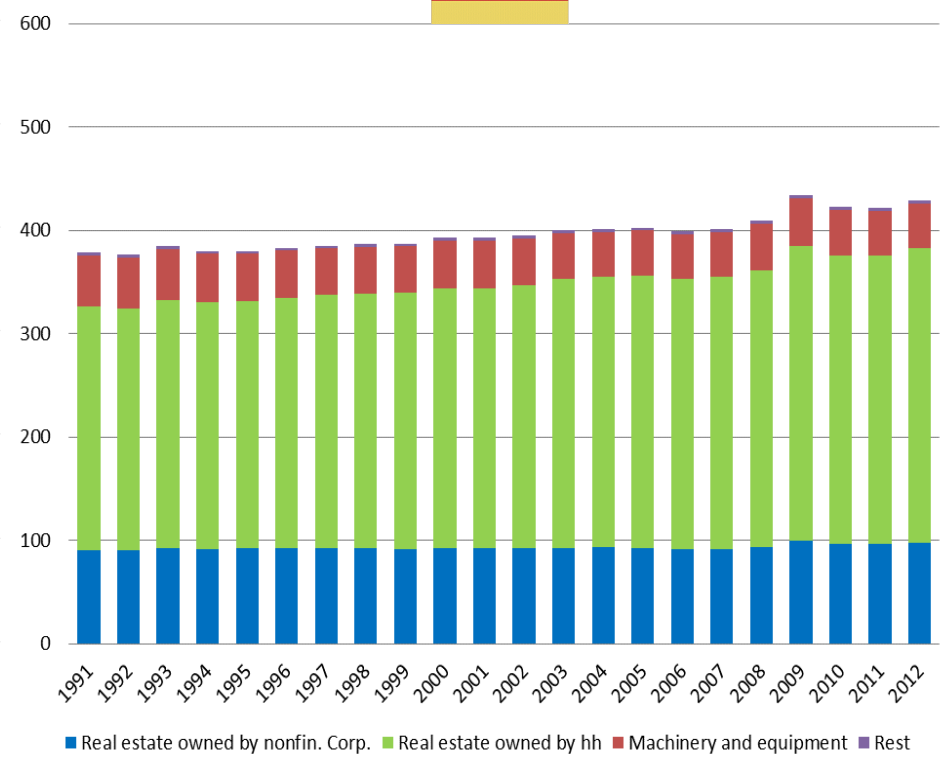
Finance of purchase of existing assets

- Real estate
- Collectibles
- Existing business assets – e.g. Leveraged Buy Outs

National non-financial assets as a % of GDP

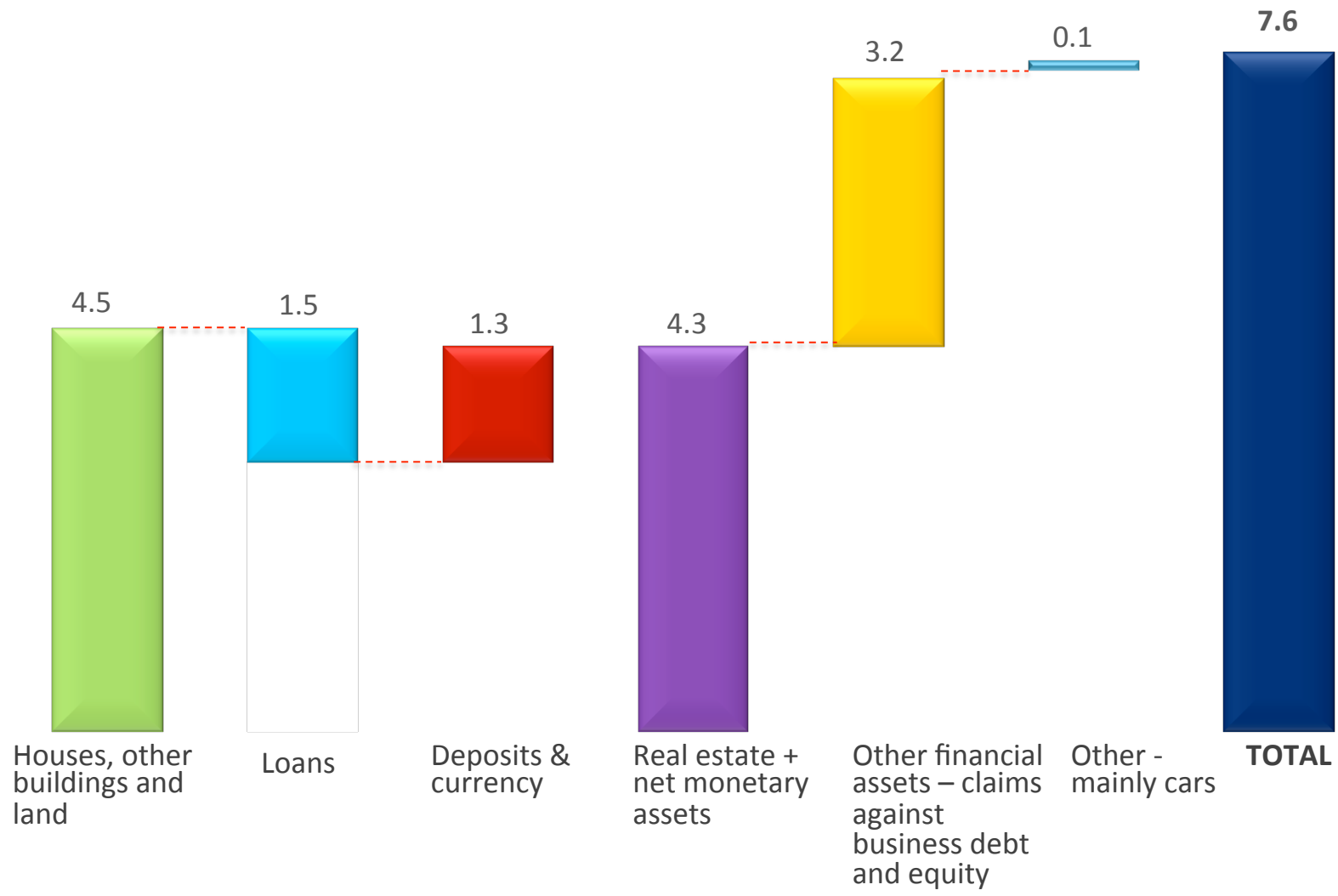


Source: Blue Book 2013

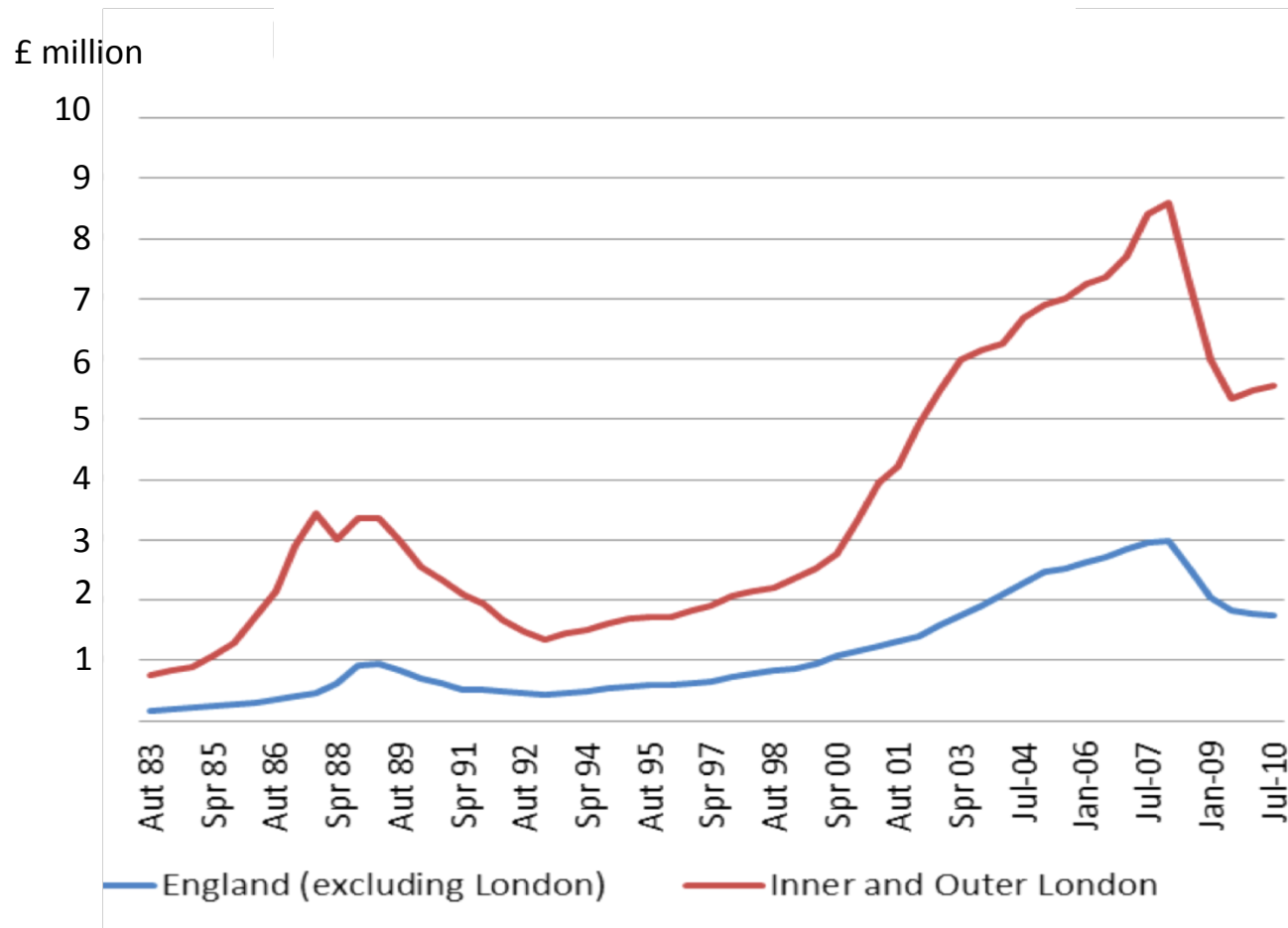


Source: Vermoögensbilanzen 1991-2012 Destatis

UK household net worth £trillion: 2012



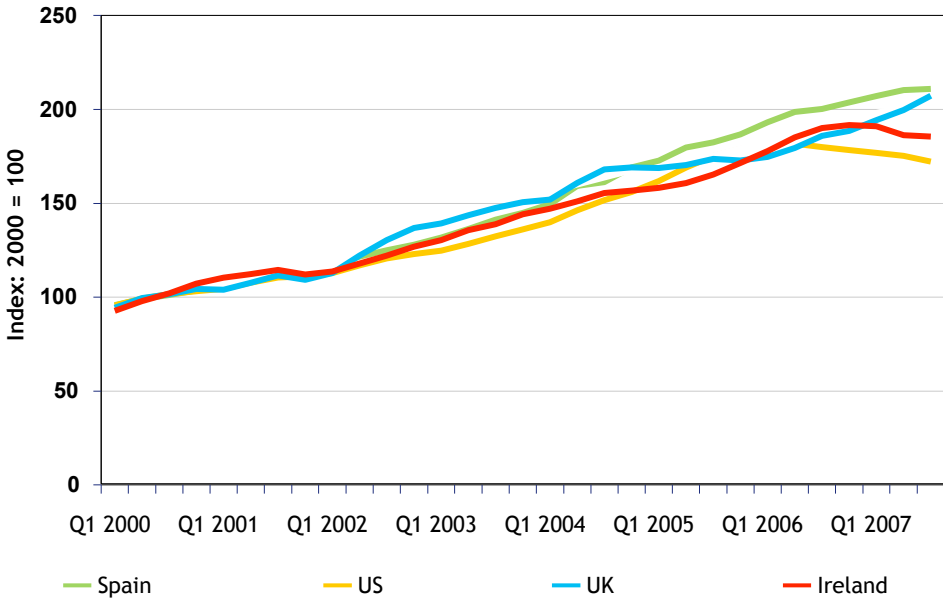
Variation in land value per hectare: UK 1983 – 2010



Source: Blue Book 2013

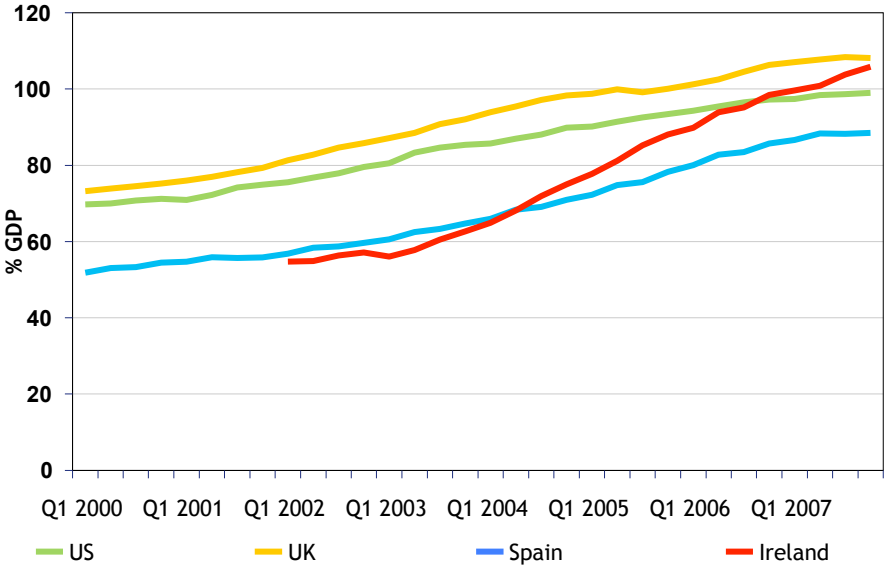
Credit extension and house prices

House prices 2000 – 2007



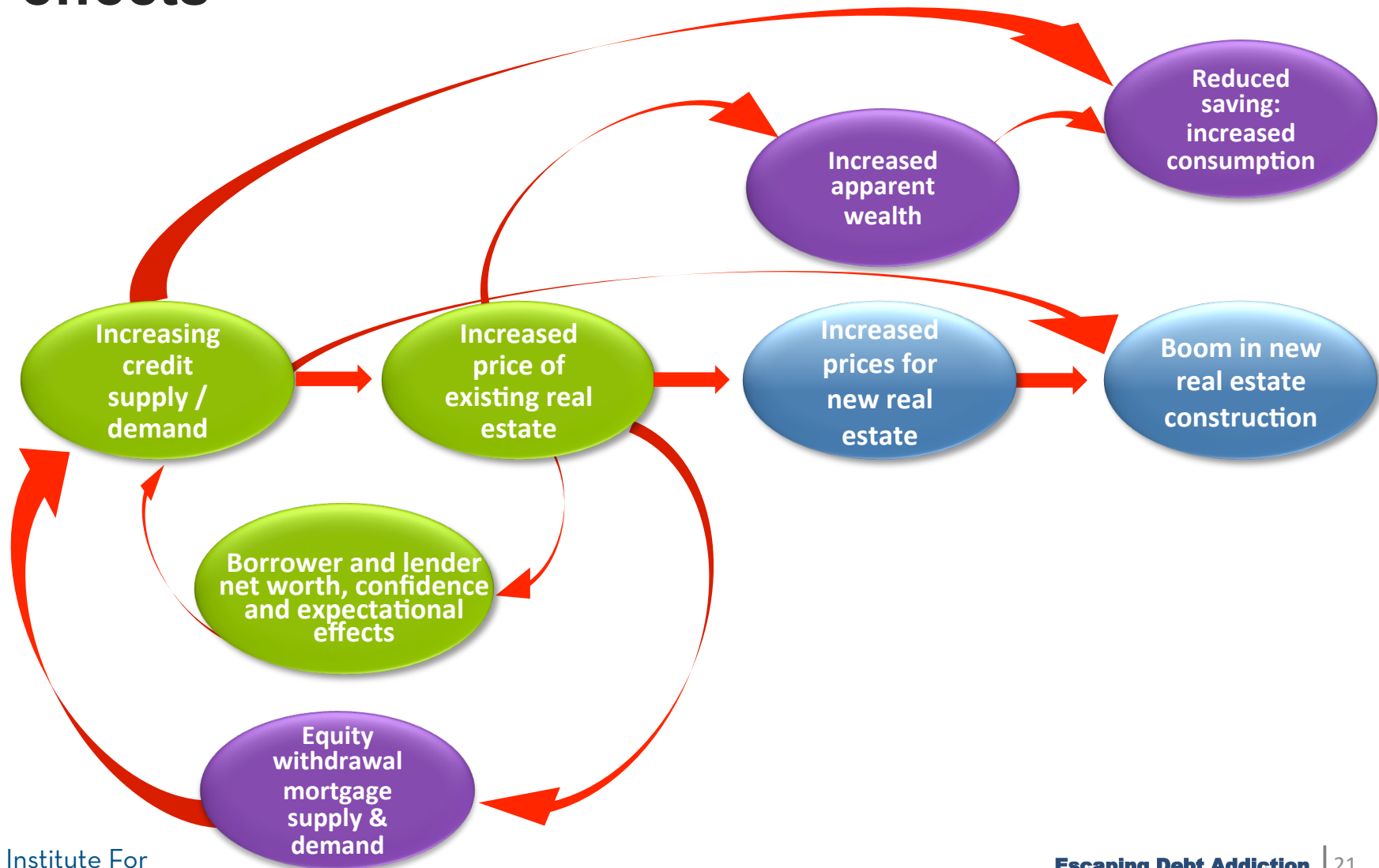
Source: Ministry of Housing (Spain), S&P (US), DCLG

Household debt as a % of GDP 2000 – 2007

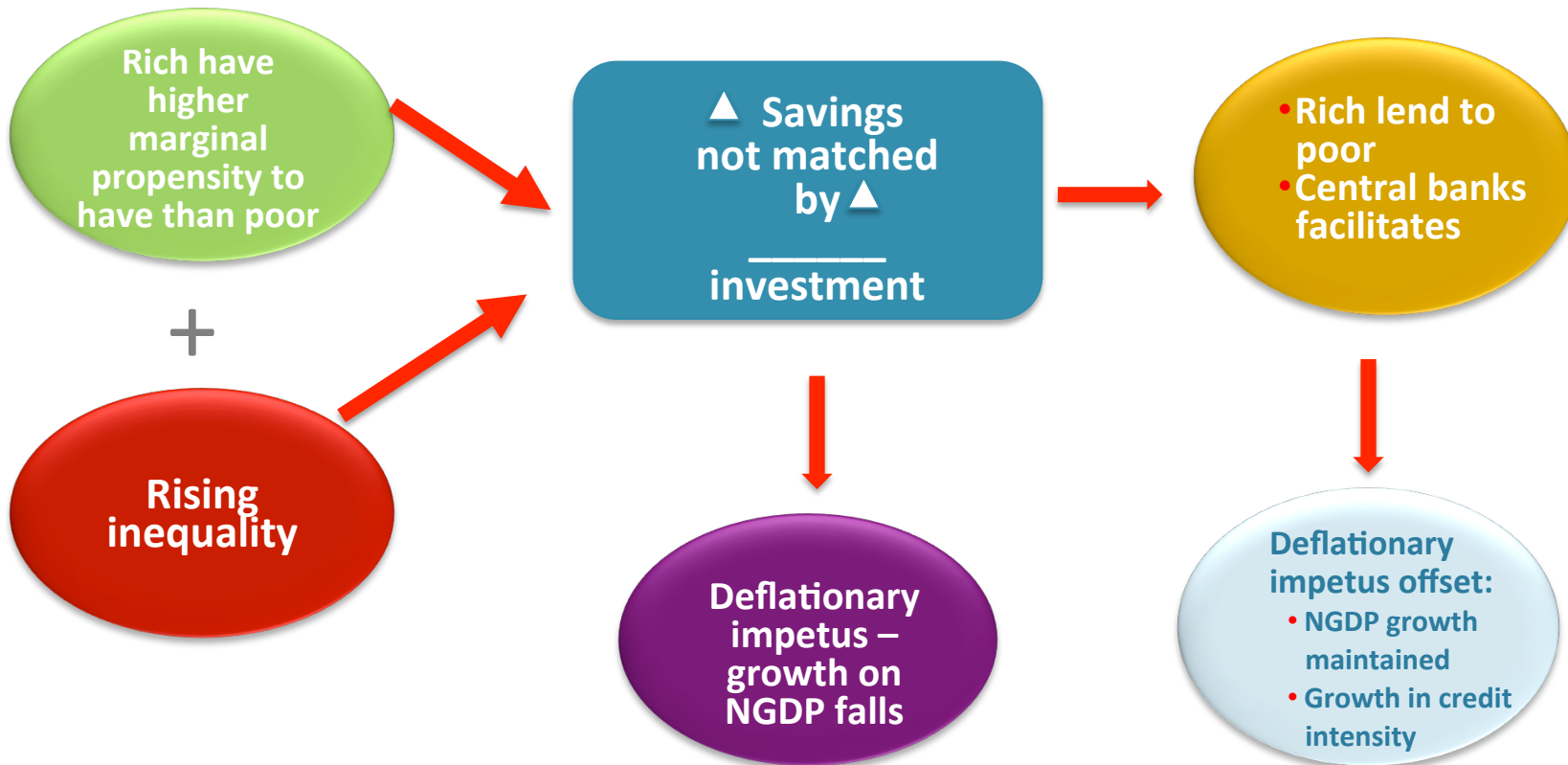


Source: BEA; ONS; ECB

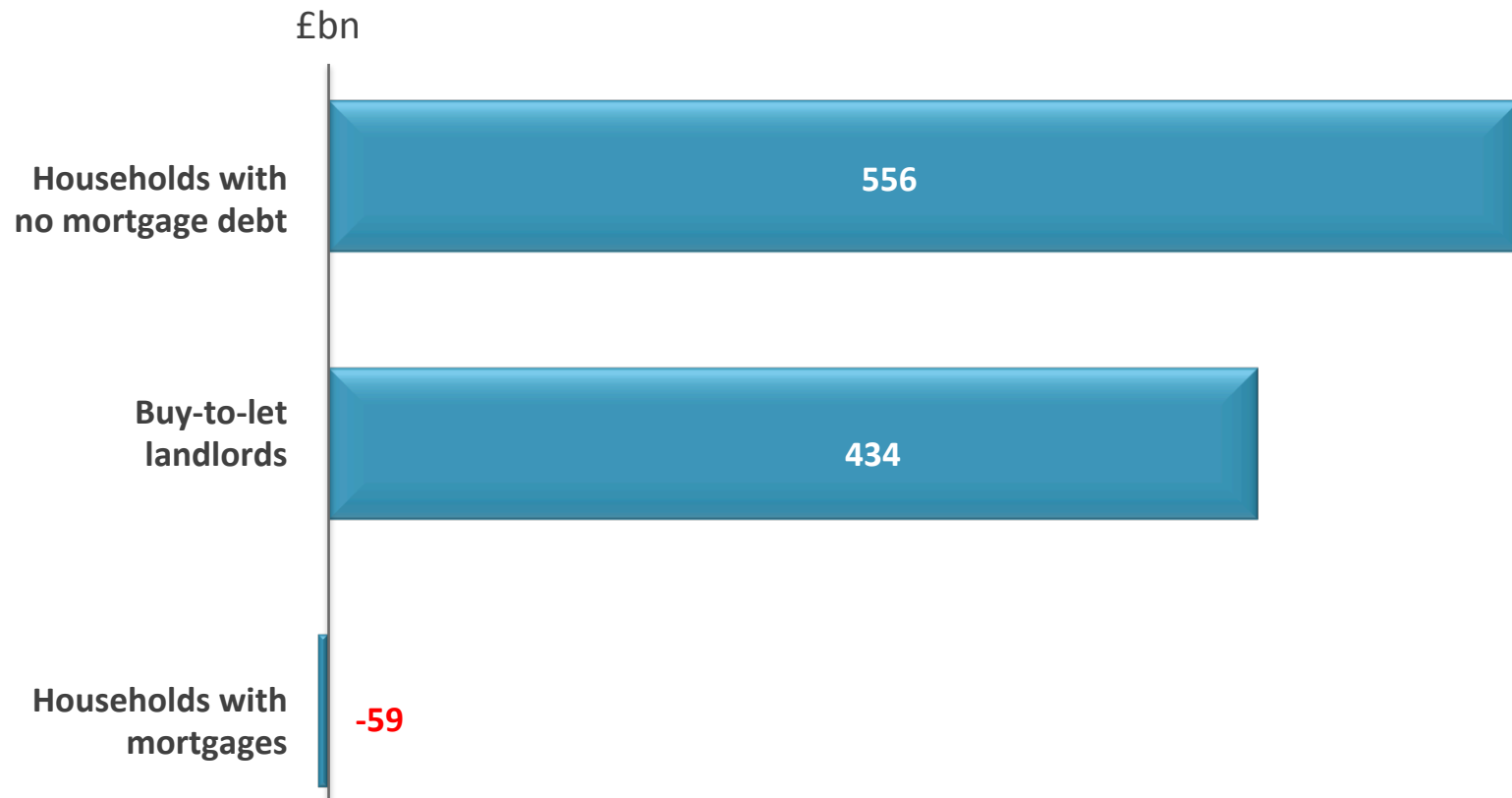
Interactions between credit categories and effects



Inequality, demand and credit

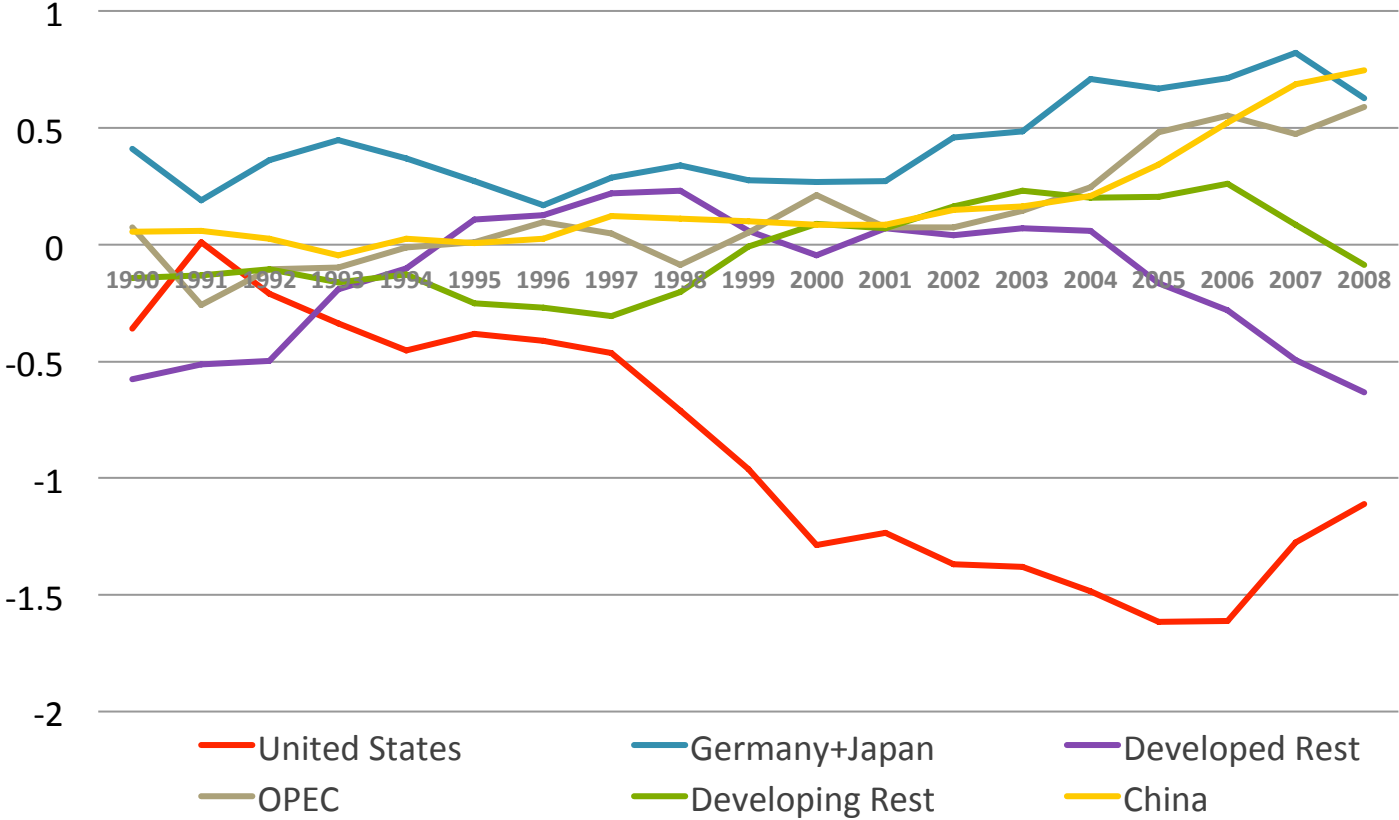


Changes in housing wealth: UK 2003 – 2013



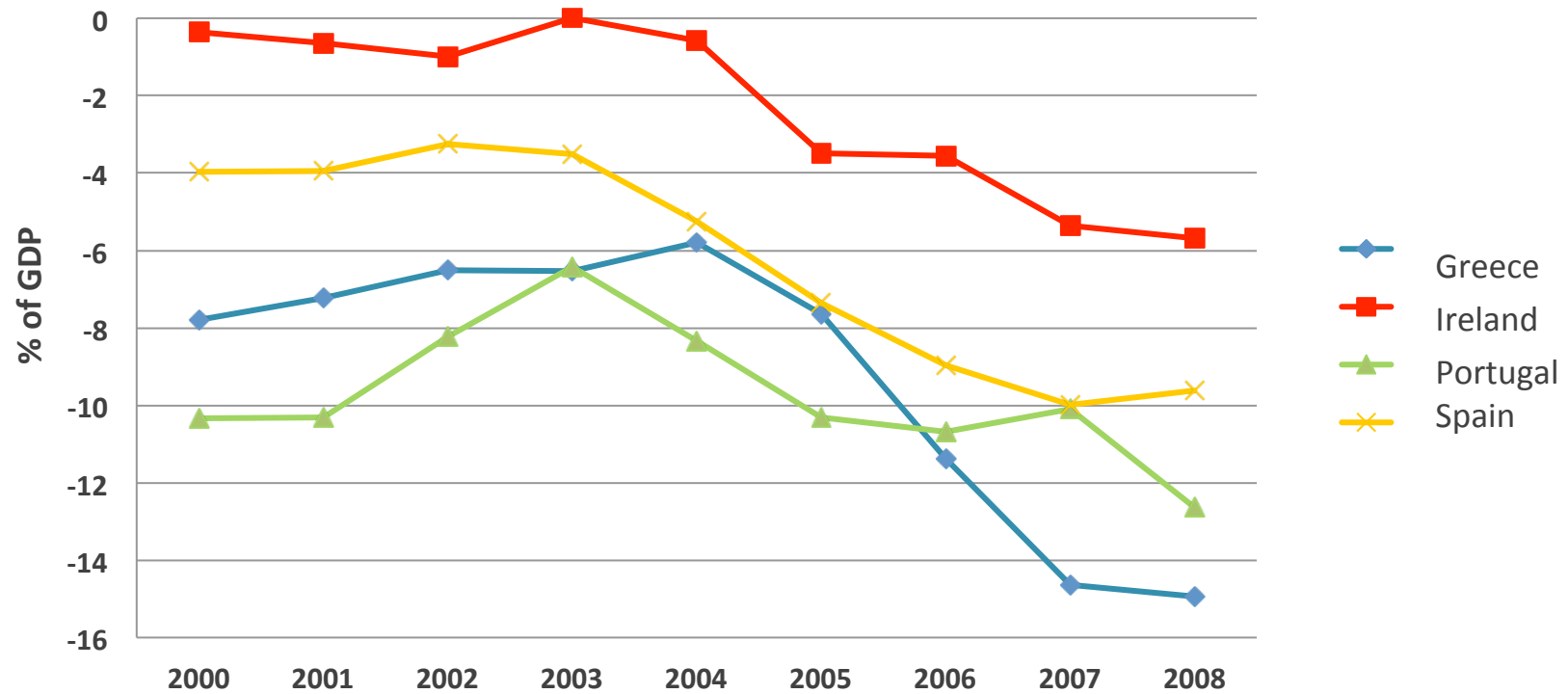
Source: Savills, *Private landlords gain the most from rising property market*, Financial Times, 18 January 2014

Global current account balances as a % of world GDP



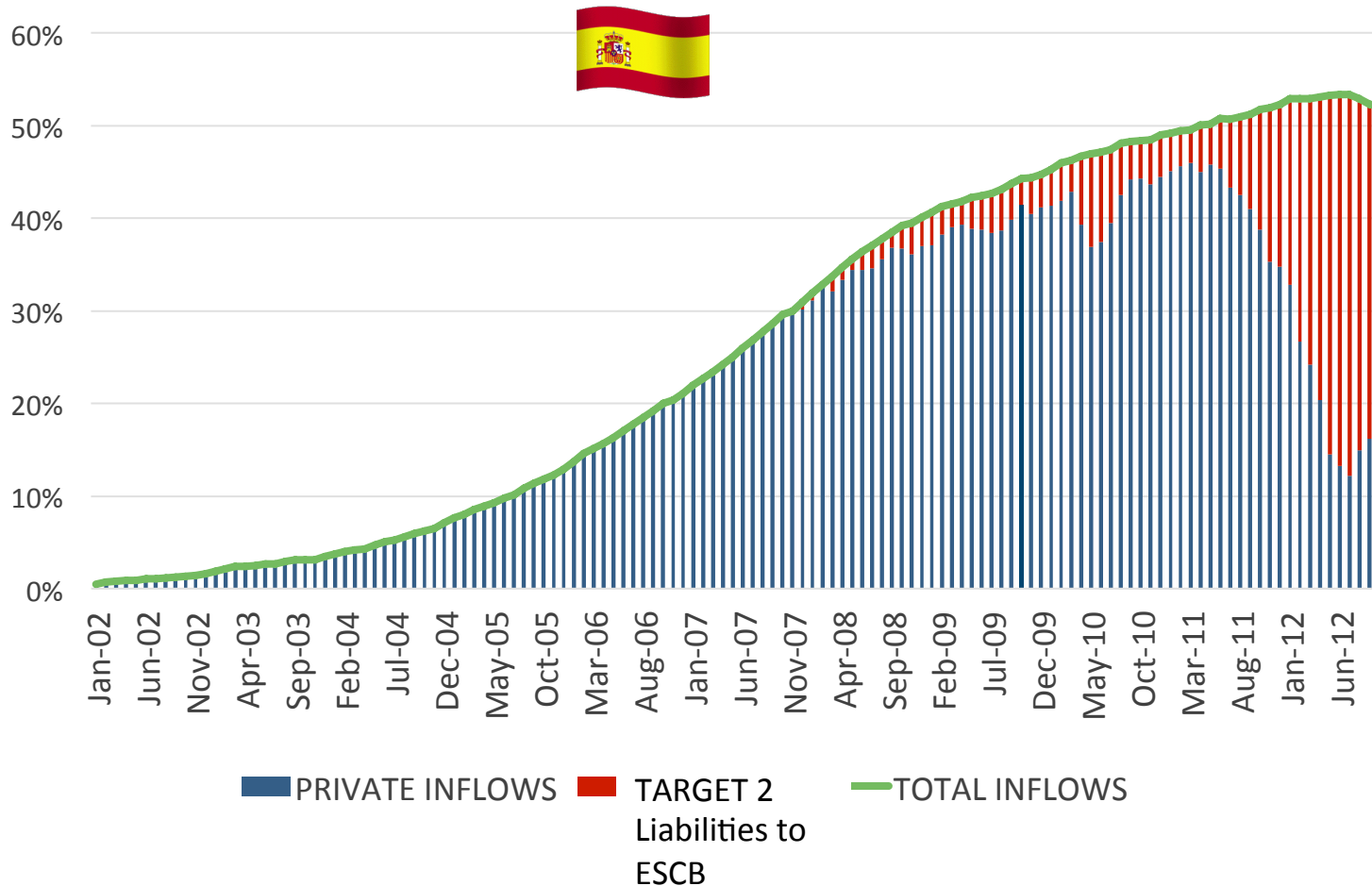
Source: IMF BOPS

Eurozone current account deficits: 2000 – 2008

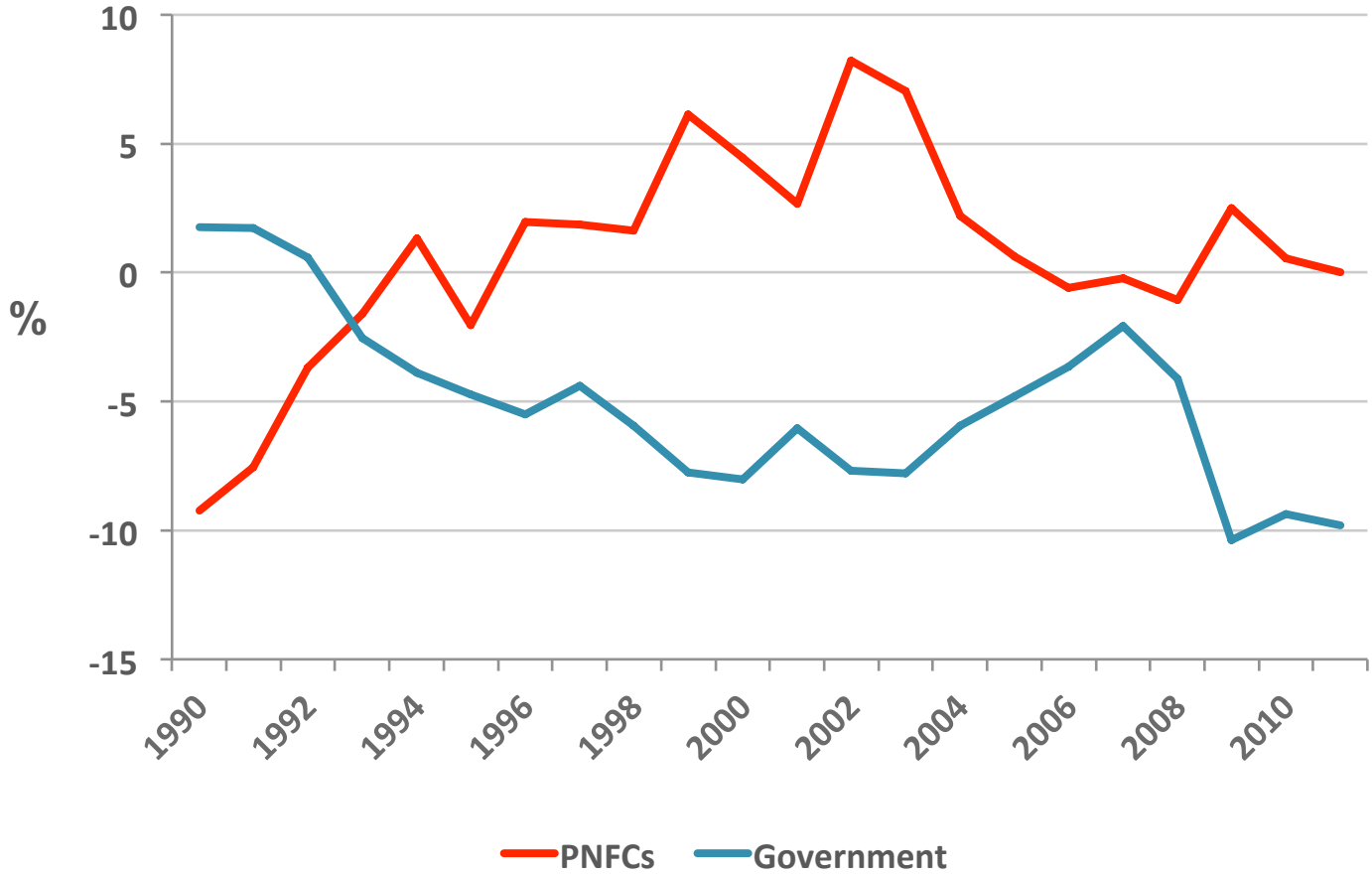


Source: International Monetary Fund, World Economic Outlook Database, October 2012

Decomposition of cumulative capital inflows: Spain (% of 2007 GDP)

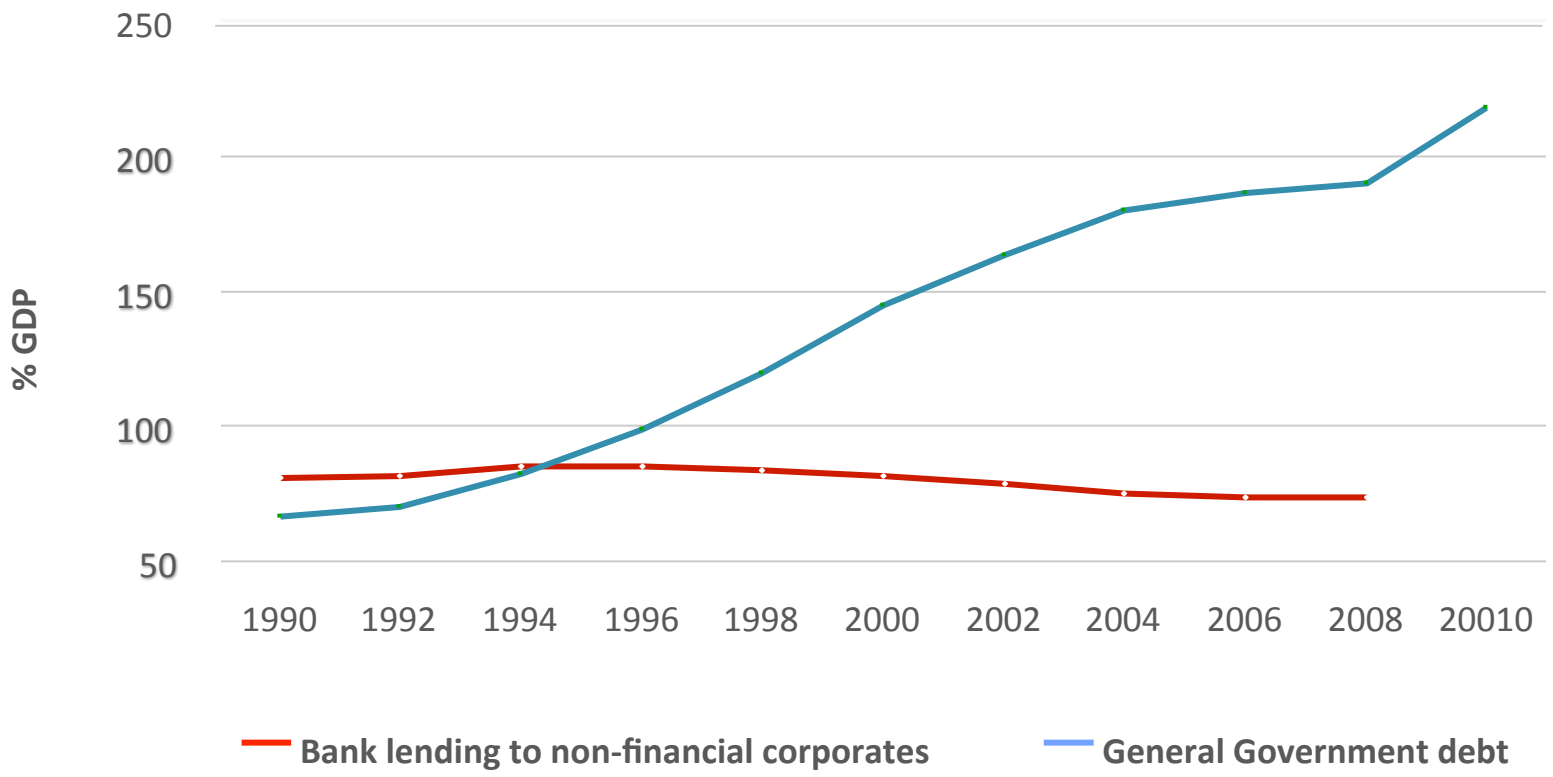


Sectoral financial surpluses/deficits as % of GDP: Japan 1990 – 2012



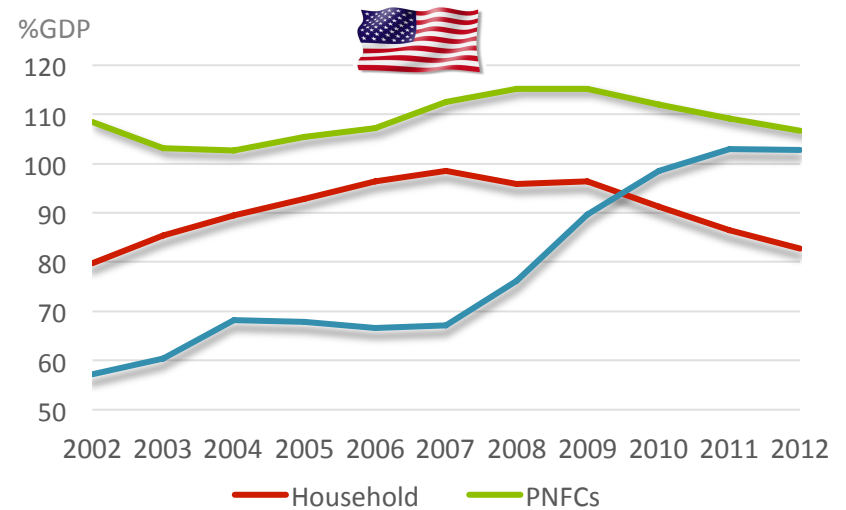
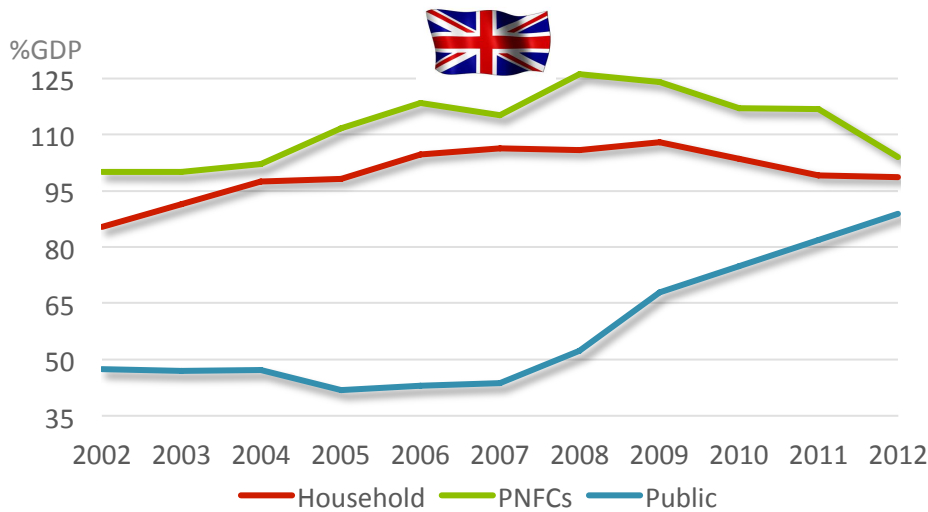
Source: IMF, Bank of Japan Flow of Funds Accounts

Japanese government and corporate debt: 1990 – 2010



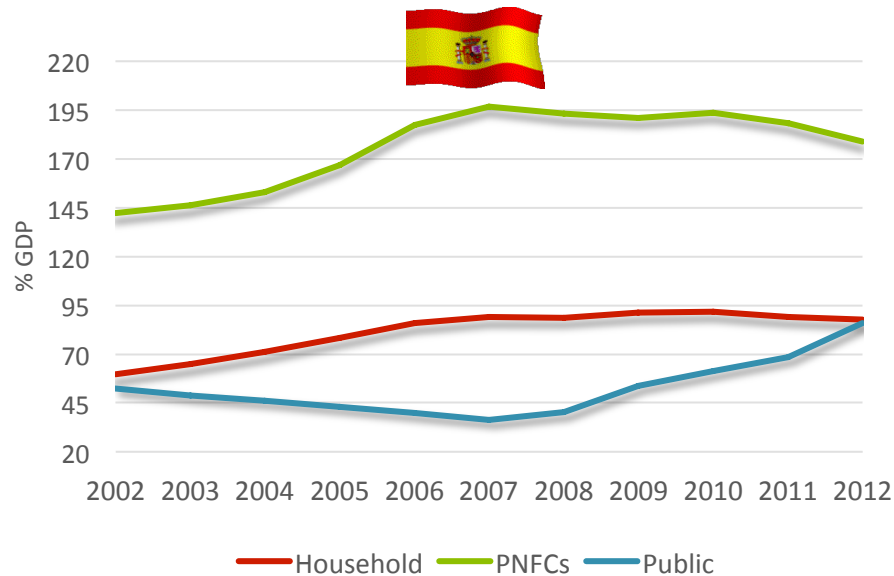
Source: BoJ Flow of Funds Accounts, IMF WEO database (April 2011), FSA calculations

Shifting leverage: private and public debt-to-GDP



Source: OECD National Accounts

Source: OECD National Accounts



Policies required to achieve more stable growth

Reduction in inequality or at least reduced pace of increase in inequality

Reduction in global current imbalances between surplus and deficit nations

- ❖ Remove biases to credit creation in deficit countries
- ❖ Remove biases to excessive savings in surplus countries

Integrated set of monetary, macro-prudential and fiscal policies to lean against 'too much of the wrong sort of debt'.

Monetary, macro-prudential and fiscal policies to combat excessive debt creation

Level as well as rate of growth of leverage a key indicator



But no precise threshold for 'too high' leverage can be defined

Preemptive interest rate rises to lean against credit/asset price cycles



But insufficient due to heterogeneous interest rate elasticity of credit demand

Tax on credit intermediation – or at least removal of tax biases in favour of debt



- Recognises the adverse externality of debt creation
- Major political difficulties given winners and losers
- Dangers of arbitrage via shadow banking

Encourage equity and hybrid contracts



Unlikely to occur spontaneously without government support

Much higher bank capital ratios



Would require parallel action to prevent shadow bank based arbitrage

Manage the mix of credit by category

Managing the mix of credit by category: possible policies

Increase capital risk weights for real estate finance above those indicated by private assessment of risk



Addresses the externality of lending against real estate

Loan-to-value or loan-to-income limits on real estate lending



Borrower constraint since lender constraints imperfect

Underwriting mortgage standards to prevent reliance on price rise assumptions



Introduced by UK FCA

Constraints on high interest consumer lending



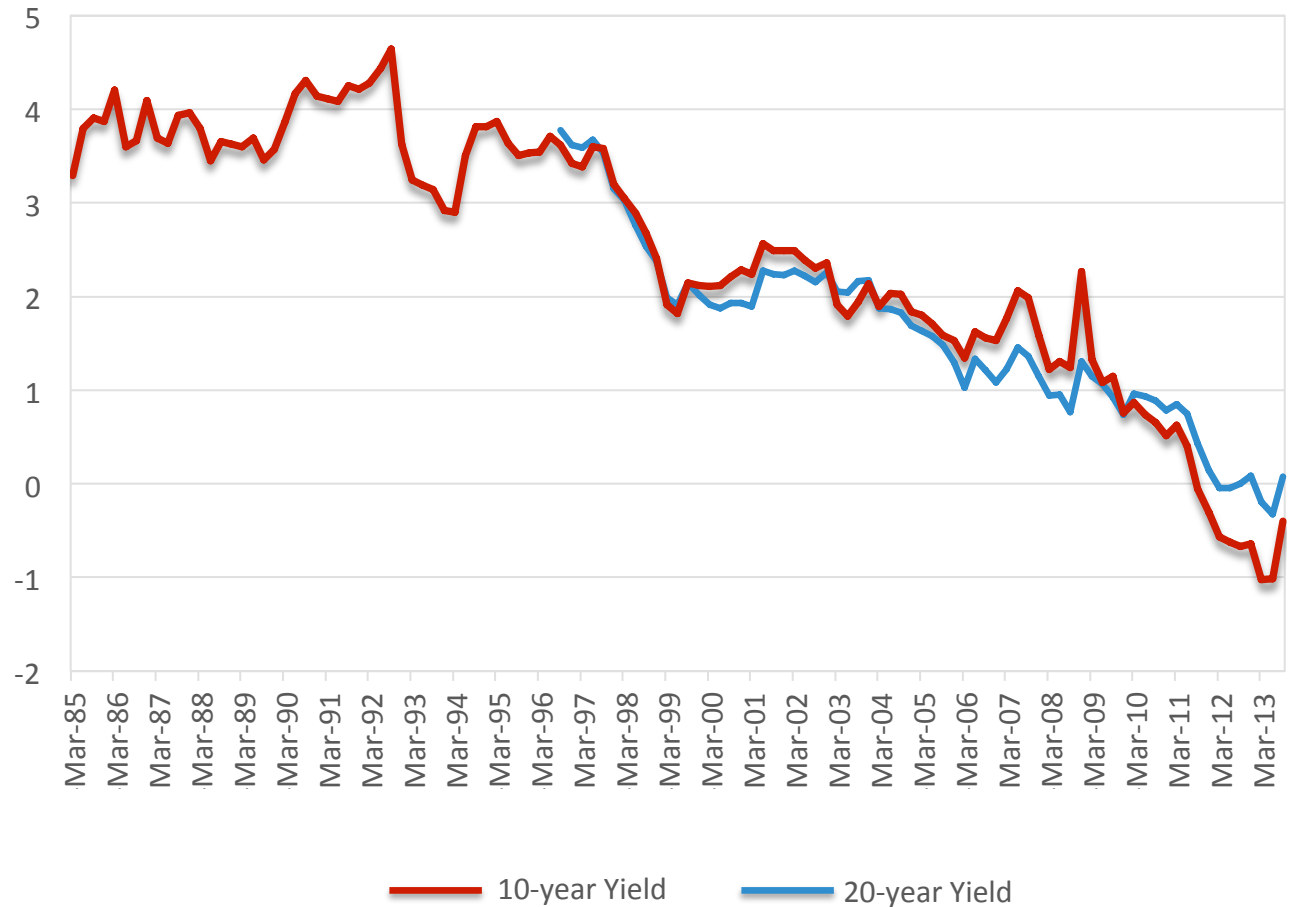
- Danger of illegal alternatives
- Constraints on marketing preferable to prohibition

Banks with dedicated focus on non-real estate business finance



To avoid crowding out of investment or trade finance

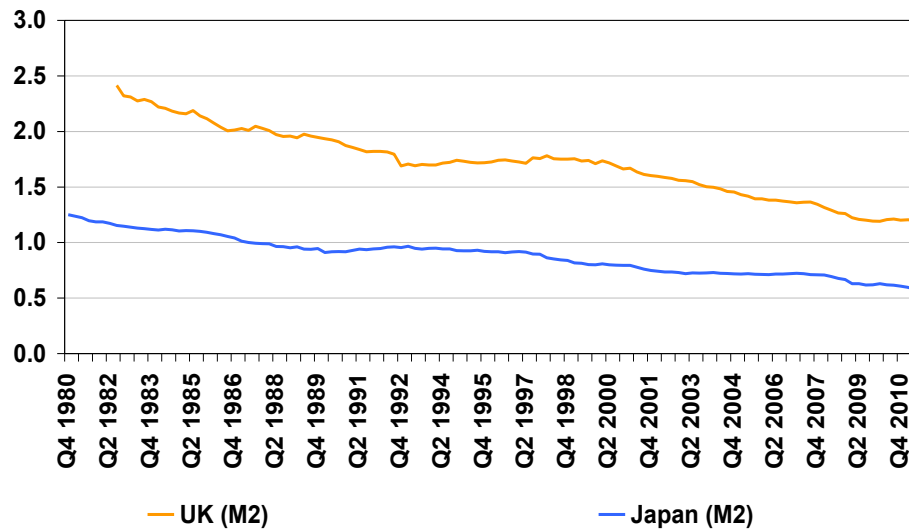
Real yields to maturity on UK indexed linked gilts



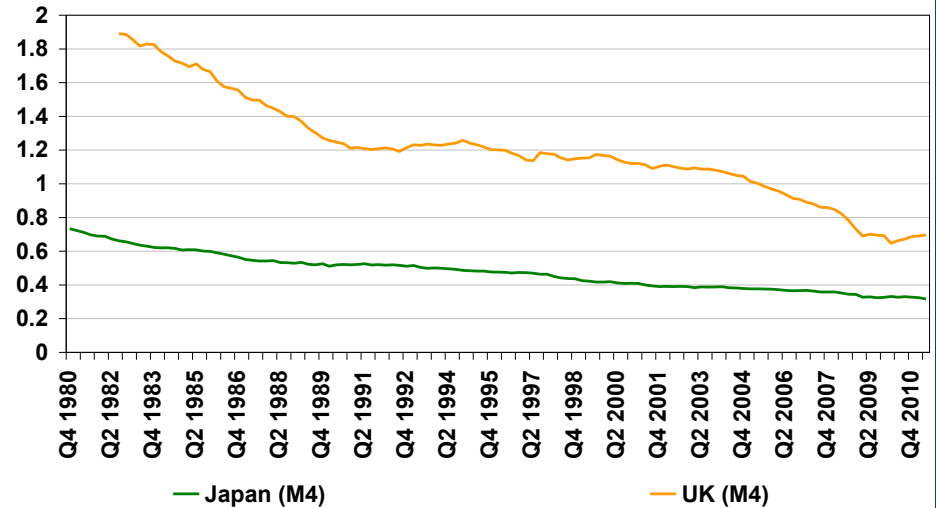
Source: Bank of England Statistics, Zero coupon real yields

Velocity of money circulation

Velocity of Money
(Nominal GDP/M2)



Velocity of Money
(Nominal GDP/M4)



Source: BoE, BoJ, Datastream