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TRANSFORMATION

LORD ADAIR TURNER ON FINANCE AND INCLUSIVE ECONOMIC TRANSFORMATION

Event Report

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INTRODUCTION BY DIRK WILLEM TE VELDE

Dr. Dirk Willem te Velde (Head of the International Economic Development Group, ODI and Director of the Supporting Economic Transformation programme) introduced the keynote speakers:

- **Lord Adair Turner** - Senior Fellow of the Institute for New Economic Thinking, Former Chairman of the Financial Services Authority, and Former member of the Economic Affairs Committee (L).
- **Stephany Griffith-Jones** - Professor IPD, Columbia; Senior Research Associate, ODI and Lead Researcher, DFID-ESRC Growth Research Programme (DEGRP)

This event was hosted by the Supporting Economic Transformation (SET) and the DFID-ESRC Growth Research Programme (DEGRP) programmes at ODI which are working on issues such as how the financial sector can be managed so that it contributes to inclusive economic transformation.

PRESENTATION BY LORD ADAIR TURNER

Speaking on his recent book, *Between Debt and the Devil: Money, Credit, and Fixing Global Finance*, Lord Turner introduced two fundamental questions surrounding the global financial crisis of 2007/08:

- Why did the crisis happen?
- Why has post-crisis recovery been so slow?

WHY DID THE CRISIS HAPPEN?

The most fundamental cause of the 2008 financial crisis is the growth of credit, specifically private credit and its accelerating growth rates. As it was occurring and accelerating, this growth of credit rang very few alarm bells. The Queen of England famously asked economists during a briefing at the London School of Economics, "Why did nobody notice it"? A large contributor was the development of common economic thought away from knowledge we already had.

Despite credit being the primary cause of the financial crisis, there is very little writing in economics on the effects of having too much credit. In fact, almost all of the academic writing out there is focused on the detriments of having too little credit in an economy. Financial deepening and increases in credit have long been considered good for long run growth. In a similar vein, leverage has long been considered neutral – neither benign nor non-benign. So neutral, in fact, that central bank models of the economy generally did not even include the presence of a banking system. Increasing leverage and credit was broadly considered to be positive, or at the very least, having no net effect on the economy.

This way of thinking would have been fine if the economy operated the way textbooks say it does. Common economic thought says that banks take money in the form of deposits, lend it to businesses, and thus allocate available capital to various places". In recent economic history, we seem to have forgotten that fractional reserve banks do not just take pre-existing money, they create credit, money, and purchasing power. Somehow, when we stopped teaching about the banking system in economics classes, we forgot this key fact about banking that was known by economists as far back as the early 19th century.

Another aspect of the banking system that economists seem to have overlooked is that the vast majority of credit funds increases in consumption, or competition for assets that already exist. The majority of credit is NOT used for investment. Economists have long focused on capital and labour, but the key area of pre-existing capital in the form of land and real estate has been vastly underrepresented in economic theories. This is particularly surprising considering that increases in wealth ratios in developed countries depend heavily on real estate appreciation.

This is exactly the area in which the overwhelming increases in credit started a cycle that brought about the financial crisis. If, as we established above, economies are very real estate intensive, the demand for pre-existing assets in real estate will be very inelastic. An increase in credit will produce cycles where credit increases the prices of these assets, which in turn lead to the creation of more credit. These cycles have historically been the main driver behind most major banking crises. These cycles occur until a loss of consumer confidence due to high leverage causes a major crash.

The canary in the mine ignored by economists pre-2007 was the example of late 20th century Japan. In the 1980s Japan had a cycle exactly as described above, leading to unsustainably high credit and real estate price levels. In 1990 the crash of confidence came as companies felt that they were overleveraged. These companies wanted to pay down their debt even though interest rates were at or near 0. By cutting investment to pay debts, the economy was forced into a recession, leading to fiscal deficits. The result was a private sector that was a net saver, while the public was a net borrower. This leads to a key point in the cycle where **debt is not eliminated, simply shifted**. The debt moved from the private to the public sector, as well as around the world. This is particularly damaging to emerging markets, where debt begins to surge.

This is the exact cycle we saw in the 2008 financial crisis, and it puts the world's economies in an environment where economic policies seem ineffective, and recovery seem dampened and slow.

WHY HAS POST-CRISIS RECOVERY BEEN SO SLOW?

The perhaps more interesting issue than the cause of the global financial crisis is why, after 2008, did nobody foresee how large a shadow would be cast by the banking crisis? The UK levels of per capita GDP have only just risen back above pre-crisis levels of 2007. The Eurozone has experienced even slower recovery and its levels of per capita GDP still have yet to reach its pre-crisis level. These measures have lagged after the crisis despite extraordinary policies put in place to mitigate the effects of 2008. This is in part because of the ineffectiveness of post-crisis policies due to the circumstances surrounding the crisis.

After credit cycles drove global economies into recession, national governments generally let fiscal deficits increase as a way to ease the adverse effects. However, as public debt increases at a much higher rate than private debt decreases, many economies tried to use austerity practices to deleverage the public sector simultaneously with the private sector. On the monetary policy side, there was general looseness among various national policies, with interest rates plummeting. However, the transition of this practice to the real economy is unclear. If people in general feel overleveraged, similar to the businesses in the private sector, they become relatively inelastic to seemingly insignificant changes in interest rates. The argument against quantitative easing results in a similar quandary – investment won't explode simply because of minor changes to already tiny interest rates. And, although one could argue for its effects through exchange rates, this would only work for one country, and not in the context of a global crisis.

One of the primary causes for concern then becomes, what is left to do in the face of a following crisis? Many economists argue that the global economy is out of policy "ammo". With interest rates at zero, quantitative easing already employed and high levels of fiscal debt, there seems to be very few remaining options in the face of future economic downtrends.

Ultimately, the response to the crisis was muddled and controversial. This was in part due to a lack of collaborative knowledge on the negative effects of excessive credit, and the various policies of developed countries seemed to have tempered results in the midst of a major financial crisis.

ANALYSIS AND IMPLICATIONS FOR DEVELOPING MARKETS

In essence, the legacy of the financial crisis was the creation of debt that the global economy could not get rid of. The question remains, what can we do to make sure it doesn't happen again? What should we have been doing?

The answer to these questions begins at asking why our economies are so credit intensive. In the 1970s, strongly performing economies were growing at about 5% GDP per year. However, this was accompanied by private credit growth of up to 15%. This was commonly accepted at the time, because 5% growth combined with steady and manageable inflation were seen as great successes, while the growth of credit was not viewed as an adverse effect. Knowing what we know now, we have to ask the question, is it possible to accomplish sustainable economic growth without such dramatic increases in credit? We answer that by looking at the three main drivers of credit growth.

There are several promoters of credit growth in an economy: international current account differences, rising global inequality, and real estate. Global current accounts are in balance, but underlying differences across countries are a mathematical necessity. Looking at the combined current accounts of the world, if one country is at a surplus, that money must be coming from another country's deficit. Rising inequality is a similar factor that must be mitigated to slow excessive credit growth. The respective propensities of high and low income individuals and countries create the conditions in which the savings of the higher income must be borrowed by the lower income. Reducing this inequality is a sure way to reduce the necessity of credit in a global economy. Finally, we come to real estate. To reiterate, credit is primarily used for pre-

existing assets in the form of real estate because of the low risk and high profitability it ensures. This is a primary reason why there must be intervention to “lean the other way” when deciding on the allocations of credit by banks.

This theory has a multitude of implications for developing markets. First and foremost, it is clear that we cannot leave the financial system to create and allocate credit optimally. There is a fundamental problem of a social externality: profit maximization on the part of banks dictates that credit go to the best investment. As a high return, low risk investment, this means real estate becomes the main destination for credit. The cycle of credit and real estate prices has already been seen to be the primary cause of most banking crises, and it is necessary to skew the balance away from real estate lending. When we look at the history of economic catch-up excluding city states, the examples of greatest success are Taiwan, Korea, and Japan. None of these countries allowed banks to have free rein of credit. When banks extend credit to an SME, there is an inherent risk that is not present in the real estate market, but it is necessary for the transformation of emerging market countries. As a rule, the potential economic emergence of developing countries depends on intervention against the tendency for banks to lend towards real estate.

PRESENTATION BY STEPHANY GRIFFITH-JONES

In the 1970s, left wing government abided by a flawed economic policy. People believed in government investment to achieve great things. This investment had always been funded by printing money, and balancing the budget was achieved simply by printing more currency. For some time, it was successful. Governments didn’t have to worry about economic transformation. This, however, inevitably ended in tears – particularly for the poor. Sky high inflation and falling real wages resulted in a global consensus that high fiscal deficits should be avoided. When we look at examples of fiscal success – notably the New Deal in 1930s America, as well as the post 2008 crisis response – we see evidence that the left has learned its lesson, at least with regards to fiscal deficits.

However, leading up to 2008, government was also following a flawed policy assumption. Mainstream thought lead us to believe that freedom of financial institutions and large deficits were side-products of growth and would have no adverse effects. This also ended in tears. Particularly in emerging economies, this thinking led to crisis after crisis, hugely constraining any developing country’s ability to catch up with the developed world. Much like consensus came about regarding high fiscal deficits, the world needs to find consensus about the dangers of an unbounded financial system.

In order for emerging economies, and indeed developed ones, to avoid future banking crises, they need to first and foremost control the overall growth of credit and debt, in both the public and private sectors of the economy. Fiscal policy can be useful, but the main aspect of change must be in the size and complexity of financial sectors. Limiting growth of private credit is much easier if the financial sector is small and well regulated. Reserve and capital requirements and limiting how much banks can expand is a good start, but it is imperative the sector as a whole remains small. The beauty of a small financial sector is the effectiveness in which it can establish these much-needed regulations.

Another problem faced by developing countries is their ability to channel credit to the productive sectors. This area is one in which structural transformation is of paramount importance. Developing countries need good public development banks that are effective channeling credit into the productive area. The big challenge, however, is to do this well, and to make real changes to the economy by sending credit to exclusively projects, not simply financial engineering.

The encouraging news for low income countries is that their characteristics put them in a good position to achieve this economic transformation. Their financial sectors are too small, but this allows them to have exceptional financial mobility. While they need to expand, it is important not to grow too quickly, because as we saw in Nigeria, it can result in crisis. Along this line, low income countries have actually had very few recent financial crises. However, there should be no room for complacency. These countries need to

avoid currency mismatches and employ an emphasis on macroprudential regulation domestically to prevent and crises during their much-needed growth.

The main takeaway from the recent financial crisis should be that regulation should be simple. To have simple regulation, you need a financial sector that is not too complex. And while low income countries need to achieve economic transformation in the financial sector – in the form of good development banks – their potential to achieve this is much aided by their ability to keep it simple.

DISCUSSION

Question/Comment:

Attention to income inequality is very important – it creates a problem in demand for credit. There should be more analysis on how corporations react to booms/busts and how it impacts the labour market. The corporate sector has a huge surplus they are not investing because of structural changes in the labour market.

Response:

Are we facing long term secular trends that are making it more difficult to balance demand? We might be. One reason corporations are cash rich is because some don't have huge investment needs. Costs in relative prices are generally falling – especially in software, etc. If you look at the aggregate price of all plant/equip. capital goods, it has come down about 30% in 30 years. We may be entering an environment where there isn't much investment needs. However, infrastructure/energy costs are not falling. These tend to be areas where public policy is needed rather than purely private needs. This of course could be inducing asset price bubbles.

Question/Comment:

How can we return to a world of "socially useful" banks? What reforms can we put in place?

Response:

Some financial activities are socially useless. Our attitude should be that complex financial engineering is unnecessary. Balance sheets of major banks used to be primarily made up of trading with other banks, but this has significantly reduced because of regulation. Our biggest problems derive from individual activities. Residential real estate is necessary, but too much becomes harmful. As our mortgage market became larger, there was an inverse impact on ease of entering the labour market. Credit is so easily available that it provides resources to people who already have housing equity. Unless you're careful, credit can accelerate inequality. This illustrates that a reasonable size mortgage market is good, but bad when it is too large.

Question/Comment:

Can Sub-Saharan African and other Developing countries change in a similar manner to the way East Asian countries did with direct credit?

Response:

If you describe what Taiwan, Korea, and Japan did in technical terms, what Indonesia and the Philippines did was the exact same. But you have to start by understanding that states fail and markets fail, and they fail because humans are fallible. How do you make sure if you go down the directed credit route it will be successful? We can't know, but we should know that leaving it to the private sector is equally fallible. We need to recognize the private sector bias and lean against it.

Question/Comment:

Credit is in investment but not in the sectors we would like to see that would contribute to transformation.

Question/Comment:

We haven't heard about the loss of investment opportunities in weaker states. We have to shift resources into poverty oriented growth. Small businesses get high rate loans. Progressive social democracy says that we deal with this with effective redistributive policies and it has to be dealt with globally because of the interconnection of current account balances.

Question/Comment:

We've been talking a lot about past financial systems – what changes will we see in the future?

Response:

We have to acknowledge that financial technology (fintech) is not transformational. SME lending is an area where fintech won't work, and I think there will be a large increase in peer to peer lending in the future. A credit process requires a credit underlying process.

Question/Comment:

Following your comments on fallibility comments, what can increase resilience to bad decisions?

Response:

There is a lot to be said about a set of simple rules. In addition to these rules, we might want to license banks that only have the one function of lending for capital investment.

Question/Comment:

Is stability itself destabilizing? If you effectively regulate the financial market are you creating the conditions for a future crisis?

Response:

This is a very philosophical question. The safer the world is the more people will seek out risk. The system will inevitably have risk. We can realize this risk exists and we can reduce frequency/severity of crises.

Question/Comment:

Are bad decisions made by banks paid for by depositors?

Response:

It is inherent to a debt contract that in an upswing debt contracts are generally safe. Depositors will never impose discipline on bank management. We need enough equity in banks that the likelihood of putting in public money becomes very low. If this happens, there comes a point where it becomes almost unimaginable that the government would need to put money in without guaranteed return.

PICTURES

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