Institute for
New Economic Thinking

Debt Traps, Public and Private

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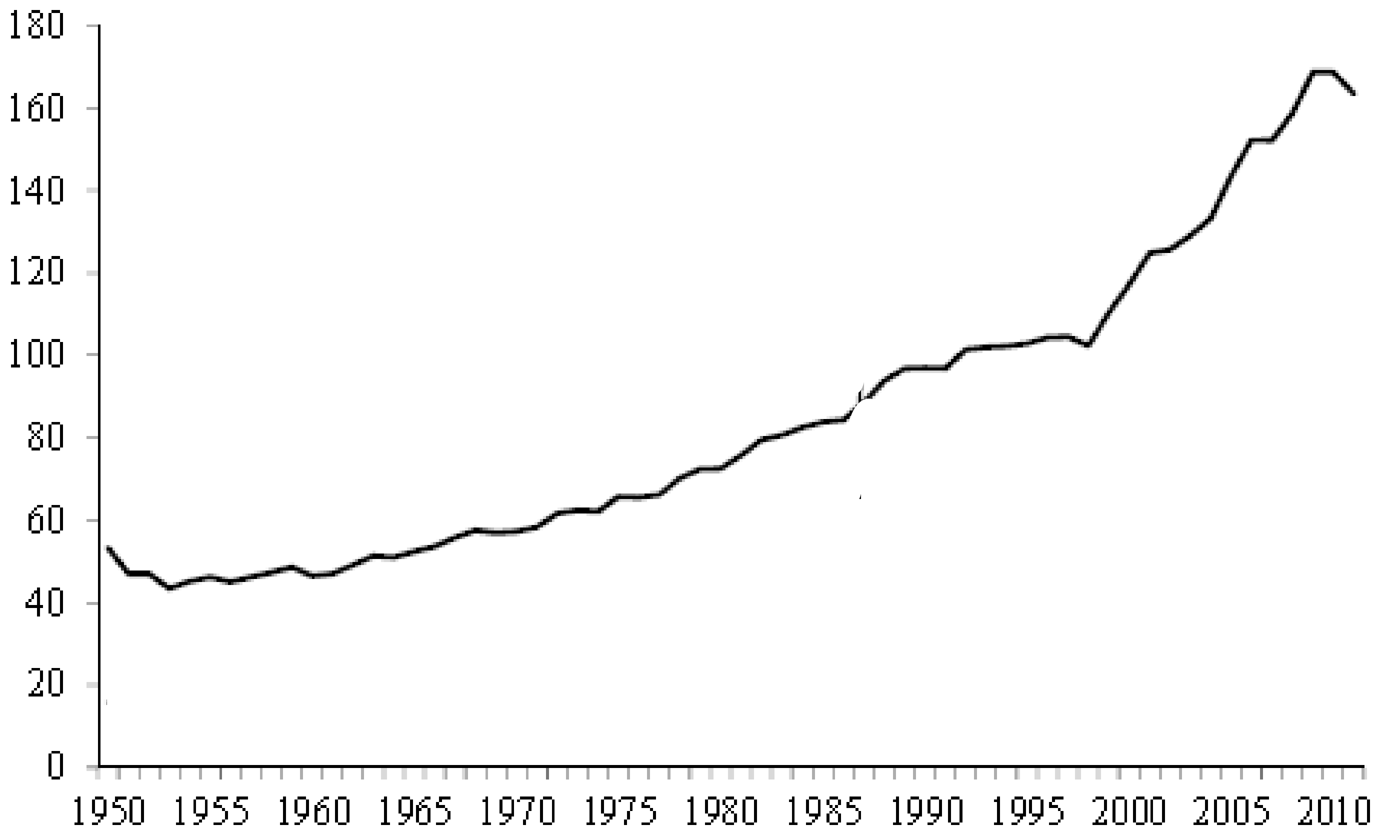
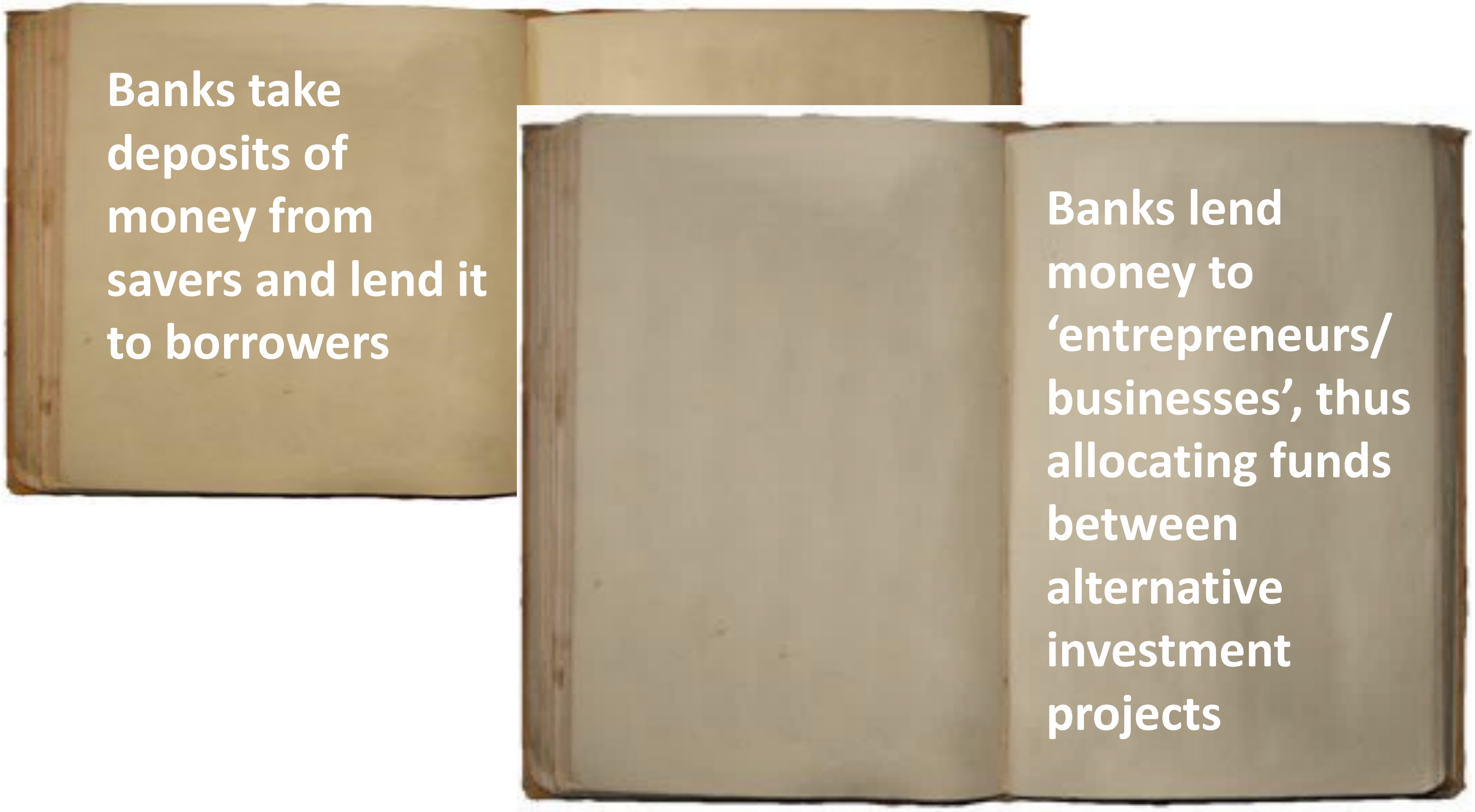
Private domestic credit as a % of GDP:
Advanced economies 1950 – 2011

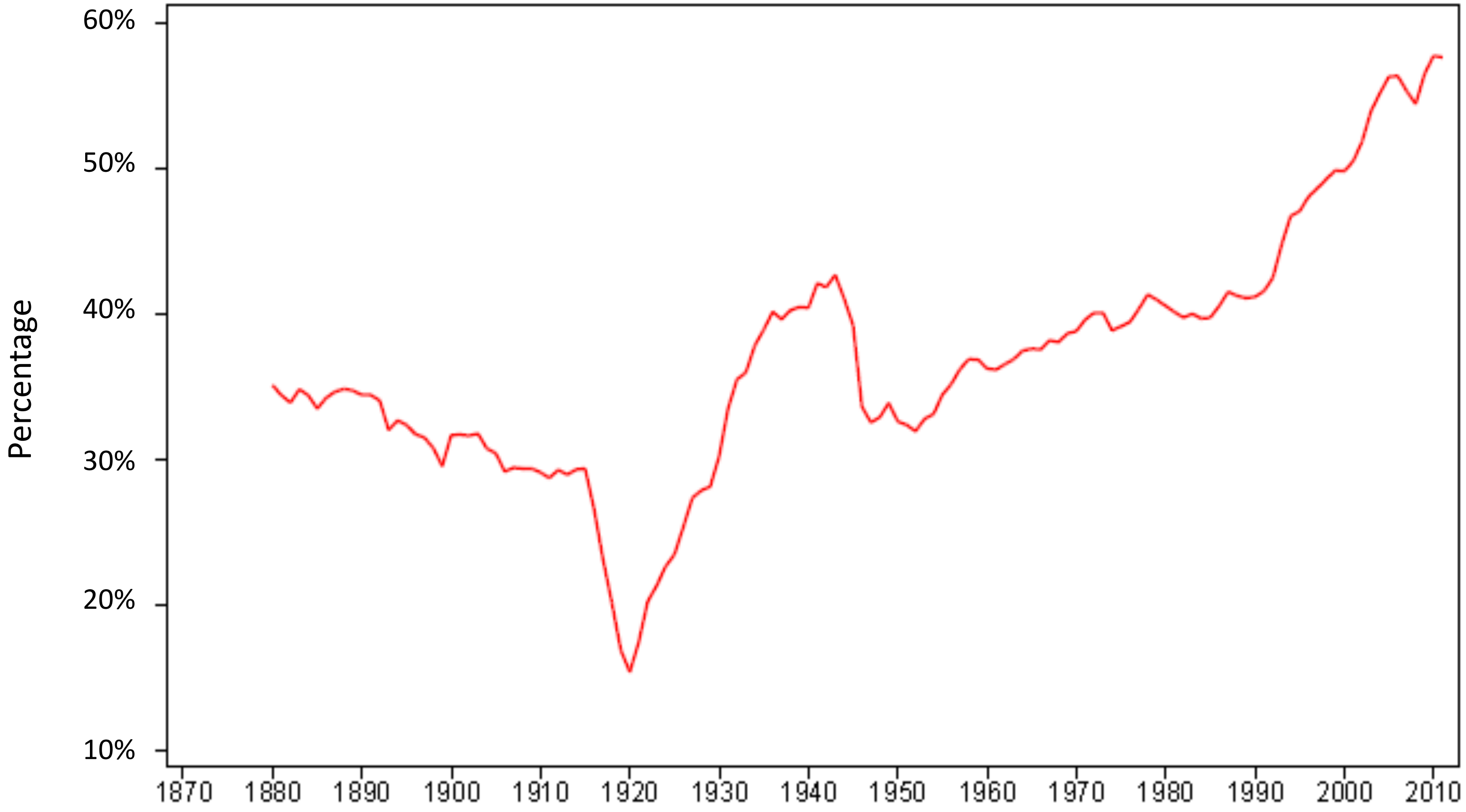


Source: *Financial and Sovereign Debt Crises: Some Lessons Learned and Those Forgotten*, C. Reinhart & K. Rogoff, 2013

Textbook descriptions of banks and bank lending

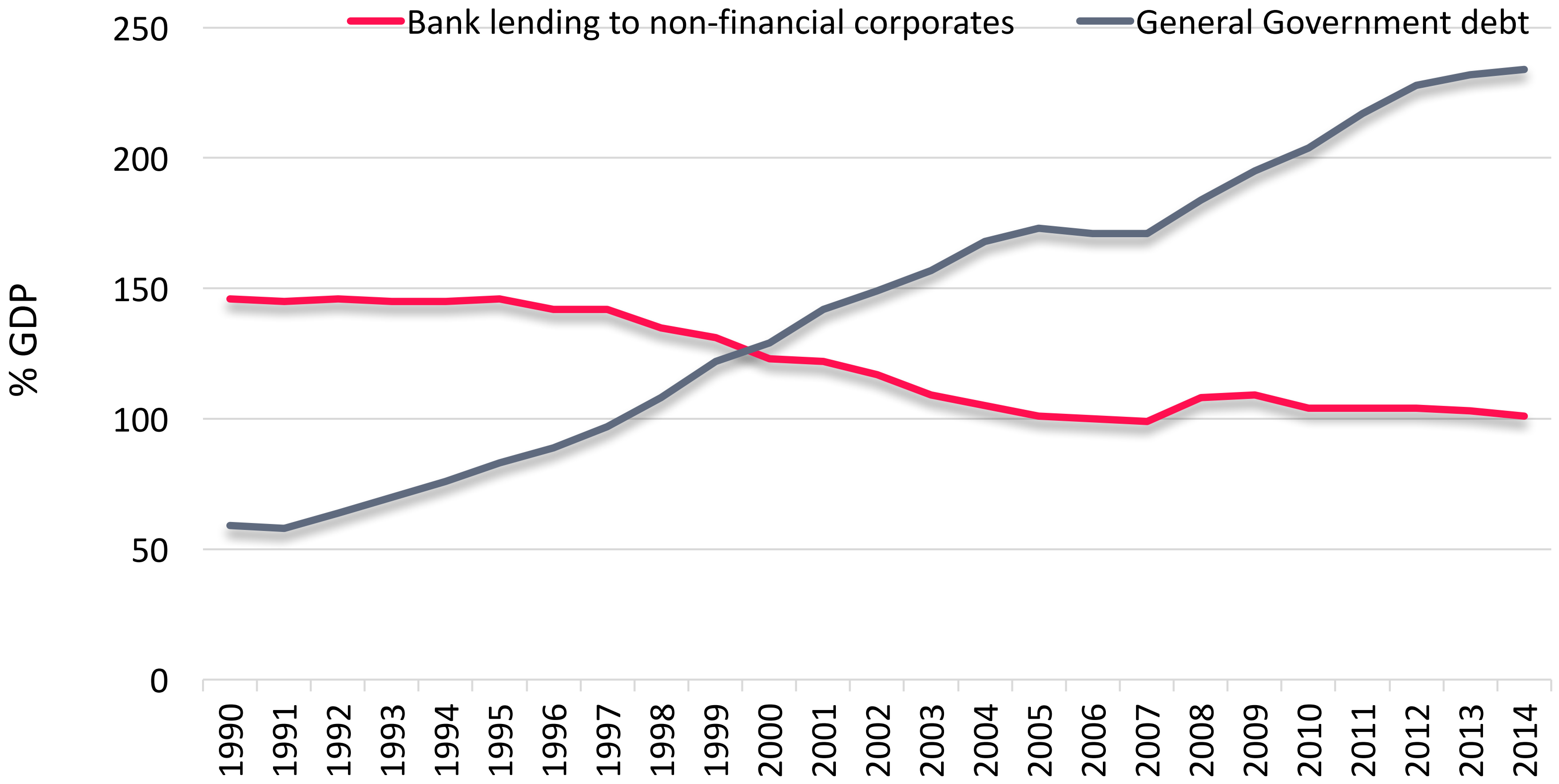


Share of real estate lending in total bank lending



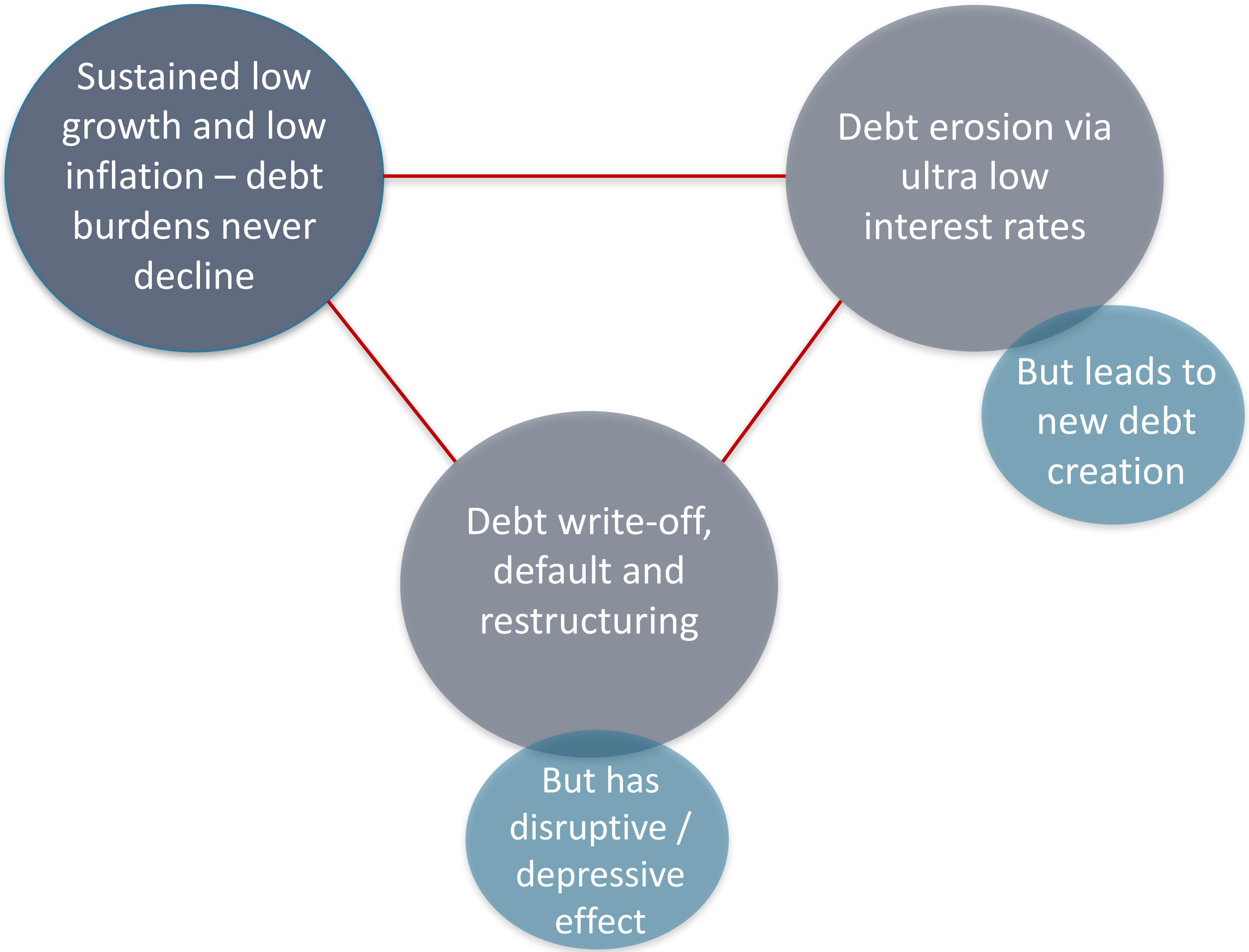
Source: *"The Great Mortgaging", Oscar Jordá, Moritz Schularick and Alan Taylor, 2014)*

Japanese government and corporate debt:
1990 – 2010



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

Debt overhang : the unavoidable choice?



Two policy questions

- How to avoid getting into this mess
- How to get out

Categories of credit creation and nominal demand

Finance of investment → Stimulates nominal demand

Finance of consumption → Stimulates nominal demand → but required just to offset impact of inequality ?

Finance of existing asset purchase →

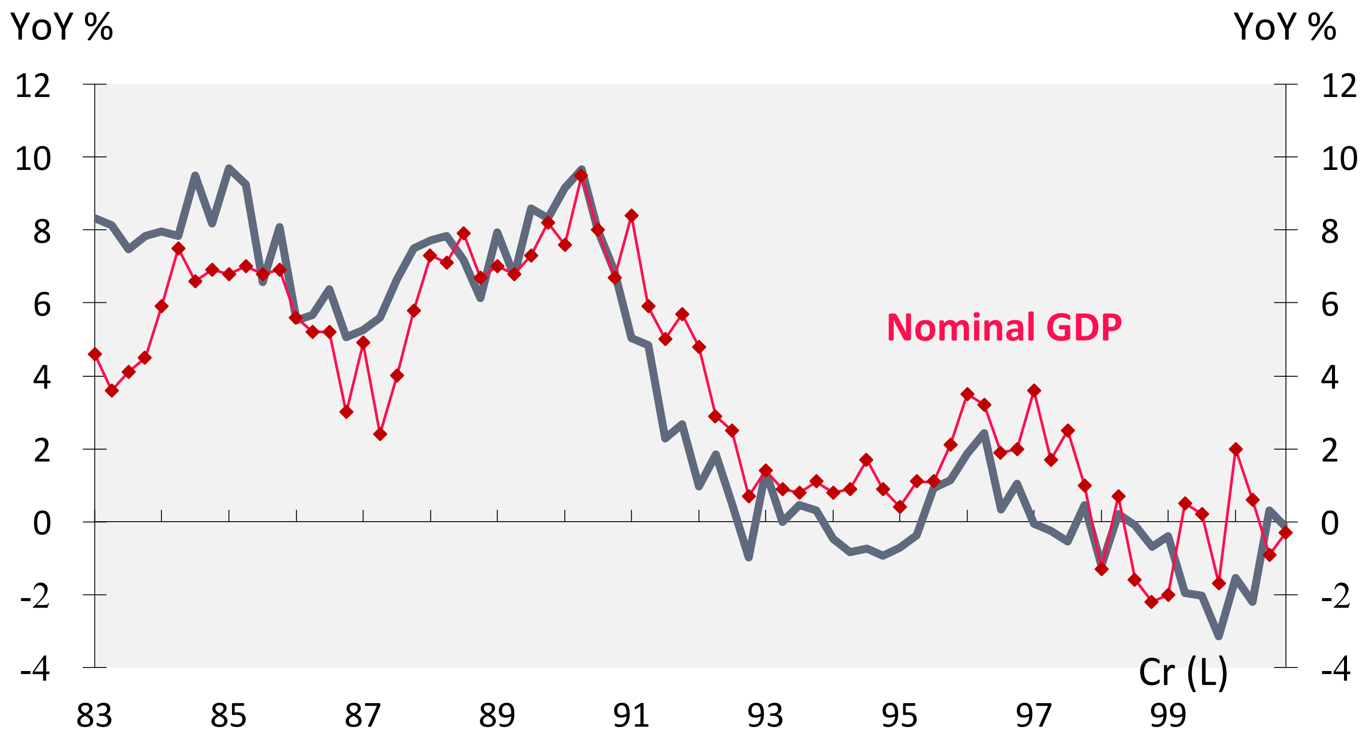
- No direct stimulus to nominal demand
- Could just increase credit, money balances and asset pricing
- May stimulate demand via wealth effects and Tobin's Q effects
- But not certainly proportional to credit created

Bank lending to real estate sector and prices

Japan 1981 – 1999

Source: Japan Real Estate Institute; Bank of Japan; Profit Research Center Ltd; calculations by Prof. Richard Werner, Southampton University (see *Princes of the Yen*, Richard Werner, 2003)

Credit creation for GDP transactions and nominal GDP: Japan, 1983 – 1999



Source: *Princes of the Yen*, Richard Werner, 2003

Quantity theory of disaggregated credit*

NOT $\Delta M = \Delta P . \Delta Y$ → Velocity of circulation stable

But: $\Delta C_R = \Delta P_R$ … where C_R = credit to finance real estate purchase+

P_R = price of real estate

And: $\Delta C_{NR} = \Delta P . \Delta Y$ … C_R = credit to finance GDP transactions

P = prices of current goods and services

So that: $\Delta M = \Delta C_R + \Delta C_{NR} > \Delta P . \Delta Y$ → Velocity of circulation falls

* See Richard Werner, *New Paradigm in Macroeconomics*

\+ Or more generally to finance existing assets

Monetary aggregates matter

- But not because excessive Money is a forward indicator of inflation
- But because excessive Credit is a forward indicator of crisis, debt overhang, post crisis depression and deflation

Two policy questions

- How to avoid getting into this mess
- How to get out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February 20th 2016
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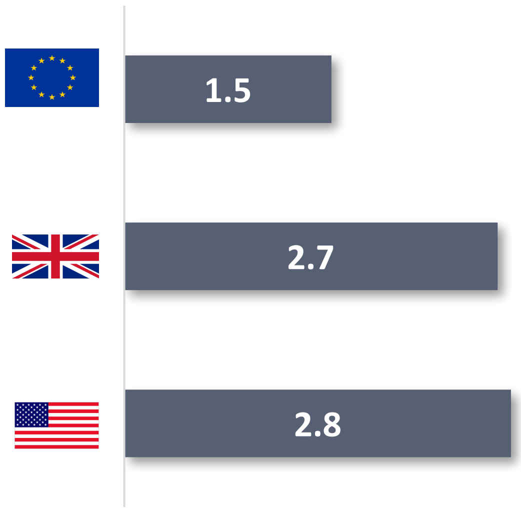
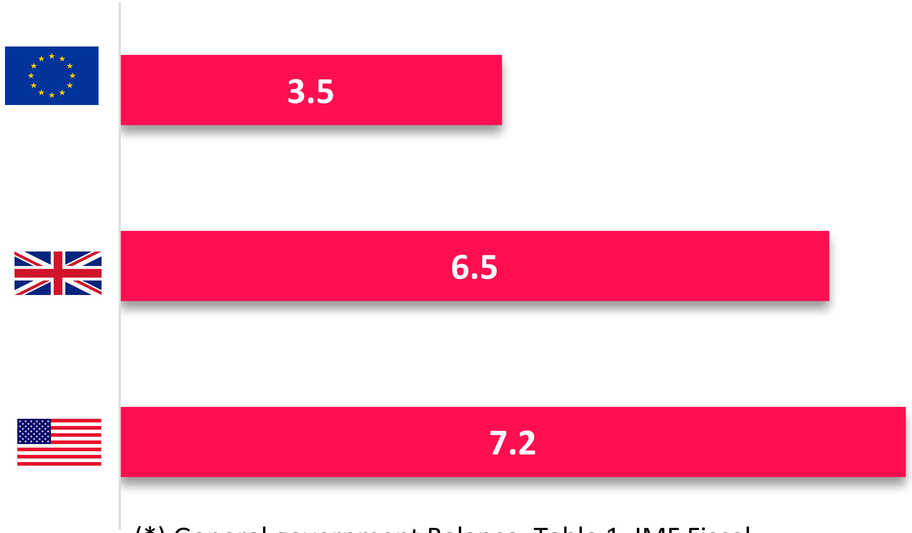
Nominal GDP growth and fiscal balance

2007 – 2016

Growth of nominal GDP % p.a.



Average fiscal deficit as % of GDP 2008-2016*



(*) General government Balance, Table 1, IMF Fiscal Monitor, April 2017

Source: IMF World Economic Database, April 2017; IMF Fiscal Monitor, 2017

Two essential sources of nominal demand growth

1. Private credit and money creation

2. Sovereign fiat money creation – now or expected in the future

	Fiat money creation	Private credit and money creation
Modern orthodoxy	Dangerous Forbidden	Free market ensures optimal result
Chicago Plan	• Essential to deliver some nominal demand growth • Can be contained by rules	So dangerous that banks should be abolished

- States fail because of short-term politics
- Markets efficient and rational

- Bank credit markets inherently inefficient and unstable
- Political processes can be rational

15.30

DEBT TRAPS, PUBLIC AND PRIVATE

Speakers
Orsola Costantini
Steve Keen
Hashem Pesaran
Moritz Schularick
Adair Turner

Discussants
Roberto Ciccone
Pontus Rendahl

Chair
Richard Vague

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