Debt Traps, Public and Private

Adair Turner
Chairman
Institute for New Economic Thinking

INET Plenary Conference
Edinburgh
22nd October 2017
Private domestic credit as a % of GDP:
Advanced economies 1950 – 2011

Textbook descriptions of banks and bank lending

Banks take deposits of money from savers and lend it to borrowers

Banks lend money to ‘entrepreneurs/businesses’, thus allocating funds between alternative investment projects
Share of real estate lending in total bank lending

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?

- Sustained low growth and low inflation – debt burdens never decline
- Debt write-off, default and restructuring
- But has disruptive / depressive effect
- Debt erosion via ultra low interest rates
- But leads to new debt creation

Institute for New Economic Thinking
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**

\[ \Delta M = \Delta P \cdot \Delta Y \]

But:

\[ \Delta C_R = \Delta P_R \]

And:

\[ \Delta C_{NR} = \Delta P \cdot \Delta Y \]

So that:

\[ \Delta M = \Delta C_R + \Delta C_{NR} > \Delta P \cdot \Delta Y \]

*Velocity of circulation stable*

... where \( C_R \) = credit to finance real estate purchase*

\( P_R \) = price of real estate

... \( C_R \) = credit to finance GDP transactions

\( P \) = prices of current goods and services

*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
Nominal GDP growth and fiscal balance
2007 – 2016

Growth of nominal GDP % p.a.

- US: 2.8
- UK: 2.7
- Eurozone: 1.5

Average fiscal deficit as % of GDP 2008-2016*

- US: 7.2
- UK: 6.5
- Eurozone: 3.5

(*) 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
Institute for New Economic Thinking

Modern orthodoxy

Fiat money creation

Dangerous
Forbidden

• Essential to deliver some nominal demand growth
• Can be contained by rules

Private credit and money creation

Free market ensures optimal result

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

Chicago Plan
DEBT TRAPS, PUBLIC AND PRIVATE

Speakers
Orsola Costantini
Steve Keen
Hashem Pesaran
Moritz Schularick
Adair Turner

Discussants
Roberto Ciccone
Pontus Rendahl
Chair
Richard Vague