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Mephistopheles at the Controls of a Helicopter: A Warning from the Adair Turner's Latest Book

On the last pages of his book *Between Debt and the Devil* Adair Turner states that "Pre-crisis orthodoxy treated free market private credit creation as by definition optimal and fiat money creation as in all circumstances dangerous – the work indeed of the devil". Now we know that the devil, whose licensed job is to tempt people, might sue them to court, because they tempted themselves to create a highly destructive credit-intense model of economic growth. The price for yielding to this temptation was paid in form of the global banking crisis and the Great Recession it caused.

The title of Adair Turner's newest book suggests that governments in Japan and some Eurozone countries are so overleveraged that it may be necessary to follow Mephistophelian advice and fund their budget deficits through overt money financing to avoid more public debt accumulation. The book's general message is that policy makers should seek a less credit-intense growth model than the one dominating since the 1970s.

1. The road towards Mephistophelian choice

The main cause of the recent global crisis was the fact that since the 1970s commercial banks – institutions with short-term sources of funding – have been involved in massive mortgage lending (Green, Wachter 2007). This produced a negative feedback loop between rising home prices and ever increasing volumes of mortgage lending.

In theory excessive bank lending should be restrained by the existence of capital adequacy ratios. In practice, this barrier was circumvented through securitization of mortgage loans. Banks would sell their mortgage loans portfolios to avoid having to increase their capital. To this end they created securitization funds (special investment vehicles) which would purchase and convert (securitize) loans into structured bonds such as MBSs (mortgage backed securities) and CDOs (collateralized debt obligations) whose issuance was among the main causes of the recent global banking crisis.

Another natural limit to how much banks can extend mortgage loans is the supply of savings as long-term loans should be funded with long-term financing. This constraint was circumvented when banks started to practice funding their mortgage loans on a massive

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scale with short-term wholesale deposits borrowed from other banks (Shin, Shin 2011; Sławiński 2013).

Securitization allowed for a confidence trick to be played. Portfolios of different quality loans were converted into AAA-rated mortgage bonds fit for sale to investment and pension funds. In practice, large American and European banks were too tempted to resist buying CDOs as they offered much higher yields than treasury bonds. Banks kept purchasing illiquid CDOs which exposed them to the risk of a sharp fall in their prices which materialized in summer 2007.

The CDO market panic was triggered by the growing number of increasing insolvent subprime borrowers whose loans were securitized. The precipitous fall in CDO prices led directly to fire sales in the MBS market, which produced across the board fall of mortgage bond prices on the global market. As a consequence, banks on both sides of the Atlantic incurred unprecedently large balance-sheet losses.

The global banking crisis brought about balance sheet recessions in Europe and in the United States (Koo 2013). Its main symptom was the halting of credit and money creation as the fall in house prices made it impossible for households to refinance their mortgage loans. Instead, they had to repay these loans out of their current incomes which led to a chronic weakness of domestic demand.

The problem highlighted in Adair Turner's book is that public debt in many developed countries (mainly in Japan and some Eurozone states) is so high that it restricts recourse to options involving fiscal expansion in order to engineer an economic recovery (McKinsey 2015). Mounting government debt is particularly risky against the prospects of low inflation and low potential rate of GDP growth which limits the prospects for deleveraging.

2. The case for helicopter money drops

The starting point of Adair Turner's argument for overt money financing of fiscal deficit is that in some developed countries central banks and governments have run out of arms. The former are not able to lower interest rates much below zero, because economic agents can escape into cash holdings[1]. The latter cannot resort to the classic debt-financed fiscal stimulus, because they are overleveraged. Thus the solution might be the overt money financing (Buiter 2014). From a technical point of view it amounts to government selling zero-coupon perpetuities to the central bank. No interest and no principal payments would be made from the budget.

Adair Turner proposes not only money fiscal deficit financing. He is also among a group of economists who point out that the important goal of QE programs is not only to lower long-term interest rates, but also to *de facto* convert treasury bonds purchased by central banks into zero-coupon perpetuities as proposed by Charles Wyplosz, Pierre Paris (2014) and a number of other prominent economists (Corsetti et. al. 2015). Such a *de facto* conversion of treasury bonds into zero coupon perpetuities can be attributed to the fact that a central bank which purchases treasury bonds returns to the government not only interest (paying seigniorage), but also principal payments (by reinvesting them), as is a common practice in central banks even after finishing their QE. Hence, the part of a public debt which ends up in central bank balance sheet is *de facto* converted into zero-coupon bonds in spite of governments declarations of its repayment.

[1] Economists postulate to circumvent this barrier by abolishing or taxing money.

Even so, despite such partial debt reduction due to QE launched by central banks, Turner is convinced that Japan and several other countries will never be able to repay their public debt in a conventional way, because to do so it would be necessary for their governments to sustain such large primary fiscal surpluses for such long periods of time that this option borders political science fiction (IMF 2014, Eichengreen, Panizza 2014). This makes the case for Mephistophelian solution of the so called helicopter money drops, i.e. fiscal deficit overt money financing without increasing public debt.

Japan's experiences illustrate that for more than two decades an expansionary fiscal policy has been shielding its economy from sliding into a deep recession, even if it did not succeed in dragging the country out of stagnation (growing below its potential). Nonetheless, it is important to underline that Japanese fiscal deficits were not money financed, but met with the help of excess savings (generated by both household and corporate sector) which were absorbed by the issuance of public debt and used by the government for covering infrastructure and current expenditures.

Adair Turner proposes to finance a part of budget deficits with overt money creation to avoid further increases in public debt in the developed countries. He underlines that overt public deficit financing is treated a *taboo* among economists and policy makers, but it was endorsed even by Milton Friedman when he was a supporter of 100% reserve (narrow) banking (Friedman 1948).

His proposal is technically challenging as it involves structuring of the tax system and government spending in such a way that the budget in a given country should be in balance when its economy grows at a rate consistent with its potential. Consequently, a budget deficit signals that economy is growing below its potential. Under such assumptions money financing of the budget deficit means nothing more than adjusting money supply to demand consistent with the equilibrium growth path. Similarly, a budget surplus signifies that the GDP growth is above the economy's potential. Through investing budget surpluses in capital markets the government could destroy a part of money supply adjusting it to money demand consistent with potential GDP growth.

Adair Turner proposes a simpler scheme of injecting money through small budget deficits. He observes that implementing100% reserve (narrow) banking proposal (Benes, Kumhof 2012) would not in fact limit money issuance only to the state. Other institutions in the proposed financial system, i.e. savings banks, would be able to create money as long as they can extend loans. The only way to prevent these institutions from issuing money would be to convert them into investment funds in line with Laurence Kotlikoff's plan (2012).

3. Wholesale deposits creation

Adair Turner's book is an outstanding contribution to monetary economics. It combines academic excellence with crystal clear reasoning and is highly accessible for all interested. It does possess all the virtues of a book intended to influence both economic thinking and policy. Nonetheless, there is one technical issue which might have been given more prominence – the banks' ability to create not only money, but also short-term wholesale deposits.

The author counts among those economists who rightly underline that money issuance is endogenous as it is created by commercial banks and not by central banks (McLeay et. al. 2014). However, this does not necessarily imply that the sole outcome of mortgage lending is money creation. Money supply consists of means of payments used to finance

current expenditures on goods and services and as such an aggregate it affects inflation. Thus, money is undoubtedly created by working capital loans extended to corporations and consumer loans extended to households. As far as mortgages are concerned, the picture is more complicated, as a large part of the newly created purchasing power is spent on real property which exerts only limited effect on inflation. This was one of the main reasons why central banks did not react sufficiently decisively to the mortgage booms before the crisis (Turner 2015).

Turner recognizes this when he explains why the massive mortgage lending in the run-up to the global banking crisis did not produce high inflation (Turner 2015). Nonetheless, it would be worth stressing a bit more that the explosion of mortgage lending was financed not only with savings, but mainly with short-term wholesale deposits created by bank themselves. The readers would benefit to learn that just as banks have the capacity to create money (retail deposits) *ex nihilo* by extending loans (Turner 2013a, 2013b), they possess an analogous capacity to create *ex nihilo* wholesale (interbank) deposits with repo transactions (Hoenig 2013, Sławiński 2015) or through re-hypothecation, i.e. re-pledging the same securities as collateral against consecutive wholesale deposits borrowed from other banks (Singh, Stella 2012, Singh Aitken 2010).

4. The general message

Adair Turner points to three main factors which produced unsustainable lending booms in a large number of countries: (1) excessive bank lending combined with misallocation of credit towards mortgages, (2) income inequalities making households too dependent on debt, and (3) global imbalances which reflected the flow of excess savings from creditor to deficit countries whose banks used them to finance their 'irrationally exuberant' mortgage lending.

The cure for unsustainable lending booms and credit misallocation lies in active use of macroprudential policy instruments (e.g., LtV and DTI ratios), and in acknowledging social and macroeconomic priorities. For example, it would be rational to favor (e.g. by using appropriate risk weighting) lending to small and medium sized enterprises instead of letting banks focus mainly on mortgage loans even though the latter seem rational from their microeconomic point of view (Turner 2015). Adair Turner is perfectly right that the working cure for inequality involves not only improving employees' skills, but also progressive changes in the tax system and in general social policy. The recipe for global imbalances is to be found in more international cooperation. The solution to taming credit-intensive growth would rest in the elimination of existing tax privileges for debt over equity financing. In addition the increasing capital adequacy ratios in banking by four or five times in relation to their current level appear necessary to reduce banks' leverages and the scope of their risk taking (Admati, Hellvig 2013).

Adair Turner's book does not elaborate on these challenging issues in a detailed way. But knowing the author's intellectual courage and the gift of independent thinking it can be safely assumed that he will put forward such proposals in his future writings.

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