SUBORDINATING FINANCE TO ROLE OF SERVANT, NOT MASTER

Ann Pettifor

Prime Economics

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STRUCTURE

Section ONE: Introduction
Section TWO: ‘Puzzles’
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Section FOUR: ‘New’ Approaches?
Section ONE

INTRODUCTION
Blanchard & Summers:

“The crisis has forced macroeconomists to (re)discover the role and the complexity of the financial sector, and the danger of financial crises.”

Blanchard and Summers:

“Should the crisis lead to a rethinking of both macroeconomics & macroeconomic policy?”

“In fact, our predicament is notoriously of another kind. ..our problem is not a human problem of muscles and endurance. It is not an engineering problem..it is not even a business problem ..nor is it a banking problem....
Keynes

“On the contrary, it is, in the strictest sense, an economic problem...
“…..or to express it better, as suggesting a blend of economic theory with the art of statesmanship, a problem of political economy.”

Section TWO

“PUZZLES”
PUZZLE 1

THE QUEEN: “IT’S AWFUL. WHY DID NOBODY SEE IT COMING?”
Blanchard & Summers:

“..prevailing macroeconomic paradigms largely ignored the possibility of financial crises…the system often reduced to the determination of a yield curve…”
To the Queen (and the rest of the world)
Blanchard & Summers retort:

“Financial crises will probably happen again.”

PUZZLE 2:
WHY LOW GLOBAL NOFLATION/ DEFLATION?
An Open Letter to Ben Bernanke

e21 Staff

NOVEMBER 15, 2010  FINANCE

To: Chairman Ben Bernanke
Federal Reserve
Washington, DC

Dear Mr. Chairman:

We believe the Federal Reserve's large-scale asset purchase plan (so-called "quantitative easing") should be reconsidered and discontinued. We do not believe such a plan is necessary or advisable under current circumstances. The planned asset purchases risk currency debasement and inflation, and we do not think they will achieve the Fed's objective of promoting employment.

We subscribe to your statement in *The Washington Post* on November 4 that "the Federal Reserve cannot solve all the economy's problems on its own." In this case, we think improvements in tax, spending and regulatory policies must take precedence in a national growth program, not further monetary stimulus.

We disagree with the view that inflation needs to be pushed higher, and worry that another round of asset purchases, with interest rates still near zero over a year into the recovery, will distort financial markets and greatly complicate future Fed efforts to normalize monetary policy.

The Fed's purchase program has also met broad opposition from other central banks and we share their concerns that quantitative easing by the Fed is neither warranted nor helpful in addressing either U.S. or global economic problems.

Respectfully,

Cliff Asness
*AQR Capital*

Michael J. Boskin
*Hoover Institution, Stanford University*
*Former Chairman, President's Council of Economic Advisors*
PUZZLE 3

WHY PERSISTENTLY LOW INTEREST RATES?
BLANCHARD AND SUMMERS on causes of low rates:

“..The 1993 Deficit Reduction Program in the US where deficit reduction led to lower interest rates at all maturities....”

Blanchard & Summers, p.4 as above.
“CBO forecasts are for the real interest rate to remain below the growth rate all the way to 2027. In reference to Hansen (1939), one of the authors has referred to this evolution as “secular stagnation.”
“Explanations fall into two groups. The first is that the after-tax rate of return to capital has decreased, leading to a decrease in all rates, risky or safe....
“Research has identified a large number of potential culprits, from the global savings glut emphasised by Bernanke (2005), to the interaction between taxes and inflation, to the decrease in the price of capital, to demographics.”
PUZZLE 4

WHY VERY SLOW RECOVERY FROM GFC?
“A series of unfortunate events”

Since the Great Recession of 2008/9 we have had the slowest recovery in our modern history – slower than the recovery from the Great Depression. For those of you familiar with children’s literature, one title for the story of the last eight years is “a series of unfortunate events”.¹

In this big picture story, the UK economy was hit by a very unfortunate event, a massive financial crisis, leading to the deepest recession for 80 years. Three years later, as it is just beginning to recover, the economy is hit again by the effects of low confidence and financial...

The UK Economy Post Crisis: A Series of Unfortunate Events? – speech by Jon Cunliffe
Deputy Governor, Financial Stability 24 February 2016
PUZZLE 5

WHY DESPITE $11 TRILLION ASSET PURCHASES BY CBs...
Figure 1: G4 central bank asset purchases, $ trillion

Source: Mark Carney, [De]Globalisation and inflation, speech, 18 September 2017

Acknowledgement: TUC blog, Geoff Tily, 21 September, 2017.
PUZZLE 5

HAS GROWTH FOR THE G4 REMAINED STUBBORNLY BELOW 2%?
Figure 3: G4 GDP growth, %

Source: OECD, average across of G4 countries

Source: TUC Blog: Geoff Tily, 21 September, 2017
PUZZLE 6:

WHY POPULAR UPRISINGS & DICTATORSHIPS?

Austria far-right
German AfD
Catalonia
Brexit
Trump/Putin/Duterte/Erodgan/Modi?
“Karl Polanyi (1944): no sooner will today’s utopians have institutionalized their ideal of a global economy, apparently detached from political, social, and cultural relations,
than powerful counter-movements—from the right no less than the left—would be mobilized

BREXIT slogans ‘Take Back Control’, ‘Take Back Our Country’, and ‘Britannia waives the rules’ represented an inchoate and incoherent attt
to subordinate unfettered, globalized markets in money, trade, and labour to the interests of British society...
...a form of social self-protection from self-regulating markets in money, trade, and labour.”
Section THREE

Old Approaches to Finance
1. Misunderstanding 70s inflation
2. Nixon Shock
3. De-regulation of Credit
4. High, real rates of interest
5. Capital Mobility
1. Misunderstanding 70s inflation
In 1961 the OECD, encouraged by ‘classical’ economists like Samuel Brittan of the FT and discouraged by what - compared to today’s standards - were high, sustainable levels of economic activity, proposed to turbo-charge the economy.

See Dr Geoff Tily, ‘The growthmen’ – a review of Diane Coyle’s ‘GDP’ a Policy Research in Macroeconomics (PRIME) publication.  [www.primeeconomics.org](http://www.primeeconomics.org)
At the time, Britain was in the happy position of providing full employment to her people. Macmillan’s 1957 comment that Britons ‘had never had it SO good’ still rang true.

Geoff Tily, As above.
It was at this point that the OECD, the British National Economic Development Corporation and Samuel Brittan championed an unsustainable and delusional new target for something they named “growth”
- a rate of change of a continuous function – which turned out to be 50% for Britain over the decade.
Sam Brittan proudly called himself a ‘growthman’ and while promoting this unsustainable and inflationary target, also pushed policies for financial liberalization.
These policies led to a series of credit booms – regarded as ‘infinite booms’ by for example, traders in sub-prime mortgages and collateralized debt obligations (CDOs) on Wall St. and in the City of London.
2. The Nixon Shock, 1971

- at the time the biggest sovereign default in history.
3. De-regulation of Credit
Lifting of Macroprudential tools/measures to target Credit Developments.
Competition and Credit Control – UK 1971

“All Competition and No Control”
(i) demand-side measures, such as limits on loans-to-value ratios, margin requirements, loan maturities, and tax policies;
(ii) and supply-side actions, including lending and interest rate ceilings, reserve and capital requirements, portfolio restrictions, and supervisory guidance.
‘REGULATION Q’ in the US placed limits on interest that banks could offer savers to attract deposits.

In the US, the 1969 Credit Control Act – phased out in 1982
“Loans would be granted to those companies and individuals that could pay the highest rate, rather than those that fulfilled authorities’ qualitative criteria.”

Duncan Needham, as above.
“Adjustable rate mortgages on FIVE houses “and a condo”” The Big Short.
External financial assets and liabilities around 110% of GDP in 1900, troughed in 1945 at about 25%, and soared to around 400% of GDP in 2015.
UK financial sector and government borrowing has continued to grow since 2008

Debt by sector, 1987–2012Q2

% of GDP

Change
Percentage points

<table>
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<tr>
<td>Q4 2000–Q4 2008</td>
<td>172</td>
<td>18</td>
</tr>
<tr>
<td>Q4 2008–Q2 2012</td>
<td>11</td>
<td>41</td>
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1 Includes all loans and credit market borrowing (e.g., bonds, commercial paper); excludes asset-backed securities to avoid double-counting of the underlying loan.

NOTE: Numbers may not sum due to rounding.

SOURCE: Haver Analytics; UK Office for National Statistics; McKinsey Global Institute
“The global stock of external assets and liabilities rose nearly 190 percentage points between 2000 and 2007.”

Global Debt

2007 = 269% GDP

2015 = 286% of GDP

2017 = 325% of GDP

McKinsey, as above. IIF, 4 April, 2017.
Global debt has ballooned

% of GDP

Emerging markets  Mature markets

1996: 126 280
2006: 146 348
2016: 215 390

SOURCE: IIF, BIS, HAVER

Source: Daily Telegraph: Global debt explodes at 'eye-watering' pace to hit £170 trillion. 04 April, 2017.
The two historical waves of economic globalisation

As a percentage of country sample GDP

Graph 1

Prior to 1970, calculated as external financial assets multiplied by two.

Above all: financial rentierism led to wider rent-seeking behaviour

"Platform Capitalism" Monopolies, Rentierism
4. High, Real Rates of Interest Prevailed.
Movements can be examined in more detail by decomposing real rates into nominal rates and price change. For clarity figure 3 shows the decomposition by decade (inflation is shown with a negative sign), and figure 4 shows decade to decade change. (R is nominal rate; P is inflation and r the real rate.)
The rate of interest

“the villain of the piece”

(Keynes)
International Interest Rates
Rises and falls and the financial crisis

Chart taken from presentation by Richard Koo, Chief Economist, Nomura Research Institute, Tokyo, to the INET Conference, Berlin, 14th April, 2012.
5. Mobility of Capital – cross-border flows.
Volatility of exchange rates; interest rates; tax evasion; tax havens; capital flight; illicit financial flows; criminal activity etc.
Share of Countries in Banking Crisis, 3-year Sum (right scale)

Capital Mobility (left scale)

Legend:
- Red line: Share of Countries in Banking Crisis
- Blue bars: Capital Mobility

Key Dates:
- 1825
- 1860
- 1914
- 1918
- 1945
- 1980

Timeline:
- 1800 to 2000
‘NEW’ APPROACHES TO FINANCE
1. A sound understanding of credit/money/finance
Orthodox, neoclassical economic models suggest that finance is a “veil” and not an independent source of risk.
“Even in the most advanced industrial economies, if we peel off the obscuring layer of money, we find that trade largely boils down to barter.”

Paul Samuelson
Bank: “a financial intermediary.”
Loan: “a lending agreement between an individual lender & an individual borrower.”

Krugman and Wells:
“The majority of money in the modern economy is created by commercial banks making loans.”

Quarterly Bulletin 2014 Q1
Borrowers CREATE the money supply

- OR -

CONTRACT the money supply
PRIVATE COMMERCIAL BANKS

– Not the Central Bank

- ‘PRINT’ THE MONEY SUPPLY
- 99% of Broad Money in the US
– 95% of Broad Money in the UK
SAVINGS NOT NEEDED FOR INVESTMENT

The money for a loan is not in the bank when a borrower applies for a loan.
“Banks do not act simply as intermediaries, lending out deposits that savers place with them, ...

... and nor do they ‘multiply up’ central bank money to create new loans and deposits.”

Quarterly Bulletin 2014 Q1
Once loan application made, collateral supplied, interest rate agreed, contract signed...hey presto..
THE RATE OF INTEREST?
Orthodox, classical and neoclassical view: 

The (‘natural’ ‘neutral’) rate of interest determined by the demand for, and supply of, *savings*.

‘the savings glut’
J M Keynes:
The rate of interest determined by the demand for, and supply of assets.

‘a shortage of assets’
KEYNES:

“The confusion lay in the futile attempt to ignore the existence of bank money and consequently the inter-relationships of money & bank credit,

KEYNES:

“….. & to make representative money behave exactly as though it were commodity money.”

3. MANAGE FLOWS OF CAPITAL, CREDIT
MACMILLAN REPORT 1931

"The monetary system of this country must be a Managed System ".

The main objects of a sound monetary policy
(a) maintenance of the parity of the foreign exchanges;

(b) the avoidance of the Credit Cycle;
and (c) the stability of the price level cannot be achieved automatically, as was thought to be the case under the old gold standard.
They require the constant exercise of knowledge and judgment by an institution of ripe experience, great resources and unchallengeable authority.” – the Bank of England.
'You overlook the most fundamental long-run theoretical reason. Freedom of capital movements is an essential part of the old *laissez-faire* system and assumes that it is right and desirable…
“To have an equalisation of interest rates in all parts of the world. It assumes that is to say, that if the rate of interest which promotes full employment in Great Britain is lower than...
....the appropriate rate in Australia, subject only to different estimations of risk, until the equilibrium rate in Australia has been brought down to the British rate
“In my view the whole management of the domestic economy depends upon being free to have the appropriate rate of interest without reference to the rates prevailing elsewhere in the world.
“Capital control is a corollary to this.”

John Maynard Keynes:
Thank you.

Ann Pettifor
Director, Policy Research in Macroeconomics
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