"Political Economy of Financial Stability and Equitable Growth"

<u>Transcript of Adair Lord Turner, *Former Chairman, UK Financial Services Authority*</u>

Can I first of all just say a great thank you to IPD and CAFRAL for organizing this whole day, which I have found incredibly valuable and I have learnt an awful lot from. It's made me well aware that I am not at all an expert on the matters of emerging markets or on some of the issues of the international capital flow debate. Because I know that it is an area where I do not have as much knowledge as in some other sectors of the financial area, I deliberately decided to use the opportunity of coming here for the conference to force myself to think about some issues.

I think we have circulated a paper which I have written. The question that I posed in there was: what are the links between the causes of the global financial crisis and issues to do with the design of the international monetary system? You could stop me by saying that there may not be many connections, and somebody quoted earlier Rakesh Mohan's statement "it wasn't a global financial crisis, it is was a north Atlantic financial crisis, you always think you are the whole globe". But, certainly some people think that there are links between what happened in the global financial crisis and the international financial system. You get statements that current account imbalance was the major driver of what went wrong. We get assertions that that those current account imbalances are driven by the reserve currency nature of the US dollar and until we move away from that in some way we are bound to get these current account imbalances. You get debates about the adequacy therefore of the IMF official liquidity provision relative to private capital flows and we get debates about freedom of gross capital flows.

So, this is undoubtedly an agenda that keeps getting put on the table, and a set of assertions which say we have this global financial crisis or even this advanced economy financial crisis in part because of deficiencies in the international monetary system or the design of our international system. To answer the question my paper first thinks through what could go wrong with the financial system in a closed economy which has one currency and one government and therefore doesn't have the complications of inter-country, international relationships and then what changes when we add the dimension of countries. The conclusions I reached are set out on the second page of the paper. My basic conclusion is that the fundamental problem, whether within or between countries, and the problem which therefore could exist even in a closed economy, is what I call "too much of the wrong sort of debt". Free financial markets left to themselves will inevitably generate excessive credit unrelated to new productive investments. That is my proposition as to the fundamental challenge within a closed economy. The problems created by current account imbalances and capital flows can be understood as a subset of that more general problem. They are about excessive debt claims which happen to be international, but for reasons inherent to their international and inter-currency nature, they are not simply *a* subset, they are a particularly problematic subset, and the current arrangements and policies result, as the title of my paper says, in “too much of the wrong sort of capital flow”.

I have four statements as to what follows for policies: two actions which are priorities and two that are not. Improvements in international official liquidity facilities, potentially valuable to many emerging economies, are, I suggest, important but not fundamental to the stability of the global financial system. Second, actions deliberately designed to reduce the reserve currency role of US dollar are also not a priority. The two other actions, national policies to remove the structural drivers of large current imbalances on both the surplus and deficit sides, and actions to constrain harmful short term capital flows, are the two priorities.

Let’s remind ourselves about the facts of global current account imbalances. They increased very significantly from late 1990s onwards, and at the top of this slide, the highest line is actually not China; it is Germany and Japan combined. By 2008, China just went ahead of them. But overall, the biggest and sustained imbalances on the surplus side were dominated by China, Germany, Japan and the OPEC nations.

The highest deficit country is the US; but the UK and peripheral European countries were also important. And the flip side of current account imbalances is of course capital flows. There is nothing inherently wrong with large capital flows; the US ran current account deficits with capital imports pretty much the whole of 19th century, but there is something very different about our current capital flows. When the UK was a big capital exporter in 1910, the UK had capital exports of 10% of its own GDP. But what those capital flows were doing was fairly easy to understand. Britain was the richest country on earth, it had savings in excess of investments while countries like Australia and Argentina had investment needs in excess of their savings, and money flowed from savings surplus countries to investment rich countries and that was how it worked.

Modern capital flows are different from that in four ways: (i) they are definitely uphill and not downhill – they go from poorer countries to richer countries or to roughly equivalent countries within the European union; (ii) they do not tend to fund higher levels of capital investment, they tend to fund either a consumption or asset price appreciation; (iii) and they are two-way, with the gross value massively higher than the net value. When British investors in 1910 were buying Argentinian railways, there were no Argentinian investors simultaneously buying British stock; but today’s capital flows include an enormous two-way element; and (iv)fourth, a lot of them are short term debt rather than the long term debt and equity forms which dominated the pre-first world war. So those are the facts we are dealing with.

Let me now just make the argument, that If we are had a closed economy, the fundamental issue is too much debt. It certainly is the case that the striking feature, not just of 10 years before the crisis, but of 70 years before the crisis, is an enormous increase in private leverage. You can see it in the US; private leverage going up from about 50% of GDP to 200% GDP over 70 years; UK household loans going from 15 % of GDP in 1964 to a 95% by 2008. One striking feature of the pre-crisis world in the rich developed society is the dramatic increase in leverage.

Part of that is real economy leverage. The other feature is that in addition to the borrowing and lending between the financial sector and the real economy, the financial sector does an enormous amount on itself, it lends money backwards and forwards between itself because of an explosion of intra-financial system complexity. So my basic proposition, if I wasn't thinking about the international world, and I was describing the advanced economies, sees three dramatic features:

- A dramatic increase in real economy leverage over many years.
- For every unit of real economy leverage, the financial system does a huge amount with itself.
- An increase in the net role of the financial system and an increase in the gross role of the financial system.

Now, why is this important? Let's start with the real economy leverage. Let's go back to the basics of why do we have leverage in the economy. Why do we have debt contracts?

Economic theory about debt contracts basically says households have savings, they put it in the banking system which lend money to businesses to do capital investment and this helps to achieve capital formation which would not occur if we relied on an only equity world. But if I was to look at UK debt created by the banking system in 2009, my calculation is that only about 15% of all that debt is funding new capital investment.

We have to understand that debt can do at least three things: it can fund consumption; it can fund the purchase of already existing asset in particular real estate and implicitly the land on which that real estate sits, and it can fund new capital investment. One of the fundamental things which can go wrong in a closed economy is that we can create too much of the wrong sort of debt and in particular the sort of debt which is fundamentally financing competition for the ownership of an already existing irreproducible asset, in particular land.

The problem is very much related to Hyman Minsky's view of the world, viz where you have an asset, the price of which is endogenously determined by the amount of credit which is pursuing it. The result is credit and asset price cycles. So, my fundamental assertion is that real economy leverage can be a problem because a free financial system itself will create too much real economy leverage focused not on new investment that creates new corporate cash flow to pay it back but on forms of asset speculation.

The problem with this debt is revealed once we get a break in confidence, and a renewal of the cycle. Crucial to the problem of debt overhang is an asymmetry between net creditors and net debtors which can exist within an economy. Once you have a fall in asset values and net worth, you have a group of people who perceive themselves to be overleveraged and are focused on deleveraging their positions, who are saving like mad, cutting investments and cutting consumption and there is no natural process whereby the people who lend them the money feel the need to increase their consumption or investment in an offsetting fashion. So the fundamental point about the asymmetry between savers and investors which we tend to think of in international terms – that is how Keynes thought about it – can exist within an economy and that is the fundamental problem. So my proposition about the closed economy is that one thing that can go wrong is too much leverage focused on real estate asset appreciation rather than new investment and when you get to the other side of the bursting of that bubble; you will have a debt overhang problem which will put you in a very difficult macro position.

The other thing that can go wrong domestically is not the increase in real economy leverage, but the proliferation of the size of the financial system on itself or the intra-financial system complexity – the result of the gross size of the financial system growing massively more than the net size.

My proposition when I then turn to international flows is to understand them as a subset of this fundamental problem of too much real economy leverage and too much gross financial system intensity. The 'too much real economic leverage equivalent' relates to net capital flows; and just as debt within an economy could be funding over-investment cycles or over-consumption or existing asset price bubbles quite as much good productive investments, so do net capital flows. The net capital flow issue is fundamentally an issue about what it finances. And the fundamental problem with those huge capital flows from China and into America is that they were not financing anything remotely equivalent to Argentinian railways in 1905. They were funding some combination of unsustainable consumption among low income people or a circular asset price bubble both in the price of new housing and of existing housing.

So the trickiness in net capital flows is that they tend to finance at times new real estate construction booms – that was to a degree of story in Spain, Ireland and US – and sometimes they can finance an existing asset price cycle – the UK had a credit and asset price cycle without a new investment cycle. Or they financed unsustainable consumption. And because they do all that, they also can create, when the thing pops, a debt overhang. But that debt overhang is more problematic because it involves an international element. The debt overhang, the asymmetry between the savers and the borrowers is between Chinese savers and US borrowers, and that is a much more difficult thing for anybody to manage their way out of than a purely domestic one.

So, my position is that net capital flows in the form that they have taken in the modern world, has been a subset of a problem of over expansive debt flows but a particularly problematic one. And equally, gross capital flows when they take debt form can be thought of as a particular manifestation, at global and international level, of intra-financial intensity which also can apply to and can cause problems at domestic levels.

So that is my analysis. I have run through it very quickly and I hope forced you to read the paper I have put forward as a set of propositions. But what do I then say about policies? I am not going to talk about IMF official liquidity facilities or the reserve currency status of the dollar.

In relation to net capital flows, I think we have to go back to why do we have these net capital flows. I think the interpretation has to do both with the structural characteristics of countries like China, Germany or Japan (until 2008 though of course no longer) creating an excessive savings. Or America and Spain, creating a structural deficit on the other side. I love the phrase from Michael Pettis's book which is the "inanity of moralizing", we shouldn't get so worked out on who is to blame between the net savers and the net deficits. We have to find some simultaneous way of getting around those imbalances because unless we do, we will continue to get a whole load of net capital flow of this character which will create problems.

As for gross capital flows, I think the key insights here are in Hélène Rey's paper at Jackson Hole. Gross capital flows interface with the domestic credit cycle and the domestic asset cycle which is where the two parts of my analysis come together. Which is why I think it is highly likely therefore that the most appropriate policy responses are precisely the ones which exist at the nexus between the international and domestic, and they are likely to be the macro prudential tools. One final one that I have added to those which were in Hélène's paper and others is that I do think that we should think carefully about the interface between macro-prudential tools addressing the international and domestic credit cycles and the legal structure of major global banking groups. I think wherever they provide significant amounts of credit domestically, they should operate as subsidiaries because that gives a mechanism for the local authorities for supervision and rules to control their contribution to the local domestic cycle.

Now, I know when I say this I will get accused by dear colleagues in the banking industry of contributing to the "fragmentation" of the international capital markets or the "fragmentation" of the international financial system. And my answer to that is you don't fragment it in its useful long term roles. There is nothing about requiring subsidiarisation of branches, which is stopping foreign direct investment, i.e. HSBC, putting more equity capital into India, where I think in the domestic environment, it should be able to compete freely with local banks provided it is doing so in a highly capitalized subsidiary form. You are not getting in the way of the transfer of equity capital, you are not getting in the way of the transfer of the long term debt capital, by demanding subsidiarisation. But you are getting in the way of the flexible backwards and forwards use of pools of global liquidity for a set of gross short term debt flows, backwards and forwards, which I think pretty much all of the analysis suggest is of no particular value. Which is why I put out a press release on this speech deliberately to stir things up back in the UK which is called *Don't worry about balkanization of the global financial system.* Those are my thoughts.