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Comments on Adair Turner's book:

"*Reprendre le contrôle de la dette*"

Money, Credit and Fixing Global Finance

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BUILDING TOGETHER

TEAM SPIRIT SOCIETE GENERALE

3 questions

- **Should debt finance real estate?**
- **Should fractional reserve banking be abolished?**
- **Should ‘overt money finance’ be used?**

Should debt finance real estate? (1)

- **Too much of the wrong sort of debt?**
  - ‘Good’ debt: financing new capital investment generating future additional income
  - ‘Bad’ debt: financing extra consumption or the purchase of an existing fixed-asset (real-estate)

- **However, in theory:**
  - Risky new capital investment should be financed by equity
    - But reluctance of investors to provide 100% equity financing (information asymmetry, risk aversion,…) → debt financing
  - Debt enhances welfare by allowing households to smooth their consumption in the face of uncertain labour income or lumpy expenditures (housing investment)
    - Households cannot issue equity against their human capital
    - But lenders are reluctant provide 100% debt financing to housing purchases →down payments

Should debt finance real estate? (2)

- **How to reduce the risk of boom-bust in housing credit?**

- **Reducing tax distortions in favor of housingdebt**

  ➢ Tax-deductibility of interest expenses for owner occupiers (in some countries) and investors in rented property (in most countries)

- **Lending against current and future borrower’s incomes (human capital) rather than against the market value of its real estate property**

  ➢ The ‘French model’

  - Fixed-rate loans
  - Guaranteed by a ‘caution’ issued by a third-party credit institution rather than by a mortgage lien on the property
  - Caps on LTIs at origination (rather than on LTVs)

  ➢ Penalized by the new regulation on ‘Interest rate risk in the banking book’ (IRRBB)?

Should fractional reserve banking be abolished? (1)

- **"*Credit creation is too important to be left to bankers*" (A. Turner)**

- **Narrow banking: separating deposit-taking from lending**
  - ➢ Deposits with 100% reserves (Treasury bills or central bank reserves)
    - 'Narrow banks': no deposit-based funding of loans
  - ➢ Credit assets with 100% equity (or LT debt) funding
    - Mutual funds / Investment trusts

- **This structure neglects the special role of banks as producers of safe and liquid assets ('information-insensitive') through maturity and risk transformation…**
  - ➢ Modigliani-Miller (all assets are perfectly liquid) vs. Diamond-Dybvig / Gorton
  - ➢ Complete transfer of this role to governments and central banks (or to shadow-banking)?

- **…and would not eliminate the risk of credit crunch and financial crises**
  - ➢ Illiquid investment vehicles subject to fire sales and runs to 'narrow banks'

Should fractional reserve banking be abolished? (2)

- **How to prevent excessive maturity transformation?**
  - ➢ The 'original sin' of the saving markets: mismatch between supply and demand in terms of maturity/risk
    - Savers: preference for safe, liquid assets
    - Issuers/borrowers: funding risky and illiquid investment

- **Acting on the 'demand-side' of maturity transformation**
  - ➢ Promoting long-term saving (funded pension plans, taxation of savings, financial education)
  - ➢ New regulations (liquidity ratios, collateralization/CCPs,…) exacerbate the demand for safe short-term assets

- **Less maturity transformation des not necessarily imply bank disintermediation**
  - ➢ Preserving the special role of banks in credit origination/monitoring
    - Covered bonds ('Danish model' for mortgage finance)
  - ➢ Due to the pro-debt tax bias, there is already a tax distortion in favor of direct market financing and against bank intermediation (due to the corporate tax on bank's return on equity)

Should ‘overt monetary finance’ be used? (1)

- **Monetary finance (or ‘helicopter money’): one-off increase in fiscal deficit financed by a permanent increase in the monetary base**

- **In which circumstances could monetary finance be a more appropriate tool for stimulating nominal demand than debt-financed fiscal policy or pure monetary policy (such as QE)?**
  - ➢ Liquidity/deflationary trap
  - ➢ Debt trap
    - Monetary finance creates fiscal space, but it does not make the government more solvent

- **Are we today in these circumstances?**
  - ➢ Risk of outright deflation have receded in the US and Europe
  - ➢ QE policies have not proved ineffective so far
  - ➢ Central banks have started to exit QE

Should ‘overt monetary finance’ be used? (2)

- **Dismal growth performance of advanced economies since the Great Financial Crisis of 2007-2009: different views on the causes and degree of persistence**
  - Demand-side or supply-side problem? Multi-year or secular?
  - Even in the case of Summers-style ‘secular stagnation’, debt-financed government spending may be more appropriate

	Demand-side	Supply-side
Secular	• Self-perpetuating excess of savings over investment, due to the lower bound on nominal interest rates (L. Summers)	• Secular decline in productivity growth due to the death of growth-enhancing innovation (R.Gordon/‘techno-pessimists’)
Multi-year	• Debt-overhang (K. Rogoff) • Global savings glut (B. Bernanke)	• Delayed impact on productivity growth of IT innovation (E. Brynjolfsson-A. McAfee/‘techno-optimists’) • Misallocation of capital (and zombie companies) resulting from the pre-crisis credit binge and post-crisis monetary policies delaying supply-side adjustment (BIS economists/ ‘Austrian school’)