Dubravko Radošević *

BETWEEN DEBT AND THE DEVIL: MONEY, CREDIT, AND FIXING GLOBAL FINANCE

Adair Turner

Princeton, New Jersey, Princeton University Press, 2016, 302 pp, ISBN 0-691-16964-0 (hardcover)

This book presents a new approach in monetary theory and policy. Adair Turner is not a mere academic economist[1], but he was one of the regulators who had to deal with the financial crisis in UK. Adair Turner held no official policy role before the crisis. As a head of Financial Services Authority (FSA) he was involved in dealing with the consequences of the global financial crisis and its effects on the financial industry in the City of London, who is still global financial centre and the most important financial centre in European Union. In introductory

* D. Radošević, Ph. D., Senior Fellow at the Institute of Economics, Zagreb. (E-mail: dradosevic@eizg.hr).

[1] Jonathan Adair Turner, Baron Turner of Ecchinswell, is a British businessman, academic and was Chairman of the Financial Services Authority (FSA) until its abolition in March 2013. He is the former Chairman of the Pensions Commission and the Committee on Climate Change, as well as the former Director-General of the Confederation of British Industry (CBI). On 29 May 2008, it was announced that he would take over as Chairman of the Financial Services Authority. He took up this post on 20 September 2008 for a five-year term to succeed Callum McCarthy. Currently he is Chairman of the The Institute for New Economic Thinking (INET). From that, he wrote a book "Between Debt and the Devil: Money, Credit, and Fixing Global Finance". On Sept. 7th 2005 he was created a life peer as Baron Turner of Ecchinswell, awarded in recognition of his public service to the nation. In 2016 he was elected an Honorary Fellow of the Royal Society. I am indebted to Dr. Adair Turner for kindly sending me the book, encouraging me thus to study more deeply post - crisis monetary economics. We hope that financial experts in Croatia and SEE will have more insights in modern monetary theory, and that policy makers, in particular central bankers will be influenced by these new ideas for radical monetary reform.

pages of this excellent book, Adair Turner made a clear statement that he was not fully aware how deep was the crisis and obviously it was the main motive to write this book, that we could understand the cause roots of the financial crisis and how to avoid the next crisis? He stated that „the lack of foresight did not reflect blind fate in free financial markets. I always believed that financial markets were susceptible to surges of irrational exuberance: I was unconvinced by the Efficient Market Hypothesis" (p. XII). To understand that, we have to return to the questions usually ignored by the policy makers and financial industry. Author had to return to the insights of the early and mid – twentieth – century economists, such as Knut Wicksell, Fridrich Hayek, John Maynard Keynes, Irving Fisher, Frank Knight and Henry Simmons. Adair Turner said that he had to „discover" the writings of Hyman Minsky (see, Minsky, 1986), monetary economist that was largely marginalized by the mainstream of the discipline[2]. Adair Turner understands the need for more financial regulation, and he said: „Radical policy implications follow. I now believe that banks should operate with leverage levels (the ratio of total assets to equity) more like five than the twenty – five or higher that we allowed before the crisis. And I argue that governments and central banks should sometimes stimulate economies by printing money to finance increased fiscal deficits. To many people the first proposal is absurdly radical and the second dangerously irresponsible: to many, too, they appear contradictory. But I hope to convince you that they are entirely consistent and appropriate, given the cause of the 2007 – 2008 crisis and severe post – crisis recession. In 2008 I had no idea that I would make such proposals. (p. XIII)."

In a nutshell, these words precisely reflect the main message of the book, how to prevent new financial crisis, how to re–regulate financial industry (private banks), how to limit excessive credit creation by the commercial bankers, without sufficient influence on the money supply by the central banks and regulators, all in order to prevent boom - bust Mynskian cycles and instability of disinflationary phase of financial cycles, when there is a deflation threat that is devastating for the unemployment (deflationary spiral) and social/political stability.

[2] Hyman MInsky acquired acknowledgement and wide spread respect among financial and academic community in the wake of global financial crisis, when Lehman Brothers collapsed triggering global financial crisis, by melting down the asset bubble on the Wall Street. This moment of bubbles burst and sharp disinflation was then called in honour of Minsky as „Minsky's moment" (The Economist, 2016), who actually predicted global financial crisis. In addition, we think that it was highly important when Minsky gained acceptance by the academics (Randal Wray, 2016) and opinion makers, for instance, Martin Wolf, chief economist in Financial Times, who published an remarkable book on financial crisis (Wolf, 2014) in which his basic theoretical framework is „inherent financial instability theory" formulated by Hyman Minsky. Dr. Turner called his approach also as Keynes/Minsky theories to emphasize the difference with Neoclassical theories (see, Turner, 2012).

The book contains five basic chapters. The first part („Swollen Finance"), begins with the explanation of (potential) instability of the financial sector of the economy, the pre–crisis assessment of the "financialization" (excessive credit expansion in deregulated economy, when there are many incentives for financial deepening and creation of the debt overhang). Pre–crisis orthodoxy was based on the monetary consensus that more finance was good for the economy and financial markets had a beneficial influence on the real economy, while there is no need for the regulation of the financial industry, because the financial markets are perfect and macroeconomic equilibrium has to be achieved without any intervention by the state or/and central banks. Some orthodox economists found that „financial deepening" is beneficial for growth, and that there are positive correlations between private credit to GDP ratio and between stock markets turnover and growth. This consensus (supported with numerous empirical and quantitative analyses) turned out to be completely wrong. Adair Turner presents several main failures in such consensus, three pre–orthodoxy intellectual errors: (1) a failure to recognize that financial markets are different from other markets; financial markets are inefficient and irrational, the Efficient Market Hypothesis (EMH) and Rational Expectations Hypothesis (REH), as theoretical foundations of pre–crisis monetary orthodoxy, are not appropriate for modern and complex financial systems; (2) ignorance of the crucial macroeconomic implications of credit and money creation, of banks, shadow banking systems and particular types of debt in general; and, (3) a failure to recognize that relationship between finance and development is not linear and limitless, that debt above certain levels is harmful. Part two („Dangerous Debt"), focuses on debt – financed growth before crisis and why it caused harm, even though inflation remain low and stable? In this chapter, Lord Turner describes why debt contracts can be valuable but also dangerous and how banks create credit, money and purchasing power. Here is also explanation of the importance of urban real estate in modern market economies, and why banks created too much of the wrong sort of debt (through mortgage lending), instability and crisis. Excessive leverage growth, unsustainable dynamics of growth of private debt produced a severe post – crisis debt overhang, leading to the situation that fixing the banks will not be sufficient to fix the economy. Turner said *that more radical policies will be required*. Recovery and growth is possible after the crisis, but there is urgent need to address three drivers of, as Lord Turner states, „unnecessary" credit growth – rising real estate values, increasing inequality and global imbalances. The most important message of this part of the book, is that we have to recognize that government stimulus of demand, through money financed deficits, is less dangerous than private credit creation. Before the 2007 – 2008 financial crisis private credit grew rapidly and far faster than growth of GDP in almost all advanced economies, as well in post–transition economies in CESEE and other emerging markets (including China). The result of such dynamics on the financial markets was the increase of private leverage, the ratio of private credit to GDP. Real economies leverage grew, because private credit grew faster than nominal GDP. The development of „fractional reserve banks" was beneficial for the development of the financial markets and many empirical studies have found evidence that „financial deepening" is good for the economic growth. But, in the pre-crisis orthodoxy there was also lack of understanding how excessive private credit leverage could be harmful, as Minsky said - „stability destabilizes". Turner explained five features of debt contracts that make them potentially dangerous, but the most important are three of them: (1) „sudden stop" phenomena, when debt markets can be susceptible to „sudden stops" in new credit supply, and refinancing of existing debt contract became impossible, due to new assessments of risks, that were previously ignored or underestimated by the creditors and investors and bankers are not willing to lend new money; (2) asset prices falls, or, asset – price disinflationary dynamics produced by „sudden stop" or loss of confidence into the market stability, when debt contracts with various types of assets as a collateral for credits became risky and unsecured loans, leading to the credit crunch and causing insolvency of the banks (rising NPLs, because of the reduced asset prices). NPLs and credit crunch can be powerful drivers of financial and macroeconomic instability. Lord Turner describes this financial market dynamics as self–reinforcing „debt deflation", which was originally formulated by Irving Fisher. In his 1911 book, Fisher described a theory of financial crises that tied them to over-borrowing during the expansion phase that preceded the crisis, and to the changes in the purchasing power of money that this expansion causes, then to the collapse in credit and the drop in the price level. This idea reached its best exposition in his 1933 article "The Debt Deflation Theory of Great Depressions" (Fisher, 1933). Irving Fisher stated there that the causes of all great depressions appear to be "over-indebtedness to start with and deflation following soon after; that where any of the other factors do become conspicuous, they are often merely effects of symptoms of these two." (Shiller, 2011, p. 1). Dr. Turner fully acknowledged Fisher's contribution and based his research on debt – deflation theory formulated by Irving Fisher. „A key theme of this book is the danger of too much debt. Beyond the certain level, increasing leverage makes the economy more fragile" (p. 134). Important also is that Lord Turner challenges the conventional wisdom of the financial intermediation of the banks, in which banks create money (lending to the corporate sector of economy) on the basis of deposits collection of households. This standard textbook description of the modern banks is largely fictional, and it fails to capture their essential role in credit creation, money and thus purchasing power. Banks create credit and money through „maturity transformation" and thus they play a crucial role in stimulating nominal demand growth. If the creation of purchasing power is directed toward investments, this will stimulate faster economic growth and employment. The opposite will happen when banks skew purchasing power toward various types of asset speculations. So, how much credit banks create and to what purposes that credit is devoted are therefore issues of vital importance for economic and monetary policies. In chapter four, there is explanation of the importance of certain categories of credit, with the division among finance for investment, consumption and existing assets. Actually, this part of the book describes various types of unsustainable private credit devoted for consumption and existing asset financing, that proves to be unsustainable and leading to debt overhang. In terms defined by Hyman Minsky, the banking/financial system has progressed from „Hedge“ to a „Speculative“ system, with two negative consequences: the first, misallocation of resources and the second, debt overhang effect. It is very important how the author analyses debt overhang related to credit booms that are not results from new investment financing, but it is instead focused entirely on already existing assets. Such type of credit booms, focused on existing assets financing, could lead into supercharged version of the credit cycles, described by Minsky. The problem of modern banking today is that only minor share of their lending activities constitutes lending to the productive investment, through intermediation mechanism of funding investments from the households' savings. The importance of real estate in wealth of the country as well as a major share of banking lending activities could generate asymmetric dynamics of credit and asset price cycles. Namely, lending against real estate, from the private perspective of individual banks, became profitable and less risky categories of lending, more manageable loan portfolio that is secured against credit risks, although in emerging economies, due to euroization process, these types of debt contracts are potentially very risky, because private banks are not able to transfer foreign exchange risk to the borrowers, and in case of sudden stop or/and bubble burst and credit crunch, it is translated into the credit risk of the lenders (private commercial banks). In addition, lending against real estate – in particular against existing real estate – generates self – reinforcing cycles of credit supply, credit demand and asset prices. Almost unlimited credit supply by the modern banking system is fuelling asset price inflation, rising prices of existing real estate with “net wealth gain” for the borrowers, which led to rising confidence of the market players, borrowers and lenders. Borrowers are willing to borrow more because net wealth effect gives them confidence to borrow more for any given loan to value (LTV) and confidence is strengthened by the expectations that asset prices will steadily rise, which in turn will increase the value of the real estate and wealth of the borrower. Such credit and asset price cycles are supported also with the limited supply of new real estate, and result is the divergence between credit supply (almost unlimited) and real estate (limited supply of new real estate and existing real estate are more expensive, fuelling thus asset bubbles). As Lord Turner describes: „at the very core of financial instability in modern economies thus lies an interface between an infinite capacity and inelastic constraint. Banks, unless constrained by policy, have an infinite capacity to create credit, money and purchasing power; so do shadow banking systems. But supply of locationally desirable real estate (and ultimately land) is always somewhat inelastic and in some cities close to fixed. Potentially infinite nominal demand and finite supply combine to make the price locationally specific real estate indeterminate and potentially volatile. The resulting credit and asset price cycles are not just part of the story of financial instability in modern economies, they are in its very essence (p. 73.)." Inherent instability of the financial system, will trigger financial crisis in the downswing, when economies turn into the bubble burst phase of Minskyan financial cycle. Falling asset prices will reduce wealth effect of the borrowers, and lending against real estate will not be fully covered with the value of the collateralised real estate, these loans becomes unsecured assets, with collateral that is not securing the loans that are granted by the banks, which leads to the lower quality of the loan portfolio (NPLs), insolvency and credit crunch, sudden stop to the rapid pre–crisis credit growth. The economy is left facing a debt overhang effect. Consequences are dire, economy is in debt–deflation crisis. To reduce debt, borrowers starts deleveraging, which shrinks their balance–sheets (economist Richard Koo, calls it „balance- sheet recession"). Rapid deleveraging and deflation depresses demand in the economy. Post–crisis conventional view on debt overhang is that restoring the banking system stability is the key priority. This is the „banking view", but the „debt view" is that we should have a significant personal debt forgiveness. Dr. Turner's judgement is that both credit supply and credit demand matter[3]. Lord Turner describes post–crisis dynamics in resolving debt overhang. The private debt has been reduced through rapid corporate – sector deleveraging, and shifts into the rising government debt. Increasing public debt shifts focus of policy makers into the fiscal consolidation policies as a remedy for high levels of public debt and fiscal deficits, although it is evident that root cause of crisis and post – crisis developments is in private debt overhang and debt – deflation recession. Once high leverage exists, all policy levers seem imperfect. But the author made here a very important conclusion that „governments and central

[3] Describing policies aimed to restore credit supply in European Union, Lord Turner is referring to the new facilities of the central banks that directly funded real economy lending (Bank of England and European central bank). He thinks that monetary policy was effectively transmitted to cheap credit supply, but the demand was not there, because borrowers were already overleveraged. In essence, it is the question of effectiveness of the monetary policy instruments of the ECB, in particular T-LTRO 2 facility, which was effectively used by the banks for refinancing the previously granted T- LTRO loans. Cheap credit supply was not transmitted to the real economy. According to some relevant analysis, there is a problem with benchmarks and the size of the incentive offered by T-LTRO2, that will influence the effectiveness of this ECB facility (Gros, Valiante and De Groen, 2016). In combination with other non – standard measures, in June 2016, ECB has introduced new financing facility, the „Corporate Sector Purchase Programme" (CSPP), i.e. outright purchases of investment – grade euro – denominated bonds issued by non – bank corporations, some sort of directed credit by the central bank to corporate sector of economy.

banks together never run out of ammunition to counter the effects of debt overhang and deflation as long as they are willing to consider the full range of available policy options (p. 87)‘[4]. In chapter six, author describes globalization, liberalization and innovation. In the section where domestic liberalization of financial systems is described, Lord Turner elaborates three major areas of liberalization, that had long term consequences on the development and stability of the financial industry. First were removed restrictions on the quantity of lending in the economy, either total or in specific sectors. Removal of quantitative instruments of monetary control, was to be determined by free market forces, in accordance with the pre – crisis orthodoxy and this resulted in excessive private credit growth, focused mostly in real estate lending[5]. Second area of domestic liberalization was the removal of distinctions between different types of banks, investment, retail and corporate. The last area of liberalization was increasing focus of central banks on low and stable inflation rate, as the sole primary objective of monetary policy. This monetary policy approach largely ignored various types of inflation, it was focused on core inflation, while asset price inflation was left to free market forces, because financial markets are self – regulated and always in equilibrium. Thus, domestic

[4] This is very important conclusion because there is a shared view in many EU countries that central banks are currently running out of the ammunition, and that the only possible policy options for debt overhang issue is fiscal consolidation (austerity) and internal devaluation. Post – crisis deflation was treated as a good policy for structural reforms of the market economies, and it was and still is tolerated by central banks and governments in many European economies, including Croatia. From historical prospective this could be very harmful, very similar to „liquidationist“ policy approach in USA after the Great Crash, when, for instance, Treasury Secretary Mellon said: „the best policy was to liquidate labour, liquidate stocks, liquidate the farmers, liquidate real estate ... It will purge the rottenness out of the system .. People will work harder, live a more moral life. Values will be adjusted, and enterprising people will pick up the wrecks from the less competent people“ (Ahamed, 2010, p. 364). Also, there is a consensus among economic historians that monetary interventions were the most effective policy option in recovery of the US economy during FDR’s New Deal. Plenty of policies are left, and the most radical policy ideas fuse fiscal and monetary policy. Lord Turner is one of the most influential proponents of such radical policy ideas, breaking the taboos in economic thinking.

[5] Domestic liberalization of the financial sector and capital account liberalization were high on the agenda of Washington consensus and was stumbling block in stand – by arrangements by the IMF. „The Washington consensus of the 1980s and 1990s sought to prevent government credit misallocation by depoliticizing credit markets, but liberalization simply swapped one danger for another” (p. 143). There were few exceptions in Asian emerging markets (S. Korea, Japan, China) who practiced rediscounting private – sector loans by the central bank, or they used guidance (moral suasion) or instructions to the banks and decide criteria that defined whether loans could be „rediscounted“ at the central bank and thus effectively funded by it. This is very close to money finance, but with the resources lent to the private sector, rather than extended to the government. As a matter of fact, it is private credit allocation versus rediscounting private – sector loans by the central bank facilities. Credit allocation is the most important element of post – crisis monetary policy in market economies (for instance, it is the case also with Croatia, see: Radosevic and Vidakovic, 2015).

liberalization of financial market paves the way for future instability: first, it laid down the basis for excessive credit expansion and misallocation of bank credits, leading to asset price inflation, debt overhang effects and Minskyan financial cycle. We could conclude that domestic financial liberalization was at the root of the financial crisis. We can not but fully agree with the author when he concluded that „the amount of credit created and its allocation is too important to be left to bankers; nor can it be left to free markets in securitized credit“ (p. 104).“ More complex systems of financial intermediation need more regulation by the regulators and central banks to prevent inherent financial instability. Basically, central banks have to implement financial stability – oriented monetary policy, monetary strategy that will enable optimal level of inflation[6] and stability of the financial system (see more on this issue, in: Eichengreen et al., 2011; Borio, 2014). These two goals have to be addressed with monetary policy strategy and macro prudential strategy of the central banks. We support ideas that mildly positive rate of inflation can make easier to service already accumulated debt; because according to „Fisher effect“ deflation increases real interest rates and it is reinforcing deleveraging and shrinking the balance–sheet of the corporate sector, which will reduce nominal demand, and results in recession or „secular stagnation“ with rising unemployment. Consequently, positive inflation – in a range between 3–4 percent - is beneficial for debt servicing in post–crisis recession[7], and reflationary monetary policy is needed. Lord Turner is more daring in his ideas and he is proposing government fiat money creation, because fiat money can create purchasing power and thus aggregate nominal demand. In addition, there is possibility to create credit and money by the private banks, but private creation of money has been deregulated and could bring additional instability. Therefore, if we do not allow to use overt money finance of fiscal deficits („monetization of fiscal deficits“ is strictly forbidden in EMU and EU), then market economies have to rely only on private credit and money creation, which is currently limited with constraints in financial markets: debt overhang, rapid deleveraging, credit crunch and insufficient money/credit supply and credit demand. Credit and money policies of private banks were pro – cyclical, as the Chicago economist Henry Simmons concluded that „in the very nature of the

[6] There is a strong consensus that continuous deflation would be bad in modern economies, although some authors make distinctions between „good“ and „bad“ deflation. We support ideas that deflation is always „bad deflation“, because it always reduces nominal demand and results with slow growth, „secular growth“ or recession.

[7] Several economists from the IMF suggested raising inflation target above 2 percent, that is used as an inflation target by European Central Bank, and by the simple rule is used as a standard measure of optimal inflation rate. Also, rather neglected in economic literature and in the post – crisis practice of central banks that inflation target has to be „asymmetrical“, due to the high level of risks of low inflation and/or outright deflation for the macroeconomic stability and financial system stability.

system, banks will flood the economy with money substitutes during booms and precipitate futile efforts at general liquidation thereafter"(p. 114; and Simmons, 1936). In order to neutralize instability of the banks, central banks developed various types of liquidity facilities (lender-of-last-resort, LoLR) and capital regulations. But, crucial is that „over the past 30 years, central banks have largely abandoned any explicit focus on the total amount or the allocation of private credit created"(p. 114). This is the major systemic failure of financial intermediation mechanism in a modern banking system. Stimulating nominal demand by the credit and money creation is left at the discretion of private banks and other financial institutions (shadow banking), that are profit – maximizing organizations, without focus on externalities and macroeconomic policy goals. As Keynes described credit–financed speculation, Lord Turner explained that „potential disconnect between capital goods speculation and current nominal demand is central to understanding the dynamics and implications of real estate credit and asset price cycles" (p.117). Credit creation that finances purchase of existing real estate does not stimulate nominal GDP to the same extent as credit granted directly to finance new real investment or consumption. Thus, taking into account that excessive credit and money creation by the private banks, and domestic and external deregulation of the financial markets, accompanied with the restrictions on fiat money creation by the central banks (removal of „discount window" and quantitative monetary policy instruments), there are two effective responses to the failures of pre–crisis orthodoxy in monetary policy: removal of commitment to free market allocation of credit and removal of the absolute ban of fiat money creation (p. 129). This is the most important point of a very complex set of ideas presented in this book, we could say that this is the major contribution to the post – crisis monetary theory. As Lord Turner simply describes „the underlying principle is that we cannot rely on free market credit creation to produce either an optimal allocation of capital or an adequate and stable level of nominal demand"(p. 130). Implications for policy are considered in Parts IV and V. Part III, chapter 9, explores the role of international capital flows in global financial crisis, when capital account liberalization was one of the basic preconditions in IMF conditionality[8] and it brings in-

[8] IMF in Hong Kong in 1997 proposed capital account liberalization as a requirement for IMF membership. Fortunately, it was not accepted and IMF changed its view on capital controls („institutional view" of the IMF was published in November, 2012). Oxford economist Ilene Grabel called this „productive incoherence". Productive incoherence refers to the proliferation of inconsistent and even contradictory strategies and statements by the IMF into new regime. Those who see continuity at the IMF emphasize the reassertion of the IMF's authority, the reiteration of pro-cyclical policy adjustment and the maintenance of existing governance patterns within the institution. In contrast, evidence of discontinuity includes the normalisation of capital controls and Fund conditionality programmes that are inconsistent in key respects. We could say that such views of the IMF were very harmful for some of the IMF members, where policy makers were under influence of the IMF, such as Croatia, where central bank implemented capital account liberalization that was reinforcing

stability that was „imported" into the emerging market economies and „EU periphery" countries. In Eurozone, design of monetary union without fiscal union, produced the Eurozone financial crisis, with severe debt overhang and divergence between „core EU" and „EU periphery". Lord Turner thinks that „unless the Eurozone can agree to the radical reforms required to support adequate nominal demand growth, breakup may be inevitable and preferable to continued slow growth and deflation[9]"(p. 131). Eurozone enlargement, in particular entry of the economically weak countries into the European monetary union (Greece, Italy, Spain, Slovenia, etc.), diminished and removed exchange–rate risk and facilitated harmful private borrowing, while sovereign risk was underestimated by the private banks, although EU did not design crisis mechanisms in the case of Eurozone instability. The free market misallocated capital, and in 2010 international capital flows in the Eurozone suddenly stopped, leaving EU periphery economies with a particularly severe debt overhang problem. Radical reform of the incomplete monetary union is needed. Strengthening monetary union or making the EU and Eurozone some kind of the „flexible union" (or „differentiated integration" approach), with different approach to political union, in particular after Brexit, will have to deal with inefficient and fragmented financial markets and instability in Eurozone. Dr. Turner made a consistent proposal for Eurozone crisis: „The general point is clear. In domestic economies both the quantity and the category of mix of credit creation must be actively managed, and countries (or currency unions) need domestic policy tolls that can offset the depressive effects of debt overhang resulting from past policy errors. Among countries, meanwhile, the wrong sort of capital flows must sometimes be constrained. The idea that international financial integration is always and in all respects beneficial is a delusion"(p. 159). In next two chapters (Part IV and Part V), the author describes his proposals for radical monetary reform in market economies. This is the most challenging part of the book, where dr. Turner explains how to fix the financial system to prevent excessive credit expansion and how to escape the debt overhang created by the past policy mistakes. This part of the book focuses on the ideas and principles that should guide radical monetary

---

unofficial euroization (dollarization) of the financial system, and produced debt overhang problem, including excessive external macroeconomic imbalances.

[9] It is astonishing how ECB underestimated deflation risk in Eurozone. For instance, dr. Peter Praet, member of the Executive Board of the ECB, in his interview in December 2014 said: „No, we don't really think that there is a high risk of a recession in the euro area. Also the risk of broadly-based deflation in the euro area is not high. And we don't see risks for the financial system as was the case in 2012, when the euro area was on the brink of a dangerous downward spiral." But, after only a month, the Governing Council of the European Central Bank (ECB) on 22 January 2015 announced an expanded asset purchase programme (EAPP): „Aimed at fulfilling the ECB's price stability mandate, this programme will see the ECB add the purchase of sovereign bonds to its existing private sector asset purchase programmes in order to address the risks of a too prolonged period of low inflation."

reform. Its basic idea is that – in addition to policy action designed to make financial system more stable (bank recapitalization, etc.) – it is even more important to manage the quantity and influence the allocation of credit in real economy. Chapter 1 describes three pre – crisis mistaken ideas, which are: liquidity and complete financial markets are beneficial for economy and stability; inflation targeting is insufficient, while bank balance-sheet matters more; and much credit growth is unnecessary and potentially harmful. Briefly, the first set of ideas refers to the theory that if financial markets are more deep and sophisticated, and more innovative it could bring positive effects on economic growth. This idea neglects the risks of unregulated financial markets. The second mistaken idea was that inflation targeting monetary strategy by the central banks will bring inflation under control and financial stability. Pre – crisis orthodoxy taught that growth of private bank money had no necessary and proportionate implications for price inflation. Monetarist theories taught that prices must be driven by the total amount of money in circulation, and that velocity of money would be somewhat stable. But, when both credit and money increased more rapidly than nominal GDP, increasing leverage (credit divided by nominal GDP) had as a consequence declining velocity of money (nominal GDP divided by money). Different dynamics of leverage and velocity of money arises from the fact that most credit was not devoted to financing new productive capital investments but to funding the purchase of already existing assets. In a nutshell, stocks of credit and money (or other bank liabilities) can grow more rapidly than GDP without ever producing high inflation which was targeted by the central bank strategy, or briefly to say, price inflation could be low, stable and under control, while asset price inflation is rapidly rising, but central banks will feel not compelled to respond with counter – cyclical policy measures. Asset–price inflation would then lead to debt overhang and it will inevitably bring financial instability and financial crisis, which was the case with Croatia and other SEE economies. Lord Turner correctly concludes, that while money is not a good forward indicator of inflation, *the stock of credit matters because of potential implications for financial stability, debt overhang and deflation. In the future we had to constrain the growth of that stock* (p. 171). The third mistaken idea of the pre–crisis orthodoxy was that credit growth was assumed essential to stimulate nominal demand and to ensure adequate investment. Pre–crisis theory assumed that there is a positive, linear and limitless relationship between financial deepening and economic development. But, post–crisis monetary theory and experience with financial crisis in some countries, recognized that it is more „inverted U" relationship, and that beyond some threshold, rising private debt to GDP can cause harm and bring financial instability[10]. We therefore need policy levers that can

[10] These post – crisis theories on the potential instability of private debt beyond certain levels, were recognized by the EU experts, although too late to prevent financial crisis in Eurozone,

constrain excessive credit growth. It is far more important, then just fixing the banks, changing architecture of the financial system after the crisis. Lord Turner, of course, is not against fixing the system through a new bank resolution procedures, or institutional reform, such as ring – fencing (making a difference between investment and commercial banks, too-big-to-fail problem), ensuring much higher equity capital requirements[11], etc. The author describes (Chapter 11, "Fixing Fundamentals") several preconditions that have to be fulfilled before financial reform: (a) regulation of real estate problem and instability it brings into the modern market economies (problem of insufficient supply of real estate, easing constraints on new real estate development and financial regulation that will constrain demand and supply of real estate bank credits); (b) rising inequality that is related to the real estate problem (how to limit availability of real estate credit and protect customers of the banks from unsustainable debt contracts); and, (c) global imbalances (there is an urgent need to deal with large current – account imbalances that have been one of the important drivers of excessive credit growth. In particular, these imbalances are very large in Eurozone, and new adjustment policies have to be designed to stimulate domestic demand in EU, while there is also a problem with China). In the next part of the book (Chapter 12, „Abolishing Banks, Taxing Debt Pollution and Encouraging Equity"), dr. Turner explains why he is against radical proposals to abolish completely private bank credit creation, abolishing fractional reserve banking system, introducing 100 % reserve banking, as a modern version of „The Chicago Plan". All deposits in commercial banks will be redeposited at the central bank (100 percent reserves), the money supply would be equal to monetary base and „banking multiplier" through which banks create private money in addition to fiat money would be abolished[12]. Basically, according to the views of

---

and various thresholds were included in the methodology for the assesment of macroeconomic imbalances within European Semester mechanism (Macroeconomic Imbalance Procedure, MIP). The headline indicators in MIP (MIP Scoreboard) consist of the indicators and indicative thresholds, covering the major sources of macroeconomic imbalances, for instance: private sector debt (consolidated) in % of GDP with a threshold of 133%; private sector credit flow in % of GDP with a threshold of 14%; year-on-year changes in house prices relative to a Eurostat consumption deflator, with a threshold of 6%; general government sector debt in % of GDP with a threshold of 60%; and for external imbalances, threshold is net international investment (NIIP) position as percent of GDP, with a threshold of -35%. EU designed MIP after the crisis in Eurozone started, and now it is „corrective", rather than „preventive" mechanism of policy coordination in EU.

[11] It is interesting that Dr. Turner is in favour of higher capital requirements as equity buffers when problems arise, rather than „bail – in" scheme, that is introduced as a main principle in a new bank resolution strategy of the EU (and ESM).

[12] It is interesting how cross – border EU banking groups (banks operating in several countries abroad, but with HQ only in one of the EU countries), reacted in financial crisis, through their subsidiaries in transition/emerging European economies. When financial crisis occurred, private banks started deleveraging and capital reversals, for instance in CESEE countries, bringing thus additional instability into these economies. Then EU, EBRD and IMF organized „Vienna Initiative",

Friedman, Fisher and Simmons, money – financed fiscal deficits were the best way to stimulate economies in deflationary times, but appropriate targets could ensure that the sizes of the unfunded deficits was compatible with desirable slow expansion in the level of nominal GDP. We cannot but agree with Lord Turner's views that such radical proposal would be too narrow and impossible in modern post – crisis financial systems, although we could embrace its key conclusion: that private money creation was at the root cause of the financial crisis and that limitless ability of the private banks to create credit and money has to be strictly regulated by the central banks. What matters for the modern post – crisis financial system is to manage the quantity and mix of credit that the banking or shadow banking system creates. Thus, here it is an important role of central banks and regulators.

Deregulated banking system has created too much of the wrong sort of debt. Three things matter: the pace of credit growth, the level of private – sector leveraging and the mix of debt by category. The rapid credit growth indicates rapid debt accumulation, which at the certain level of private – sector leverage - that is considered as unsustainable level of indebtedness - determines the severity of debt overhang. Rapid rise of debt and high private–sector leverage precipitates financial crisis and boom–bust cycle. Excessive credit creation is forward indicator of asset - price inflation, financial crisis, post–crisis debt overhang and deflation. Deciding when asset bubble has started, the size of divergence from market equilibrium and when the bubble is expected to burst is an art, not a science. Different types of debt contracts create different risks, and debt mix is very important, in addition to level of indebtedness. There are simple rules and thresholds that define how much debt is too much and what mix of debt is optimal. Lord Turner proposes a clear philosophy: we need to constrain the quantity and influence the mix of debt that banks and shadow banks create (chapter 13, part IV, „Managing the Quantity and Mix of

---

a working group/coordinating mechanism of multilaterals and private banks with its primary goals to coordinate sudden stop, deleveraging and capital outflows from CESEE economies, in order to prevent sovereign defaults in these countries. But, the main instrument for such policy was that private banks should not decrease their exposure in the CESEE bellow pre – crisis levels (although, there was no appropriate mechanism for the regulation and sanctions) and that post – crisis private credit creation will be funded by the increase of the deposits at banks. Actually, Vienna Initiative introduced some kind of transitional credit mechanism that is similar to 100 % reserves banking, the national banking system can be in effect treated as if it were in part a 100 % reserve system and in part a fractional reserve banking. Fiscal policy was implemented in accordance with Fiscal Compact. To conclude, CESEE economies fell into outright deflation, and they were not able to reduce debt overhang. Post – crisis macroeconomic policies in CESEE countries could be simply described as a 100 % reserves banking, with the prohibition of money – financed fiscal deficits, that are targeted through fiscal consolidation strategies (austerity). Debt – deflation crisis, paradox-of-thrift recession and balance – sheet crises are inevitable implications of such post – crisis monetary arrangements. Deflation and secular stagnation or even stagdeflation, with high unemployment, are inevitable results of such economic/financial policies.

Debt"). That will require five sets of policies: (1) bank regulation designed not merely to make the banking system itself safe but also constrain lending to the real economy particularly against real estate; (2) constraints on risky non–bank credit intermediation of shadow banking), even if are at the expense of reduced market liquidity; (3) constraints on borrowers' access to credit; (4) measures to put sand in the wheels of harmful short–term debt capital flows; and, (5) actions to ensure that there is enough credit to fund required capital investments, for instance through the creation of banks with a dedicated focus on specific lending categories (p. 195 – 196). We will briefly explain details of such policies. Slowing down credit booms could be achieved using interest rate as a monetary policy tool. Advantage of this policy instrument is that it has linear impact on all categories of debt contracts and it is difficult to avoid its influence, as it is possible when central bank is using quantitative policy instruments, because there is always opportunity of „regulatory arbitrage". In particular, we have to agree that the most effective way to lean against the credit and asset–price booms is raising interest rates. If money interest rates were set bellow Wicksell's „natural rate of interest", as dr. Turner suggests, there were strong incentives to borrow cheap money, making credit and asset–price booms and bringing financial instability. This argument was made by William White (2012), one of the few economists who warned of the dangers of private credit booms before the crisis. Major disadvantage of interest rate as a policy tool is that different categories of debt contracts could have different elasticity of response to changing rates, and then interest rate policy could become ineffective. In the book, the author refers to the interest rate policy of the Swedish Riksbank between 2011 – 2014, which was quite unsuccessful and property boom in Stockholm continued in spite of the raising interest rates. Constraining bank credit creation is possible, by using central bank macro prudential instruments. The essential problem is that there is no natural rate of interest, when credit is used for different purposes, but there are instead several different and potentially unstable expected rates of return. Thus post – crisis monetary policy options need to abolish pre–crisis monetary orthodoxy that interest rate policy has neutral impact on credit allocation, and new policies has to rely to quantitative levers, including ones that discriminate among different categories of credit. This means that central banks have to use more „targeted" policy instruments, aiming to constrain the level of debt and mix of debt contracts[13]. The main policy for constraining bank credit creation, could be capital requirements, because higher capital buffers could reduce risks and could resolve the too-big-to-fail problem. In the book, there is

[13] The use of „quantitative instruments" to control credit and bank liquidity necessarily influenced money creation and inflation and had an impact on credit allocation as banks substituted the assets on their balance sheets. Credit controls often have to be backed up with capital controls and could thus be targeted specifically at the banking sector without leading to an exchange of assets with the rest of the financial sector (see, Monnet, 2014).

proposal to significantly increase capital adequacy ratio from 4,5 % (actual regulatory requirement for major banks is in the 7 - 10 % range) to 20 – 25 % of the gross unweighted value of their assets (p. 199). Essentially, this means that leverage ratio for the private commercial banks should be limited to the level of 4 : 1. But the issue is how to raise equity capital buffers without exacerbating the deflationary impact of deleveraging? *This book's central argument is that we must constrain private credit growth; the pace of credit growth and the structure of debt mix*. Much higher capital requirements is policy instrument designed for ensuring long–term financial stability. But, taking into account volatility of financial cycles, with swings from boom to bust phases, this capital requirements are applied throughout the whole economic cycle. What we need is a counter–cyclical policy instrument that can lean against the cycle. These are counter–cyclical capital buffers, that central banks could use in order to prevent asset bubbles. Reserve ratios are additional policy options, which could affect bank credit growth. It is usually defined as quantitative reserve requirements, minimum reserves that commercial banks must hold at the central bank as a proportion of all liabilities or assets, remunerated or interest–free holdings, which defines whether this tool will impose a tax on credit intermediation? Reserve asset requirements are in form a quantitative rather than price tool, but have significant implications on interest rates. The major problem here is also that different categories of credits can have different elasticity of response, while there is a need for differentiated approach when central banks apply this policy instrument. Lord Turner made specific proposals that capital requirements have to be established against specific categories of lending; risk weight should reflect social, not private, risk. Palley (2004) in his paper argues for developing a new system of financial regulation based upon asset-based reserve requirements (ABRRs). Such a system represents a shift in regulatory focus away from the traditional concern with the liability side of financial intermediaries' balance sheets. ABRRs have both significant macroeconomic and microeconomic advantages. At the macroeconomic level they can provide policy makers with additional policy instruments. In the book there is the important conclusion that central banks need to ensure that capital requirements for different types of credit reflect systemic and macroeconomic risks. That could be achieved either through maximum leverage ratios (that is, capital requirements against the gross unweighted value of assets. Leverage ratios for private banks are not yet limited by the Basel III rules) or by setting risk weights for real estate lending significantly higher. Constraints on borrower's access to credit could be regulated by maximum allowable LTV or LTI limits in the residential mortgage market and commercial real estate. There are strong arguments in principle for preferring LTI, since it more directly addresses the issue of debt servicing capacity and better constrains the danger of self–reinforcing credit and asset–price cycles. Structural measures in monetary reform are also very important, for instance ring–fencing in and between countries. They could be also an establishment of specialized banks for specific types of debt contract finance (investment banks, etc.), that excludes real estate finance and other more risky types of debt contracts. Central bank policy instruments such as directed bank credit towards productive investments are also possible. We refer to „functional efficiency" of the financial system (term coined by James Tobin), that is, the ability of the financial system to provide finance for long – term investment. The practice of rediscounting private – sector loans by the central bank could be necessary, to increase „functional efficiency" of the post–crisis financial systems. *All these measures have one single aim, and that is to provide enough of the right sort of the debt. Faced with a free market bias toward real estate lending, interventions favouring other types of lending are justified*. Lord Turner's reform agenda set out above represents a dramatic rejection of the pre–crisis orthodoxy. Some elements of it are already accepted by the central banks and regulators, such as capital requirements, counter–cyclical capital buffers add some other macro prudential rules, to ensure stability of the financial systems, but some of the basic requirements of Basel III standards were delayed or not fully applied (level and definition of capital, leverage ratio, the treatment of regional German banks, transition period for full application of Basel III rules, etc.; see more in: Howarth, 2014). *But other go far beyond post – crisis consensus: constraints on the pace of credit growth and level of debt, and intervention by the central banks in the allocation of credit, using different approaches in regulation of different types of debt categories*. Private credit creation is inherently unstable (Fisher, Knight, Keynes, Simmons, Minsky), and central banks should intervene against free market credit creation bias towards „speculative" finance. Central banks have wide – ranging responsibilities (Eichengreen, 2011; Borio, 2014) and they have to prevent future financial crisis. Part V. of the book answers a question how to escape from the debt overhang left behind by past policy mistakes? The author is willing to consider all policy options (in chapter 14, Part V, „Monetary Finance – Breaking the Taboo"), including „overt money finance" - OMF (or, „Helicopter Money"), creating additional fiat money to finance increased fiscal deficits. Insufficient demand is the main problem in post–crisis recovery, and debt overhang prevent implementation of traditional fiscal policy stimulus, due to „crowding out" and „Ricardian equivalence" effects. Post–crisis theory explains that fiscal policy could stimulate nominal demand, because there is underemployment and spare capacity, so direct fiscal stimulus effect will produce additional real growth as well as price inflation. In such circumstances, faster GDP growth could reduce future debt to GDP ratio. But, there are limits to our ability to use traditional fiscal stimulus to escape the debt trap. Thus we need to find policies that stimulate nominal demand and do not result in rising public debt. Now, it comes to "Helicopter Money" explained by Milton Friedman (1948). *He said that inadequate nominal demand is one problem to which there is always a possible solu-*

tion. If an economy was suffering from deficient demand, he suggested, the government should print dollar bills and scatter them from a helicopter. People would pick them up and spend them; nominal GDP would increase; and some mix of higher inflation and higher real output would result. The magnitude of impact of helicopter money is determined with the people propensity to spend, or it would depend on how much people spend rather than saved their new–found financial wealth. The macroeconomic impact of helicopter money is dependent by the size of monetary stimulus, in terms of proportion of monetary stimulus in GDP. Lord Turner summarizes Friedman's simple example, as three truths: „We can always stimulate nominal demand by printing fiat money; if we print too much, we will generate harmful inflation; but, if we print only a small amount, we will produce only small and potentially desirable effects“ (p. 219). Essential principle of helicopter money in modern financial system could be applied as an electronic transfer to all citizens to their commercial bank deposit account. This will have immediate impulse on increasing nominal demand. Or, alternatively, it could cut tax rates or increase public expenditure. Helicopter money could be implemented as a pure fiscal and/or as a pure monetary stimulus. It is indeed essentially a fusion of the two. The main issue is whether we can contain their long–term impact in a modern economy with fractional reserve banks. Monetary stimulus would create additional private credit creation and purchasing power created by the private banks, and initial stimulative effect of monetary stimulus could be multiplied through fractional reserve banking system. This was the reason why Irving Fisher, Henry Simmons and lately Milton Friedman supported the idea to introduce 100 % reserve banks. Monetary stimulus with 100 % reserve banks will offset deposit multiplication of initial monetary stimulus, containing thus the potential ability of the private banks credit creation, and introducing a sort of financial discipline into the financial system. For them, 100 % reserve system and overt money finance of small fiscal deficits were thus a completed policy package. Lord Turner correctly concludes that these policy approaches also suggest the obvious solution: „any dangers of excessive long – term demand stimulus can be offset if central banks impose reserve asset requirements“ (p. 221). This would in fact impose a 100 % requirement on the new fiat money creation. In addition, it would be important if central banks will remunerate these bank reserves or they will not pay interest on them. Reserve requirements remunerated at a zero interest rate impose a tax on future credit creation. *Money – financed deficits today, suggests Dr. Turner, plus implicit taxes on credit intermediation tomorrow might be the optimal combination*. There are three specific uses of over money finance: Bernanke's helicopter money; one–off debt write–off, and, radical bank recapitalization. In Eurozone countries, overt money finance is strictly forbidden by the Maastricht Agreement and Articles of the Agreement (Statute) of the European Central Bank. ECB has not any legal mandate to implement such a policy (i.e. ECB Article 123.1), while

US Federal Reserve was able to implement such monetary policy. But, the author suggested that rebooting the Eurozone will not be possible without fiscal as well monetary stimulus ideally combined in the form of monetary finance. *The best pragmatic short – term strategy, may involve operation that post facto turns out to be money finance, but whose essential nature can be denied for fear of legal and political challenges*[14]. Money finance could be one – off or continuous policy, while in the case of secular stagnation, money finance could be a continuous device, with necessary constraints to limit adverse consequences of helicopter money in modern financial system with fractional reserve banks. Money finance could be limited within constraints of central bank independence and inflation targeting (see, Turner, 2015). Chapter 15, Part V, „Between Debt and the Devil – A Choice of Dangers"), summarizes the analysis of the previous chapter and presents some concluding remarks. Lord Turner suggests how to solve dilemma between debt (debt overhang) and the devil (financial crisis and secular stagnation) within new paradigm for post – crisis economics. „*Pre – crisis orthodoxy combined total anathema against fiat money finance with an almost totally relaxed attitude to private credit creation. Optimal future policy must reflect reality that we face a choice of dangers and must combine far tighter controls on private credit creation with the disciplined use of fiat money finance when needed*" (p. 240). The book provides nicely written and well-structured review of monetary economics and main currents of post – crisis monetary theories. It is a necessary reading for academic financial experts, policymakers, central bank and government decision - makers, in advanced as well as in emerging economies, in designing post – crisis financial and economic policies.

REFERENCES

Ahamed, Liaquat, (2010): *Lords of Finance: 1929, The Great Depression and the Bankers Who Broke the World;* Windmill Books; London

Borio, Claudio, (2014): *Monetary Policy and financial stability: what role in prevention and recovery?;* Bank for International Settlements; BIS Working Papers; No. 440; Basel; January 2014

[14] As an example of some sort of central bank operations that post facto could be amounted to money finance, but in reality it was not overtly stated in advance, we could consider a new type of ECB refinancing operations, called PSPP (Public Sector Purchase Programme) under EAPP. Under this facility, ECB will buy long – term bonds issued by the European Investment Bank (EIB), for infrastructure investment funding. This is very close to money finance without quite crossing the line. PSPP is limited by amount of purchase and its impact could be proportionate to the level of ECB monetary intervention.

Eichengreen, Barry, et al. (2011): *Rethinking Central Banking*; Brookings Institution; Washington DC, September 2011

Fisher, Irving, (1933): "The Debt - Deflation Theory of Great Depressions"; *Econometrica* (1), October 1933

Friedman, Milton, (1948): "A Monetary and Fiscal Framework for Economic Stability"; *American Economic Review* 38(3), 245 - 64

Gros, Daniel, Valiante, Diego and De Groen, Willem, (2016): *The ECB's Latest Gimmick: Cash for Loans;* CEPS; CEPS Policy Brief; No. 341; Brussels, March 2016

Howarth, David, (2014): *The Difficult Search for Bank Stability in Europe: Basel III, CRDIV and European Banking Systems*; Presentation held at the University of Luxembourg; Luxembourg; 12 February, 2014

Minsky, Hyman, (1986): *Stabilizing an Unstable Economy*; New York; McGraw – Hill

Monnet, Eric, (2014): *Monetary Policy Without Interest rates: Evidence from France (1948 to 1973) Using Narrative Approach*; VoxEU; CEPR, Brussels; 05 July, 2014; www.voxeu.org

Ostry, Jonathan, Prakash Loungani and Davide Furceri, (2016): "Neoliberalism: Oversold?"; *Finance & Development*; IMF, Washington DC, June 2016

Palley, Thomas, (2004): "Asset Based Reserve Requirements: Reasserting Domestic Monetary Control in an Era of Financial Innovation and Instability", *Review of Political Economy*, Routledge; London. 16 January, 2004

Radošević, Dubravko and Vidaković, Neven, (2015): "Monetary Policy versus Structural Reforms: The Case of Croatia"; *Bančni Vestnik* (Monthly Journal of Slovenian Bankers' Association/Zdruzenje Bank Slovenije); Ljubljana; December 2015

Shiller, J. Robert, (2011): *Irving Fisher, Debt Deflation and Crises*; Cowles Foundation Discussion paper No. 1817; Yale University; New Haven

Simmons, Henry (1936): "Rules versus Authorities in Monetary Policy"; *Journal of Political Economy* 44(1):1-30

The Economist, (2016): *Minsky's Moment*; London; 30th of July, 2016; www.economist.com/news/economics-brief/

Turner, Adair, (2012): *Economics After the Crisis: Objectives and Means*; The MIT Press; Cambridge; MA

Turner, Adair, (2015): *The Case for Monetary Finance – An Essentially Political Issue*; Paper presented at the 16th Jacques Polak Annual Research Conference Hosted by the International Monetary Fund, Washington, DC, November 5–6, 2015; https://www.imf.org/external/np/res/seminars/2015/arc/pdf/adair.pdf

William, White (2012): *Ultra – easy Monetary Policy and the Law of Unintended Consequences*; Working Paper 126, Dallas, Federal Reserve Bank of Dallas

Wolf, Martin, (2014): *The Shifts and the Shocks: What We've Learned - and Have Still to Learn – from the Financial Crisis;* New York, Penguin Press

Wray Randall, Larry (2016): *Why Minsky Matters? An Introduction to the Work of Maverick Economist;* Princeton University Press; Princeton