Understanding and Forecasting the Credit Cycle—Why the Mainstream Paradigm in Economics and Finance Collapsed

by Richard A. Werner

Introduction

Professor Richard A. Werner, DPhil (Oxon), BSc (Economics, LSE), began his academic career as Marie Curie Fellow of the European Commission at the University of Oxford. From 1997 to 2004 he was Assistant Professor at Sophia University, Tokyo. Since 2004 he has been at the University of Southampton, School of Management, where he is Chair in International Banking and founding director of the Centre for Banking, Finance and Sustainable Development.

Professor Werner has two decades of experience in the financial sector, including as chief economist at Jardine Fleming Securities (Asia) Ltd, Senior Managing Director at Bear Stearns Asset Management, and as senior consultant or visiting researcher at the Asian Development Bank, the Japanese Ministry of Finance, the Bank of Japan, the Japan Development Bank and the Nomura Research Institute. Richard served as member of the asset allocation board of a US$6.5bn Japanese corporate pension fund, and has been working as global macro fund manager and provider of forecasting services and economic policy advice to investors and governments.

His book *Princes of the Yen* was a no. 1 bestseller in Japan in 2001. In his 2005 book *New Paradigm in Macroeconomics*, he warned about the dangers of “recurring banking crises,” including the pending financial collapse in the UK, and detailed the required policy responses. Richard has been voted one of the top economists by investor surveys and is sought as a commentator by the media. The World Economic Forum, Davos, selected him as “Global Leader for Tomorrow” in 2003.

Crises Have Disproven Mainstream Neo-Classical Economics

The global financial crisis has led many observers to question the success of an array of government policies adopted in the past decade or so in many countries. Most have been directly or indirectly based on the thinking that markets should be the ultimate arbiter, and hence deregulation, liberalization, and privatization was the policy mantra.

The doubters are now in good company. For about two decades, Alan Greenspan, chairman of the Board of Governors of the Federal Reserve System from August 1987 to January 2006, has been considered the oracle on any issue involving banking, monetary, fiscal, and economic policy. The “Maestro” has been a staunch champion of the deregulation mantra and the belief that markets, if left unregulated and to their own devices, would produce the best possible outcome for society. Likewise, he also believed that bankers should not be further regulated as their self-interest would ensure an optimal result. This thinking is commonly known as “mainstream” or “neo-classical” economics. From about 1980 onwards, it was initially adopted by international organizations such as the IMF and the World Bank in their policies imposed on dozens of developing countries, but since the mid-1980s it has became the guideline of other Washington-based decision-making bodies, such as the US government (hence it is often called the “Washington Consensus” on economic policy). It has since also become the basis of government policies worldwide, such as in Thatcherite and New Labour Britain, or more recently in Japan, Korea, or Germany. Even nonmarket economies such as China have begun to adopt a growing set of recommendations derived from this free market economics.

Dr Greenspan, an academically trained economist and key promoter of this creed, has, however, now changed his mind. On October 23, 2008, he admitted—reluctantly, under cross-examination by irate Congressmen—that this entire approach to economics is flawed and that his faith in the free markets had been wrong. Greenspan had been summoned to give formal testimony to the House Committee on Oversight and Government Reform of the US House of Representatives about his role and involvement in the events that led to the financial crisis. His testimony must be considered a watershed in the debate about different economic theories and policy recommendations.

Representative Henry Waxman of California, chairman of the committee, asked him: “You had the authority to prevent irresponsible lending practices that led to the subprime mortgage crisis. You were advised to do so by many others. Do you feel that your ideology pushed you to make decisions that you wish you had not made?”

Greenspan: “…Yes. I’ve found a flaw. I don’t know how significant or permanent it is. But I’ve been very distressed by that fact.” The exchange goes on:

Waxman: “You found a flaw in the reality.” Greenspan: “…[A] flaw in the model that I perceived as the critical functioning structure that defines how the world works, so to speak.”

Waxman: “In other words, you found that your view of the world, your ideology was not right. It was not working.” Greenspan: “Precisely. That’s precisely the reason I was shocked…”

There was a second admission, concerning the methods used to calculate and manage risk in the entire financial sector: “This modern risk-management paradigm held sway for decades. The whole intellectual edifice, however, collapsed in the summer of last year,” Greenspan testified.

The crisis has with one stroke not only discredited the particular decisions by those responsible for the crisis—central bankers, financial regulators, and bankers—but it has disproved the entire mainstream “neo-classical” paradigm of thinking about economics and economic policy. The Washington Consensus, the basis for recent government and central bank policies all over the world, has been proven wrong.

But the current crisis is not the only piece of evidence that there has been something seriously amiss with the mainstream economic theories and the policies based on them. Other evidence includes the increasingly visible environmental destruction, or the many previous financial and economic crises the world has seen. Indeed, banking and financial crises have recurred with such frequency over the past centuries that their occurrence must be considered one of the few constants in economic life. Each time, much surprise is exhibited by the experts. Over the past three decades, the number of banking and financial crises has increased (to over 100 countries) and the swings of the business cycle have become more pronounced. (It is noteworthy that this happened, as central bank independence and power over economic policy has increased significantly during this time period).

Thus the experience in many countries has contradicted key aspects of mainstream theories. There is one country, however, where the number of “anomalies” or contradictions of the mainstream approaches has been the largest: this is Japan, the second largest economy in the world. First, Japan’s meteoric postwar rise, which was based on nonmarket policies, cartels, and “guidance” of industries and credit, could not be explained. Then, in the 1980s, Japan experienced a surge in asset prices and capital outflows that economists had not expected (and could not explain). Just when observers were predicting that Japan was about to take over the world, in the early 1990s, asset prices fell sharply and economic growth decelerated for over a decade (soon we will have clocked up two decades). These almost twenty years of recession, deflation, and economic depression have occurred despite all the textbook recommendations having been implemented. During the 1990s, record fiscal spending delivered record government debts, but there was no recovery. Lowering interest rates to zero failed to accelerate growth. Structural changes increased deflation and bankruptcies, but did not boost demand.

What’s Wrong with Mainstream Economics?

Just why is it that, while science is constantly making visible progress, economics seems to be stuck in a time warp, without making any visible advances? Here we are in the 21st century, with man having been on the moon, and with the most advanced telecommunications technology spreading knowledge faster than ever before. Yet, the financial markets are allowed to generate the same kind of boom–bust cycle as in earlier centuries.

Could it be that mainstream economics suffers from adhering to some fundamental errors that must compromise all its results? The most familiar diagram in economics is that of a downward-sloping demand and an upward-sloping supply curve. Most observers, but also most economists believe that economics has shown that prices move to equalize demand and supply so that, thanks to the working of the markets, we experience “equilibrium” or market clearing. But, actually, economics has done no such thing. Quite to the contrary, it has shown that such market clearing would only be possible if and only if we lived in a world of perfect information, complete markets, and where many other unrealistic assumptions held—all of which are necessary to achieve this textbook outcome. Since it is evident to everyone that these assumptions do not hold on the planet we live on, it should be clear that economics really has proven that in our world we cannot expect any market ever to clear. But instead of learning from this finding that equilibrium cannot exist, and hence any economics based on equilibrium needs to be discarded, the unrealistic fictional equilibrium models have become the mainstream. Economists are obliged to pretend that the emperor is not naked, that markets clear, that there is equilibrium, and, even more preposterous, that markets deliver the best possible outcome for society.

For Dr Greenspan it took over 40 years to have his eyes opened. Let's hope that others will be quicker. But how is it possible that theories that have no bearing on reality could become the foundation of an entire approach that in turn becomes the dominant ideology globally, influencing government policy and even the thinking of ordinary people?

The theoretical sleight of hand is that economics, as virtually the only discipline, has got away with arguing that its theories do not need to be based on the fundamentals of economic reality (a methodology called "inductive"), but can exclusively be based on "axioms" and assumptions (the deductive methodology) that have been assembled as it suited best to obtain a predetermined ideological goal—the goal to present market outcomes as supreme. No surprise, then, that the performance of such economics has been dismal.

So what would nonfiction economics look like? Markets cannot clear, because information, time, and money are rationed. So what happens in the world we live in, where markets do not clear? Demand does not equal supply. And such rationed markets are determined by quantities, not prices. Their outcome follows the "short-side principle:" whichever is smaller, demand or supply, that quantity will be transacted. And that short side can extract additional, nonmarket benefits.

This has far-reaching political implications. While the rhetoric is of a globalized world, dominated by anonymous market forces, which decide the flow of goods, services, and capital across the globe, the reality is that the majority of trade flows are decided by planners—bureaucrats or bureaucrat-like managers at large-scale corporations, who make discrete allocation decisions. The reality of "market capitalism" is therefore that the market plays a much smaller role than is widely claimed. Recognizing pervasive rationing and lack of market clearing implies that instead of the dream-world of efficient (and hence politically neutral) markets, we live in a reality of powerful allocators who make decisions that suit them, but which are in no way linked to what is best for the overall economy or society. This sharply lowers the hurdle for government intervention to be beneficial to society.

Mainstream economics purports to have shown that government intervention is almost always inefficient and creates distortions. However, this finding only comes about, because government intervention has to beat the super efficient markets of the illusory theoretical dream world – and by definition it cannot do that. But if we leave the dream world oftheoretical mainstream economics, we find that on our planet markets are not just often failing, they are virtually never in equilibrium. This sharply lowers the hurdle for government intervention to become beneficial to society. And it explains the otherwise puzzling finding that many countries, such as 20th century East Asian economies and 19th century Germany, succeeded so spectacularly in developing their economies quickly on the basis of strategic though pervasive government intervention.

The Reality of Credit Creation: There Is No Such Thing As a Bank Loan

What are the implications for finance and banking? For small firms, the price of money (the interest rate) is usually less important than the question of whether a loan can be obtained at all. Banks prefer to ration and allocate credit—even in the best of times—because due to the high demand for this useful thing called money, the theoretical market-clearing interest rate would be so high as to leave them with only risky projects, while sensible projects could not service the loans. This explains why interest rates are far less important in the economy than is generally claimed. Instead, the quantity of credit is the most important variable determining growth, asset prices, and exchange rates.

The most important institutional reality that has been neglected by theoretical equilibrium economics is the key function banks perform: they create between 95% and 98% of the money supply. The first and most important form of privatization that has swept the world has been the privatization of the creation and allocation of money, which is implemented by privately-owned commercial banks.

This means that there is no such thing as a “bank loan.” Banks do not lend money. “Lending” refers to transferring control of the lent object to the borrower. If I lend you my car, I can’t drive it at the same time. That’s not what banks do when they issue a “bank loan.” Instead, they are allowed by the current regulatory framework to create new money out of nothing—which is called “credit creation.” The collective decisions of commercial bank staff thus determine how much money is created, who gets the newly created money and to what use it is put.

Mainstream economics assumes that the best possible outcome will be achieved if banks are left alone in making their decisions about how much money should be created, to whom it should be handed over, and for what purpose. But the current crisis has demonstrated that we can’t expect banks’ credit decisions to be in any way beneficial to the overall economy, social welfare, or even the bankers themselves—as Alan Greenspan has now admitted. The incentive structure at banks is such that they tend to create too much credit, when not needed, and for unproductive use. This is followed by banks creating too little money, when more would be needed.

There are some simple rules for sound banking and sound economics that need to be followed. Whenever credit is created and used to increase the amount of goods and services provided, it will result in noninflationary growth; more money comes about, but also more goods and services. Whenever credit is created and used for unproductive purposes, inflation comes about; more money chases limited goods or assets. The unproductive credit creation can take two forms. When credit is extended for consumption, it will result in consumer price inflation. When credit is extended for non-GDP transactions (which means mainly financial and real estate transactions), there will be asset inflation. Both cases are unsustainable and, if sufficiently large, result in banking and economic crises.

In the research experience of this author, this framework (first proposed in a 1992 paper, published as Werner, 1997) delivers the most reliable models for forecasting nominal GDP growth, equity markets, bond markets, and even currencies. Credit used for GDP transactions is the most reliable forecaster of nominal GDP growth. Credit used for non-GDP transactions ends up driving up real estate and asset prices, and ultimately turns into bad debts. It is thus a key variable to watch by policy makers, if one wants to prevent asset bubbles and banking crises, as I have suggested many times in the past two decades. Empirical evidence and further details can be found in the book, *New Paradigm in Macroeconomics*.

To prevent banking crises, it must be ensured that the bulk of credit creation is used for productive purposes. Specifically, aggregate bank credit for transactions that are not part of GDP (something that can be easily verified by loan officers) needs to be monitored, and suppressed when it rises in excess of overall bank credit growth (see Werner, 1997, 1999). This simple measure would have prevented the credit bubbles in the United States, the United Kingdom, Ireland, Spain, and many emerging markets, which have now burst and caused the current crisis. It would also have prevented the Japanese depression since 1990 or the US Depression of the 1930s, among others. Central banks used to monitor precisely this but, following the deregulation advice of mainstream economics, they chose to abolish their “credit guidance” policies and instead let rip the unproductive bank credit expansions. Ironically, now the UK, French, and German governments want to monitor the allocation of new bank lending (to small firms) policy advice of the kind I have given consistently and repeatedly since 1991, but which was rejected as ‘inefficient interference’ in ‘free markets’. This amounts to closing stable doors when the horse has already bolted.

Thus one also needs to ask why those institutions that could have prevented the bubbles have singularly failed to do so, although they had been given unusually strong powers with little accountability to democratic institutions—the central banks. They cannot feign ignorance: apart from employing the largest number of economists of any institution and spending vast resources on ‘research’ (none of it on the taboo topic of credit creation), I have also contacted many central banks and finance ministries and have in the past twenty years published many articles based on my credit model, warning of pending crises (such as today’s UK banking collapse) and indicating that bubbles and subsequent collapses could easily be prevented by monitoring and restricting speculative (non-GDP) credit creation. Central banks – and governments for that matter – were not interested. This suggests that the very independence and lack of accountability of central banks has been a factor in allowing the creation of credit bubbles and the propagation of the current crisis. Central banks should be made to monitor credit flows and be more directly accountable to democratically elected assemblies for the macroeconomic results.

How to Fix the Banking System and Ensure Employment

What should be done to end the current crisis and avoid large-scale unemployment? Just like the Japanese government in the early 1990s, governments have responded by increasing fiscal expenditure, funded by borrowing, and central banks have responded by lowering interest rates. Neither will help. The privately owned creators of the bulk of the money supply are battening down the hatches; in their increased risk aversion they will reduce credit creation. Just as their excessive credit creation affects us all, so does their reduction of credit. For economic growth, as traditionally measured, credit creation is necessary. This is why the current policies will not help. Fiscal policy on its own does not create credit. By borrowing more, national debt is increased, but the money for the fiscal stimulation is the same money that is removed from the economy through bond issuance. Thus fiscal policy, if not backed by credit creation, will crowd out private demand dollar by dollar. And lower interest rates will not help—even if they drop to zero—if the quantity of credit does not increase. This is why Japan will soon be in the twentieth year of recession after its own credit bubble burst in 1990. (My predictions and recommendations to this effect over the past twenty years have been met with stony silence or outright rejection by policy makers.)

The solution is simple: fiscal stimulation, in the form of purchases of nonperforming assets from banks, and public purchases of bank equity, should be funded either by the issuance of government money (such as Kennedy's 1963 "United States Notes," to give a graphic example), or, failing that, undertaken directly by the central banks, for their own account. In both cases, national debt and interest liabilities will not increase, but credit creation will. Growth will not collapse. This also makes sense from a moral hazard perspective. The tax payer is not responsible for the current mess, the central banks are—so let them pay.

In countries, where central banks are not cooperative with governments, credit creation can still be jump-started by stopping the issuance of government bonds and instead funding the public sector borrowing requirement through direct borrowing from the commercial banks (a policy I first proposed in 1996). All of the above proposals I termed 'quantitative easing' in my publications, such as articles for the Nikkei in 1995 and 1996. When the Bank of Japan adopted my terminology (which has now conquered the world), it unfortunately chose to use my label, but not the actual policies: it focused on expanding banks' reserves, which I had already explained would not help.

More Info

Book:

- Richard A. Werner. *New Paradigm in Macroeconomics*. Basingstoke, UK: Palgrave Macmillan, 2005.

Articles:

- Werner, Richard A. "Towards a new monetary paradigm: A quantity theorem of disaggregated credit, with evidence from Japan." *Kredit und Kapital* (1997): 276–239.
- Werner, Richard A. "Soundness of financial systems: Bank restructuring and its impact on the economy." Paper presented at the International Conference on Central Banking Policies, May 14–15, 1999, Macao. Published as: Werner, Richard A., "Post-crisis banking sector restructuring and its impact on economic growth." *Japanese Economy* 30:6 (November–December 2002): 3–37.

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