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West's debt explosion is real story behind Fed QE dance

By Gillian Tett

Western finance cannot be fixed without tackling credit addiction

The danger with addictions is they tend to become increasingly complusive. That might be one moral of this week's events. A few days ago, expectations were sky-high that the Federal Reserve was about to reduce its current $85bn monthly bond purchases. But then the Fed blinked, partly because it is worried that markets have already over-reacted to the mere thought of a policy shift. Faced with a choice of curbing the addiction or providing more hits of the QE drug, in other words, it chose the latter.

In many ways this is understandable; the real economic data is still soft. But as investors try to fathom what the Fed will (not) do next, it is worth pondering a timely speech made recently by former UK regulator Lord Turner*. As he told Swedish economists last week, and repeated to central bankers and economists in London this week, the real story behind the recent dramatic financial sagas – be that the market dance around QE or the crisis at Lehman Brothers five years ago – is that western economies have become hooked on ever-expanding levels of debt.

Until this situation changes it is delusional to think that anyone has really "fixed" western finance with post-Lehman reforms, or created truly healthy growth, Lord Turner insists. Put another way – although he did not say so bluntly – one way to interpret this week's dance around QE is that policy makers are continuing to prop up a financial system that is (at best) peculiar and (at worst) unstable.

Such criticisms, of course, are not new: maverick far-right and far-left economists have been making them for years. But what makes Lord Turner's contribution notable is that until recently he was sitting at the centre of the global financial system – and post-Lehman reform process – he now thinks is so flawed. And from that perspective he points out some curious contradictions. Take what banks do. A standard economics text book, Lord Turner writes, claims that banks exist to "raise deposits from savers and then make loans to borrowers" ... and "primarily lend to firms/entrepreneurs to fund investment projects". Thus "demand for money is a crucial issue" in terms of growth.

But this depiction is a fiction, he says. The reason? He calculates that today in the UK a mere 15 per cent of total financial flows actually go into "investment projects"; the rest support existing corporate assets, real estate or unsecured personal finance to "facilitate lifecycle consumption smoothing".

Some non-investment finance is socially useful, Lord Turner admits; but much is not. In real estate, for example, most credit just "funds the purchase of already existing houses" rather than investment in new homes (ie construction). And what is really striking about the non-investment piece of this financial picture is that it has exploded; as a result, as the Bank of England's Andy Haldane also pointed out in a debate in London last week, the size of private credit, relative to GDP, has doubled to 200 per cent in the past 50 years.

This makes a mockery of existing textbooks and official policy assumptions. But the explosion in credit has another peculiar implication, both Mr Haldane and Lord Turner note: since total credit keeps rising inexorably, even as growth remains flat, the "productivity" of money is falling, even as the propensity of the over-leveraged system to have booms and busts, amid investor sentiment swings, has risen.

So is there any solution? Lord Turner offers a few ideas. He wants a radical overhaul of the intellectual models that economists use (including, presumably, those in central banks.) He also wants policy makers to deliberately reduce credit. Thus the Basel III framework for banks should have tough counter-cyclical capital requirements, he argues, and regulators should reintroduce "into the policy toolkit quantitative reserve requirements, which more directly constrain banking multipliers and thus credit growth than do increases in capital requirements".

Now, of course, that is not happening; on the contrary, British banks are under political pressure to provide more mortgages, as house prices hit new peaks, and the Fed is so determined to kickstart the US housing market it keeps gobbling up those mortgage bonds. Of course, the official policy line is that this is just a temporary affair: once there is strong, sustainable growth, this will stop.

But don't bet on that soon; or not in a world where asset prices and animal spirits are now so dependent on cheap money, and so central in driving growth. Either way, as investors celebrate this week's QE decision, they would do well to remember that 15 per cent estimate for productive investment. And it would be fascinating if somebody tried to work out what the ratio for the US economy is today. Particularly if that calculation was to emerge from the Fed.

**Adair Turner on Credit, Money, and Leverage, Institute for New Economic Thinking*

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