IS THE GLOBAL ECONOMY – ‘SAFER, SIMPLER & FAIRER’ - as FSB CLAIMS?

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Prime Economics

www.primeeconomics.org
To G20 Leaders

A decade after the start of the global financial crisis, G20 reforms are building a safer, simpler and fairer financial system.
1. UNDERSTANDING THE SYSTEM

2. GLOBAL ECONOMY

3. THE OUTLOOK
UNDERSTANDING MONEY AND MONETARY SYSTEM
‘MONEY AS COMMODITY’
Orthodox, neoclassical economic models suggest that finance is a “veil” and not an independent source of risk.
“Even in the most advanced industrial economies, if we *peel off the obscuring layer of money*, we find that trade largely boils down to barter.”

Paul Samuelson
Bank: “a financial intermediary.”

Paul Krugman and Robin Wells
Loan: “a lending agreement between an individual lender & an individual borrower.”

Krugman and Wells:
“The majority of money in the modern economy is created by commercial banks making loans.”

Quarterly Bulletin 2014 Q1
Borrowers CREATE the money supply

- OR -

CONTRACT the money supply
“Credit and credit alone is money.

Credit and not gold or silver” (or Bitcoin) “the acquisition of which is the aim and object of all commerce.”

Mitchell Innes ‘What is Money’ May, 1913.
PRIVATE COMMERCIAL BANKS

– Not the Central Bank

- ‘PRINT’ THE MONEY SUPPLY
Private, licensed, commercial banks “print”

- 99% of Broad Money in the US

– 95% of Broad Money in the UK
SAVINGS NOT NEEDED FOR INVESTMENT

The money for a loan is not in the bank when a borrower applies for a loan.
“Banks do not act simply as intermediaries, lending out deposits that savers place with them, … and nor do they ‘multiply up’ central bank money to create new loans and deposits.”

Quarterly Bulletin 2014 Q1
Once loan application made, collateral supplied, interest rate agreed, contract signed…hey presto..
Walt Disney's
THE SORCERER'S
APPRENTICE
DEREGULATION OF MONEY-CREATION, POST 1960s
LIFTING OF MACROPRUDENTIAL TOOLS/MEASURES TO TARGET CREDIT DEVELOPMENTS
(i) demand-side measures, such as limits on loans-to-value ratios, margin requirements, loan maturities, and tax policies;
(ii) and supply-side actions, including lending and interest rate ceilings, reserve and capital requirements, portfolio restrictions, and supervisory guidance.
‘REGULATION Q’ in the US placed limits on interest that banks could offer savers to attract deposits.

COMPETITION AND CREDIT CONTROL – 1971

“All Competition and No Control”
IN THE US THE 1969 CREDIT CONTROL ACT
- phased out in 1982.
External financial assets and liabilities around 110% of GDP in 1900, troughed in 1945 at about 25%, and soared to around 400% of GDP in 2015.
UK financial sector and government borrowing has continued to grow since 2008

Debt¹ by sector, 1987–2012Q2
% of GDP

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<tr>
<td>Growth</td>
<td>172</td>
<td>18</td>
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<td></td>
<td>11</td>
<td>41</td>
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<td></td>
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<td>-10</td>
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<td>34</td>
<td>-8</td>
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¹ Includes all loans and credit market borrowing (e.g., bonds, commercial paper); excludes asset-backed securities to avoid double-counting of the underlying loan.

NOTE: Numbers may not sum due to rounding.

SOURCE: Haver Analytics; UK Office for National Statistics; McKinsey Global Institute

McKinsey & Company
“The global stock of external assets and liabilities rose nearly 190 percentage points between 2000 and 2007.”

THE RATE OF INTEREST
“Henceforth bank lending controlled on the basis of cost, that is, through interest rates…”

Duncan Needham *UK Monetary Policy from Devaluation to Thatcher, 1967-82* 2014. P. 3
“Loans would be granted to those companies and individuals that could pay the highest rate, rather than those that fulfilled authorities’ qualitative criteria.”

Duncan Needham, as above.
“Adjustable rate mortgages on FIVE houses “and a condo””  The Big Short.
Figure 2: UK and US long-term corporate real rates of interest

Movements can be examined in more detail by decomposing real rates into nominal rates and price change. For clarity figure 3 shows the decomposition by decade (inflation is shown with a negative sign), and figure 4 shows decade to decade change. (R is nominal rate; P is inflation and r the real rate.)
The rate of interest

“the villain of the piece”

(Keynes)
International Interest Rates
Rises and falls and the financial crisis

Chart taken from presentation
by Richard Koo, Chief Economist,
Nomura Research Institute, Tokyo,
to the INET Conference, Berlin,
14th April, 2012.
The two historical waves of economic globalisation

As a percentage of country sample GDP

Graph 1

THE GLOBAL ECONOMY TODAY
Global Debt

2007 = 269% GDP

2015 = 286% of GDP

2017 = 325% of GDP

McKinsey, as above. IIF, 4 April, 2017.
Global debt has ballooned
% of GDP

Emerging markets
Mature markets

1996: 126 280
2006: 146 348
2016: 215 390

SOURCE: IIF, BIS, HAVER

Source: Daily Telegraph: Global debt explodes at 'eye-watering' pace to hit £170 trillion. 04 April, 2017.
"Platform Capitalism" Monopolies, Rentierism (un-earned wealth)
COLLATERAL – at the heart of the GFC

CAUSE OF THE NEXT CRISIS?
Traditional Banking

- Bank money arises from credit creation via relationship banking, funding assets held to *maturity*
SHADOW BANKING?

- Shadow money arises from credit creation through securities markets, funding securities (collateral) that are *continuously* re-priced in repo transactions

(Peer 2015 quoted by Daniela Gabor, as above.)
Shadow Banking

- Shadow banks are financial intermediaries that conduct maturity, credit, and liquidity transformation without explicit access to central bank liquidity or public sector credit guarantees.

- The banks have played a key role in the market-based financial system, particularly in the run-up to the financial crisis.
FSB: "Banks (the Big Four) are considerably stronger, more liquid and more focused."
August 9, 2007 (Reuters)

BNP Paribas: “The complete evaporation of liquidity in certain market segments of the U.S securitisation market has made it impossible to value certain assets fairly, regardless of their quality or credit rating”
“Securities lending largely responsible for the collapse of AIG when the market seized in September, 2008.”

“Assets Under Management (AUM) are currently estimated at around $87 trillion globally.”

(TheCityUK (2013)).

• AUM: Market-based banking model

- Increased activities in securities and derivatives markets
- Cross border
- Off-balance sheet (shadow banking)

Daniela Gabor, Presentation to PRIME event, 09 August, 2017
Chart 1 Total AUM of US insurance companies, pension funds, mutual funds and other funds, 1946 – 2013

Source: US flow of funds
(a) Other non-property funds include closed-end funds, exchange-traded funds and money market mutual funds
Bank of England

The Age of Asset Management?

April, 2014

Chart 2 Total AUM of UK insurance companies, pension funds and mutual funds, 1980 – 2012

Source: OECD, ONS, Investment Management Association and Bank calculations
The U.S. Federal Reserve raised short-term interest rates in December 2016 and March 2017, as expected, with markets pricing in two additional rate increases by the end of 2017 or early 2018.
BACK IN THE REAL WORLD...
2. Capital Expenditures as a Share of Total Firm Assets
(Nonfinancial corporate sector; percent)

Average 1980–2000 = 5.8 percent

Average 2002–16 = 4.5 percent

Sources: Federal Reserve; National Bureau of Economic Research; National Federation of Independent Business; and IMF staff estimates.

Note: Shaded areas indicate economic recessions.
The debt service burden for the corporate sector as a whole has risen strikingly despite low rates.

1. Corporate Debt Service and Interest Rates

![Graph showing corporate debt service and interest rates over time with periods of recessions highlighted. The graph includes a line for prime lending rate (percent, left scale) and a line for debt service ratio (percent of income, right scale).]
Net equity financing has been falling the past four decades, as debt finance has continued to rise.

3. Corporate Liabilities and Net Equity Issuance (Percent of assets)

Increase in debt and other liabilities

$7.8 trillion

$3.0 trillion

- Negative net equity issuance (gross issuance minus share buybacks)
Corporate cash holdings are tapering ...

1. Corporate Cash Holdings on Balance Sheet

- Blue line: Cash (trillions of U.S. dollars, left scale)
- Red line: Cash (percent of assets, right scale)

Recessions:

Values:
- X-axis: Years (1980 to 2016)
- Y-axis: Cash (trillions of U.S. dollars)
... as profits recede from a high level.

2. Corporate Profits (Percent of GDP)

Recessions

1960 70 80 90 2000 10

IMF
April 20 17
China’s credit continues to rise faster than GDP ...

1. Credit and GDP Growth
   (Percent change year over year)

Credit (adjusted for local government debt swap)

Credit-to-GDP ratio (right scale)

Adjusted

Unadjusted

Nominal GDP
... and signals financial crisis risk, as suggested by international experience.

2. Fast Credit Growth and Past Major Crises (Percent of GDP)

- Japan bubble
- Spain housing crash
- Thailand during Asian crisis
- China credit surge
- U.S. subprime crisis

1980 83 86 89 92 95 98 2001 04 07 10 13 16

- 230
- 200
- 170
- 140
- 110
- 80
- 50
Chinese banks are now among the largest in the world, also relative to the size of the economy...

3. Bank Total Assets to GDP (Percent)
QE – LIFE SUPPORT FOR SEMI-COMATOSE BODY OF THE GLOBAL ECONOMY?
Figure 1: G4 central bank asset purchases, $ trillion

Source: Mark Carney, [De]Globalisation and inflation, speech, 18 September 2017

Acknowledgement: TUC blog, Geoff Tily, 21 September, 2017.
G4 central banks will have pumped $11 trillion

($10,917,000,000,000)

into their economies by the end of 2017.
Chart D  Advanced-economy risk-free real interest rates remain close to historically low levels

International ten-year real government bond yields

Sources: Bloomberg and Bank calculations.

(a) Zero-coupon bond yields derived using inflation swap rates. UK real rates are defined relative to RPI inflation, whereas US and euro-area real rates are defined relative to CPI and HICP inflation respectively.
Figure 3: G4 GDP growth, %

Source: OECD, average across of G4 countries

Source: TUC Blog: Geoff Tily, 21 September, 2017
Bloomberg world stock mkt cap

We’ve never had it so good: Global equities now worth $84.8tn, highest value ever in history. Equals to ~110% of world GDP.
Chart A.35 UK commercial real estate prices look stretched based on ranges of sustainable valuations

Commercial real estate prices in the United Kingdom and ranges of sustainable valuations

Indices: 2007 Q2 = 100

Ranges of sustainable valuations

Upper part of ranges: low rental yields persist.
Lower part of ranges: rental yields rise, consistent with a fall in rental growth expectations or a rise in risk premia.

Aggregate CRE prices
London West End office prices

Sources: Bloomberg, Investment Property Forum, MSCI Inc. and Bank calculations.
Central Banks Retreat from QE?

ECB begins discussions on tapering QE despite stronger euro

Draghi says appreciation adds uncertainty but expects decisions on stimulus in October

7th September, 2017
“... the precise degree and timing of this effect are subject to considerable uncertainty”
“The US stock market today looks a lot like it did at the peak before all 13 previous price collapses.”

“According to my data, real S&P Composite stock earnings have grown 1.8% per year, on average, since 1881.
“….From the second quarter of 2016 to the second quarter of 2017, by contrast, real earnings growth was 13.2%, well above the historical annual rate.”

Robert J. Shiller, as above.
“...my analysis should serve as a warning against complacency.

Investors who allow faulty impressions of history to lead them to assume too much stock-market risk today may be inviting considerable losses.”
“It is only with trembling fingers, then, that this column declares: the stock market is roaring, and that makes perfect sense.

Financial Times editorial, October 6, 2017.
“The rise is supported, first, by synchronised global growth. Company performance has been impressive in the US in particular. Earnings growth in the first and second quarters was in the double-digits.”

Financial Times editorial, October 6, 2017.
The crisis of capitalism

Brazil and the crisis of the liberal world order
Polarised politics and the rise of nationalism echo Trump's US and Brexit Britain

"Gideon Rachman

Discontent from Germany’s eastern states boosts AfD

Kalanick’s appointment of two new directors is ‘highly unusual’ and ‘disappointing’

Bitter divisions over Uber board spill into public

Trump’s war on trade deficit backfires

The Big Read

Ryanair still flies a flag of contempt for customers

Catalan independence vote greets truncheons and rubber bullets

Regulators cannot allow the state to take control

UK Politics & Policy
Labour’s galvanising conference in Brighton
The UK opposition party gathered for their annual conference this week and it was a success for leader Jeremy Corbyn. But how united is the party behind the scenes? And what can we expect to hear from the Conservatives next week?
Is the system safer?
Is it simpler?
Is it fairer?
Thank you.