MARTIN WOLF

The Shifts and the Shocks
What we’ve learned – and have still to learn – from the financial crisis
the essence of a system that we already know is extremely fragile, and which is sure to implode once again in our current world of global financial integration, fast trading and huge flows of funds across borders. So the question is whether one can do simple things that would make the system more or less on its present lines more robust, and if not what the alternatives might be. That is the subject of Chapter Seven.

Third, this leads the discussion to the big macroeconomic challenges. How should we manage a world of savings glut – or, which comes to the same thing, excess supply? Is there a real chance of secular stagnation and, if so, what might be done about it? These are in fact plausible worries. In particular, our big problem is the addiction to ever-rising debt, and the most worrying debt is not the public debt with which policymakers are obsessed but private debt, whose collapse, as we have seen, creates huge public-sector debt problems. It is extremely disturbing, however, that the policies being pursued in the big high-income economies amount to an attempt to get the credit machine going again. So this raises a question. Is it possible to balance our economies without such a huge reliance on ever-rising leverage? The answer is: yes. This can be done in two complementary ways. One is to close external imbalances. The other is to use the government’s ability to create non-debt money. The latter is regarded as unthinkable. But it may in fact be the least dangerous way of running our economy. These then are the issues addressed in Chapter Eight.

Finally, there is the question of the future of the Eurozone. It has become a bad marriage, but one from which it is immensely costly to escape. The question is whether it will be turned into a good marriage – one that all members would join again. At present, this seems highly unlikely. Instead, it will continue to fail to achieve full economic adjustment or provide the basic insurance needed to cope with untoward events as well. Moreover, there is a real danger of falling into a deflationary trap, because of the fundamental asymmetries in the adjustment processes and the failure of the European Central Bank to do its job. This being so, one cannot conclude that the crisis is over. On the contrary, it is perfectly possible to imagine that it would recur. This, then, is the topic of Chapter Nine.

Orthodoxy Overthrown

The message London’s success sends out to the whole British economy is that we will succeed if like London we think globally. Move forward if we are not closed but open to competition and to new ideas. Progress if we invest in and nurture the skills of the future, advance with light touch regulation, a competitive tax environment and flexibility. Grow even stronger if this is founded on a strong domestic market built on the foundation of stability.

And whether it be in advanced high value-added manufacturing, our creative industries, pharmaceuticals, digital electronics, in fast-growing education exports, I believe, just as you have done in financial services, we can demonstrate that just as in the 19th century industrialization was made for Britain, in the twenty-first century globalization is made for Britain too.

Gordon Brown, Mansion House Speech, 21 June 2006

Why did nobody notice it?

Question of Her Majesty Queen Elizabeth II at the London School of Economics, 4 November 2008

[T]hose of us who have looked to the self-interest of lending institutions to protect shareholder’s equity (myself especially) are in a state of shocked disbelief. Such counterparty surveillance is a central pillar of our financial markets’ state of
balance. If it fails, as occurred this year, market stability is undermined.

Alan Greenspan, Testimony before the House of Representatives Committee on Oversight and Government Reform, 23 October 2008

Credit means that a certain confidence is given, and a certain trust reposed. Is that trust justified? And is that confidence wise? These are the cardinal questions. To put it more simply—credit is a set of promises to pay; will those promises be kept? Especially in banking, where the 'liabilities', or promises to pay, are so large, and the time at which to pay them, if exacted, is so short, an instant capacity to meet engagements is the cardinal excellence.

Walter Bagehot, Lombard Street

On 4 November 2008, at the height of the financial crisis, Queen Elizabeth II visited the London School of Economics, one of the world's leading centres of academic economics, to open a new building. While she was there, she asked a group of dignitaries a simple question: 'Why did nobody notice it?'

In response to the Queen's question, the British Academy convened a forum on 17 June 2009. Shortly after these deliberations, a reply was sent to her Majesty. In brief, it argued that the big failures lay in not recognizing how large the risks were to the system as a whole, how bad risk management was, and how big the mess bequeathed by the crisis would turn out to be. The institutional and political failure was the inclination of both politicians and regulators not to look the gift-horse of pre-crisis prosperity in the mouth.

This is hardly an adequate answer. It is easy to accept that the timing of a crisis is unknowable. An economic system is too complex for a precise prediction of the timing of a crisis: indeed, such a prediction, if widely agreed, must be self-defeating. But it is not enough to blame institutional failure, because the institutions that failed were those many economists had lauded, particularly those central to modern finance. This then was not an institutional failure, but an intellectual one. The remark at the head of this chapter by Alan Greenspan, chairman of the Federal Reserve from 1987 to 2006, underlines this point. Rational pursuit of self-interest is the core ideology of the free-market economy. But, at the height of the crisis, Greenspan stated the loss of his faith that self-interest would deliver financial stability. It is as if the Pope declared he no longer believed in the Resurrection of Jesus Christ.

Here is another indication of intellectual failure. On 8 April 2011, at the conference of the Institute for New Economic Thinking (INET) in Bretton Woods, New Hampshire, I interviewed Larry Summers, winner in 1993 of the John Bates Clark medal for American economists under the age of forty, former US treasury secretary, and recently departed director of President Obama's National Economic Council. I asked what economics, if any, he had found relevant to the task of putting the US and world economies together again, after the crisis. He responded: 'There are things economists didn't know. There are things economists were wrong about. And there were things where some economists were right... There is a lot in Bagehot that is about the crisis we just went through, there's more in Minsky and perhaps more still in Kindleberger... I think economics knows a fair amount. I think economics has forgotten a fair amount that's relevant. And it has been distracted by an enormous amount.' Later in the interview, when asked what he found useful as a policymaker in deciding on the response to the crisis, Mr Summers referred to Keynes.

What did these four thinkers named by Summers have in common? They were all dead and their work was so far outside the contemporary academic mainstream that they had become Orwellian 'unpersons'. True, central bankers were aware of the great Victorian economic journalist, Walter Bagehot. But his work was gathering dust on a shelf marked 'irrelevant to contemporary concerns'. Many of today's leading macroeconomic theorists, notably including Chicago's Nobel laureate Robert Lucas, probably the most influential of all, regard the work of John Maynard Keynes as embarrassing and that of the post-Keynesian Hyman Minsky with something bordering on contempt. Charles Kindleberger of the Massachusetts Institute of Technology was an economic historian and, as a result, far below the salt where princes of academic economics sat.

The economics that dominated academia and has shaped thinking for several decades proved useless in predicting, tackling or even
imagining the biggest financial debacle in the world's most advanced economies for eighty years. During the crisis, moreover, the people in authority ran as fast as they could back to Bagehot and even Keynes — indeed, Bagehot and Keynes on steroids. Yet the fact that a meltdown of the world's most advanced financial systems had occurred for a second time is significant. One great depression might be a fluke. A second such crisis begins to look like a pattern. True, policymakers learned lessons from the great economists who had themselves learned from the 1930s. They stopped another depression. But it was still a huge recession from whose effects the affected economies had not emerged six years later.

So what went wrong intellectually and what can be done about it?

THE FAILURE OF OFFICIAL ECONOMICS

In a lecture given at the South African Reserve Bank on 2 November 2012, Adair (Lord) Turner, outgoing chairman of the UK's Financial Services Authority, addressed exactly this question: what had economics got wrong? His answer was:

The financial crisis of 2007 to 2008 was caused by excessive credit creation, excessive leverage, and too much maturity transformation. The fact that these excesses caused such havoc, and that private incentives and market disciplines failed to check their development, reflects three facts which are fundamental to understanding financial system dynamics and risks.

(i) First, debt contracts create specific financial and economic stability risks and those risks intensify as the proportion of all contracts which take a debt and in particular a short-term debt form increase.

(ii) Second, that the existence of banks as we know them today ... exacerbates these risks because banks can create credit and private money, and unless controlled, will tend to create sub-optimally large or sub-optimally unstable quantities of both credit and private money.

(iii) Third, that bank or shadow-bank lending secured against real assets which can change in value, can be even more volatile and pro-cyclical, resulting in credit and asset price cycles which end in crashes and subsequent recessions.

The most sophisticated modern economics ignored these dangers because they had been removed by assumption. The workhorse macroeconomic analytical tool used by central banks was a 'dynamic stochastic general equilibrium model' in which finance barely appeared: the underlying models were of movements towards equilibrium in the demand and supply for real goods and services in the economy, not ones in which financial forces had independent effects, on the lines suggested by Minsky. Meanwhile, modern theories of finance focused on how markets would or should price assets, without paying attention to the impact of big shifts in asset prices on the economy as a whole. The dominant assumption of the macroeconomic models was rational expectations and that of financial theory was market efficiency. As Felix Martin notes, in his book on money, 'By ignoring the essential link between the financial securities traded on the capital markets and the monetary system operated by the sovereign and the banks, academic finance built a theory of finance without the macroeconomy just as neoclassical macroeconomics had build a theory of the macroeconomy without finance.' In effect, the compartmentalization of money and macroeconomics from finance and market efficiency removed an understanding of the interconnections among these aspects of the economy.

This brings us back to Lord Turner's analysis. In the words of staff at the Bank of England, 'In the modern economy, most money takes the form of bank deposits. But how those bank deposits are created is often misunderstood: the principal way is through loans made by commercial banks. Whenever a bank makes a loan, it simultaneously creates a matching deposit in the borrower's bank account, thereby creating new money.' Thus, in making an advance to a would-be borrower a bank simultaneously creates a debt owed to it by the borrower and a deposit in favour of the borrower. Thereafter, the deposit may be transferred to somebody else, as payment or as a gift: it has become money. In this way banks create almost all of the money in
the economy. Of course, individual banks need to hold on to deposits. Otherwise, they would have to shrink their balance sheets. But the deposits they lose would go to other banks (unless customers actually flee into cash). So the system as a whole would not lose deposits and it is the system as a whole that matters to the economy.

True, the distinction between banks and non-bank financial intermediaries must not be exaggerated. Most such institutions generate maturity mismatches and high leverage inside the economy. But banks have two advantages over other intermediaries: the central bank will always provide the reserves that solvent banks need to ensure the ‘moneyness’ of their liabilities, namely, their ability to be redeemed or used in payment, at par with central-bank (that is, government) money; equally, since the 1930s an increasing number of governments have guaranteed the value of at least a proportion of deposits explicitly, regardless of the solvency of the banks, and are implicitly believed to be behind even more of the deposits – quite possibly all of them. Banks, particularly big banks, should be viewed as more a part of the state than of the private sector. These valuable privileges allow banks to expand their lending in good times with next to no constraint. It is easy, after all, for banks to hold on to the deposits they need to fund their expanded lending, precisely because of the public confidence generated by the support provided to banks by the government and central bank. Banks are explicitly part of the government’s monetary system. Of course, once the Federal Reserve offered equivalent support to money-market funds in September 2008, the latter came to have much the same characteristics as banks.

What then stops the bank-led financial system from expanding credit and money without limits? The obvious answer would be that it would stop when participants ran out of profitable opportunities. But this is not a convincing answer if the activities of the hyperactive intermediaries in aggregate create the perceived opportunities: credit growth breeds asset-price bubbles that in turn breed credit growth. This is, at core, a disequilibrating process. That is why microeconomic financial theory is next to useless in explaining it. It is a macroeconomic process, moreover, not a microeconomic one: it shapes the entire economy.

There could then be two further answers to the question: what stops credit expansion? One is that a crisis stops it. That is all too unpleasantly true: in the end the elastic credit system snaps back into a credit crisis: that is the ‘Minsky moment’, when panic sets in. A more pleasant answer is that the central bank stops credit expansion by raising interest rates. The implicit answer of the pre-crisis official orthodoxy was that central banks would stop the excess credit expansion in time, or at least not too late, by responding to rising inflation in the prices of goods and services. But that signal would fail if rising asset prices and expanding credit were not closely related to inflation. That is precisely what happened in the 2000s.

Thus, the period before the crisis saw strong external demand for assets denominated in the currencies of the economies in which credit and money were growing rapidly, and a lack of inflationary pressure in the world as a whole, largely because of a huge expansion of capacity and employment in the production of tradeable goods. Even a huge credit expansion generated no overt inflationary pressure. But asset prices – house prices, above all – rose substantially.

The reason orthodox economics failed to pick up the risks was, in short, that it ruled out what most mattered. Modern financial economics do not equilibrate smoothly. They are dynamic systems characterized by uncertainty and ‘animal spirits’, in which the most powerful destabilizing force is the ability of the private financial sector to generate credit and money and so to produce euphoric boom and panic-stricken bust.

So what now? Let us start with what the official sector and the economists who advise it tell us they have learned. Then let us look at fundamental critiques.

THE OFFICIAL RESPONSE TO ITS ERRORS

In the fourth of a series of lectures on ‘The Federal Reserve and the Financial Crisis’, delivered in Washington DC in March 2012, Chairman Bernanke addressed ‘The Aftermath of the Crisis’. Mr Bernanke was not only the chairman of the Federal Reserve, the world’s most important central bank and the epicentre of policymaking throughout
the crisis, but is also a distinguished academic economist. He should be viewed as an authoritative source for the opinions of most officials and informed academics. In this lecture he did two important things. The first was to defend the interventions of the Federal Reserve and other important central banks after the crisis. The second was to lay out the agenda for post-crisis policymaking. This is what he said:

[We] began by noting the two principal tools of central banks, serving as lender of last resort, to prevent or mitigate financial crises, and using monetary policy to enhance economic stability. In the Great Depression, as I described, those tools were not used appropriately. But, in this episode... and I should say that... other major central banks have followed... very similar policies to those of the Fed... these tools have been used actively. And in my belief, in any case, we avoided – by doing that, we avoided – much worse outcomes in terms of both the financial crisis, and the depth and severity of the resulting recession.

A new regulatory framework will be helpful. But again, it's not going to solve the problem. The only solution in the end is for us regulators and our successors to continue to monitor the entire financial system and to try to identify problems and... respond to them using the tools that we have.

Mr Bernanke then made three fundamental points about the role of central banks, in the light of the crisis.

First, the interventions during the crisis, though huge in scale, were 'very much in keeping with the historic role of central banks, which is to provide lender-of-last-resort facilities in order to calm a panic. And what was different about this crisis was that the institutional structure was different. It wasn't banks and depositors. It was broker-dealers and repo markets. It was money-market funds and commercial paper but the basic idea of providing short-term liquidity in order to stem a panic was very much what Bagehot envisioned when he wrote Lombard Street in 1873.' This is broadly correct, so far as central-bank operations are concerned, though the interventions of finance ministries went well beyond standard lender-of-last resort operations, since they involved buttressing the solvency of failed institutions.

Second, these interventions saved the economy from another 'Great Depression', by preventing a cascading collapse into bankruptcy not just of the financial sector, but of large parts of the US and world economies. We do not know the counterfactual and never will, which makes it easy for opponents of these interventions to argue they were unnecessary. But it is hard to believe that an unmanaged implosion of much of the Western world's financial system, at a time of overextended balance sheets in much of the private sector, would not have created a global depression at least rivalling that of the 1930s. No sane policymakers could have taken that risk and, fortunately, after the post-Lehman shock, they did not do so. We were forcibly reminded of the dependence of the financial system on the unique capacity of the state to create the money that people want when they trust nothing else.

Third, the way oversight of the stability of the financial system as a whole will work is for 'the regulators and our successors to continue to monitor the entire financial system and to try to identify problems'. This is in addition to a host of more detailed changes – to be discussed in Chapter Seven – aimed at making institutions and markets less fragile. The financial sector, argues Mr Bernanke, will need the permanent, persistent and penetrating oversight of a paternal state. The core of the market economy – its brain, so to speak – cannot be trusted to operate without adult supervision. This is not a small matter.

Mr Bernanke emphasized, then, that 'maintaining financial stability is just as an important a responsibility as monetary and economic stability. And indeed, this is... very much a return to where the Fed came from in the beginning. Remember the reason that [the] Fed was created was to try to reduce the incidents of financial panics, so financial stability was the original goal of [the] creation of the Fed. So now we sort of come full circle.' But he did not forget the other goal: monetary stability. On this he argued that:

... markets have been confident that the Fed will keep inflation low, inflation expectations have stayed low. And except for some swings up and down related to oil prices, overall, inflation has been quite low and stable.

At the same time, while we've kept inflation low, we've also made sure that inflation hasn't gone negative... Those of you familiar with the Japanese situation understand that's been a big problem for their
economy now for quite a few years. We certainly wanted to avoid deflation. I talked about deflation also in the context of the Great Depression. So, monetary ease also guarded against the risks of deflation by making sure that the economy didn't get too weak.20

In sum, Mr Bernanke offers the following conception of the three roles of the central bank in the economy: inflation targeting (in other words, macroeconomic stabilization); financial oversight; and unlimited crisis intervention. All important central banks now accept these tasks, though the Federal Reserve, with its dual mandate, would also state that its aim is to achieve the highest employment possible, consistent with achieving the inflation target.

How then might one summarize post-crisis central-bank orthodoxy on, as I will call it, the 'new orthodoxy'? It comes in three parts. First, central banks still believe in seeking to stabilize inflation, a lesson the high-income economies learned in the inflationary era of the 1970s.21 Second, they seek a second set of instruments, to achieve stability in the financial system as a whole. These instruments fall under the title of 'macroprudential policy'.22 Third, central bankers are strengthened in their role as lenders of last resort, but want to avoid rescuing insolvent institutions. So they need ways of resolving (reorganizing the financial structure or even closing) institutions, ways that won't trigger financial Armageddon. Financial institutions should, accordingly, not be allowed to become too big, too complex or too interconnected to fail.

This approach is, however, open to powerful objections. Three are particularly important.

First, this new orthodoxy gives enormous discretionary power to bureaucrats in managing the financial system in particular, which is the heart of the supposedly market economy.

Second, the new orthodox doctrine does not resolve the confused relationship between the state and the private sector as suppliers of money. On the contrary, it reinforces that confusion.

Third, the doctrine assumes that monetary policy can be targeted at price stability, while macroprudential policy is targeted at financial stability. More important, it is assumed that they will not get in each other's way, with monetary policy sometimes undermining financial

stability by encouraging excessive credit creation, and macroprudential policy undermining monetary policy by halting credit creation.

Not surprisingly, given the poor performance in the run-up to the crisis and the doubts about the workability of the new doctrines, many object to the emerging official post-crisis ideology. These objections have their roots in the work of important economists from the past: Knut Wicksell; Ludwig von Mises and Friedrich Hayek; Henry Simons; John Maynard Keynes and Milton Friedman; and Abba Lerner. This is a very old set of debates. But they are as relevant today as ever before.

ALTERNATIVES TO THE NEW ORTHODOXY

The power of the financial system to create credit and money is enormous, for both good and ill. The mixed public-private arrangement of today is certainly not the only way this system could work. The choice of alternatives is far from a purely technical matter. It has, inevitably, deep political implications.

So what are the alternative visions of financial, monetary and fiscal systems?

Knut Wicksell on the Market and Natural Rates of Interest

The big lesson of recent experience is that private-credit provision can be highly destabilizing even when inflation is under control. The new central-banking orthodoxy described above is, of course, an attempt to stuff the genie of financial-sector-driven instability back into the bottle.

The view that the credit system is destabilizing is one shared by post-Keynesians, such as Minsky, and Austrian economists, such as von Mises.23 The man from whose ideas these very different strands descend is the great Swedish economist, Knut Wicksell (1851–1926), whose classic work, Interest and Prices, was published in 1898. In this, he started from the observation that banks were able to create
credit-backed money, as explained in the quotation from the Bank of England above. Given the existence of such credit-backed money, Wicksell argued, two interest rates operate in the economy: the ‘natural’ rate and the ‘money’ rate. The former cannot be observed directly: it is the real return on new capital, as seen by profit-seeking entrepreneurs. The latter can be observed directly: it is the lending rate of the banking system.

In Wicksell’s theory, when the money rate is below the natural rate, banks expand credit to meet rising demand from business. What is driving businesses to borrow is their belief that the return on investment (the natural rate) is above the cost of borrowing from banks (the money rate). The demand for new lending then expands credit and money (in ways already discussed above) and so drives the real economy and ultimately inflation upwards. When the money rate is above the natural rate this process goes into reverse: credit and money contract. There is then a risk of deflation. Since credit expansion and contraction are cumulative processes, with today’s credit expansion or contraction influenced by yesterday’s expansion or contraction, via their effects on activity and prices, changes in credit and money have powerful real effects on the economy.

Wicksell influenced both Austrian economists and Keynes, but in different directions. A contemporary descendant is the influential neo-Keynesian, Michael Woodford, of Princeton University, whose work provides support to management of expectations via inflation targeting, in line with contemporary orthodoxy. Woodford focuses on Wicksell’s concern with achieving stable inflation. Other descendants include William (Bill) White, former economic adviser and head of the monetary and economic department of the Bank for International Settlements, and Claudio Borio, Deputy Head of the Monetary and Economic Department and Director of Research and Statistics at the BIS (already mentioned in Chapter Five). These economists focus more on Wicksell’s insights into credit, insisting that deviations between natural and market interest rates may emerge in destabilizing credit expansions and contractions rather than in measured inflation or deflation, other than in the very long run.

The problem, these economists emphasize, is that central banks have allowed the credit system to become excessively elastic. This is, they argue, why the incidence of financial crises has increased. The current orthodoxy, they note, is that macroprudential regulation will control such elasticity. But they question whether regulation can curb the impact of a monetary policy pushing in the opposite direction. Their conclusion is that monetary policy must ‘lean against the wind’ of credit expansion. Bill White argues similarly that policy is now on a treadmill, with a succession of ever more desperate monetary policies designed to remedy the malign longer-term impacts of the last set of such policies. He is concerned that the result of the policies adopted in response to the post-2007 crisis will be even worse. All this occurs, argue such Wicksellians, because the money rate of interest has been kept below the natural rate for far too long.

The latter group of neo-Wicksellians argue, correctly, that inflation targeting, far from stabilizing the economy, may destabilize the financial system and so the economy, in the medium term. Yet, while this diagnosis is persuasive, the policy recommendations are not.

First, it is impossible to hit two targets – price stability and financial stability – with one instrument. Second, the natural rate of interest is unknown: attempts to use the rate of economic growth as a proxy for the natural rate, as White does, are unpersuasive. That relationship would only hold in a long-run equilibrium. But the dominant feature of our economy is that it has not been in such an equilibrium: a world of fast growth and very low real rates of interest is a disequilibrium world. This is because of the once-in-a-century impact of the rise of China and the other emerging economies on the world stage, what I have called the ‘shifts’ in Chapter Five. Third, the extent of the needed ‘leaning against the wind’ is unknown and unknowable – the links between monetary policy and asset prices are not subject to precise control, according to current knowledge. Fourth, it is unclear how a legal mandate upon the central bank to achieve both monetary and financial stability via monetary policy could be made operational. Finally, seeking to stabilize finance might destabilize inflation and inflation expectations, thereby making the real economy more unstable, not less so.

The neo-Wicksellians have indeed identified a problem, but not put forward a workable solution. The conclusion I draw is that in an environment of rapid credit growth, monetary policy should be tighter than strict inflation targeting would suggest. But monetary policy
cannot achieve two targets at once: other instruments will indeed be needed to make the financial system less destabilizing, as the new orthodoxy would suggest.

The Austrians on Bank Credit and Malinvestment

Wicksell greatly influenced the Austrian economists, Ludwig von Mises (1881–1973) and Friedrich Hayek (1899–1992), both of whom played an important role in academic debates on money and finance in the 1920s and 1930s. They lost these debates in academic and policy circles partly for methodological reasons – their rejection of the growing role of mathematics in economics – but far more for political ones – the opposition to any policy response to the greatest crisis that had ever befallen capitalist economies, other than letting it burn itself out. Paradoxically, their defeat in academic liberates Austrian economics. It has become politically influential, principally in the US, where Austrian economics has become a favourite economic ideology of libertarians and so of parts of the modern Republican Party: former Congressman Ron Paul is a devotee. The reason for this appeal is that, unlike the Chicago School, in which the late Milton Friedman was the dominant post-war figure, the Austrian economists see no case for a government role in managing the market economy, including even the money supply. Many contemporary ‘Austrians’ favour a return to the gold standard. Naturally, they are opposed to every element of the new (or old) orthodoxy on monetary and financial policy. They are purist adherents of laissez-faire. This is why ‘they have condemned the Federal Reserve’s policies during the great recession’. Instead, they see depressions as healing events.

Von Mises followed Wicksell in his attention to the natural and money rates of interest. But he added a great deal of detail to the role of banks in a credit expansion. As the Spanish Austrian, Jesús Huerta de Soto, explains, ‘According to Mises, the amplification of any inflationary process, via credit expansion will sooner or later spontaneously and inexorably reverse and provoke a crisis or economic recession in which the investment errors committed will be revealed and massive unemployment will emerge along with the need to liquidate and reallocate all the resources wrongly invested. To eliminate recurrent economic cycles Mises proposes the establishment of a banking system with a 100 per cent reserve requirement for demand deposits.’33 Ironically, a great apostle of the free market wished to suppress the free market in the provision of money. In this way, he recommended, the ability of banking institutions to create credit and money would be ended, by legal fiat, though the reserve backing would come from gold.

Hayek argued that divergences between natural and money rates of interest would lead to distortions in the structure of production. Thus, if a positive gap opened up between the natural and money rates of interest, possibly because of the efforts of the central bank to expand credit, expected profits would rise, since the real returns on new investments (the natural rate) would be above the rate at which business could borrow (the money rate). This would encourage a credit expansion (that is, false savings), via greater leverage in the banking system, and a move towards more capital-intensive (in Austrian terminology more ‘roundabout’) methods of production: the lower the cost of capital (in this case, proxied by the money rate) the more capital-intensive will become the most profitable techniques of production. Such forced adoption of capital-intensive techniques is ‘malinvestment’. The bigger the divergence between the two rates of interest, the bigger the boom and the bigger the bust.34 In particular, Hayek blamed the Great Depression on the expansionary credit policies of the Federal Reserve during the 1920s.35 In the words of Mr Huerta de Soto, ‘Hayek views the Keynesian remedy for the Great Depression as nothing more than a temporary solution with adverse consequences. Indeed any artificial rise in aggregate demand will severely distort the productive structure and can only generate unstable employment.’36 In later years, Hayek devoted his attention to the idea of privately issued money, rather than the 100 per cent reserve-backed money of von Mises.

In the debates of the 1930s, the Austrians lost the public argument on business-cycle theory to the Keynesians and, subsequently, the monetarists. They ceased to have much influence on ideas about macroeconomic policy for a long time. Both economics and politics explain this failure. The economic explanation was the scale of the slump. It was impossible to argue that no more was involved than the reversal
of the malinvestment during the 1920s. Indeed, this theory is puzzling, particularly given that it comes from such passionate believers in laissez-faire. Why should business people be so misled by mistaken monetary policy? If business can be so wrong about this, what else might it be wrong about? Moreover, why should the reversal of malinvestment lead to a depression? It should lead, instead, to the scrapping of some capital, along with a boom in more profitable investments.

A far more plausible view is that the scale of the downturn in the Great Depression was due to a steep decline in demand, largely due to the banking and monetary collapses. This decline in demand also generated massive involuntary unemployment. The Austrian School's support for the 'liquidation' recommended by US Treasury Secretary Andrew Mellon and its opposition to any remedial intervention by government was (rightly) judged indefensible in the place where it counted: the electoral process. In the US, Franklin Delano Roosevelt became president. In Germany, Adolf Hitler became chancellor. What these two vastly different leaders shared was their rejection of laissez-faire. By the end of the 1930s, a defeated Hayek abandoned his efforts at business-cycle theory, moving more to political philosophy and the economics of information, in both of which he made influential contributions.

Today's adherents of the Austrian school, such as former Congressman Paul, tend to argue in favour of a return to nineteenth-century political economy: the gold standard (with its direct link between the supply of money and the supply of gold); abolition of the central bank; ending of financial - and other forms - of regulation; elimination of social safety nets; and so forth. If people with this set of views had been in charge in 2007 and 2008, the results would probably have matched those of the 1930s. That would have discredited them for another two generations. In the US, however, a frightened Republican administration was shortly followed by an activist Democratic one. This allowed Austrian economists and other libertarians to blame the disappointing aftermath of the crisis on those who sought to cure it. Indeed, in the US, it has become conventional wisdom that the Obama administration's stimulus programme failed when it was just insufficiently large, partly because of fierce Republican opposition and partly because of what turned out to be false optimism among economists working for the administration. Given this mistaken view on what had just happened, Austrian liquidationism may be tried in the next great crisis, with predictably dire results. Yet it is hard to believe that the nineteenth-century gold standard could be successfully reintroduced into a modern democracy.

This is not the only reason why the approach of the Austrian School has to be rejected. They are right to argue that the conditions leading to a crash are important. But their recommendation that the right response to the crisis itself is to do nothing does not follow from their (correct) view that significant mistakes caused it. Doctors do not refuse to treat someone who owes his heart attack to overeating, recommending that he just go on a diet instead. First, they treat him, and then when he is better he can go on a diet.

Nevertheless, the Austrian School's critique of the official orthodoxy has value, even if their theory and policy ideas do not. First, the credit system is, as they remind us, destabilizing. Second, stable inflation does not guarantee economic stability. Third, booms will create malinvestment and excess debt, which will then have to be dealt with in one way or another. It is not surprising, therefore, that construction, finance and debt itself all shrank after the boom ended. Finally, the idea that regulators will be able to fine-tune monetary policy on the basis of economic forecasts, and safeguard the stability of the financial system on the basis of their analysis of systemic risk, is rather optimistic. Indeed, we must assume at least a degree of failure.

Henry Simons and the Chicago Plan

Misses concluded that the ability of private institutions to create debt-backed money out of thin air, as a by-product of their lending (as discussed above), needed to be brought under control, via 100 per cent reserve banking - that is, a system in which deposits are backed by central-bank reserves, one to one. The Chicago School - another group of free-market economists - came to the same conclusion in the 1930s, for the same reason: they concluded that the bank-based monetary system (which we still have today) was itself unstable and so destabilized the economy. The economists involved were hugely distinguished and respected: Frank Knight (1885–1972), who pioneered
the crucial distinction between calculable risk and uncertainty; Henry Simons (1899–1946), author of the most complete version of the Chicago monetary plan; Irving Fisher (1867–1947), the most famous pre-Second World War American economist; and, after the war, Milton Friedman (1912–2006).10 Again, as with the Austrians, these free-market economists concluded that the ability to create credit-backed money had to be ended if the market economy was to be protected from ruinous crises.

The thrust of the plan, which was first proposed in 1933 at the trough of the Great Depression, was to give government the exclusive right to create money, thereby taking it altogether away from private businesses (that is, banks). All versions of the plan required 100 per cent reserve backing of deposits. In other words, households and businesses would keep their holdings of deposits in banks, which would, in turn, hold accounts at the central bank or, possibly, hold government debt. Deposits would, therefore, fund the government. The economic argument is that only in this way would there be no banking crises: banks could not fail. The philosophical argument is that a monetary system is both a social contrivance and a public good. Society should gain the reward from what society has created. The plan then proposed that the money supply, now under full government control, would expand in accordance with a rule—probably a target rate of growth based on expected growth of the economy, expected changes in demand for money and an inflation target.

If reserves backed deposits 100 per cent, what would finance lending to the economy? This is the crucial question for all such schemes. The original Chicago Plan proposed replacing traditional banks with investment trusts that issue equity and sell their own interest-paying securities. But, as we have learned from the emergence of the money-market funds and the repo markets, which played a central role in the shadow-banking system, such debt can once again become an attractive replacement for money, with lethal consequences for stability. Two alternatives were proposed, both of which aimed at eliminating this risk. Under one, recommended by Simons, all private property would take the form of currency, government bonds, corporate stock or real assets. Thus, the investment trusts would take the form of equity or property mutual funds. Under the other alternative, banks would borrow from the government, not the private sector, to fund their riskier assets.

The essential aim of the plan is to give the government a monetary monopoly; private institutions would not issue money-like liabilities except when backed by government money. What would be the advantages? Fisher claimed four. First, preventing banks from creating and then destroying credit and money in self-reinforcing cycles would eliminate the biggest source of instability in the economy. Second, 100 per cent reserve banking would eliminate the possibility of bank runs: banks would be completely safe. Third, if the government financed itself by issuing money at zero interest, rather than borrowing at interest, debt interest and net government debt would fall dramatically. Indeed, in almost all countries, government would become a net creditor. Finally, since money creation would no longer need private debt, the level of such debt could fall dramatically. Indeed, in the transition, the government could use the excess of the total supply of money over its own debts to fund a dramatic decline in private debt, through buy-backs. I would add to these benefits that the extinction of conventional bank-created money would almost certainly shrink the financial sector, reduce the aggregate incomes earned by bankers and so improve the distribution of income.

The fiscal implications alone would be dramatic. According to an important International Monetary Fund working paper on the Chicago Plan by Jaromir Benes and Michael Kumhof, total bank deposits in the US are around 180 per cent of GDP.41 Assume the demand for money merely grows in line with nominal gross domestic product, at about 5 per cent a year. If it failed to do so, interest rates would rise and the economy might be pushed into deflation. So each year the money supply would need to grow by 9 per cent of GDP if it were to remain at 180 per cent of GDP. This would fund about 40 per cent of the Federal government in normal years, allowing a dramatic reduction in taxes. Republicans should love that! To this should be added savings on government-debt interest (on the assumption that these would not be interest-earning deposits) and the earnings on any money lent to the private sector.

Also dramatic would be the implications for the operation of monetary policy. The central bank would have direct control over the money
supply. It could be told to follow a strict rule, as the Chicago School proposed, which would include a precise inflation target. The central bank could set any interest rate it liked, including negative rates, up to the point that people preferred to hold cash instead of deposits. The stabilization of the economy would become a relatively simple challenge because the main obstacle to it would have been eliminated.

Not surprisingly, the opposition of the banking industry forced abandonment of the Chicago Plan in the 1930s. Those who enjoy such an extraordinary privilege – in this case to create state-backed money at will – would not willingly give it up. But the idea of what is called narrow banking – an important part of the Chicago Plan – returns, quite understandably, in every generation. Minsky, though a post-Keynesian, also endorsed 100 per cent reserve banking in 1994. The plan for Limited Purpose Banking, proposed by Laurence Kotlikoff of Boston University in his book Jimmy Stewart is Dead, has close similarities to the Chicago Plan. On the political left, James Robertson, a British environmentalist, has gone further in his proposal that the central bank should create all money directly and hand it over to the government to spend as it sees fit. But, from a monetary point of view, that is the same as 100 per cent reserve banking. More recently, Andrew Jackson and Ben Dyson have endorsed a similar approach for Positive Money, a UK campaigning organization. The crucial point is that these proposals for replacing private debt-created money with government-created money are perfectly feasible and would bring substantial benefits: far less private debt and far less private indebtedness.

The self-interest of private bankers would again be a significant factor in opposing such ideas. But there are also intellectual objections. Walter Bagehot opens Lombard Street by arguing that:

... much more cash exists out of banks in France and Germany, and in all non-banking countries, than could be found in England or Scotland, where banking is developed. But that cash is not, so to speak, 'money-market money': it is not attainable... But the English money is 'borrowable' money. Our people are bolder in dealing with their money than any continental nation, and even if they were not bolder, the mere fact that their money is deposited in a bank makes it far more obtainable. A million in the hands of a single banker is a great power;

he can at once lend it where he will, and borrowers can come to him, because they know or believe that he has it.

Bagehot attributes British economic dynamism to the public's willingness to trust their money to risk-taking private banks. Yet we do not know that economic progress depends on the instability of a credit-creating banking system. Certainly, the authors of the Chicago Plan and others in their intellectual tradition pose a profound challenge to the contemporary new orthodoxy that some combination of inflation targeting with skillful macroprudential regulation will allow the world economy to ride the financial tiger in reasonable safety. Unfortunately, while something as radical as the Chicago Plan may be a necessary condition for stability, it is unlikely to be a sufficient one: the market economy could still be unstable. Moreover, the gains for dynamism generated by a risk-taking private system might outweigh the risks to stability.

The rational strategy is to make more changes now than the new orthodoxy suggests (which will be discussed in Chapter Seven and the Conclusion) and plan to move to still more radical ideas if huge crises recur. But it would be too disruptive and risky to make a massive shift in the nature of our economies towards the Chicago Plan without first trying more limited reforms, albeit radical ones by the standards of the new orthodoxy. It would also be rational to encourage some (possibly smaller) countries to experiment with still more radical plans for eliminating banking as we know it. Indeed, so great has been the failure of the financial system that the idea of a monoculture of banking and financial systems, governed by the same global rules, seems inordinately foolish. We simply do not know enough to settle on just one system. Experiment is essential. The Chicago Plan or variants upon it is definitely an experiment worth making.

**Keynes versus Friedman on Fiscal versus Monetary Policy**

The economic debates of the 1930s bequeathed an agreement between John Maynard Keynes (1883–1946) and his successors, on the one hand, and the monetarists on the other hand, over one decisive
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matter: that aggregate demand matters. The economy does not automatically operate at full employment. Potential output does not automatically become actual output in a complex monetary economy. In these respects, Keynesians and monetarists are very much on one side, since they are both concerned about aggregate demand, and the Austrian economists are on the other, since they reject this concern altogether. A divide did emerge, however, between Keynesians and monetarists on which tools to use and how. That divide still exists today. Indeed, the debate over the relative importance of fiscal and monetary policies in the post-crisis period was among the most important debates of all.

This is not true in normal times, when interest rates are significantly positive. In these circumstances, most (though not all) of the descendants of Keynes would agree with Milton Friedman and his successors that monetary policy can deliver the desired stability of demand. Important disagreements remain, however. First, Friedman’s view emphasized not the price of money (the interest rate), but its quantity. He was a quantity theorist in the tradition of Irving Fisher: he argued that what mattered was not the price of money, the rate of interest, but its quantity, the stock of money. Friedman believed that the rate of interest does not tell one whether monetary policy is loose or not. Only the rate of growth of the money supply does that. His underlying assumption was that, despite radical changes in monetary institutions towards a credit-based – and away from a commodity-based – monetary system, it is possible and desirable both to define what money is and control its growth more or less precisely. Furthermore, argue quantity theorists, if one achieved a steady rate of growth of the money supply, the growth of nominal demand would also be stable: there is, in other words, a direct relationship between the money supply and nominal spending in the economy. Second, Friedman argued that the best approach would be to follow a rule for growth of the money supply, rather than rely on the discretion of central bankers. If one did that, any short-term disruptions to the real economy generated by vagaries in the supply of money would be ironed out, leaving the underlying real economy to function as smoothly as it could.

Monetarism’s great successes were in the 1960s and 1970s when naive Keynesianism blew up because it underplayed inflationary expectations and believed too confidently in macroeconomic fine-tuning. The assumed trade-off between unemployment and inflation broke down, whereupon Keynesian fine-tuning of the real economy, via active fiscal and monetary policies, became largely discredited and was subsequently abandoned. Of course, it was logically possible to have a Keynesian view of the role of fiscal policy in demand management, while accepting the crucial role of expectations. Nor was it essential for Keynesians to believe in macroeconomic fine-tuning.

Given our ignorance, they could have believed in coarse-tuning, instead – namely, the use of fiscal policy to guide the economy only in extreme circumstances. Similarly, it would have been perfectly possible to believe money is of great importance, but not pay much attention to expectations, while believing in a degree of fine-tuning. But, as a matter of historical fact, the Keynesians of the 1960s mostly downplayed inflation expectations and largely believed in fine-tuning. This opened up a vulnerable intellectual wing to the monetarist counter-attack, which combined the role of expectations, the centrality of money, and the difficulties inherent in discretionary macroeconomic fine-tuning.

When monetarism was tried in the 1980s and 1990s, it failed, since neither defining nor controlling the money supply proved at all easy. This then led to the pre-crisis orthodoxy of inflation targeting by the central banks, which relied on interest rates not quantitative control over money. At the back of policymakers’ minds was the notion of the ‘natural rate of unemployment’ proposed by Milton Friedman and Edmund Phelps, or, as it would be called today, the non-accelerating inflation rate of unemployment (NAIRU) or, alternatively, a zero output gap. This, then, was a kind of synthesis between Keynesianism and monetarism: natural-rate Keynesianism, implemented via active, indeed fine-tuning, monetary policy.

This orthodoxy also broke down, first in Japan in the 1990s, then in the West after 2007, because of what both Keynes and Friedman both ignored: the tendency of the credit system to run riot, as Wicksellians, Austrian School economists and ‘Minskyans’ emphasize. After the crisis, much of the world found itself with close to zero nominal short rates. At that point, the debates revived. Both monetarists and most adherents of the contemporary orthodoxy argued that
monetary policy could still work effectively, either by expanding the quantity of money or lowering the yield on other securities, particularly long-term bonds. One policy, it was thought, would achieve both those outcomes: quantitative easing, by which was meant the expansion of the monetary base. By using newly created central-bank money to buy bonds, the central bank could, it was believed, both expand the money supply and lower yields.

Figure 37 shows what happened to US M2, the broadest measure of money the Federal Reserve publishes, after 1980. M2 consists of currency held by the public, plus deposit liabilities of financial institutions principally belonging to households. Figure 37 also shows the ‘monetary base’. This consists of currency, again, and the deposits of banks at Federal Reserve banks (that is, the central bank). The monetary base is the government-created money in the system; it is a liability of government. The rest of the money supply is the liability of banks. The monetary base is sometimes called ‘outside money’ and the bank-created money supply ‘inside money’. Until the recent crisis, virtually all M2 was inside money—a by-product of the rapidly expanding lending activities of private financial intermediaries. The monetary base barely grew. In the early years of the crisis, however, lending to the private sector by financial intermediaries shrank. By expanding the monetary base, principally through quantitative easing, the Federal Reserve compensated for the cessation of bank lending to the private sector, thereby keeping M2 growing. This is exactly what Milton Friedman would have recommended. From the monetarist point of view, it was the obvious thing to do. Since monetarists are generally viewed as being on the ‘right wing’ economically, it was amusing to watch the scorn with which many on the political right wing treated these actions by the central bank in the US.

Keynesians argue that when short-term rates are close to zero, monetary policy is no longer very effective. Certainly, apparently reasonable monetary growth, measured by M2, did not generate a vigorous recovery, though it almost certainly stopped a far deeper recession. The difficulty, as we saw in Chapter Five, is that the economy suffers from a savings glut—desired savings exceed desired investment, despite the extremely low interest rates. In the well-known expression: money is pushing on a string. Moreover, though the short-term rate may be near to or at zero, it is impossible to bring the long-term rate that low, because of 'liquidity preference': at negligible long-term rates, the downside for holders is large (since investors would lose a fortune if yields returned to normal) and the upside negligible. So people will not hold the long-term bonds if the yield falls below a certain level. If the central bank wanted their yields to go still lower, it would have to buy almost all of these bonds outright: in effect, it would find itself financing the government directly. A better solution, argue Keynesians, is to lower desired savings directly, while keeping rates of interest at zero. To do that, the government has to spend more itself or implement tax cuts that will encourage the public to spend more. This is the simplest and most direct way to revive the economy. Furthermore, such a fiscal policy will have no effect on short-term interest rates and will raise long-term interest rates in countries with their own central banks only if it encourages confidence in a recovery. The risks of default are more or less zero in this case.

This debate between Keynesians and monetarists on the best
macroeconomic policy response to a crisis is very much live, both within academe and more publicly. It will be a big part of the discussion in Chapter Eight, where it will inform our analysis of the new orthodoxy in action.

Minsky's Instability Hypothesis

Hyman Minsky (1919–1996), fascinatingly, a post-Keynesian product of the Chicago School, developed one of the most comprehensive critiques of pre-crisis and, by implication, the post-crisis new orthodoxy too. As we saw in the Preface, Introduction and Chapter Four, his crucial points were three: first, he believed that instability is an inherent feature of a dynamic capitalist economy, not just of the financial system; second, he doubted whether any regulatory rules could contain this instability durably; and, finally, he believed that the combination of 'Big Government' with the 'Big Bank' (the central bank) was the only way to contain the consequences of severe instability.

While disagreeing, rightly, with the notion that inflation targeting could deliver stability, Minsky would have appreciated the need, stressed by Mr Bernanke, for regulatory watchfulness and with the efforts of the Federal Reserve to rescue the economy from the crisis. He would have emphasized that the economy is now in a depression mode and will take a great deal of government-led effort to escape from a more severe crisis. All these are very important lessons, to be considered further in Chapter Eight.

Lerner, Chartalism and Modern Monetary Theory

A final school of thought, which is called 'chartalism' (from the idea that money is just a token, for which the Latin word is charta), argues that the conceptual failure of the contemporary monetary and fiscal orthodoxy is not that it gives too much room for central-bank or government discretion, but that it gives far too little: thus, it goes beyond Keynes and most Keynesians. The essential idea is that the purpose of monetary and fiscal policy is to ensure full employment. In an economy based on freely floating fiat (government-created or government-backed) money, the government suffers from no fiscal constraint: it can always create money that residents have to accept. The constraints are only macroeconomic, particularly excessive inflation.

Adam Smith made reference to the idea of state-created paper money, noting that the governments of the British colonies in North America 'find it for their interest to supply the people with such a quantity of paper money as is fully sufficient and generally more than sufficient for transacting their domestic business'. But the theory emerged in full form in 1895, the heyday of the gold standard, with the publication of Georg Friedrich Knapp's analysis of the role of the state in creating money. Taxation makes money valuable, he argued, since private citizens need it to pay those taxes. This, in turn, makes paper money acceptable in the economy at large. It is simply the most readily transferable of all possible credits, since the government is the most powerful and most permanent of all possible debtors and all money is just transferable credit: its value derives from the willingness of people to trust in it.

This idea influenced Keynes and was taken up in 'functional finance' proposed by the influential post-Keynesian, Abba Lerner (1903–1982). Since the government can issue currency at will, the level of taxation and the extent of borrowing are tools to influence the economy. They have nothing to do with any need to finance the government, since it can fund itself by creating money. Thus all forms of balanced-budget household economics applied to the government are nonsense unless it has ceased to be able to create money (as has happened inside the Eurozone). In Lerner's words, 'Government should adjust its rates of expenditure and taxation such that total spending is neither more nor less than that which is sufficient to purchase the full employment level of output at current prices. If this means there is a deficit, greater borrowing, "printing money", etc., then these things in themselves are neither good nor bad, they are simply the means to the desired ends of full employment and price stability.' So long as these policies do not generate excess demand, there is no reason to fear their inflationary effects. This does not mean no constraint on monetary policy exists, but those constraints come from inflation and the associated risks of sharp declines in the value of the currency against other currencies.

Today's proponents of this set of ideas call it 'modern monetary
theory. An essential point is that the private sector can be a net accumulator of financial assets if and only if the government runs a deficit or the economy as a whole runs a current-account surplus (that is, foreigners run a financial deficit). If the government runs a financial surplus in good times, as orthodox Keynesians propose, the private sector will, in the absence of a current-account surplus, run a financial deficit. The latter deficit will need to be financed by the creation of bank credit, which may ultimately prove destabilizing.

A crucial and unquestionably correct point in modern monetary theory is this: banks do not lend out their reserves at the central bank. Banks create loans on their own, as already explained above. They do not need reserves to do so and, indeed, in most periods, their holdings of reserves are negligible. Only the central bank (by open-market operations), government (by spending and taxation) or private individuals (by reducing or increasing their holdings of cash) can change the aggregate level of bank reserves. Nor is the amount of money that banks create related in any direct way to reserves in the contemporary monetary system, as central banks have discovered: reserves increased dramatically after the crisis, but lending did not. The amount of money that banks create is dependent only on how much they think they can profitably lend at the interest rates set by the central bank.

Because the risk perceptions of banks vary dramatically, depending on the economic climate (for which they themselves are, in aggregate, in large part responsible), their willingness to create loans will also vary dramatically, from feast—a time of credit boom—to famine—a time of credit bust. If a bank needs reserves to meet settlement or cash obligations, today’s central banks will freely supply them at the rate of interest it has determined. Thus, this rate of interest will then determine the rates at which banks lend. If the central bank engages in quantitative easing (that is, it creates money with which to buy assets from the public), it will increase aggregate banking reserves automatically. The central bank pays members of the public in return for the bonds it buys from them. Members of the public then deposit this money in their accounts at commercial banks, which then have increased liabilities to the public and a matching increase in deposits at the central bank. Those matching deposits are, of course, bank reserves.

Moreover, to repeat, banks themselves can do nothing to lower the aggregate levels of bank reserves, since the only use of reserves is to settle accounts with other banks. Other businesses and households do not hold accounts at the central bank. So one bank’s loss of reserves (deposits) at the central bank is always another bank’s gain. It does not affect the total quantity of reserves outstanding. Of course, the government and central bank can change the quantity of reserves by buying and selling assets in the market. Similarly, the public can change the quantity of reserves by asking for cash, instead of bank deposits. The banks, in turn, get the cash from the central bank, in return for their reserves or by borrowing from the central bank, which creates the reserves. In brief, one should envisage the relationship between banks and the central bank as being identical to the one between the public and the banks. The central bank is the banks’ bank.

Modern monetary theory poses another fundamental challenge to the official orthodoxy. It argues that in an economy based on fiat money, the job of the central bank and government, together, is only to stabilize the economy. Moreover, these entities can always create the needed demand by spending the money they create. Of course, there is a constraint: too much demand relative to supply will indeed generate inflation. But this will not happen just because of quantitative easing, unless its effect is to increase the overall supply of (broad) money faster than the public is willing to hold it. That has certainly not happened during this crisis, which is why the hyperinflation some feared has turned out to be an illusory danger. Deflation is a far greater risk.

The reason not to give the government the power to use its ability to create money as a tool of stabilization, in this direct way, is not that it is technically difficult. It is rather that many view it (with reason) as politically dangerous, because it puts too much discretionary power in the hands of politicians whose estimate of full-capacity output might be dangerously optimistic. The answer to that concern is institutional: give the power to decide how much money to create to the central bank, but ask the central bank to do this directly via the creation of outside money, not indirectly via the expansion of inside money. Interestingly, the MMT view of monetary policy and the
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Chicago Plan are essentially the same, the difference being mainly the institutional setting within which the state creates money, rather than private banks.

CONCLUSION

The people who have developed the critical perspectives outlined above differ on political values and so on whether the aim should be less state and more private or less private and more state intervention. They differ on whether policy should be guided by rules or discretion. They differ on whether the state should have an active role in managing the economy. They differ on whether money and credit are the sole source of instability in the economy. But, on one point, they agree: the balance between the role of the state as ultimate supplier of money, and that of the private sector as actual creator of almost all of the credit and money we use, is highly destabilizing. We have made a pact with the devil. It is not a new bargain. On the contrary, it goes back many centuries. But we have recently been reminded that the dangers are huge. Moreover, the liberalization of finance seems to lead to crises almost automatically. Surely this strongly suggests a need for a new kind of system.

Let us now turn to the twin challenges the authorities are attempting to address: getting out of the present malaise; and restoring a stable and dynamic world economy. What, precisely, are they trying to do? Does it have a chance of working? What else might be needed? These are the questions to which we turn.

7

Fixing Finance

[W]e ... committed to reach agreement expeditiously on stronger capital and liquidity standards as the core of our reform agenda and in that regard fully support the work of the Basel Committee on Banking Supervision and call on them to propose internationally agreed rules to improve both the quantity and quality of bank capital and to discourage excessive leverage and risk taking ... It is critical that our banking regulators develop capital and liquidity rules of sufficient rigor to allow our financial firms to withstand future downturns in the global financial system.

Communiqué of finance ministers and central-bank governors of the G-20, 5 June 2010

Capital comes at a cost – both to banks and to the economy at large in the form of forgone lending as institutions shrink to meet extreme capital-to-asset ratios ... It’s no surprise that loan levels in the US and Europe have suffered over the past five years and will continue to do so with regulators’ demands for even higher levels of required capital.

To tell banks they need more capital and then complain that some borrowers are not getting funding is a political statement, not an economic one. The incentives are obvious. When regulators set rules, they should not be surprised that banks naturally adjust to the incentives they created. Yet too often