The failure of free-market finance

By Adair Turner
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Five years after the collapse of the US investment bank Lehman Brothers, the world has still not addressed the fundamental cause of the subsequent financial crisis – an excess of debt. And that is why economic recovery has progressed much more slowly than anyone expected (in some countries, it has not come at all).

Most economists, central bankers, and regulators not only failed to foresee the crisis, but also believed that financial stability was assured so long as inflation was low and stable. And, once the immediate crisis had been contained, we failed to foresee how painful its consequences would be.

Official forecasts in the spring of 2009 anticipated neither a slow recovery nor that the initial crisis, which was essentially confined to the United States and the United Kingdom, would soon fuel a knock-on crisis in the eurozone. And market forces did not come close to predicting near-zero interest rates for five years (and counting).

One reason for this lack of foresight was uncritical admiration of financial innovation; another was the inherently flawed structure of the eurozone. But the fundamental reason was the failure to understand that high debt burdens, relentlessly rising for several decades – in the private sector even more than in the public sector – were a major threat to economic stability.

In 1960, UK household debt amounted to less than 15% of GDP; by 2008, the ratio was over 90%. In the US, total private credit grew from around 70% of GDP in 1945 to well over 200% in 2008. As long as the debt was in the private sector, most policymakers assumed that its impact was either neutral or benign. Indeed, as former Bank of England Governor Mervyn King has noted, "money, credit, and banks play no meaningful role" in much of modern macroeconomics.

That assumption was dangerous, because debt contracts have important implications for economic stability. They are often created in excess, because in the upswing of economic cycles, risky loans look risk-free. And, once created, they introduce the rigidities of default and bankruptcy processes, with their potential for fire sales and business disruptions.

Moreover, debt can drive cycles of over-investment, as described by Friedrich von Hayek. The Irish and Spanish property booms are prime examples of this. And debt can drive booms and busts in the price of existing assets: the UK housing market over the past few decades is a case in point.

When times are good, rising leverage can make underlying problems seem to disappear. Indeed, subprime mortgage lending delivered illusory wealth increases to Americans at a time when they were suffering from stagnant or falling real wages.

But in the post-crisis downswing, accumulated debts have a powerful depressive effect, because over-leveraged businesses and consumers cut investment and consumption in an attempt to pay down their debts. Japan's lost decades after 1990 were the direct and inevitable consequence of the excessive leverage built up in the 1980's.

Faced with depressed private investment and consumption, rising fiscal deficits can play a useful role, offsetting the deflationary effects. But that simply shifts leverage to the public sector, with any reduction in the ratio of private debt to GDP more than matched by an increase in the public-debt ratio: witness the

Irish and Spanish governments' high and rising debt burdens.

Private leverage levels, as much as the public-debt burden, must therefore be treated as crucial economic variables. Ignoring them before the crisis was a profound failure of economic science and policy, one for which many countries' citizens have suffered dearly.

Two questions follow. The first is how to navigate out of the current overhang of both private and public debt. There are no easy options. Paying down private and public debt simultaneously depresses growth. Rapid fiscal consolidation thus can be self-defeating. But offsetting fiscal austerity with ultra-easy monetary policies risks fueling a resurgence of private leverage in advanced economies and already has produced the dangerous spillover of rising leverage in emerging economies.

Both realism and imaginative policy are required. It is obvious that Greece cannot pay back all of its debt. But it should also be obvious that Japan will never be able to generate a primary fiscal surplus large enough to repay its government debt in the normal sense of the word "repay." Some combination of debt restructuring and permanent debt monetization (quantitative easing that is never reversed) will in some countries be unavoidable and appropriate.

The second question is how to constrain leveraged growth in the future. Achieving this goal requires reforms with a different focus from those pursued so far. Fixing the "too big to fail" problem is certainly important, but the direct taxpayer costs of bank rescues were small change compared to the damage wreaked by the financial crisis. And a banking system that never received a taxpayer subsidy could still support excessive private-sector leverage.

What is required is a wide-ranging policy response that combines more powerful countercyclical capital tools than currently planned under Basel 3, the restoration of quantitative reserve requirements to advanced-country central banks' policy toolkits, and direct borrower constraints, such as maximum loan-to-income or loan-to-value limits, in residential and commercial real-estate lending.

These policies would amount to a rejection of the pre-crisis orthodoxy that free markets are as valuable in finance as they are in other economic sectors. That orthodoxy failed. If we do not address the fundamental fact that free financial markets can generate harmful levels of private-sector leverage, we will not have learned the most important lesson of the 2008 crisis.

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