Adair Turner, *Between debt and the devil: money, credit, and fixing global finance* (Princeton University Press 2016)

Examines the causes of the Global Financial Crisis of 2007-08, why mainstream economics failed to see it coming, and how to avoid a recurrence. Australia is not mentioned but the findings apply as much here as anywhere else that is linked into the global financial system.

All text below is quotes. Occasionally I insert text in [ ] to clarify the context. The quotes are not intended as a synopsis of the book; I have focused on points that seem particularly relevant to the housing crisis in Australia. 3 pages only.

From the Preface

On Saturday, September 20, 2008, I became chairman of the UK Financial Services Authority. Lehman Brothers had failed the previous Monday; AIG had been rescued by the Federal Reserve on the Tuesday. Seventeen days later I was with Alistair Darling, UK finance minister, and Mervyn King, governor of the Bank of England, discussing with the major UK banks the need for public capital injections. The UK government ended up owning 85% of the Royal Bank of Scotland and 45% of Lloyds Bank Group. We faced the biggest financial crisis in 80 years. Seven days before I started, I had had no idea we were on the verge of disaster.

Nor did almost everyone in the central banks, regulators, or finance ministries, nor in financial markets or major economics departments. In April 2006, the International Monetary Fund (IMF) had described in detail how financial innovation had made the global financial system more stable. In summer 2007 the first signs of distress were seen as manageable liquidity problems. In summer 2008 most experts agreed that the point of maximum danger in this financial crisis had already passed. And even after the meltdown of autumn 2008, neither official commentators nor financial markets anticipated how deep and long lasting would be the post-crisis recession. Almost nobody foresaw that interest rates in major advanced economies would stay close to zero for at least 6 years. Almost no one predicted that the eurozone would suffer a severe crisis.

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3-4 The fundamental problem is that modern financial systems left to themselves inevitably create debt in excessive quantities, and in particular debt that does not fund new capital investment but rather the purchase of already existing assets, above all real estate.

4 Lending a family money to buy a house can be socially useful, but too much mortgage debt in total can make the economy unstable.

4 One objective of this book is therefore to define the policies needed to prevent excessive debt creation leading to future financial crises: these policies need to go far beyond current regulatory reforms. The second is to propose how to escape from the debt overhang which past policy errors have bequeathed and which continues to depress economic growth across the developed world: doing that will require policies previously considered taboo.

4-5 Free financial markets can generate more trading activity than is socially beneficial: so financial transaction taxes are in principle justified. And financial firms enjoy more opportunities than in other sectors of the economy to make money without truly adding value—to extract economic “rent.”

6 ... the vast majority of bank lending in advanced economies does not support new business

investment but instead funds either increased consumption or the purchase of already existing assets, in particular real estate and the urban land on which it sits. As a result, unless tightly constrained by public policy, banks make economies unstable.

10 Policies related to urban development and to the taxation of real estate can be as crucial to financial stability as the technical details of financial regulation or interest rate decisions.

11 We should also use public policy to produce a different allocation of credit than would result from purely private decisions, deliberately leaning against the private bias toward real estate and instead should favor other potentially more socially valuable forms of credit allocation. Minimum risk weights that determine the capital needed to support different categories of lending should be set by regulators and not, as under current Basel agreements, on the basis of individual banks' assessments of risks. Constraints on mortgage borrowers through maximum loan-to- value (LTV) and loan-to- income ratios (LTI) have an important role to play. And we should be willing to place some limits on the free flow of international capital; some fragmentation of the global financial system can be a good thing.

66 As research by Jordà, Schularick, and Taylor shows, what banks do in advanced economies has changed dramatically in the past 45 years (see Figure 4.2). In 1928 real estate lending averaged about 30% of all bank lending; by 1970 it had edged up to 35%; by 2007 it was approaching 60%. In addition, a significant proportion of the remaining 40% is likely to finance commercial real estate. As Jordá, Schularick and Taylor put it: "with very few exceptions, the banks' primary business consisted of non-mortgage lending to companies both in 1928 and 1970. In 2007, banks in most countries had turned primarily into real estate lenders. The intermediation of household savings for productive investment in the business sector—the standard textbook role of the financial sector—constitutes only a minor share of the business of banking today".

Some of that real estate lending finances investment in new real estate, whether residential or commercial. But the vast bulk finances the purchase of real estate assets that already exist, with households borrowing to purchase already existing houses, and companies and institutional investors borrowing to make investments in existing commercial property. For instance, the UK mortgage credit and house price boom of 2000–2007—unlike the credit and price booms in Florida, Spain, or Ireland— was primarily an existing assets boom, with only a relatively small rise in new construction.

68 For advanced economies on average, 80% of house price increases between 1950 and 2012 can be attributed to rising land prices and only 20% to increases in the constructed value of the housing.

71 More credit supply produces rising real estate prices ...

72 Throughout modern economic history real estate credit and prices move together. In the latest upswing, from 2000 to 2007, mortgage credit in the United States increased by 134% and house prices by 90%; in Spain the increases were 254% and 120%; in Ireland, 336% and 109%.

92-93 The 1970s-1990s saw liberalization of financial markets in almost all advanced and many emerging economies. ... Both the total quantity and the allocation of credit in the economy should, it was now believed, be determined by free market forces. The consequence was the relentless rise in the share of credit extended to finance real estate.

104 The amount of credit created and its allocation is too important to be left to bankers; nor can it be left to free markets in securitized credit.

134 Neither in Japan and Korea in the 1950s to 1980s nor in China over the past 30 years was the quantity and allocation of bank credit creation left to free market forces. ... their success depended on the deliberate repression of free financial markets.

162 Bank capital requirements should be four or five times their current levels, and capital to support real estate lending should be set far higher than private risk assessments suggest is appropriate. Short-term debt capital flows should be constrained by some fragmentation of the international financial system. And a new policy philosophy is required: central banks cannot focus solely on low and stable inflation nor financial regulation only on the solvency and liquidity of individual institutions. Public policy needs quite explicitly to manage the quantity and to influence the allocation of credit creation: it cannot rely on free markets in credit to produce optimal social results.

166 Debt can be dangerous, even if all bankers are as honest, responsible, and professional as possible, and even if each individual loan seems in itself socially useful and economically sustainable. We therefore need strong public policies to constrain the total quantity of credit created and not solely to ensure solvent and better run banks.

175 Credit and real estate price cycles ... have been not just part of the story of financial instability in advanced economies: they are close to the whole story.

190 Money is different from other commodities, goods, or services, and neither the economic nor the political arguments in favor of free markets apply to money.

196 The pre-crisis [pre GFC 2007-08] orthodoxy that we could set one objective (low and stable inflation) and deploy one policy tool (the interest rate) produced an economic disaster.

204 Bank capital and reserve requirements and shadow bank regulations seek to limit the quantity and volatility of credit supply. ... They need to be supplemented by quantitative constraints that limit borrower access to credit. Maximum allowable LTV or LTI limits can be applied in the residential mortgage market and, somewhat less effectively, in commercial real estate. And they could be applied either as standards held constant throughout the economic cycle or varied across the cycle, tightened during real estate booms and relaxed in downswings. Several emerging economies, and some advanced economies which managed to avoid the latest financial crisis, already apply such limits [e.g. Canada, Germany]. They should be part of the armory of macroprudential regulation.

205 **More restricted mortgage credit supply can help make homes *more* affordable and limit the highly unequal impact of credit and asset price cycles on the distribution of wealth**.

245 [In the lead up to the GFC of 2007-08] modern macroeconomics largely ignored the operations of the financial system and in particular the role of banks.

246 You cannot see a crisis coming if you have theories and models that assume that the crisis is impossible.