Use It or Lose It

Understanding Financial Crises through an Evaluation of Creditor Behaviour

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Use It or Lose It: Abstract

The global financial and economic crisis can be understood through the requirement that a closed system of payments must balance. The circular flow model advanced emphasises the emergence of creditors, and their tendency to persevere with a savings habit (intentionally selling more than they buy) long after such abstemious behaviour has served its underlying usefulness.

The paper suggests that the financial system acts in the service of creditors to both achieve financial returns for them and to serve as a pump to maintain the circular flow of expenditure in the face of habitual non-spending on the part of many creditors. The financial services industry plays a quixotic role in enabling periods of 'boom' in what would otherwise be a state of semi-permanent recession.

The presence of a substantial group of habitual savers creates imbalances in the global economy that results, if creditors do not switch to a spending (use it) strategy, in a (lose it) rebalancing. The lose-it scenario may be a classic financial crisis (which may turn into an extended global recession such as the early 1930s), or a period of inflation (which may turn into a period of global stagflation such as the late 1970s).

The paper argues that sustainable long run solutions require creditors to use their credit balances by running expenditure deficits, with particular emphasis on them selling fewer rather than buying more goods and services.

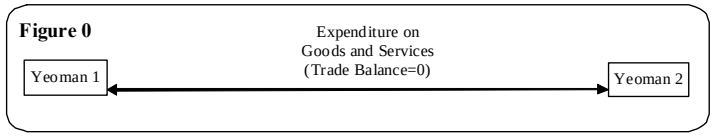
Global Financial Crisis

- Debt Crisis? do we blame debtor behaviour
- Banking Crisis? do we blame intermediaries
- Credit Crisis? do we blame creditor behaviour
  - I explore the creditor side of the creditor-debtor relationship, and show how creditor behaviour can accumulate excessive debt and impede its resolution
  - ***financial crises can be seen as "rebalancing" events in which total historical claims on current and future output are diminished relative to current claims***
  - I take a global perspective from the outset
- Can saving be a virtue and debt a sin, when credit and debt are like two sides of one coin?

Simplest Model of Global System

- Two participating economies.
  - think of Thomas Jefferson's ideal citizen yeoman
    - essentially self-sufficient, but free to engage with other yeomen
  - ***collective*** and ***individual*** one and the same
    - each yeoman is simultaneously a household, a firm, and a nation
    - can use language of basic exchange, circular flow analysis, and/or balance of payments
- Circular Flow Analysis
  - No actual money in this model. Flows of "payments" can nevertheless be thought of as money flows.
  - Starting situation of balanced exchange between 2 yeomen. Figure 0.
    - Current Account Balance and Trade Balance = 0

Balanced Global System with two economic agents



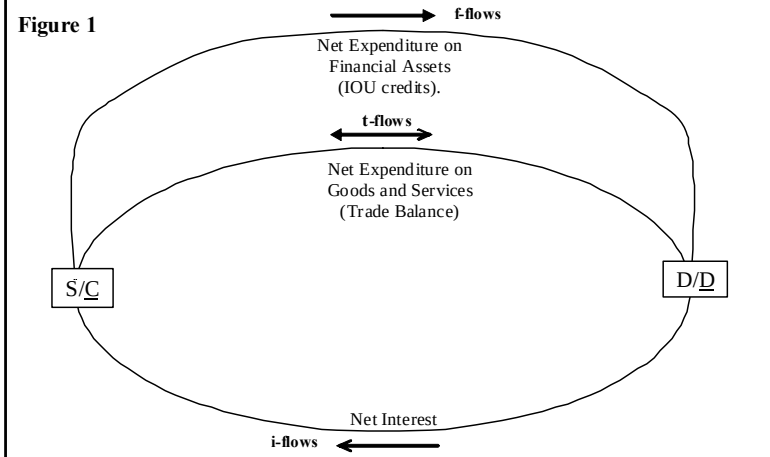
Emergence of Creditor Behaviour

- Yeoman 1 – "C" – adopts a savings strategy.
  - this means C plans to sell more to Yeoman 2 than he plans to buy from Yeoman 2
    - thus Yeoman 1 plans to *lend* to Yeoman 2
  - C can only accomplish this strategy if Yeoman 2 agrees to adopt a borrowing strategy
- Yeoman 2 – "D" – adopts a borrower strategy.
  - means D agrees to sell less to C than he buys from C
    - may agree to pay interest
  - C acquires IOU credits; D acquires goods + IOU debits
    - maybe capital goods if D is confident that C will eventually spend
- We commonly (wrongly?) assume, implicitly, that D initiates this creditor-debtor relationship

Emergent Creditor Behaviour

- Figure 1 – Balance of Payments Analysis
  - Trade surplus balanced by acquisition of IOU credits (finance/capital account deficit).
  - Flows shown represent "payments", not goods.
    - t-flows, f-flows
  - Emergent interest payment (**i**-flows) enable IOU credit accumulation to take place with balanced trade; or even a trade deficit (reversing the **t**-flows).
    - IOU credit accumulation (financial account deficit) requires a current account surplus, but not necessarily a trade surplus
  - Yeoman 1 is "S/C": Creditor running a CA Surplus
  - Yeoman 2 is "D/D": Debtor running a CA Deficit
- Balance of Payments definitions and identity

Balance of Payments: Normal State of Global System



Balance of Payments Definitions

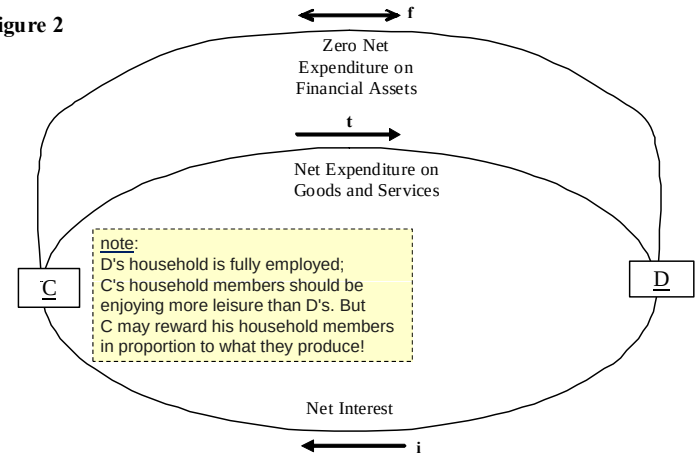
Note: Balance of Trade = **t**; Current Account Balance = **t+i**; Financial Account Balance = **f**
Balance of Payments Identity: **t + i + f = 0** (always);
for a **C** (creditor) economy: **i ≥ 0**; for an **S** (surplus) economy: **f < 0**, **t+i > 0**.

Balancing Creditor Behaviour

- "Use It" Scenario 1
  - C finishes saving strategy
  - new, indefinite, strategy:
    - C runs a trade deficit as payment of real interest from D
  - strategy is acceptable to D so long as interest liability does not represent too great a share of D's output
  - Figure 2
- "Use It" Scenario 2
  - C accepts repayment of some IOU credits from D
    - D pays both interest and repayments in form of goods and services. D is now a surplus economy (S/D rather than D/D).
  - Figure 2a
    - Reverts to Figure 1, as C switches back to saving strategy

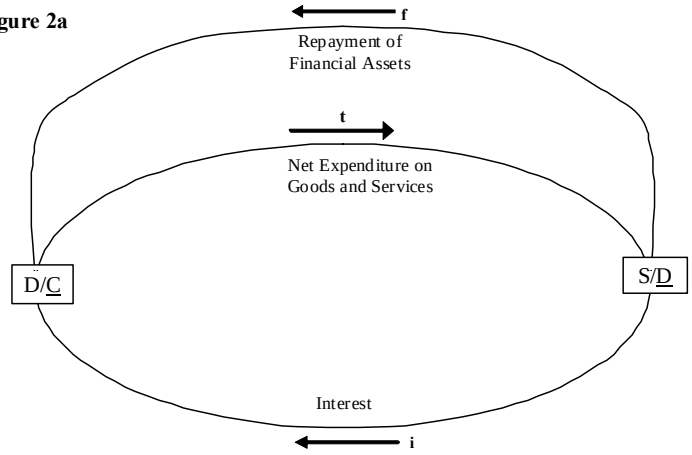
Balance of Payments: Stable System - Static

Figure 2



Balance of Payments: Stable System – Alternates with Fig 1

Figure 2a



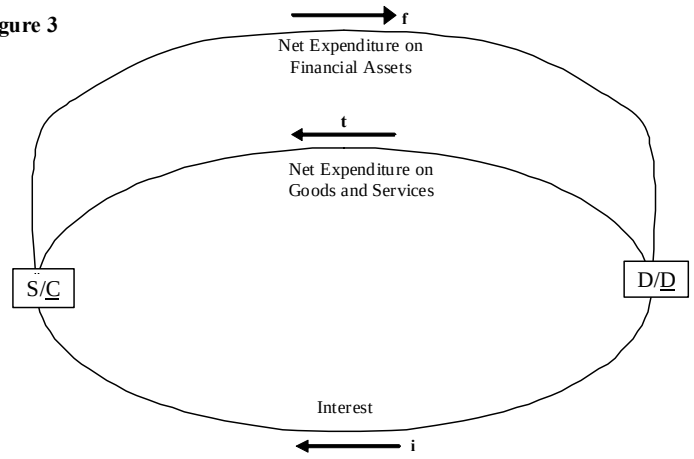
Unbalancing Creditor Behaviour

- Savings strategy has become a ***habit***
  - C *fails to choose* to no longer accumulate financial assets; perseveres (irrationally?) with saving strategy
  - C "reinvests" interest; continues to sell more than he buys
  - Figure 3
- D's response
  - D may resist this strategy; or may enjoy C's beneficence
  - while D recognises he will default if C eventually reverses his strategy, D reduces his underused productive capacity
- C's eventual nervousness
  - C eventually realises that D cannot service (or repay) his debt in actual goods and services
  - C seeks such repayment from D, D defaults, C "loses it"

Balance of Payments:

Unstable System – Excess Credit Accumulation

Figure 3



Ponzi Finance

- The reality of Figure 3
  - interest is "paid" to C by D borrowing from C, his creditor
  - no other outcome is possible if C refuses to run a trade deficit
  - D becomes a pro-active borrower, dependent on C's credit, and is no longer sensitive to rate of interest
    - D is unable to service debt
    - D seduces C into lending him more by raising the interest rate he offers
    - t-flows most likely treated by D as consumable gifts
- Defined in Balance of Payments terms

Ponzi Finance

defined in Balance of Payments terms

In our Balance of Payments terms:
Ponzi finance exists, for C, when $\mathbf{i > 0}$, $\mathbf{t \geq 0}$, and therefore $\mathbf{f \leq -i}$.
In the simplest form of global Ponzi finance, $\mathbf{i + f = 0}$; $\mathbf{t=0}$.

Crisis Rebalancing – "Losing It"

- Default rebalancing (1914-8, 1929-45; 2007-9)
  - a crisis is a period in which rebalancing takes place
  - when C requires interest to be paid as goods/services; D cannot or will not run the required trade surplus
  - when C wishes to exercise his IOU credits by claiming a share of D's output, and D cannot or will not run the required current account surplus
- Inflation rebalancing (1974-82)
  - when historical claims (IOU credits) are devalued
    - including negative (real; nominal?) interest rates
  - modest inflation has balancing tendency when no crisis, extending the period between financial crises
    - favours risk-taking creditors; unlike default rebalancing

Version 2: Communities of Yeomen

- Groups of Creditors and Debtors
  - decision-making no longer collective
  - basic principles of relationship between C (creditor group) and D (debtor group) continue to hold
- The reality of larger global systems creates opportunities for individual creditors and individual debtors to become unaware of the logic of the collective dynamic.
  - individual creditor yeomen able to compete with other creditor yeomen to avoid "lose-it" consequences of crisis rebalancing – some succeed
  - debtors can escape individually but not collectively

Version 3

- Creditor and Debtor country economies with national currencies
  - economies have limited centralised decision-making
  - D countries can only run the required trade surpluses if their currencies are substantially devalued
  - crisis rebalancing may involve creditor nations incurring significant foreign exchange losses
- Domestic policy pitfalls
  - perverse monetary policies that, through interest rate differentials, encourage **f**-flows from C to D countries
    - includes anti-inflation policies that reinforce the accumulation of creditor-debtor imbalances; risks future stagflation
    - raises chance of simultaneous default & inflation rebalancing

Version 4

- C behaviour relates to individuals (the financial and trading decision-makers), rather than to the countries as a whole.
  - ***Possibly the largest credit balances belong to C individuals who reside in D countries***.
  - Rebalancing reduces the real values of financial assets (IOU credits; historical claims) of a majority of creditor (C) individuals.
- C individuals – holding vast quantities of financial assets – resist the rebalancing process, making crises longer or more frequent.
  - promote government policies that resist rebalancing

Financial Services – esp. Banking

- Banks provide services to creditors, enabling them to save (ie lend) without sensing that they are one-side of a debtor-creditor "joined at the hip" (Attwood, *Payback*) relationship.
- Acting under competitive pressure, they market (ie pump) debt so as to maximise interest payments to their C customers.
  - bubble lending circumvents debtor interest rate resistance
- Lending – to any willing debtor – completes the circular flow of payments (f-flows), as per Figures 1 and 3.

Income Inequality

- Persons with very high incomes are almost always net savers, despite the presence of conspicuous consumption.
  - major sources of high incomes:
    - selling goods and services to persons on low-middle incomes
    - selling financial services
  - high incomes depend on a global economic system in which the distribution of expenditure is much less unequal than the distribution of income
- Income inequality is an important dimension to the problem of recurring crises.
  - policies that equalise incomes are stabilising

End of Crisis Event

- Sufficient rebalancing to return from Figure 3 scenario, to Figure 1 scenario.
- Crisis sequence continues if Figure 2 "Use It" scenario is not adopted by creditors.
- Period between crises lengthened by:
  - extent of rebalancing
    - current crisis is ending with barely enough rebalancing, so period to next crisis will be shorter than average
  - political commitment to income equalisation
  - increased creditor education
    - awareness of *mercantilist fallacy* that CA surpluses equal wealth
  - extended period of low or negative real interest rates
  - reduced policy focus on combating inflation

Sustainable Use-It Solution

- Requires creditors – ie persons with historical claims on future output – to
  - sell less than they buy
    - ie run trade deficits so debtors can run the surpluses contractually required of them
  - rather than have creditors buy more, creditors can economise by selling less
    - *sustainable behaviour is selling less, not buying less*
  - pursue philanthropy, but not giving that undermines debtors' opportunities to sell goods and services
- Requires income distribution systems that
  - recognise public property rights
  - raise productivity by rewarding reduced labour supply