

A photograph of the main building of Lund University, featuring classical architecture with columns and a pediment. The sky is blue with some clouds. A flag is visible in the upper left corner.

Are we heading towards a new financial crisis?

TOWARDS A SUSTAINABLE FINANCIAL SYSTEM, LSE FRIDAY 21ST MARCH 2014

LARS JONUNG. KNUT WICKSELL CENTRE FOR FINANCIAL STUDIES, LUND UNIVERSITY



Are we heading towards a new financial crisis?

- My answer is yes. (of course)
- Why?
- Since the fall of the Brettons Woods system – the last part of the gold standard – the frequency of financial crises has increased.
- Nothing fundamentally has changed after the Great Recession. The lesson of financial crisis has not been learned.
- We should expect future crises



Are we heading towards a new financial crisis?

- We need a framework to understand the coming crises.
- Let us look at the economist who provides us with a relevant theory of the present financial system.



KNUT WICKSELL (1856-1926)

Professor at Lund University,
1901-1916.

- a) Theory of the pure credit economy
- b) a) Father of inflation targeting – the cumulative process based on the pure credit economy



Knut Wicksell of yesterday

- *First economist to analyze a pure credit economy. It is an unstable system where banks (the financial system) can create credit/bank loans without being anchored by reserve requirements.*
- *Price stability (monetary stability) can be obtained if the central bank sets the bank rate equal to the real rate.*
- *Knut Wicksell's norm for price stability.*
- *Adopted in Sweden in September 1931*

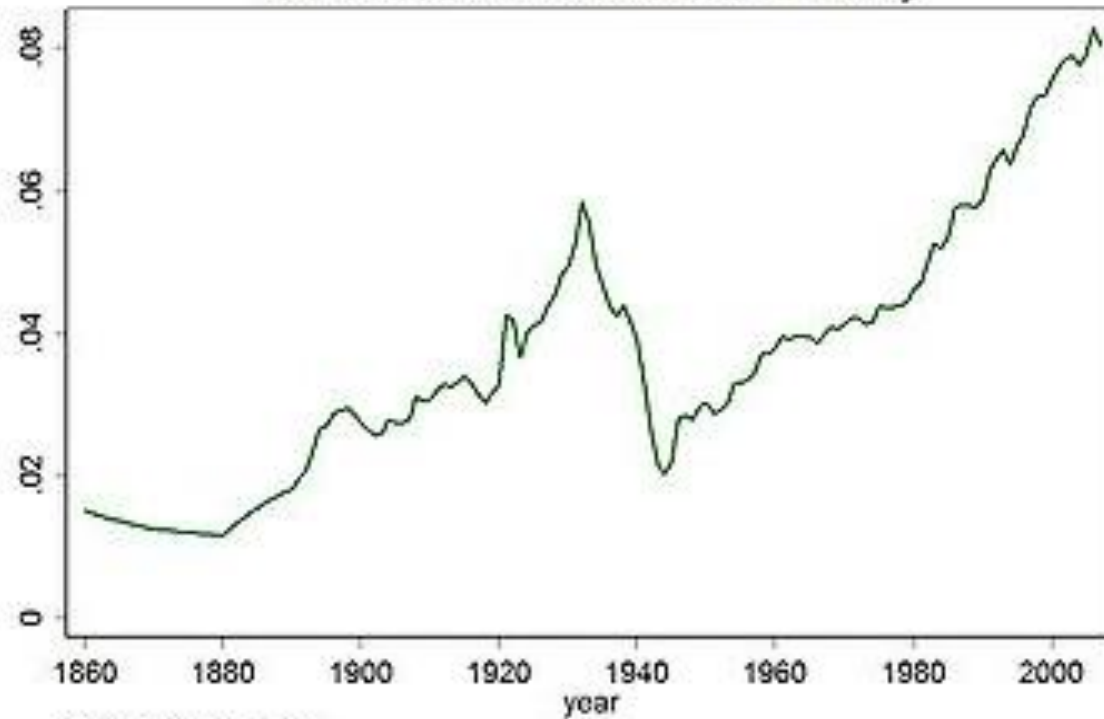


Knut Wicksell of today

- *Central banking today is based on inflation targeting.*
- *ECB, Bank of England, Federal Reserve and other "modern" central banks follow Wicksellian rules where they try to set the policy rate equal to the real rate (or close).*
- *The financial system has moved to a pure credit system where the reserve/capital base is declining. The gold standard of Wicksell's time is gone.*



GDP share of US Financial Industry



Source: Philippon, 2008

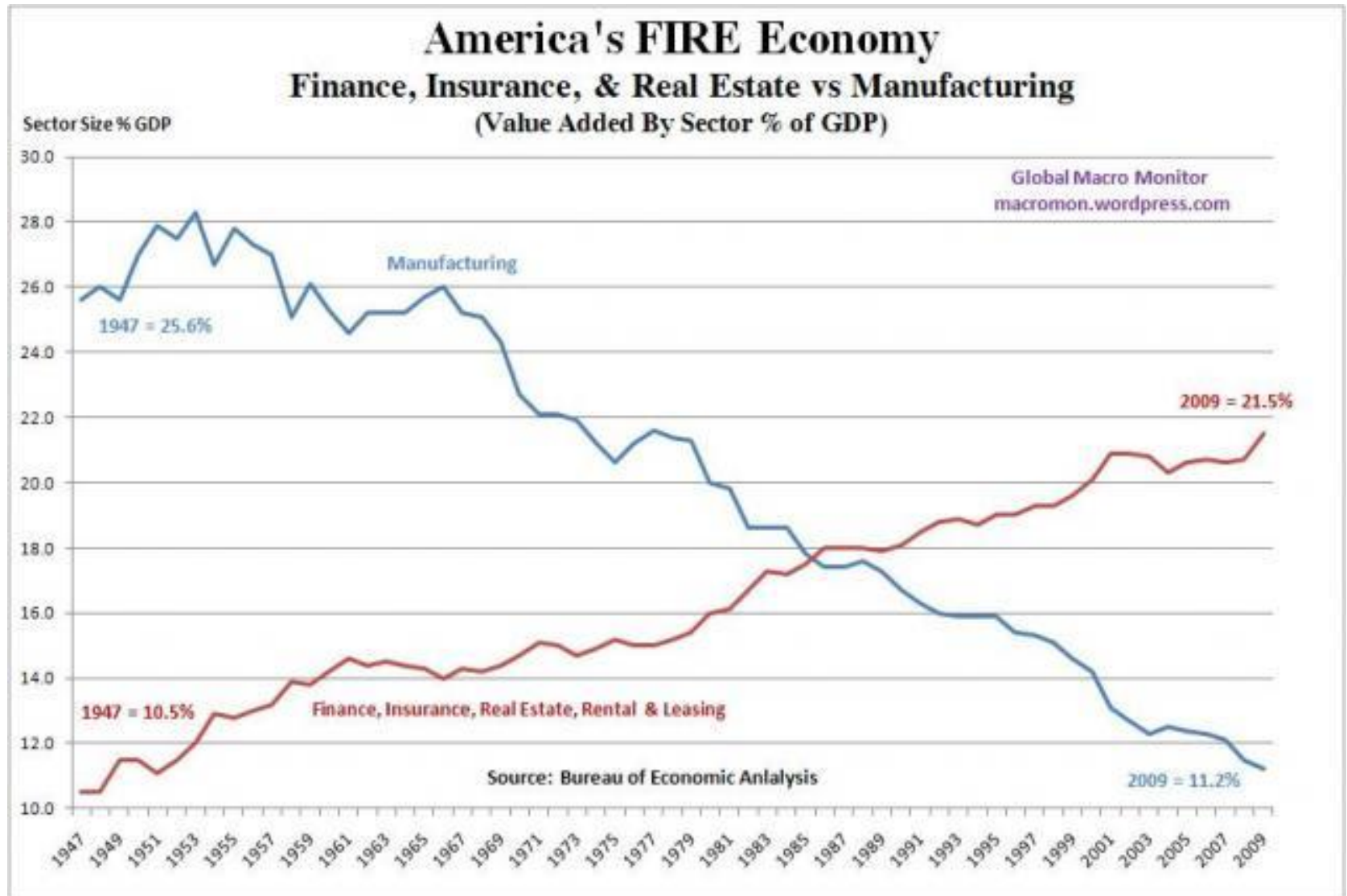
The financial system has expanded compared to other industries

Any breaks on the rate of expansion?



Financialisation of the economy

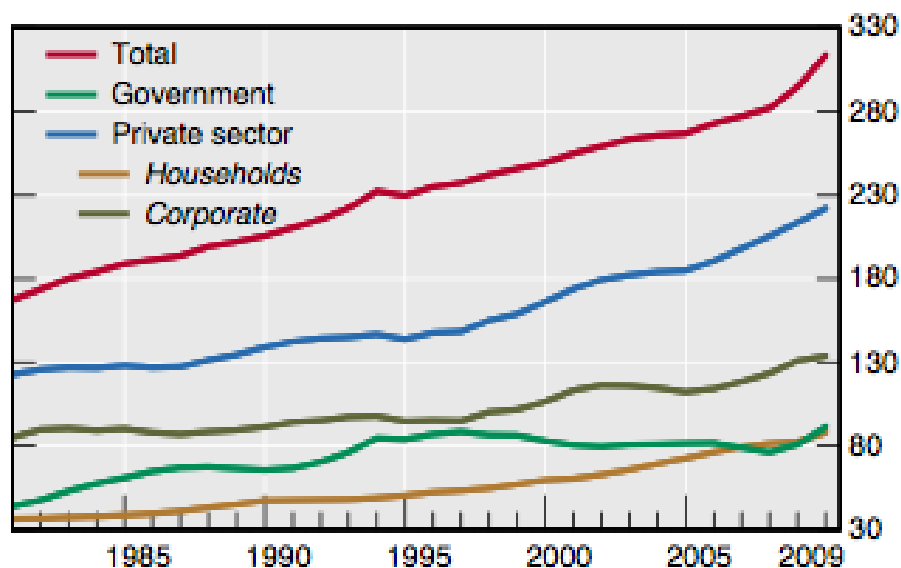
U.S. ca 20% of economy



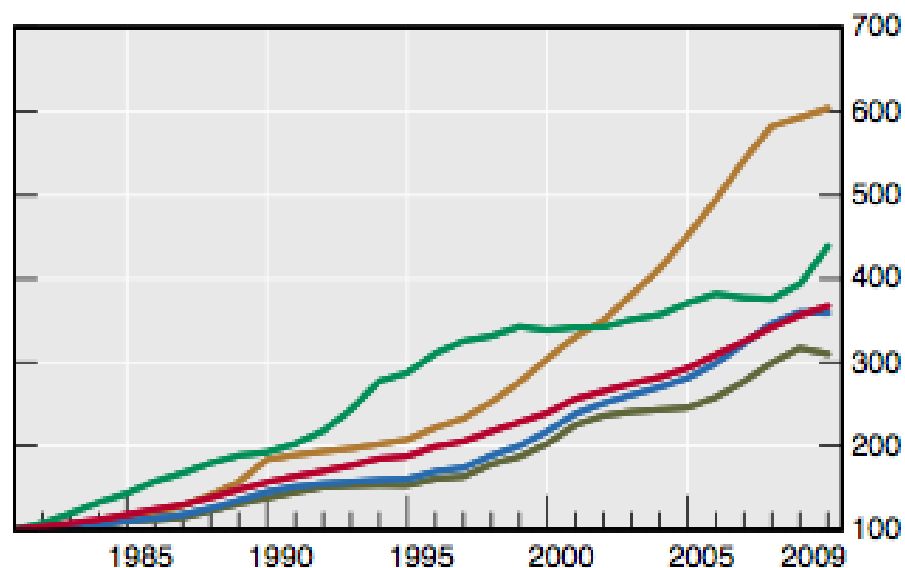
Rising debt is the “new normal” across every developed economy

Non-financial sector debt

As a percentage of GDP¹



Real levels, deflated by consumer prices²

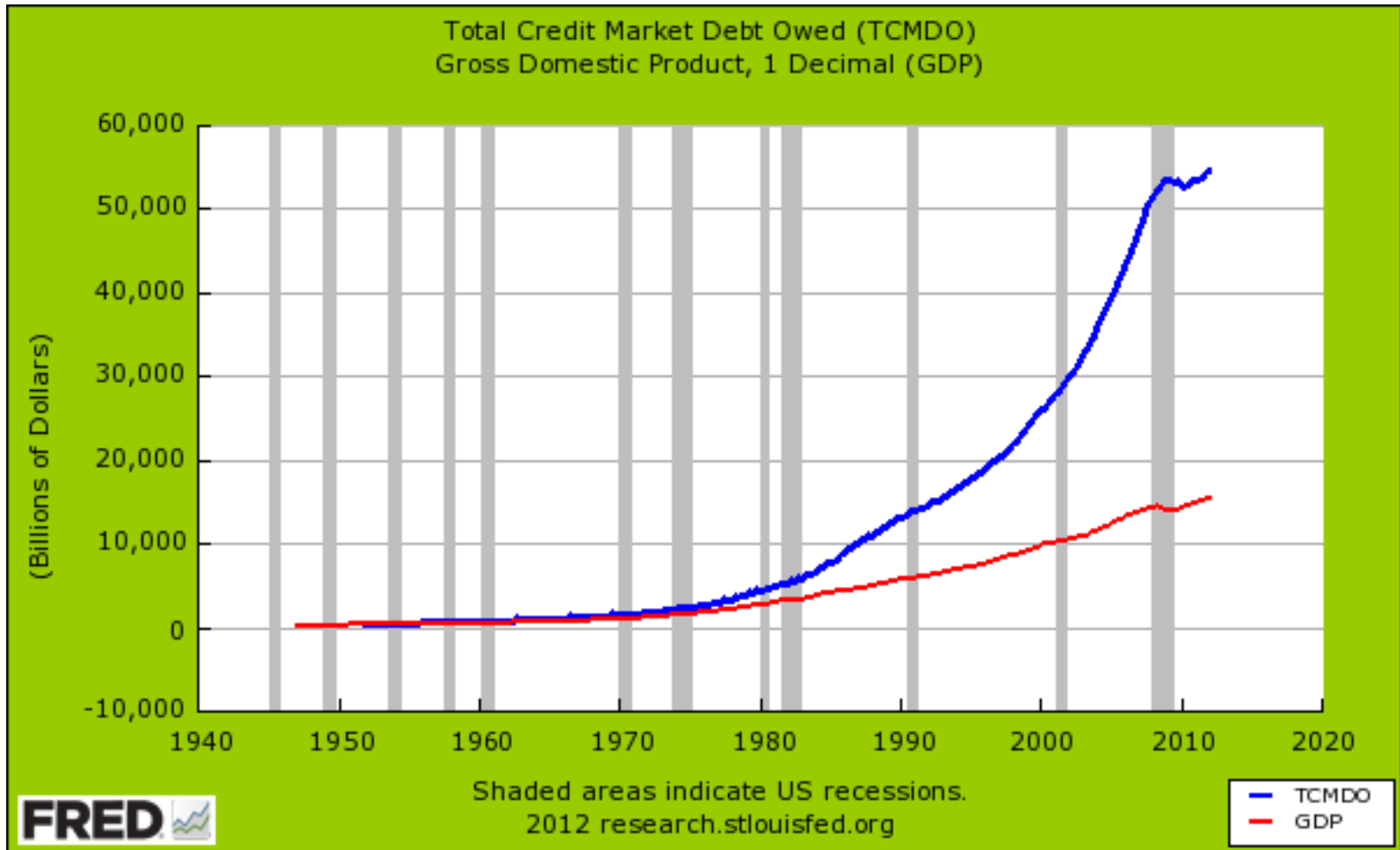


¹ Simple averages for 18 OECD economies.

² Rebased to 1980 = 100; simple average of 16 OECD economies, including the United States.

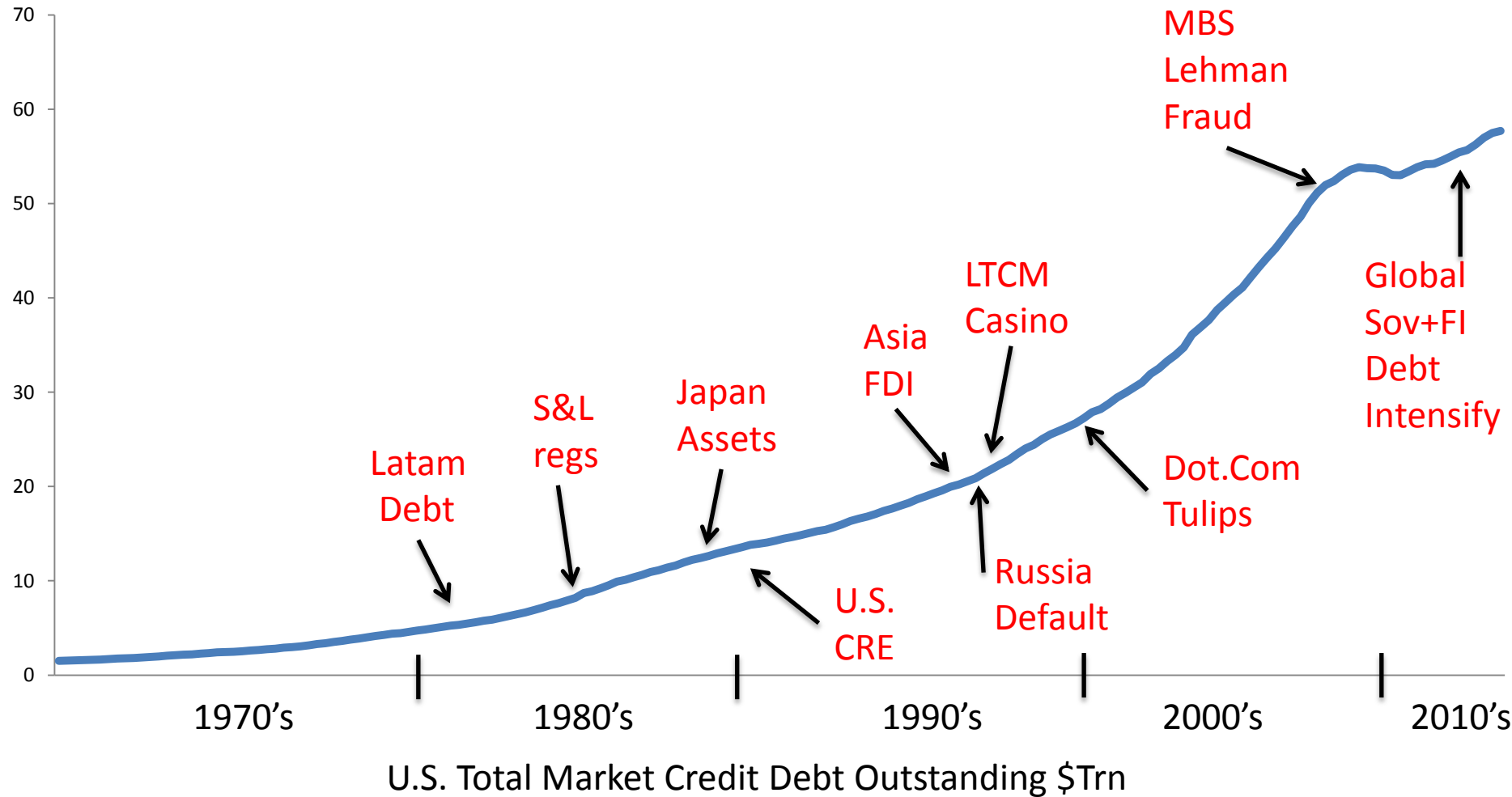
Debt Experiment - has it worked?

Credit Growth > Income growth = Unsustainable

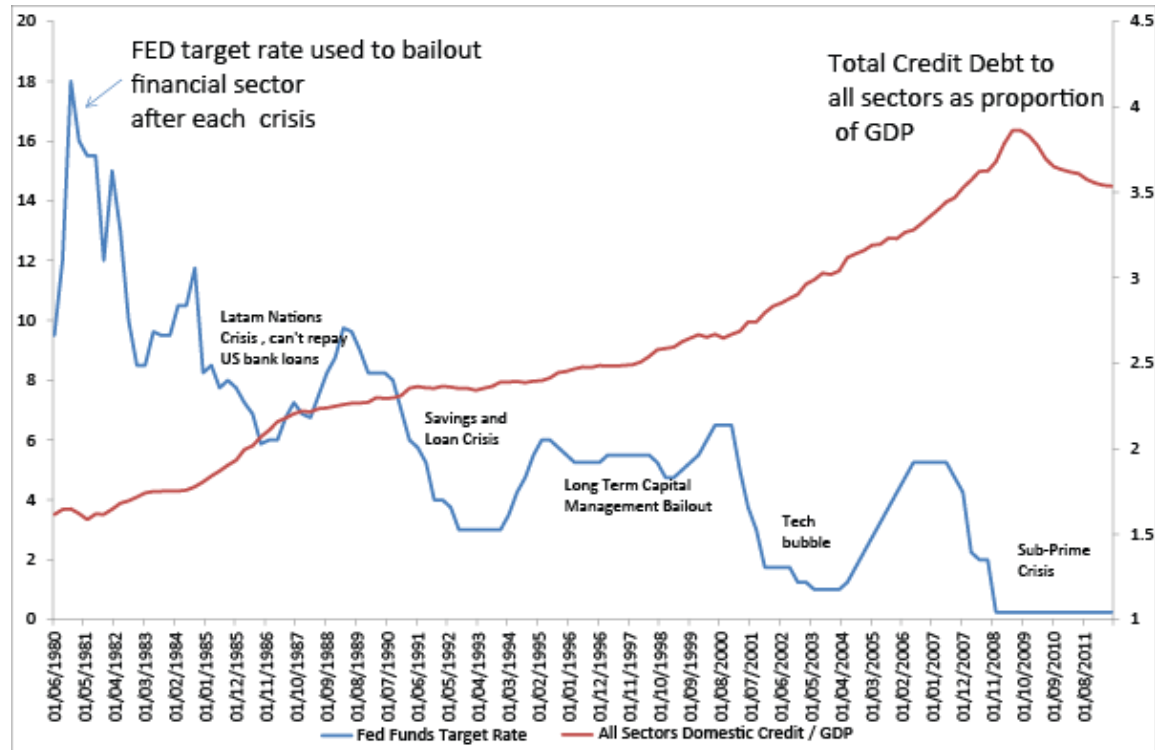


The marginal productivity of debt: the more you add, the less GDP you get

10 leveraged-induced bubbles in 30 years hasn't stopped the growth of the debt



Policies designed to save the financial system has increased the volume of credit over time



Knut Wicksell of today

- *The financial system is inherently unstable –*
- *it is getting more unstable through ongoing financial innovations.*

- *And inflation targeting is contributing to financial instability*

- *A trade-off between monetary stability (consumer price stability) and financial stability (asset price stability).*



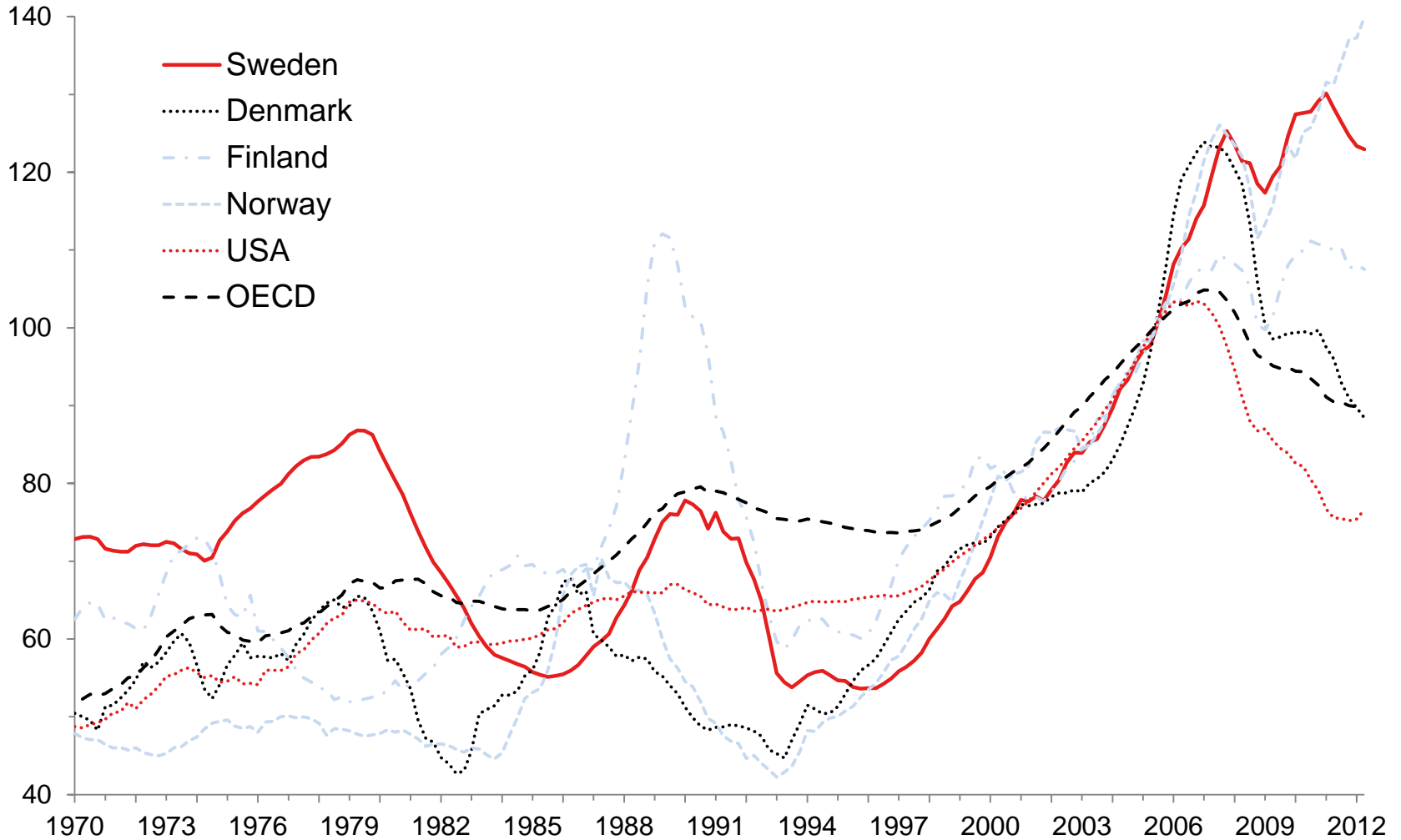
Knut Wicksell of today

- *Where will the next crisis emerge?*
- *My answer: in countries which have not recently had a financial crisis.*
- *Where do you find them?*



Real house prices

2005=100



Knut Wicksell of tomorrow

- *How can the system be made more stable – according to Wicksell?*
- *Restrict the growth in credit relative to real income*
- *Bretton Woods period*
- *Unlimited liability commercial banking*
- *Where is the real rate of interest?*



Knut Wicksell of tomorrow

- *My optimistic forecast*
- *Basel I, II and III – will be followed by Basel IV – after the next financial crisis*
- *After the next financial crisis we may find a more stable credit system.*
- *We need a new financial crisis to learn this lesson. We are wasting the present one?*



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