13th Conference of the Association for Heterodox Economics

Economists of Tomorrow

6-9 July 2011
University of Trent Nottingham, UK

PUBLIC DEBT, STABILIZATION AND FINANCIAL DEREGULATION

DRA. EUGENIA CORREA
Professor, PhD Program Economics Faculty,
Mexico National University
Correspondence
correa@servidor.unam.mx

DR. GREGORIO VIDAL
Professor, Coordinator of PhD Social Science Programs
Metropolitan University-Iztapalapa
gbv@xanum.uam.mx

AHE2011031P.

Abstract

In the early 50s Minsky set forth the idea that the financial innovation of financial institutions constrained central bank authority over growth of the money supply. These innovations can mean growing liquidity in an environment of economic growth and regulated financial competition. But in a short and temporal dynamic of financial concentration under market deregulation, such innovations can restrict liquidity and make all operations in financial markets more vulnerable. Wray and Papadimitrious have even argued that if central banks rescue institutions as a lender of last resort, these innovations become validated, strengthening the continuity of innovations. This paper discusses the financial stabilization policies undertaken in response to the 2007 crisis and some implications for changes in financial structures, with particular focus given to the role of the public debt. We conclude that public debt has been an essential tool for the validation of financial innovation in the recent crisis. Especially because the public debt has made possible the financial profitability in the short term, at least for financial assets segments more concentrated. The constraints of public budgets to ensure and increase the ability to pay debt interest, is exerting great pressure on the social commitments of the North-Western countries. It is a lesson learned in Latin America since the 80s.

PUBLIC DEBT, STABILIZATION AND FINANCIAL DEREGULATION[*]

"This is no storm in an academic teacup"

Introduction

The great fear in conventional monetary theory is that inflation weakens currencies, obstructs economic growth and reduces financing for investment. But, what can we say about the combined action of financial inflation and economic deflation? The price of financial assets once again is in a period of accelerated increase, as can be seen, for example, in the level of recovery of stock markets and of profits in large banks, as well as in the financial flows between institutional investors. While the signs of deflation continue, as seen in levels of unemployment, drops in consumption and salaries, slow growth and even stagnation between regions and productive chains, precarious employment conditions, the fall in prices of physical and financial assets, real estate, etc. In addition, the expectations of greater inflation are not materializing, even in spite of the important increase in energy and food prices.

We can therefore formulate a hypothesis. Is it the case that financial inflation with economic deflation weakens currency and credit, particularly deteriorating the two fundamental sources of financing which are private credit and public expenditure? This question could even be posed in the form of another question: could the crisis's "exit" policies, which include deficit and public debt reduction, which for now are the principle supports of financial inflation, deteriorate and weaken the capacity of credit flows and public expenditure to finance growth?

These moments of economic and financial restructuring, pushed by financial crisis, create conditions of widening profitability, compensating for the fall in demand and investment with the liquidation and or proprietary transfer of assets and their future rents, but which are monetized through financial inflation. (Minsky, 1987a, Toporowski, 2010)

This financial inflation, before and after the sharpest moments of the devaluation of financial assets that all crises imply, has developed in the context of a hierarchical structure of finances, intermediaries and instruments. As such, both central banks acting as lenders of last resort, as well as a small group of banks and institutions and public debt were configured as the fundamental support of the bailout and the reconfiguration of the financial systems in crisis.

This paper will attempt to analyze the role of public debt in the bailout and stabilization of financial markets during financial crises, discussing the financial stabilization policies followed in the 2007 crisis and some implication for the changes in financial structures, emphasizing the role of the public debt. We conclude that public debt has been an essential tool for the validation of

[*] Translation into English of Wesley Marshall.

financial innovation in recent crisis. We conclude that public debt has been an essential tool for the validation of financial innovation in the recent crisis. Especially because the public debt has made possible the financial profitability in the short term, at least for financial assets segments more concentrated. The constraints of public budgets to ensure and increase the ability to pay debt interest, is exerting great pressure on the social commitments of the North-Western countries. It is a lesson learned in Latin America since the 80s.

I. Financial stabilization policies in the 2007 crisis and public debt

The financial authorities of the world's largest countries have undertaken several policies in an attempt to resolve the financial crisis. The first step, (initiated at the end of 2007), consisted of multiple programs of liquidity provision (the purchase of devalued assets, or capital injections) including the administration of acquisitions, temporary capitalization programs and nationalizations, and the lowering of central banks' interest rates. The second step (initiated toward the end of 2008), with changes in accounting rules in order to allow a more favorable valuation of assets and reduce the increase in capital requirements. A third step (initiated in mid 2009), that put on discussion changes in financial regulation and even financial reforms.

These steps advanced in achieving their objective in as much as they simultaneously slowed asset devaluation and lowered the risk assessments of asset portfolios in addition to the returning many financial intermediaries to profit. This profit recovery, even though based on government support and the deepening of speculative practices, has been considered by many to be the end of the financial crisis. Even though this implies that the recovery of credit for investment and the sustained growth of demand will remain postponed for a long while.

This recovery in profitability in large part has been possible by governments´ large scale liquidity injections, in addition to newly formed speculative bubbles, such as those in energy and food, renewed operations in highly speculative instruments and, substantial earnings through operations in the developing world.

The financial reforms undertaken are still a long way from reaching their principal objectives of stability and prevention. However, there are evidences that these reforms are designed to administer the crisis. (Viñals, et.al. 2010; Gordon and Metrick 2010; Woolley, 2010) Until now, the administration of the crisis continues to be one of its crucial elements, as it redistributes the market power of the largest conglomerates and may come to construct or reconstruct territories and instruments, the modalities of the recovery of the liquidity sources of financial systems and reconstruct the financial business model. For now, the strategies of crisis administration continue to seek to curb the appearance of further losses, finding the formulas for the profitable placement of enormous volumes of funds and evading and hiding all of the illegal practices that have characterized financial operations in the last years under the guise of creative

accounting and the opacity with which financial innovation operates (Correa, 2010; Omarova, 2009; Poszar, et. al. 2010).

In the case of the United States, for example, according to the Federal Reserve Board (2011), the support given to 11 financial entities between 2008 and 2010 has ascended to more than 10 trillion dollars, specifically through the Primary Dealer Credit Facility (PDCF). Of this total 25% corresponds to Citigroup and 20% to Morgan Stanley. (Duarte, 2011)

In many countries, deficit spending and public debt can be explained both by the bailout of financial conglomerates and their largest investors, and by the fall in receipts due to the recession.

However, not all of the largest economies increased their public debt in equal degree during the crisis of 2007-2010. As can be seen in Table 1, the greatest increases were in the UK, the US and Spain, followed by Japan, Canada and France. Meanwhile, the low growth in public debt has been notable in Germany and Italy.

Table 1

General Government Net Debt (percentage of GDP)					
	2006	2007	2008	2009	2010
United States	41.9	42.6	48.4	59.9	64.8
Japan	84.3	81.5	96.5	110.0	117.5
United Kingdom	38.0	38.2	45.6	60.9	69.4
Canada	26.3	22.9	22.4	28.4	32.2
France	59.3	59.3	61.8	71.3	76.0
Germany	52.7	50.1	49.7	55.9	53.8
Italy	89.8	87.3	89.2	97.1	99.6
Spain	30.5	26.5	30.4	41.8	48.8
Portugal	58.8	58.1	61.1	71.9	79.1
Greece (1)	106.1	105.1	110.3	126.8	142.0

Source: IMF (2011)
(1) Gross Debt

Greater differences can be seen in the behavior of the general government balance as a percentage of GDP, as can be seen in Table 2. The deficit shows an enormous jump in the US, UK and Japan; and, to a much lesser degree in France and Italy. Another case is German, Canada and Spain. In Germany, the surplus grew considerably, while Canada went from a surplus to deficit and Spain barely diminished the surplus that it had.

The differing behavior among these indicators also signal the different forms in which the financial crisis shook financial systems. In the UK, US, and to a lesser degree, until, now, Japan and Spain are the countries in which large bans have required substantial bailouts. In Spain the rescue and restructuring of banks (and the *cajas de ahorro*) are still in progress, and it is noteworthy how even with a fiscal surplus, net public debt increased 40% in these four years.

While vast differences exist in the variation of public debts and balances and other indicators, the capacity to administer the financial crisis is also quite

different, given the institutional context, both internal and external, within which the crisis has developed. Bailout funds have been copious in the US and UK, even reaching the partial or total nationalization of large entities. In these cases, the accelerated and unstoppable loss in the value of financial assets soon enough effected the entire hierarchical structure of the lender of last resort function, in such a way as that governments and central banks offered large quantities of resources to float the gigantic networks of interbank operations and the opaque over the counter operations. The institutional arrangement of these financial structures and the monetary and credit sovereignty of these countries are also present (Minsky, 1987a).

Table 2

General Government Balance (percentage of GDP)					
	2006	2007	2008	2009	2010
United States	-2	-2.7	-6.5	-12.7	-10.6
Japan	-4	-2.4	-4.2	-10.3	-9.5
United Kingdom	-2.6	-2.7	-4.9	-10.3	-10.4
Canada	1.6	1.6	0.1	-5.5	-5.5
France	-2.3	-2.7	-3.3	-7.5	-7
Germany	-1.6	0.3	0.1	-3	-2.3
Italy	-3.3	-1.5	-2.7	-5.3	-4.5
Spain	2	1.9	-4.2	-11.1	-9.2
Portugal	-4.1	-2.8	-2.9	-9.3	-7.3
Greece	-6.1	-7.7	-9.5	-15.4	-9.6

Source: IMF (2011)

On the other hand are the economies of the European Union (EU), which are subject to the institutional structure created by the Euro that restructured and in large part eliminated the lender of last resort hierarchy. As such, each individual country is confronted with the alternative of generating its own fiscal savings to rescue banks or to lose them, with many possible intermediate situations falling between these two outcomes.

Even so, in the current conditions of the monetary union the increase of public debt, indispensable for financial stabilization, is not within the reach of each and every one of the bloc's countries. As such, the public debt's refinancing is not merely the growth of interest bearing paper by a sovereign government, but also a debt supported by flows, as if it is a private debt. Or, as has been the case of the external debts of developing countries, a debt in foreign currency whose payment requires inflows. Countries such as Greece, Portugal and even Spain have therefore been singled out as the periphery of the Union, even as such periphery of the Union may continue increase in the number of countries. For these countries, public debt commitments backed by public revenue, means translate such revenues to financial sector and implement pro-cyclical policies, increasing taxes or reducing no interest payments spending. This is also a path well trodden by developing economies, which not only prolongs the recession and weakens not only chances for a full recovery, but also public services and institutions.

Even so, the largest economies are still far from a situation in which public debt commitments represent an important part of public revenue. As can be seen in

Table 3, there are important differences among countries. At one extreme are the cases of Greece, and to a lesser degree Italy, which are still far from those of the UK, US, Portugal and the group of countries with a lower ratio of debt payments to revenues, including Japan, Spain, France Germany and Canada.

Table 3

Public Debt Commitments as Percentage of the General Government Revenue

	2006	2007	2008	2009	2010
United States	5.6	5.9	6.1	5.8	5.6
Japan	1.6	1.6	2.5	3.0	3.6
United Kingdom	3.9	4.2	4.2	4.9	7.1
Canada	1.5	1.5	0.0	2.3	1.6
France	4.4	4.6	5.1	4.5	4.5
Germany	5.5	5.5	5.5	5.2	2.8
Italy	9.7	10.3	10.6	9.2	9.3
Spain	3.2	2.7	3.0	3.5	3.9
Portugal	6.4	6.6	6.9	6.9	6.6
Greece	11.8	14.6	12.6	14.0	15.9

Source: IMF (2011)

II. Minsky: public debt and financial innovation. Changes in financial structures and the role of public debt.

Minsky is well known in academic and financial market spheres for his contributions to the understanding of the cycle of financing. However, a very important part of his work relates to the transformations within financial structures, including institutions, corporations and market rules and instruments. Toward the end of the 50s Minsky warned of the existing dangers of changes in operations in the government bond houses, when these entities expanded their business of purchases and repurchases of bonds with non financial corporations and these began to finance themselves through such operations. “Once non financial corporations are habituated to making "loans" with government debt as collateral, the possibility exists that collateralized loans using non government paper will develop” (Minsky, 1957, 181).

Years later, Minsky discovered, in its analysis of commercial paper default in the Penn-Central Railroad in 1970, that the Federal Reserve to inject additional funds into the banking system through open market operation protected the commercial paper market. In addition, the commercial paper became a covert liability, but did not appear in the balance sheet of the bank. Thus, in the words of Minsky “This practice introduce an additional component to the effective money supply that was not constrained by the traditional powers of the Federal Reserve” (Minsky, 1987a, 103) Then, the off balance sheet banking operations create additional money supply that were added to the money-credit circuits and this was the birth of the so called shadow banking. Minsky (1987b) added the securitization as all the wave of financial innovation that create additional money supply but that also added new link in the hierarchy of the lender of last resort.

The growing uncertainty in which financial and non financial firms operate, the greater volatility in interest rates and in exchange rates, in addition to the cyclical decrease in demand and the speculative dynamic of corporative finance, deteriorate the quality of private debt. But the same does not occur with public debt when governments create the currency in which debt is issued (Minsky, 1987a, 39). Financial opening, however, changed the hierarchical monetary and credit structure, in which public debt also participates.

Even amidst the advanced stage of financial globalization the great crisis of 2007-8 has shown that public debt has been essential in several senses, to: 1. Unlock the successive episodes of credit crunches that presented themselves between 2007-2009; 2. Validate, even in part, assets that resulted from financial innovation; 3. Give continuity to the profitability of financial conglomerates, although partially

This financial crisis has shown how financial inflation, with its roots in the nineties, has been expanded disproportionately between assets and intermediaries; and how, eventually, financial inflation is contained with the discovery of gigantic Ponzi positions that must be kept afloat with public funds (Toporowski, 2010). Credit is therefore sustained in global financial conglomerates that conform a hierarchical, competitive and transnational structure, while currencies are also supported by the credit generating power of the States.

As with previous financial crises, the crisis of 2007 and the subsequent bailout policies are showing that public debt is once again called upon to be the liability able to slow the deterioration in the prices of other financial assets, establish a floor for earnings and contribute to the recovery of financial markets' profitability. However, as Galbraith (2011) points out, the performance of this debt depends on whether the rate of interest is lower than the rate of economic growth. During recent years, the yield on government bonds decreased in the majority of advanced economies, even though several countries have suffered the market consequences of credit downgrades.

Conglomerated financial entities and large investors that have survived thanks to public indebtedness do not flourish in low yield markets. Some financial flows are part of liquidity has now moved into speculation in energy and raw materials; but also in the expansion towards developing countries in the search for higher yields in several local financial markets; or alternatively in taking positions in natural resources and basic public services.

The credit downgrades on the debt of 17 developed countries in the last months therefore carry the objective of exerting upward pressure on government bond yields. The elevation of the interest rate on these risk free bonds both in nominal and in real terms will add to pressures for further budget cuts while bolstering financial inflation, but on the terrible road of economic depression.

In addition, budget cuts in redistributive spending (services, pensions, health, education), places even more of the burden of financial profitability on working

and middle classes. As Galbraith (2011) notes, the actions of credit agencies do not reflect a default risk on paper that is 100% safe and extremely liquid, but rather the pressure to grant new gifts to banks and rentiers.

The difference between private and public debt is crucial. The payment commitment of firms depends on cash flows, whether they result from borrowing, selling output or asset performance. The payment commitments of households likewise depend on the flows of wages and salaries, new debts, capital gains or asset sales. This is not the case of public debt, given that its servicing reflects the capacity of governments to impose taxes, to maintain high levels of public spending, and the economic dynamics that create profits for businesses and savings in sovereign currencies (Minsky, 1987).

Public debt is a safe and secure asset class for households and businesses, as well as for financial entities. It has been a fundamental support for financial innovation and of course creates liquid assets that improve the performance of financial entities that have suffered losses during the crisis.

However, in a great crisis such as the current one, “big government” can be insufficient, particularly in the context of a global financial market with highly concentrated and powerful entities and players. Therefore, slowing debt-deflation and achieving durable stabilization will require social and political actions, as well as much deeper economic reforms, in which conditions of full employment may well be crucial.

In a recent article in the New York Times Paul Krugman direly warned of this new domination over political and economic discourse that erases all fundamental themes. The US Congress is fixated upon cutting as much public spending as possible, especially to give meaning to the idea that only by reducing the public deficit will the economy and dollar stabilize. They have made irrelevant all ideas of economic recovery sustained in job creation and energy and infrastructure renovation. But also in the UK and EU countries, many agreements have been reached on budget cuts since 2010, from salaries and pensions, to spending in education and health services.

As James Galbraith (2009) has reiterated, the authorities of the United States are forgetting the lessons learned in the previous great economic and financial crisis and are driving the country towards a long deflationary period, with high unemployment and a general deterioration in the living conditions of the population. This economic weakness, paired with the noteworthy and experienced military and colonialist capacity, may contribute to increasing external transfers. With these factors in consideration, the expectations of financial profitability can continue to be fulfilled, even though this may mean growing economic concentration, precarious employment and impoverishment.

References

Arestis, P., et.al. (2002) Threshold effects in the US budget deficit. Working paper No. 358, Levy Institute.

Duarte, C. (2011) Programas anticrisis y déficit fiscal en los Estados Unidos, en Revista Ola Financiera, No. 9, mayo-agosto.

Galbraith, J. (2009) No habrá regreso a la normalidad: Una solución a la crisis económica en Revista Ola Financiera, No. 3, www.olafinanciera.unam.mx

Galbraith, J. (2011) Is the federal debt unsustainable? Policy Note, 2/2011. Levy Institute.

Gorton, Gary and Andrew Metrick (2010) Regulating Shadow Banking System, Yale and NBER.

International Monetary Fund (2011) Fiscal Monitor. Shifting Gears Tackling Challenges on the Road to Fiscal Adjustment, April.

Lapavitsas, C. and I. Levina (2010) Financial Profit: Profit from Production and Profit upon Alienation, Discussion paper no. 24, SOAS, University of London, UK

Minsky, H. (1957) Central Banking and Money Market Changes, The quarterly journal of economics, no. 2, vol. LXXI, may.

Minsky, H. (2008/1987a) Stabilizing an Unstable Economy, McGraw Hill.

Minsky, H. (2008/1987b) Securitization, Policy Note, Levy Institute.

Omarova, Saule (2009) The Quiet Metamorphosis: How Derivatives Changed th "Business of Banking"

Philippon, T. (2008) The evolution of the US Financial Industry from 1860 to 2007: Theory and Evidence.

Pozsar, Zoltan, Tobias Adrian, Adam Ashcraft and Hayley Boesky (2010) Shadow Banking, Federal Reserve Bank of New York, Staff Reports no. 458 July.

Reinhart, Carmen M. and Kenneth S. Rogoff (2011) A Decade of Debt. NBER Working Paper No. 16827 February.

Reinhart, Carmen M. and M. Belen Sbrancia (2011) The Liquidation of Government Debt. NBER Working Paper No. 16893 March.

Rochon, L.P. (2003) On money and endogenous money: postkeynesian and circulation approach, in Rochon, L.P. and S. Rossi (2003) Modern Theories of Money, Elgar Edward, UK.

Toporoswki, J. (2010) Why the World Economy Needs a Financial Crash and Other Critical Essay on Finance and Financial Economics, Anthem Press, UK.

Viñals, José, Jonathan Fiechter, Ceyla Pazarbasioglu, Laura Kodres, Aditya

Narain, and Marina Moretti (2010) Shaping the new financial system. IMF staff position note SPN/10/15.

Woolley, Paul (2010) Why are the financial markets so inefficient and exploitative –and a suggested remedy, in Adair Turner and others (2010), *The Future of Finance: The LSE Report,* London School of Economics and Political Science. www, futureoffinance.org.uk