Renegade INC

Richard Werner: QE Infinity

Ross Welcome to Renegade Inc. As the Russian proverb goes, there's nothing more permanent than a temporary solution. Quantitative easing was introduced to buy central bankers time so they could fix the structural problems in the economy. But quickly, QE became the solution to every possible economic hiccup. Temporary QE has now become the permanent problem, which has juiced asset prices, created epic amounts of private debt and left most of us poorer.

Ross Welcome to Renegade Inc, and I'm delighted to be joined by an old friend of the show, Professor Richard Werner. Welcome back. It's been a long time and you're very requested. It's good to see you.

Richard Werner Thanks for having me. It's a pleasure to be back again.

Ross We sit here, Richard, about 13 years after 08 and now the House of Lords are worried about QE, quantitative easing. The best person to talk about that is the guy you first termed it - that was you. Why did you term it? What does it mean and why is the House of Lords now worried about it?

Richard Werner Yes. well, I proposed this monetary policy, a new monetary policy, in 1995 when I was chief economist at an investment bank in Tokyo, because I predicted - and already had predicted since 1991, when the top banks in the world were all Japanese and Japan was supposed to take over the world - and I put out my forecast that actually, no, Japanese banks were going to go bust, and that Japan was going to move into the biggest recession since the Great Depression.

Ross But that must have been the most contrarian call at the time insofar as everyone was saying that all the land under the Imperial Palace was worth more than all of California combined.

Richard Werner Yes. I mean, most of the strategists were recommending in the early 90s when the Bank of Japan was lowering interest rates for the first time, to buy Japanese stocks. Yes, they'd fallen a bit, but they're lowering rates. And the official story, the interest rate story is when you lower rates, this is good for the economy, is good for stocks. So bye bye bye. And I was saying the diametrically opposite - sell. In fact, I was still a student at Oxford in '91 when I put out that paper as an Oxford discussion paper I put options on the Nikkei, which worked because they were heading further down. And so then when I was chief economist in '95 in Tokyo, I proposed a policy to get out of what I was expecting was really going to happen now - a massive, complete banking crisis. And it's therefore a tool that was designed to get out of banking crises quickly and help the economy recover very quickly. But of course, it has to be implemented in the right way. And the definition of the tool is really more or less well, different from what they turned it into. The key principle is, again, credit creation. I had already proposed my quantity theory of disaggregated credit or the the general quantity theory, because the money supply is created by the banking system through credit creation. When banks lend, they create money out of nothing. That's how 97 percent of the money supply is created. And the important question is what is the money being used for?

And that will determine everything else. It's a crucial decision because if it's used for productive purposes, implementing new technologies, increasing productivity, you will get economic growth without inflation, which is really what we want. But if banks create money and it's used for unproductive things, that's when you get into trouble. There's two possibilities. One is for consumption, clearly you get consumer price inflation because you've got, you know, people consuming more. But there's not more goods and services. That's perhaps more understood. But what's usually ignored is when banks create money and it's used for purchasing assets, because it's money creation, bank lending is money creation, you are printing money, pumping it into asset markets. What's going to happen with the asset price? Of course it's going to rise and they're going to rise and everyone will make money, including the banks and the borrowers. So it looks, and for quite a while it looks really good, but it is from the beginning very clear that it's unsustainable. And if it is big enough - and often it is big enough - then it will lead to a banking crisis. And this is, of course, what happened in Japan in the '80s - massive bank credit expansion. We can perhaps mention why this happened is an interesting question. But once you have this, then it's clear you are setting the stage for a big banking crisis and that could turn into a long recession. And my policy then came in to essentially prevent this long recession and very quickly get out of it. And it's very easy suggestion. So the true definition of quantitative easing is to quantitatively increase credit creation in the economy for GDP transactions.

Ross Right. But that's very targeted, isn't it?

Richard Werner Yes, exactly.

Ross And what actually has happened with central banks across the world is a scattergun approach.

Richard Werner Exactly.

Ross And actually, you know, wherever you foresee a problem, whether it be banking through to a pandemic, let's have another go at QE.

Richard Werner Exactly. That's been the problem since 2008. The credit creation has not been targeted at those transactions that actually help the economy and contribute to the creation of wealth and lead to high, sustainable, equitable, non-inflationary growth without crises. Instead, they did more of what really led to the crisis in the first place, which is bank credit creation for asset purchases. And that clearly makes things worse in the long run. While in the short term you think, oh, great, we're all doing well, we're earning money.

Ross But it's the drug addict analogy, isn't it? One more hit or Pringle's, if you like. Once you pop, you can't stop because there is a law of diminishing returns. You will juice all these asset markets. Asset prices will go through the roof. The financial sector will do very well, thank you very much. The real economy, well, here we go, we've been starved of any investment.

Richard Werner And of course, you said the next time bomb in the banking system because bank credit creation for asset purchases is not sustainable also from a banking perspective because ultimately and there's no natural income streams to service and repay the loans. What you have is capital gains. But the capital gains are contingent on the game continuing. In other words, banks continuing to create more credit pumping into asset markets. There's new money that is driving up asset prices and creating more capital gains. So it's a Ponzi scheme.

Ross And you can't taper one of those because you get a 'taper tantrum' as they call it?

Richard Werner Well, now, actually, that's an interesting question. So even when we are in this situation where we have created asset bubbles, what is the right policy? In Japan the bubble had already burst and we were in this early stage of moving into a big, massive recession. And my policy then was geared at ending that recession and getting out of the recession. Now we're in a situation where the bubble has not burst yet. And looking at credit creation of central banks and banks across the globe - I follow 38 countries - actually, the scenario is still very bullish for asset markets.

Ross It won't be any surprise to you that in this report, the House of Lords claim there have been knowledge gaps when it comes to using QE. You've just highlighted them because, again, we're back to the scattergun approach. Let's just throw more money at it and see what happens. What would be a more targeted approach than now to try and get us out of this? Well, we're hooked on this magicked money, as Ann Pettifor writes about. So how do we extricate ourselves? Because it seems to me that whenever you touch any of this from a policy point of view, the whole house of cards comes down.

Richard Werner The question is, what is the goal? What do we want to achieve?

Ross We want to refloat the real economy. We want to get the banking sector back as a tertiary service as opposed to a primary driver. And we want to rethink society in a way that allows the working man and woman on the street to actually get involved in it. I mean, it's quite a big brief.

Richard Werner That's what you'd like to do. That's what I'd like to do. But is that what the policymakers are really aiming at? That's the problem.

Ross Do you think that they're that cynical that they're just going to look after the FIRE sector - financial, insurance and real estate?

Richard Werner With policy makers and planners and central planners, the best thing is to not really place too much store by what they say, but watch what they do. It's the concept of revealed preference. That tells you, you know, their actions reveal their preferences.

Ross So what do you think, having had a look at their actions, what are their revealed preferences?

Richard Werner Well, it doesn't look good. And the troubling thing is that consistently over the years, the revealed preferences don't look good. And there seems to be this tendency to have a essentially a preference for boom-bust cycles and both increasing the frequency and the amplitude of business cycles when really that's quite a destructive tendency and quite a costly tendency for society. So the point is, it is always possible also at this very moment in any country in the world to have high economic growth that's also sustainable, environmentally sustainable. So high, sustainable, even environmentally enhancing economic growth, that is equitable, increases equity and reduces inequality, is non-inflationary and does not lead to crises. We can do this in any country. It's a magic formula.

Ross Are you sure about this because policymakers who will listen to that and go, really?. We've tried like hell and we haven't been able to.

Richard Werner Well, they haven't tried at all.

Ross How do you do it?

Richard Werner Essentially, you have to look at the mechanism that has delivered this. It's an empirical question. And we've you know, we can observe countries that have performed extremely well, double digit economic growth for decades. That is the high growth system, which is the East Asian high growth system implemented in Japan, Korea, Taiwan, and since 1978 under Deng Xiaoping in China as well.

Ross But you always hear from the policymakers, yeah, they're outliers, they're different. There is something odd that happened there. We can't use that as a model.

Richard Werner Well, of course they have to say that because the policies adopted by these highly successful, high growth economies are diametrically opposed to what the IMF, the World Bank and all the international institutions are recommending countries to do in order to allegedly achieve high growth. Tell me how many countries have actually succeeded since the creation of the IMF and the World Bank in moving decisively from developing country status to industrialised nation status?

Ross When the IMF are looking at countries that have developed, why have they deployed these policies? Is it because they haven't got the knowledge to understand how to really go about rebooting these economies?

Richard Werner I think that hypothesis is not tenable. There's no empirical evidence for that. The designers of those policy recommendations for developing countries are very smart people. They do understand key concepts and key realities.

Ross So who are they serving?

Richard Werner Well, you just need to look at the result. The result has been that developing countries have consistently been suppressed in their economic development and their resources have been extracted very efficiently and very cheaply for the benefit of the industrialised countries. So essentially, it's a continuation of the colonial relationships on an economic front. This is what the IMF and the World Bank have been overseeing in the last 70 years or so.

Ross Welcome back to Renegade Inc. It's part two and we're here with Richard Werner. Richard, how best to then divide the two policy responses and say actually what we should be doing is adopting this one?

Richard Werner One important aspect of this, and you won't be surprised to hear this, of course, is the banking system. Why? Because banks are not financial intermediaries. They do not just gather deposits and then do the analysis and lend out that money. This is how textbooks describe it, even in the leading top finance journals in the world, US journals. That's not how banks operate. Banks don't take deposits because at law there is no such thing as a bank deposit. It's simply a loan that we've given to the bank. So we're general creditors and banks don't lend money. They're in the business of purchasing securities. If you take out a bank loan, the loan contract that you've signed is an IOU, a debt instrument that you've issued. You've issued a security and the bank is going to purchase that and you'll say, oh, that's confusing. But anyway, I don't care. I just want the money. And the bank will say, well, look into your account that you have with us. You'll find it there. If the bank clerk says we've transferred it there, that will be incorrect because, of course, no money was transferred to your account from either inside the bank or outside the bank. It was newly created and the numbers were entered into your account because, you see, it's not a deposit. It's a record of how much money the bank owes you. And when they purchased your loan contract and accounts payable liability was created, which is now slightly incorrectly recorded in the bank's books as another type of liability called customer deposits.

Ross A brilliant bit of analysis and not a bit of analysis that you heard anywhere else.

Richard Werner So this is how banks create money. In other words, the money supply is created out of nothing by the banking system. And we have to be aware of this power of the banking system. Since this truth is has spread more widely and people realise that banks are actually money creators, the response by a lot of influential decision makers has been, oh, banks, create money. Well, let's stop this. Let's abolish banks and let's make life hard for banks. Let's have more regulations to make life very hard. So profitability goes down. Let's flatten the yield curve and reduce interest rates to zero and negative territory. That means banks can't earn money and the traditional productive lending for productive purposes is not any more profitable. So you're driving banks out of business. And also, let's introduce competition from the bank regulators. Let's have the bank regulators compete against banks by offering current accounts to the general public. There's been so many policies in the last 15 years to make life hard for banks that banks have been driven out of business, particularly the small banks. But that's really now the answer finally to a question, because when you look at the highly successful economies that have high growth systems and the key example, it's really China because they were initially not successful. You find that the answer is in the structure of the banking system. So let's go there. So 1978 - China. The previous period was fairly disastrous - Cultural Revolution - which essentially locked down policies, destroying the food supply chain, creating famine, millions of people dying. And so Mao as leader didn't really have a very good, strong economic result to boast of. But a new leader came to power, Deng Xiaoping, and he was very smart. He analysed what is necessary for high economic growth. He went to Japan. He looked at Germany. He looked at the US. And he had the right conclusions. So people say, oh, he opened up and he introduced market reforms. And in a way that's true. But it's not just general market reforms. Developing countries have market reforms and they've tried this for 70 years and that hasn't been successful. So what is it that made China extremely successful? Of course, it's a combination of things, but one of the key policies was Deng Xiaoping decided to create banks, found banks, set up new banks, thousands of banks, credit unions, small banks, retail banks, local banks, investment banks.

Ross But what was the mandate? What was their mandate?

Richard Werner To create credit for productive purposes.

Ross Oh, wow!?

Richard Werner And you need lots of them. And a decentralised system. So the structure of the banking system then is one where you have many, many small banks in a decentralised fashion. These are essentially your agents that on the ground kick the ties off tens of thousands of small firms. That's a hard job, you know. You have to do real work. You have to analyse the statements. You have to go there and check them out.

Ross It's a lot easier being centralised and just lending on an asset price that's going up, right? because a rising tide lifts all boats.

Richard Werner That's right. And of course, there's a reason why it's difficult because it's highly important for the economy if you do this difficult job of actually checking out each small loan to small firms. And so that's what Deng Xiaoping did. He created thousands and thousands of small banks across China. And the result was over 40 years we had double digit economic growth. More people have been lifted out of poverty in China than anywhere in history. This is phenomenal. This is the lesson from China. However, what has been happening in the last 20 years, in fact, the last 30 years, but accelerated, of course, since 2008, is the central planners - because they like centralisation - have been clamping down on small banks, so they've been dying. Fifteen thousand have disappeared in America over the last three or four decades. The ECB is a new central bank. So the eurozone essentially started only around the year 2000. So, you know, 21 years. So how many banks on a net basis were newly created in those 21 years? What do you think?

Ross I think that this number is anemically low.

Richard Werner Yes, it was a slight trick question. It was a negative, of course. It was a negative figure. We've got minus 4,800 banks since the creation of the ECB. In other words, the ECB has killed already almost 5,000 banks in its very short history. Now, have they killed the Goldman Sach's of this world?

Ross Forget it.

Richard Werner Exactly. I mean, that's where Draghi and others used to work for. Of course, it's the small local community banks that are forced to merge with others and get bigger and bigger and ultimately disappear because they've become like a big corporate bank.

Ross Which is where all the rents trickle up.

Richard Werner Exactly.

Ross And enormous pay for executives. Real economy starved. No real innovation.

Richard Werner And also, as the banks get bigger - and I have done an empirical study with one of my PhD research students published actually recently in Journal of International Money and Finance. And that study shows that the big banks do big deals - this is on American data - it's the small banks that lend to small firms. But also over time, as banks grow in size because they're forced to merge, they become the same. So as small banks get bigger, they also lend to bigger companies. And that is the problem. And that's also why we actually constantly need to create new banks and we need to actually slow down this pressure we've put on banks to merge and become bigger, which can be done with the right policies. But since 2008 the policy has been quite wrong because they've forced mergers of banks. And that's been a combination of massively increasing regulation on banks, in Europe in particularly unfairly, because in America, small banks have their own regulator. But in Europe, any small credit union and small local co-operative bank with, say, 20 staff, they have to meet the same reporting and compliance requirements as Deutsche Bank with 2,000 people on the job.

Ross But it's impossible.

Richard Werner Exactly. So they're driven out of business. So regulation. But the second one is also monetary policy and back to QE because the wrong type of QE has been implemented. They should go back to my original writings about what QE should be doing. It should enhance bank credit creation for GDP transactions and for productive purposes. But actually they've mainly introduced bank credit creation and central bank credit creation for asset purchases, driving up asset prices. But by doing that, by buying government bonds, you're actually pushing down long-term interest rates. And that's bad for the banks that are lending to the real economy, doing the real lending by evaluating loan projects and so on, because that means the long-term interest rate is being pushed down so the margin they can earn on their real economy lending to SMEs is going down and down and down to zero. And so that's another factor, how they're being driven out of business. So the screws have been tightened so much on small banks, they've been disappearing. And that's a trend that urgently needs to be stopped. And fortunately, at the Bank of England it's been recognised it's a good thing to create new banks. So they have been encouraging the creation of new banks. That's unusual and that's great. That's the right tendency. We need to set up new banks. Of course, they also need to be the right type. We've had lots of so-called challenger banks that are there simply for shareholders that want to maximise profits. But what's going to happen when these these type of challenger banks, which are essentially big banks but small, when they get successful? Well, since the shareholders are in it for the money, as soon as you get the right offer, they're going to sell off to the next big bank.

Ross And then you get more consolidation.

Richard Werner This is how the banks have disappeared, because in the UK there used to be thousands of small banks until the First World War. But before the First World War, there's this huge consolidation drive where the big banks swallowed up the thousands of small banks, you know, hundreds of provincial county and country banks everywhere. That's when economic growth was much higher in Britain as well, you see, because that's what you need - a diversified, decentralised banking system with many, many small banks on the ground lending to small firms. That creates jobs, prosperity, and also it helps small firms be very competitive. You know, actually, it's an interesting topic. The government has been worried for the last three years about why is productivity so low?

Ross Right, exactly.

Richard Werner Well, I can give you the answer.

Ross Go.

Richard Werner Let's look at a country that's highly successful in productivity - Germany. And, of course, one key measure is your exports. I mean, German exports have been almost as large as Chinese exports for many years and, until 2009, larger than Chinese exports, when clearly Germany is much, much smaller than China.

Ross Yes, but what's driving that?

Richard Werner And now what's driving that is the productivity because to be successful at exports, you have to be highly productive and efficient. And what is driving that? Well, what many people don't realise is that many of the successful exporters in Germany are small firms, family owned firms, small businesses. And in fact, there's a definition, it's called hidden champions. This is when a small firm, because it's small, people don't know that the name it's not famous, you know, small firm, but it is a global market leader having number one, two or three of champion gold, silver, bronze market share in the world. So they're defined as hidden champions. Now, if you draw up a chart of the number of hidden champions that every country has, where these SMEs are global market share leaders, Germany stands out. Like there is just almost no competition. Germany has fifteen hundred. And then number two is, as you'd expect is the US. But it's like three hundred. It's a completely different category. And then most countries have maybe 30, 40, 50. Why is that? It's because the small firms in Germany, they can implement the latest technologies. You know, in Britain, we always think that what we need to develop new technologies. But actually Britain is very good at developing new technologies and having inventions that's not where the problem is.

Ross It's about applying them.

Richard Werner Applying them but in a practical sense, for firms that actually turn it into immediately saleable, successful products. Now, for that, what do you need? You need your small firms to get funding. It's just a money question because it's expensive to upgrade your technology. But the German small firms can do it because they have small banks locally that only lend to them. And the bank manager knows their history and they know they've got this new technology now. Have you seen it? Oh, yeah, that looks really good. And we better give them a loan to implement that technology. They'll be fine for the next six, seven years.

Ross And those banks will often put a bank member on the board to ensure that that loan doesn't go bad?.

Richard Werner There's many ways to get the incentive structure right. And so that explains the enormous German success and high productivity in the economy, because you have a decentralised banking system consisting mostly of small banks that lend to small firms for productive purposes. You get high growth, you get good exports, high productivity. That's really what you want. Now, this can be done in any country. You just need to create these small banks, which is, of course, what I've been working on. We've got the Hampshire Community Bank coming online now. We're about to submit our bank authorisation, huge documentation for a licence to the Bank of England and PRA FCA. We've got a top notch team of experienced bankers in their various respective specialisations on the bank.

Ross All power to you. What you've done in this episode is you've taken us from the House of Lords, the Lords in their worrying about QE - understandable worries, scattergun approach. You saying actually this is a way more directive way of doing it, way more effective way of doing it. This is how you do it. Also, it's antifragile and it gets the real economy moving, is that right?

Richard Werner Absolutely.

Ross Done. So we're done for episode one. We'll see you in the second one.

Richard Werner Thank you very much.

Ross That's it from Renegade Inc. this week. You can drop the team a mail - studio@renegadeinc.com. Join us next week for more insight from those people who are thinking differently. But until then, stay curious.