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Easy money is a dangerous cure for a debt hangover

Central banks should be held responsible for prudent lending not stable prices, writes Amar Bhidé

Sweden's Handelsbanken is an exemplar of prudence, barely touched by the 2008 financial crisis. It operates globally like a small community bank, to the point that it has just fired the chief executive, reportedly for attempting to centralise power. Branches lend as they see fit but are required to scrutinise creditworthiness and shun dodgy borrowers. The target loan loss ratio is zero; low loan losses, in turn, allow the bank to offer competitively priced loans and personalised service to creditworthy customers.

Since it is better placed than lenders that rely on rule books or statistical models to assess the creditworthiness of entrepreneurs, Handelsbanken is also well positioned to satisfy the credit needs of small businesses. What is good for Handelsbanken is therefore good for long-term economic growth as well as for financial stability.

However, prudent case-by-case lending also undermines the stimulative effect of the loose money unleashed by central bankers. Experienced financiers with their fingers on the local pulse will not lend more to less worthy borrowers simply because of low or negative interest rate policies. If anything, easy money — for all the grand theories of its macroeconomic benefits — worries them.

All-out monetary easing campaigns mounted by central banks in many developed economies since 2008 have therefore relied on incautious or ill-informed recruits. Cheap money has boosted the share of credit disbursed by lenders willing to take a chance on credit-scoring models or on voguish sectors without detailed knowledge of those to whom they are lending. Yield-hungry insurance companies and pension funds have stampeded into bond markets, allowing issuers to raise vast sums without the scrutiny or conditions that a careful banker would require.

But feeding another credit binge is a dangerous way to cure a debt hangover. After 2008 banks and bond markets financed frenzied over-investment by oil and mining companies. The bust is already with us.

Property prices have taken flight from London to Manhattan to Toronto to Stockholm. The US market in car and student loans looks like another credit blowout in waiting.

Meanwhile, small and medium-sized businesses have been left behind. Big banks that gamble on consumer credit or property loans are reluctant to make business loans without individualised analysis.

Small loans made to businesses by the 10 biggest banks in the US, for instance, have fallen by more than a third from their 2006 peaks even as consumer debt has rebounded. But small businesses that cannot issue bonds in public markets require bank loans to finance their expansion and sustain economic growth and dynamism.

Central bankers argue that the risks of over-lending are contained and that without their aggressive intervention economies would be mired in a deep recession.

But they base their assessment of risks, and of what would have happened without their intervention, on models whose mathematical sophistication hides a primitive representation of finance and the economy.

Until the 2008 crisis, the vaunted US Federal Reserve's economic model did not include the financial sector. And there is no reason to believe Fed economists can now reliably ascertain the relationship between easy money and racy lending.

Central banks assert that their legal mandates to ensure price stability — and, in the US, full employment — have required unprecedented easing. But the laws do not specify how prices or full employment are to be measured or the range of their acceptable variation. Moreover the 2 per cent inflation that many central banks are striving mightily to sustain implies that prices are steadily increasing rather than steady.

Abolishing central banks, however, is a libertarian fantasy. Instead, governments should remove the justifications and temptations for go-for-broke central banking by eliminating price stability and employment mandates. Both constructs are nebulous, and in a dynamic economy constantly buffeted by myriad cross currents, impossible for central banks to secure.

What the Fed and other central bankers can — and should — be held responsible for is prudent lending by banks, as was envisioned by the US Congress when it passed legislation creating the Fed in 1913.

More or less stable prices and low joblessness were regarded as desirable byproducts. They were not — and should no longer be — the explicit goal.