

The Radical Uncertainty of the Economy

By Jean-Pierre Landau

Former Governor of the Bank of England and a renowned economist, Mervyn King presents his views on the recent financial crisis and urges economists to accomplish a "necessary intellectual revolution leading to a complete reform program".

Reviewed : Mervyn King, *The End of Alchemy: Money, Banking, and the Future of the Global Economy*, New York, W. W. Norton & Company, 448 p.

The several lives of M.King

Mervyn King is a giant in contemporary central banking. Throughout his long and brilliant career, he has been Chief Economist, Deputy Governor and, finally, Governor of the Bank of England (during ten years). Before proceeding further into the presentation of the book, four – very different – points should be known about him.

First he is an economist. He belongs to a (recent and limited) generation of Central Bankers who (such as Ben Bernanke and Janet Yellen) come from academia rather than being market practitioners or Government officials. His book contains very deep insights on the nature and history of money that only an extremely sophisticated intellectual could produce. All readers whether they are money specialists, students or non-economists, will find great pleasure and great enlightenment in this book. There is an abundance of historical references, some very unique.

Second, he has always been suspected of being a "covert monetarist", which, in the decades preceding the crisis, made him an exception. Monetarism refers to a doctrine that emphasizes the importance of the quantity of money - as opposed to the interest rate- in the conduct of monetary policy. When Mervyn King ruled the Bank of England, monetarism was in disrepute. The dominant framework was "inflation targeting" with the interest rate as the only instrument of monetary policy. It has been said, including by M. King himself, that monetary policy was conducted "without money". Mervyn was a major promoter and brilliant explainer of the "inflation targeting" framework. Yet, he always showed a penchant for money. He published in 2002 an article "no money no inflation" which stands apart of all contemporary literature. He laments in the book that *'in recent years, many economists have been reluctant to use the word 'money'...It is a striking fact that, as economics has become more and more sophisticated, it has had less and less to say about money'* (p.58). From his "monetarist" perspective, M. King gives a singular explanation of the effect of "quantitative easing" (i.e the massive expansion of asset purchases by central banks since the crisis) that relies mainly on the increase in the quantity of money as a transmission mechanism. All other Central Bankers rather insist on the "portfolio rebalancing" mechanism, a concept more difficult to apprehend and harder to substantiate.

Third, Mervyn King is a sport fan. He seems to like and know about almost every sport. He is an avid tennis player and served as director at the All England Lawn Tennis Club, which oversees the Wimbledon Championship. Sporting metaphors abound in all his speeches and writings. In the book he cannot help but comparing Wimbledon to the City of London, both being world leaders in their respective domains - and both working with (almost) only foreign players. He also formalized the "Maradona" approach to monetary policy, which is duly explained in the book. The doctrine refers to the second goal scored by the Argentinian football star against England in the World Cup semi- finals in June 1986 in Mexico (the first one was famous for the "hand of god"). Mervyn King notes that Maradona followed a straight line to score directly into the English goal. How could he do it, bypassing five English defenders in the process? " *The answer is that the English defenders reacted to what they expected Maradona to do. Because they expected (him) to move left or right, he was able to go straight on. Monetary policy works in a similar way. Market interest rates react to what the Central Bank is expected to do*" (p.123). A Central Bank that has gained sufficient credibility may be able to follow a straight line, i.e; not to take any action in response to a shock and let the market do the job in its place. For instance, if inflation picks up, market interest rates may rise, therefore spontaneously toughening monetary conditions.

Finally, alas, Mervyn King is a Eurosceptic. A full chapter in his book is devoted to exposing the Euro weaknesses and predicting its ultimate failure. Most of the development is historical and brilliantly presents numerous examples of monetary unions that broke down. The message is clear, if not original. Money is a political construct. Money and nations are inseparable. Like all people blessed with a clear analytical mind, the thinking of M. King suffers from a double handicap. It cannot detach from history and it has difficulty in considering messy situations. Economists are very reluctant to consider as sustainable those situations that do not

clearly fit into an accepted model. And the euro certainly does not. To his credit, Mervyn King does not simply repeat the standard euro skeptic refrain that usually goes as follows: the euro is not an "optimum currency area", it does not neatly fit into the model, and therefore it is doomed. His discussion is essentially political: "*creating a monetary union of separate sovereign states was and remains an enormous gamble, one that requires a high degree of mutual trust to be successful*" (p.148). The author clearly assumes that this degree of trust will never be achieved. Some sentences, however, belong more to a political pamphlet than to dispassionate analysis. For instance: "*monetary union has created a conflict between a centralized elite, on the one hand, and the forces of democracy at the national level, on the other*".(p.171)"

Economics and uncertainty

The main argument of and interest of the book, however, is elsewhere. This review cannot fully give justice to the richness of its content. It will focus on two key concepts that drive all development: radical uncertainty and alchemy.

For the benefit of his general readers, Mervyn King uses the term of "radical uncertainty". rather than the more technical one ("knightian "uncertainty) used by professional economists. Simply put, the future is inherently unpredictable. It is impossible to attach a probability to future events. There are just too many things than we cannot know, including the events themselves. We cannot possibly predict what kind of goods will be produced in twenty years, by whom, using what technology, in what political environment. While this seems obvious to the common reader, most modern economic theory is based on the reverse hypothesis. It usually posits the existence of "complete markets", where goods and financial assets can be priced indefinitely in the future and for all states in the world. By contrast, "*radical uncertainty means that many of the markets in which price might move to produce and equilibrium simply cannot and do not exist. The market economy cannot, therefore, coordinate spending plans*" (p.207). Conventional macroeconomics also assumes rational individuals that can assign probabilities to all possible future events: "*at the heart of modern macroeconomics is the illusion that uncertainty can be confined to the mathematical manipulation of known probabilities*"(p.87). Taking away those two assumptions deprives most contemporary macro economic models from their foundations.

This rehabilitation of uncertainty is probably the deepest and most fascinating aspect of the book. Uncertainty explains why money exists. It is not simply to "buy stuff". By holding money, as a store of value, we keep our options open as to our future purchases and investments. We protect ourselves against uncertainty. Money is the necessary link between the present and a radically uncertain future. "*Money gives us the ability to exchange labour today for generalized purchasing power in the future. [...] it is principally [...] a way of coping with an uncertain future*" (p.62). That is the reason why ensuring the stability of money is an essential social function. In

a world of radical uncertainty, money is the only asset whose value can be made predictable over the very long run (subject to appropriate monetary policies). The same holds for financial assets (securities, saving accounts, pension claims) but to a lesser extent as "*in times of financial stress, only claims issued and guaranteed by Government will fully serve the purpose*" (p.62). With a value (almost) completely certain over time money, naturally serves as a means of payment (a medium of exchange) and unit of account.

Uncertainty leads to a better understanding of the original Keynesian theory. "*Keynes' basic argument was that capitalism might fail to deliver full employment because it could not coordinate the spending plans of all the different participants in the economy*". This inability "*creates the possibility that demand may well be below its full employment potential*". Economic depression is not "*the outcome of short term rigidities but of misjudgments about the nature of the future*" – and therefore cannot necessarily be solved through short-term stimulus.

With radical uncertainty, individual economic agents do not optimize, they "cope". They adopt strategies that may seem unsophisticated but are robust to a change in the environment and protect them against unforeseen events. Hence the importance of "narratives" – commonly held beliefs that influence expectations, especially in financial markets. "*Under radical uncertainty, market prices are determined not by objective fundamentals but by narratives about fundamentals*". A crisis may occur if and when the gap between the reality and the narrative becomes obvious. A revision of the narrative becomes necessary, which triggers an abrupt adjustment in asset prices and financial flows.

Radical uncertainty also explains the current state of low growth in the world economy. "*Aggregate demand is an incomplete concept for understanding the current situation because our spending plans today depends on the narrative we form for the future our perception of our wealth and future income*" (p.223). The narrative before the crisis was excessively optimistic, based on the belief that stability was granted for ever – the so-called "Great Moderation". Conversely, if the narrative is pessimistic, as maybe currently the case, no short term stimulus will work. The fundamentals and structural factors that drive the narrative - for instance expected low productivity - must be addressed for aggregate demand to start growing. While very informal, this way of looking at the situation offers a brilliant synthesis between the supply and demand driven explanations of current low growth.

Alchemy and the reverse side of the coin

The second basic concept studied by the author is "alchemy", that gives its title to the book. It refers to the activity of banks and other financial intermediaries. Just as an alchemist transforms lead into gold, banks transform illiquid and risky assets into liquid and immediately redeemable deposits ("*bank deposits- money with a safe value into illiquid and risky investments*"

Monetary economists know that this is also the process through which most of the money is actually created in our economies. This a fascinating aspect of the alchemy, but one that worries Mervyn King enormously: *"during the twentieth century government allowed the creation of money to become the by product of credit creation. Most money today is created by private institutions – banks. This is the most serious fault line in the management of money in our societies today."*

Indeed, that same alchemy that keeps our economy working is also the cause of its intrinsic fragility. If all depositors ask for their money back at the same time, banks cannot meet their commitments, as their assets are illiquid and a crisis occurs. Central Banks were created as lenders of last resort that provide money to banks and the general public "in bad (crisis) times", at a penalty rate. Clearly, Mervyn King is very uncomfortable with that lender of last resort function. *"The toxic nexus between limited liability, deposit insurance and lender of last resort means that there is a massive implicit subsidy to risk-taking by banks" (p.176)* Also, lending as last resort may constrain the Central Bank into tolerating or expanding the quantity of money more than it would wish: *"the key function of a monetary authority is to determine the supply of money in both good times and bad" (p.139)* and the *"two roles for money – in good and bad times – are usually discussed and implemented separately, with the first being seen as monetary policy and the second as financial policy. That compartmentalisation... contributed to the failure to understand the evolving problems of the major economies prior to the crisis" (p.63).*

How, then, bring the alchemy to an end?

At that point, the tone of the book shifts from the general to the technical and this review will follow suit. Mervyn King examines and dismisses the most radical remedy known as the "Chicago school". In that scheme, banks are forced to match the totality of their deposits with fully liquid assets (in practice, Government bonds): the creation of money is disconnected from the expansion of credit. Loans to the economy would be made by other "non-banks" institutions, that would be prohibited to take deposits and are financed exclusively through the issuance of equity or long term debt. Because money will be backed by public debt, the issuance of money will in effect be restored to the Government. However, as Mervyn King notes, this would not dispense the Government from the obligation to rescue distressed non-banks because, even without creating money, they can borrow short and lend long and therefore face liquidity crises. "An element of alchemy" would subsist as it would still be necessary to create money in bad times.

The author, therefore, opts for a less radical – and more perfect- solution: transforming the lender of last resort (the Central Bank) into a "Pawnbroker For All Seasons (PFAS)". The Central Bank would stand ready to provide liquidity at any time (good or bad) for a uniform

rate against good collateral. There would be no distinction between ordinary refinancing and the lender of last resort function. In counterpart, banks would be required to hold permanently an amount of liquid assets equal to their deposits. To ensure that liquidity support would not transform into a solvency bail out, the Central Bank would apply a discount (a "haircut") to the value of the loans and securities held by the banks

Will that be enough to end the alchemy? Mervyn King himself seems to doubt it. The book ends with a call to future researchers and policymakers. Much of the *"necessary intellectual revolution leading to a complete reform program"* of money and banking *"will have to be of the task of the next generation"* (p.252). For the contemporary reader, this concrete proposal may seem too incremental and too radical at the same time. Too incremental as it only expands marginally on the current role of Central Banks. Most of them, including in the euro area already permanently refinance banks against collateral, Too radical as it may have unintended consequences. Here, we will point to some questions that remain unresolved, starting from the less to the more important. Central Banks may be forced to assess (and accept) credit risk, which they do already, but on a much broader scale. In effect their valuation of collateral would guide all others, driving rating agencies and financial regulators in the determination of a bank's soundness. This is a huge responsibility to take on, and one that could interact with their duties and mandates on monetary policy. It may also constraint their ability to regulate money creation, as the quantity of deposit money in the banks would heavily depend on their assessment of the acceptable collateral.

The biggest interrogation, however is more fundamental and goes to the heart of the book itself: the relation between radical uncertainty and alchemy. As mentioned, uncertainty is the ultimate reason why we need money (or, more generally, safe assets). Because of uncertainty, there will always be a gap between our preferences as savers (we want liquidity) and the needs of investors, who need long term commitments. Maturity and risk transformation (the technical designation for alchemy) will always be necessary if radical uncertainty persists. Or, to use the author's concepts, radical uncertainty makes the alchemy unavoidable. The great intuition of the book is to show the tension that results from that forced coexistence. It is not clear that this tension is fully resolved by the proposed remedy, nor that it can ever be.

Published in *Books&Ideas*, 3 April 2017.