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Quantitative Lending Directives are Needed

by

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Quantitative Lending Directives are Needed

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Housing booms and busts have been a recurrent feature of developed economies for well over a century. They not infrequently lead into severe banking and general economic crises as in 2007-2009 with recovery impaired by bank reluctance to lend out the excess reserves that they in due course start to accumulate. In the US, this bank reserve excess skyrocketed from under $2 billion in February 2008, to over $600 billion a year later, Aaron Edlin and Dwight Jaffee observe. They endorse trying the Scott Sumner's proposal of price incentives to entice banks to lend out this excess. Keynes however was pessimistic about such price incentives operating on bankers once their animal spirits have fallen into fear. In his later years, Keynes' proposal of the remedy was for the government to tax the public and for the government itself to dole out the money to those entrepreneurs who yet had courage. Keynes' educated Nugget Coombs, head of Australia's World War 2 Reconstruction Committee, and then governor of its central bank 1960-1968, found a way to order the bankers to lend, instead of the government needing to do the lending in situations he discerned as market failure. Admittedly Coombs quantitative lending directives were not for the sort of entrepreneurial venture capital projects that Keynes my have envisaged, but for conventional sectors such as housing and rural industries. Combs deemed that since central bankers understand imprecisely how bankers react to particular price incentives in booms and busts, to adequately expand loans in cyclically depressed sectors, and to adequately curtail loans in boom phases price incentives need to supplement price incentives.

It is a hubris, unsubstantiated by any shred of evidence, for economists to propose that today we have acquired such a clear understanding of financial markets that central bankers can sufficiently rapidly fine tune price incentives on hitherto non-price-incentivized magnitudes like excess reserves, to seek to do everything by price incentives alone. By all means let us implement Scott Sumner's proposed excess reserves price incentives and start seeking to estimate their effects. But let us also go in for more secure methods in the current emergency of requiring banks to reduce their excess reserves by a given percentage each month if they are to continue to reap the benefits of taxpayer guarantees of the security of public deposits lodged with them. In this respect a sensible complement to price incentives is Swapan Dasgupta's proposal to effectively ban excess reserves via prohibitive penalties, a proposal also endorsed by Aaron Edlin and Dwight Jaffee.

It may also be desirable for central banks to issue sectoral lending directives to direct some quantitative amount of bank lending toward social desirable projects and long term projects, such as environmental, educational and public transport infrastructure improvements. When taxpayers indirectly bolster the banking system even in normal times, and are directly funding it a present, it is entirely appropriate for its official sector representatives to "interfere" to enhance the social return reaped from bank loans.

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