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Credit easing won't deliver growth [1]

Written by **Vuk Vukovic** [2] | Thursday 10 November 2011

Upon observing gloomy reports [3] of the UK economic growth figures last month (and with seemingly never-ending eurozone woes), panic has spreadthrough Westminster. The Conservatives are getting anxious and cannot seem to wait until their long term growth plan starts yielding its first results. The government wants to see higher growth immediately, as its popularity is decreasing at approximately the same rate as unemployment levels are increasing.

In times of slow growth, rising unemployment, no signs of recovery and record low consumer and investor confidence comes an idea that is supposed to alter the financial sector by decreasing the role of banks in the economic recovery and leaving it up to the government to kick start lending ? not via fiscal stimulus, but something very similar and yet very unconventional ? credit easing.

Credit easing implies the government buying corporate bonds from small and medium-sized businesses and therefore providing them with enough money to start investing and hiring again. It is supposed to be a swift way to deliver credit to businesses and start up economic growth in the short run until the long run stabilization reforms start to yield their expected effects. The idea comes as somewhat revolutionary for the system where the government wishes to create a market for loans and bonds of small and medium-sized businesses (SMBs) thereby removing the dependency of the SMBs on the banks.

Since George Osborne, who made the proposal, hasn?t yet found a way to enforce it, several ideas emerge on how this is supposed to be done; (i) buying loans and bonds directly from the SMBs by a government agency; (ii) buying SMB loans from the banks (either by the government or by private investors via government subsidies), securitizing them and selling them off to private investors; (iii) buying the banks? corporate bonds and thereby reducing their funding costs and creating an incentive for banks to increase lending; (iv) offer a government guarantee on SMB loans increasing confidence for the banks to increase lending to the SMBs.

The first proposal implies a simple fiscal stimulus to certain businesses who found themselves in problems and need recapitalization. The problem arising, among many others, is adverse selection. There is no way for a government bureaucrat to possess enough information to determine which companies should get the necessary funding and which companies will have the strength to invest it in potentially prosperous projects.

With rising uncertainty surrounding the world economy, it is questionable why would the firms start increasing production and start hiring again if they anticipate more contraction in the future and higher taxes due to unsustainable deficit and debt levels. It is more likely that both businesses and consumers use this money to pay off their debts rather than increase hiring or production. The stimulus in the form of bond purchases can only result in a type of social transfer from the government to politically prominent firms that found themselves in trouble.

The second proposal has similar implications to the quantitative easing policy, where someone is supposed to artificially clean the riskier loans off the banks? balance sheets. There is an additional clause to securitize these risky loans and sell them off as ?safe? assets. The government will be the middleman that pools the securities together and gives them a government guarantee giving the security a high rating. These sorts of securities will soon enough become a desirable asset and their demand will increase. An increasing demand will yield more and more securities and more and more credit to businesses ? an effect that is in theory a good one.

However, due to an increasing demand for these low risk securities it is very likely that the banks will start to decrease lending standards and offer loans to high-risk business projects. Knowing the typical regulatory train of thoughts, I dare to say the regulators will encourage banks and other institutions to fill up their assets with these securities in order to re-capitalise themselves and become safer (see Basel I and II and the recourse rule).

Needless to say, this will create an artificial demand for business loans which could lead to an even more dangerous bubble than the mortgage loan bubble as it?s eventual burst will impact the businesses directly. Creating an asset bubble to bring an economy out of a recession proved to be disastrous so far (remember Fed in 2001). Let?s not repeat the same mistake for Britain.

In conclusion, credit easing will undermine the government?s credibility in trying to pursue a long term credible growth path, the very basis upon which their austerity plan can work. By committing to balancing the budget in order to keep its deficit cut promise, the Treasury will send signals to investors that the growth plan is credible and that the government isn?t looking for short-term fixes but rather a long-run stabilization path. Even though the European debt market will influence the UK recovery substantially, more uncertainty and more asset bubbles isn?t a proper incentive for growth and it never will be.

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