“Toward a Unified Framework of Credit Creation”

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ABSTRACT: We identify the origin of the contradicting perspectives on credit creation offered by Austrian, Mainstream and Post Keynesian economists as the neglect of the primacy of such assets as goods, properties and securities, which always pre-exist any transaction and loan. We develop a unified framework of credit creation based on three leading variables: (i) the amount of collateral assets accepted, (ii) the level of leverage and (iii) the level of trust and confidence. As credit expands along these dimensions, the money supply becomes more endogenous and the financial system more vulnerable to internally generated instabilities manifested as booms and busts. Empirical evidence demonstrates a significant shift in the components of bank balance sheets and a decoupling of bank assets from deposits since the mid-1980s, marking a shift from credit creation within traditional fractional reserve banking to “securitized-fractional reserve banking”. Applying our framework of credit creation to the global financial crisis, we argue that growth over recent decades has been increasingly financed by credit creation and that the subprime crisis was both a signature and only one possible trigger in an increasingly unstable financial system. As trust began to recede, so did leverage and the amount of assets accepted as collateral, leading to a contraction in credit and to liquidity spirals. Subsequent measures by policymakers can be interpreted as attempts to avoid further contraction along these three variables.