FINANCIAL TIMES

November 25, 2011 2:40 am

Lending contraction must be tackled

From Mr Daniel J. Aronoff.

Sir, Robert Skidelsky and Felix Martin correctly identify the contraction of lending as the proximate cause of sluggish growth in the UK, and the inability of monetary policy to spur credit expansion as a manifestation of the failure of current policy ("Urgently needed: a plan C to save Britain's economy", FT.com, November 23).

I would add to their two underlying sources of monetary transmission failure – increased interest rate risk spreads and decreased borrowing demand from an overleveraged (or pessimistic) private sector – a third factor: the contractionary effect of debt overhangs on bank balance sheets, resultant from past and ongoing deterioration in asset values.

But their Plan C – which I surmise to be a return to Keynesian deficit spending – is not viable because it ignores the precariousness of the current deficit funding predicament. One only has to consider the recent German bund auction to recoil at any proposal that calls for an increase in government borrowing.

A policy they should have considered, and which I think policymakers in the US and Europe will eventually be forced to reckon with, if only because of the lack of alternatives, is to address the problem of lending contraction at its ultimate source: the over-indebtedness of banks and households.

What is required is a restructuring of balance sheets. There are many possible ways to do this, but any approach will require banks to raise equity capital and to convert some portion of existing debt into equity and to provide relief (perhaps in the form of partial debt to equity conversions) to overburdened household borrowers.

Daniel J. Aronoff, President and Chief Executive, The Landon Companies, Bloomfield Hills, MI, US