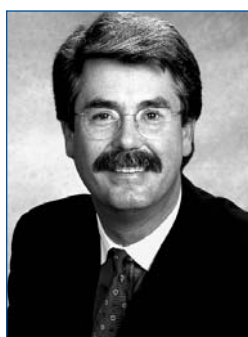


# Global Central Bank Focus

by PIMCO's Paul McCulley

## Credit, Markets, and the Real Economy: Is the Financial System Working?

*A Reverse Minsky Journey*



Paul McCulley

*Comments Before the 17th Annual Hyman Minsky Conference on the State of the U.S. and World Economies April 17, 2008*

Thank you, Dimitri, for the great honor you have given to me to speak before this august group—where Hyman Minsky is not just a household name, but a most revered name. Unfortunately, I never had the pleasure of meeting the great man, unlike so many of you. But the influence of Professor Minsky's work has been profound in my professional career. Indeed, that influence has never been greater than over the last couple years, both in my own work and in how we have managed portfolios at PIMCO—well over \$750 billion of bonds, or debt units, if you prefer, the straws that stir the drink in Minsky's Financial Instability Hypothesis.

I will never forget when over five years ago, I introduced Bill Gross to Minsky thinking. This was during the corporate debt crisis—Enron and all that—in 2001 and 2002. I said it was a "Minsky Moment," a phrase that I had coined back in 1998, during the Asia debt crisis. Bill was intrigued, as he always is about ideas, and asked for copies of his work. I loaned him the 1986 volume "Stabilizing an Unstable Economy."<sup>1</sup> He read it cover to cover and became a disciple—not immediately, but over time, and surely by 2006, the last year of the triple bubbles in property prices, mortgage debt, and the shadow banking system.

We at PIMCO were ready for what was to follow, as Minsky had lain out precisely—in what I call a "Reverse Minsky Journey." Ponzi Units evaporate. Then many Speculative Units morph into Ponzi Units and are shot. Surviving Speculative Units are only those with explicit liquidity support from banks, who have explicit liquidity support from the Federal Reserve. Hedge Units, of course, remain standing tall, fundamentally sound, though cheaper in price, providing an excellent long-term buying opportunity.

This has been precisely the process in place since almost a year ago, and particularly since last August, when the shadow banking system—defined as any levered lender who does not have access to (1) deposit insurance and/or (2) the Fed's discount window—experienced a modern-day run, with asset-backed commercial paper holders refusing to roll over their paper. It has not been fun. It has not been pretty. And it is not over.

Along the way, policy makers have slowly recognized the Minsky Moment followed by the unfolding Reverse Minsky Journey. But I want to emphasize "slowly," as policy makers, collectively, still suffer from more than a thermos full of denial. Part of the reason is human nature: to acknowledge a Reverse Minsky Journey, it is first necessary to acknowledge a preceding Forward Minsky Journey—a bubble in asset and debt prices—as the marginal unit of debt creation morphed from Hedge to Speculative to Ponzi.

That is difficult for policy makers to do, especially ones who claim an inability to recognize bubbles while they are forming and, therefore, don't believe that prophylactic action against them is appropriate. Nobody likes to admit they were blind, dumb, or asleep at the switch. Or all three.

But framing policies to mitigate the damage of a Reverse Minsky Journey requires that policy makers do precisely that. They must openly acknowledge that we are where we are because they let the invisible, if not crooked, hand of financial capitalism go precisely to

where Professor Minsky said it would go, unless checked by the visible fist of counter-cyclical, rather than pro-cyclical regulatory policy.

That's not to say that Minsky had confidence that regulators could stay out in front of short-term profit-driven innovation in financial arrangements. Indeed, he believed precisely the opposite:

*"In a world of businessmen and financial intermediaries who aggressively seek profit, innovators will always outpace regulators; the authorities cannot prevent changes in the structure of portfolios from occurring. What they can do is keep the asset-equity ratio of banks within bounds by setting equity-absorption ratios for various types of assets. If the authorities constrain banks and are aware of the activities of fringe banks and other financial institutions, they are in a better position to attenuate the disruptive expansionary tendencies of our economy."*

Minsky wrote those words in 1986! Twenty-two years later, we can only bemoan that his sensible counsel was ignored. To be sure, he presciently envisioned Basel I and now Basel II. But neither of those arrangements fundamentally addresses the explosive growth of the shadow banking system, or what Minsky cleverly called "fringe banks and other financial institutions." Indeed, much of the growth of the shadow banking system in recent years was driven by profit-seeking bankers using off balance sheet vehicles, levered to the eyeballs, so as to arbitrage the capital strictures of Basel I.

And it was all quite dandy while asset prices, notably property prices, were soaring. Which, of course, propelled the Forward Minsky Journey. There were no regulatory cops on the beat, only regulatory czars in corner offices, actively accommodating growth in the shadow banking system.

Most fundamentally, regulatory authorities ignored the systemic liquidity risk imposed by the shadow banking system versus the conventional banking system: without access to either deposit insurance or the Fed's discount window, and mostly void of any meaningful term financing, the shadow was a sitting duck for a classic run on liquidity. And ever since last August, that has been precisely what has unfolded, punctuated by the run on Bear Stearns last month.

Along the way, the Fed has taken gallant and bold steps to inject liquidity into the markets, creating lending facility after lending facility. But up until last month, when the Fed opened the discount window to investment banks, who are the largest shadow banks of all, the Fed's role as liquidity provider of last resort was simply not effective, however valiant it may have been. Channeling liquidity to conventional banks, in hopes that they would pass it along to shadow banks, simply did not work very well, though it did have the salutatory effect of allowing some banks to (reluctantly) expand their balance sheets so as to absorb assets being disgorged by shadow banks.

As the Bear Stearns rescue forcefully demonstrated, the Fed had no choice but to open the discount window to investment banks, to facilitate the takeover of Bear in particular and even more importantly, to prevent a cascading of runs. This was a moment of truth and clarity, if there ever was one. I applaud the Fed for doing what it had but no choice to do. At the same time, the Fed's action demands a complete re-think of the bifurcated regulatory regime for conventional banks and investment banks.

Most elementally, all institutions that have access to the Fed's discount window must have *pari passu* regulatory oversight. It really is that simple. Access to the window is unambiguously a public good—and only the Fed can provide it, because only the Fed has the legal power to unlimitedly create deposits on itself out of thin air. Accordingly, access to the window must—as it does in the case of conventional banks—carry the *quid pro quo* of prudential regulatory oversight, complete with enforcement powers.

Investment banks won't want that, of course. But then, all rational people want lunch for free. The Fed, owned by "we the people," was not created to be in the free lunch business. That doesn't mean that investment banks actually have to eat lunch. Indeed, conceptually they could legally forswear any right to eat at the Fed's cafeteria, in which case they could remain as they are. But as a practical matter, as the Bear Stearns episode made clear, this is not a practical solution: in extremis, if you are deemed too big to fail, or at least too big to liquidate on the wire, you will have access to the discount window. Reality is reality.

Accordingly, regulatory arrangements need to be brought into sync with reality. I don't profess to have a detailed regulatory reform plan ready to present you. I don't. What I'm laying out is simply a bedrock principle: if you have access to the Fed's discount window, the Fed should—and will, I strongly believe—have the power to supervise and regulate your business—core capital requirements, risk management, liquidity management, et al.

Which brings us back to Hy Minsky. Again, back in 1986, he offered a powerful, but simple proposal for how the Fed could exercise more supervisory control over commercial banks, which I think is applicable to investment banks (and any other levered financial institution that ultimately gets access to the discount window). In Minsky's own words:

*“Commercial bank reserves mainly result from the ownership of government securities by the Federal Reserve. The government security/open market technique of supplying reserves to the banking system is not the only way reserves can be furnished. Prior to the Great Depression, a major part of reserves that were not based on gold were based on borrowings by banks at the discount window. The resurrection of the discount window as a normal source of bank reserves is a way of tightening Federal Reserve control over commercial banks. If commercial banks normally borrow at the Federal Reserve discount window, they will necessarily accept and be responsive to guidance by the Federal Reserve.”*

*As long as bank reserves are mainly the result of open-market purchases of government securities, the giant banks are virtually immune to Federal Reserve pressures. If normal functioning requires banks to borrow at the discount window, then the capital adequacy and asset structure of banks will be under Federal Reserve supervision. A shift to a greater use of the discount window as a normal source of bank reserves should diminish the destabilizing influences in our economy that are the result of too rapid an expansion of bank financing of business and asset holdings.”*

I certainly agree that the Fed should make greater use of the discount window, and less use of open market operations on the left hand side of its balance sheet. And, indeed, that's precisely what the Fed has been

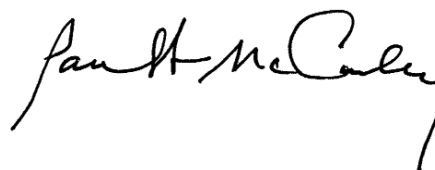
doing since last August and particularly since the introduction of the Term Auction Facility (TAF) in December, followed by the alphabet soup of additional lending facilities since then. To me, this makes perfect sense. As Minsky says, and my own son knows, if you have no choice but to borrow (in order to get the reserves you need), then you will listen to the lender.

To be sure, there is the pesky little problem of investment bank holding companies that don't own a bank and don't have deposits against which they must hold reserves at the Fed. But to me, that's not an insurmountable problem: The Fed could simply impose reserve requirements on some bucket of short-term, non-deposit funding instruments used by both investment and commercial banks (so as to keep the playing field level).

Again, that's not a comprehensive plan for the regulatory reform that ineluctably should and will unfold in the years ahead. But I think that nugget from Minsky is a gem, a true diamond. And the Fed is also wearing it, if not on the wedding finger, at least on its pinky.

Which brings us back to where I began: Minsky's insight that financial capitalism is inherently and endogenously given to bubbles and busts is not just right, but spectacularly right. And when the financial regulators are not only asleep but actively cheerleading financial innovation outside their direct purview, a disaster is in the making, as the last year has taught us. We have much to learn and relearn from the great man as we collectively restore prudential common sense to bank regulation—both for conventional banks and shadow banks.

As a disciple of his work, it has been a great honor to speak with you today. Believe me, Hyman Minsky is much more than a shadow member of PIMCO's investment committee!



Paul McCulley  
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<sup>1</sup> He also forgot that he had borrowed the book from me and about a year later, asked me about a particular passage. I told him that I couldn't look it up, because he still had my copy. Chagrined, he immediately had his assistant buy me a replacement copy on the Web. That's just the kind of man he is—a borrower of character, as JP Morgan would say.

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