

Global Central Bank Focus

by Paul McCulley

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Comments Before the Money Marketeers Club *Playing Solitaire with a Deck of 51, with Number 52 on Offer*



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Thank you, Dana, for that wonderfully kind introduction. It is a deep honor to be speaking before this august club for the fourth time. When I look at the list of speakers over the last 50 years, I am very humbled.

As I've mentioned before when here, this forum is one of the very few for which I actually write a speech. Not that I actually deliver it the way I write it—that might be **congenitally** impossible for me!—but because I want to be held accountable, to be forced to both own and eat my own words. And to re-read them again and again, before speaking yet again.

Looking Backward

In May 2004,¹ just before the Fed embarked on a tightening process from 1% Fed funds, my axe to grind was that the conventional wisdom of a constant neutral real Fed funds rate was wrong. Put more wonkishly, as I'm wont to do, I challenged the notion of a constant in the Taylor Rule.

As all in our profession know, John Taylor conveniently assumed that if the active cyclical terms in his Rule—(1) the gap between actual inflation and targeted inflation and (2) the gap between actual and potential GDP (Gross Domestic Product)—drop out, because inflation is at target and GDP is at potential,² then the real Fed funds rate should approximate the potential real growth rate of the economy, determined by demographically-driven labor force growth and productivity growth. That's the constant term in the Taylor Rule, and John assumed it to be constant.

I took issue with this concept of the constant in Taylor being constant on two key fronts, one a matter of theory and the other a matter of practicality.

On the theoretical front, I have always made a distinction between cash and capital or, in the words of today, the difference between capital and liquidity. I've always believed in the capitalist notion of no risk, no reward. Thus, I've always struggled with the notion that government-guaranteed cash, or liquidity, if you prefer, should pay a positive after-tax real rate of return.

Yes, I believe nominal cash yields should be high enough to offset the inflation rate, which is an implicit tax. And since we tax nominal returns, I have also always believed that the nominal cash yield should be high enough to not only offset the implicit inflation tax, but also the explicit tax on the inflation tax. But I've never believed that cash should generate a real after-tax return. Again, no risk, no reward.

Cash always trades at par, at least in nominal terms, and that's a very precious attribute. You can have it if you want it. But if you do, you should not get paid for it, but rather pay for it, in the form of forgoing any after-tax real return. If you want a positive after-tax real return, you gotta take some risk, summarized best, perhaps, by the possibility of your investment trading south of par.

Which means that I did and do believe that a positive neutral after-tax real rate of interest does exist, even if it is not constant. But for me, unlike John, it's the after-tax real rate of interest on high grade, long-term, private sector debt obligations.

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Global Investors

Back in May 2004, I posited that we should use the long-term swap rates as a proxy—the credit risk of the AA global banking system. (Note I said system, not any individual bank.) That after-tax real rate of return should, I argued, be consistent with John Taylor's assumption—widely embraced in our profession—that there is a functional connection between potential real growth rates and real interest rates. Thus, John and I were actually in the same analytical church, but we were sitting in very different pews, singing from a different hymn book.

We both wanted to tie the neutral real rate to the potential real growth rate of the economy. But he focused on the overnight risk-free rate, which the Fed directly controls, while I focused on the long-term private sector rate, determined by the market. Translated, John was and is a Fed funds man while I was and am a financial conditions man.

Which brings me to my practical beef with John: I don't believe that the neutral rate—whichever one you choose—is constant, but rather time-varying, a function of changes in broad financial conditions. With my colleague, and good friend, Ramin Toloui, I wrote a lengthy essay on this issue this past February.³ No need to replot that plowed ground again tonight, except to say that the financial crisis over the last year proves my point in spades.

Be that as it may, most of you thought I was singing way off key back in 2004. And truth be told, I felt that at the margin too, as I recognized my theoretical construct implied a very steep yield curve, an open invitation for entrepreneurial financial operators to lever to the eyeballs into the carry trade.

Thus, I openly acknowledged that if the Fed were to embrace my notion of a neutral zero after-tax real rate on cash, then it would be necessary to put regulatory limits on the use of leverage by financial intermediaries. At that time, policy makers were doing just that with the GSEs (Government Sponsored Enterprises), putting limits on growth of their balance sheets. I was encouraged by this.

But falsely so, as the next several years demonstrated painfully, with unbridled growth in the Shadow Banking System, a term I coined in August 2007 at Jackson Hole. Recall, Shadow Banks are levered-up intermediaries without access to either FDIC deposit insurance or the Fed's discount window to protect against runs or stop runs. But since they don't have access to those governmental safety nets, Shadow Banks do not have to operate under meaningful regulatory constraints, notably for leverage, only the friendly eyes of the ratings agencies.

The bottom line is that the Shadow Banking System created explosive growth in leverage and liquidity risk outside the purview of the Fed. Or, as I said here last time in November 2007, again playing the wonk, Shadow Banking both (1) shifted the IS Curve to the right and also (2) made it steeper, or less elastic, if you will. In such a world, Fed rate hikes had little tempering effect on the demand for credit, or if you prefer, little tightening effect on financial conditions.

And so it came to pass with the Fed hiking the nominal Fed funds rate to 5¼%, double that which I had forecast in May 2004, as financial conditions refused to tighten in sympathy with the Fed's desire. I was proven spectacularly wrong.

It was the Forward Minsky Journey, as I lectured here last time. And it ended in the Minsky Moment, defined as the moment when bubbly asset prices—made so by the application of ever-greater leverage—crack, kicking off the imperative for deleveraging, notably by the Shadow Banking System. We can quibble about the precise month of the Moment. I pick August 2007, but would not argue strenuously with you about three months either side of that date.

Whatever moment you pick for the Moment, we have, ever since, been traveling the Reverse Minsky Journey, violently shifting the IS Curve back to the left, with an even steeper slope. This prospect implied, I argued 16 months ago, that the Fed would inevitably cut the Fed funds rate dramatically, in more-than-mirror image of the hiking process, as financial conditions would refuse to ease in sympathy with the Fed's intentions.

In turn, I forecast that by the next time you invited me here again, the Fed funds rate would likely be at or below the 2½% level that I had so petulantly forecast back in May 2004. I also forecast that I might be contemplating buying a second home, after never having owned more than one.

Looking Forward

Which brings us to today, with the nominal Fed funds rate pinched against zero. I simply wasn't bold enough in my forecast last time here. And while I haven't bought a second home, I am indeed contemplating buying one. I'd like for it to be in a certain city a few hundred miles south of here, but that's a decision above my power grade, even if below my pay grade. But I digress.

What I want to discuss with you tonight is just how simple the solution to our current global economic and financial crisis is on paper, contrasting that to just how difficult and complex the solution is in reality.

The present crisis, in textbook terms, is a case of the dual, mutually reinforcing maladies of the Paradox of Thrift and the Paradox of Leverage. In many respects, they are the same disease: what is rational at the individual citizen or firm level, notably to increase savings out of income or to delever balance sheets, becomes irrational at the community level.

If everybody seeks to increase their savings by consuming less of their incomes, they will collectively fail, because consumption drives production which drives income, the fountain from which savings flow. Likewise, if everybody seeks to delever by selling assets and paying down debt, or by selling equity in themselves, they can't, as the market for both assets and equity will go offer-only, no bid.

Both of these maladies require that the sovereign go the other way, (1) dis-saving with even more passion than the private sector is attempting to increase savings, thereby maintaining **nominal** aggregate demand and thus, **nominal** national income; and (2) becoming the bid side for the levered private sector's offer-only markets for assets and equity. It really is that simple, at least on paper, as Keynes and Minsky wisely taught.

The problem with the desirable textbook solution is that it suffers from constrained political feasibility. Actually, dealing with the Paradox of Thrift is practically much easier, even if less critically important, than dealing with the Paradox of Deleveraging. While Congress may belly-ache and wrangle incessantly about the precise size and composition of fiscal stimulus packages, it is safe to say that but for a few wing nuts, we are all Keynesians now in the matter of cracking the Paradox of Thrift.

In contrast there is limited political consensus for using the sovereign's balance sheet and good credit to break the Paradox of Deleveraging. Put differently, while we may all now be Keynesians, we are not all Minskyians. What is ineluctably needed involves socializing the losses of a banking system—both conventional banking and shadow banking—**after** the spectacular winnings of the Forward Minsky Journey were privatized. It simply doesn't sit well politically. In fact, it stinks to high heaven.

Thus, to quote my partner Mohamed El-Erian, we must contemplate a scenario in which the economically desirable solution is not politically feasible, while that which is politically feasible may not necessarily be economically desirable. Last Sunday, on *60 Minutes*, Ben Bernanke addressed this nasty reality directly when he said that perhaps the most severe risk we face is the lack of political will.

I applaud him, both for doing the interview, speaking directly to the American people, and for speaking the truth. But that doesn't necessarily mean that the truth will set us free. As Kris Kristofferson wrote long ago, and Janis Joplin made famous, we cannot dismiss out of hand the proposition that freedom is just another word for nothing left to lose.

I trust not. But the honest answer is that we honestly don't know. We are living in a world of hysteresis, in which outcomes become path-dependent, where multiple outcomes are possible, where both policy input and economic/financial outcomes become hostage to serial correlation. How's that for talking wonkish?

Concluding Comment

Seriously, let me conclude by once and again quoting Mohamed, who observes that what we are experiencing is not a crisis **within** the market-driven, democratic capitalist system of most of our careers, but rather a crisis **of** the system itself. This is not a spat within a marriage, but rather a test of the sustainability of the marriage itself. It's playing solitaire with a deck of 51.

Fortunately, the 52nd card is now on offer, if only policy makers are willing to seize it and play it: Competitive Quantitative Easing (mixed with Credit Easing, in some cases). Usually, when we think of competitive global policies, we think of them in a negative way, as in competitive hiking of tariffs or competitive currency depreciation. While different in execution, these two forms of competition are economically very similar, a competitive attempt to secure a larger piece of a too-small global aggregate nominal demand pie.

In contrast, Competitive Quantitative Easing (QE) offers scope for growing the global aggregate demand pie, with an **endogenous** enforcement mechanism.

How so? First, let's consider what QE is all about. In an oversimplified nutshell, it involves a central bank voluntarily surrendering for a time its independence from the fiscal authority, taking the short-term policy rate to the zero neighborhood, thereby obviating any need to control growth in its balance sheet. For those of us in the room old enough to remember the jargon—and there are more than a few!—QE obviates any need for the central bank to keep “pressure on bank reserve positions,” so as to hit a positive target for its policy rate.

It's not quite that simple, I recognize, for central banks that are allowed to pay interest on excess reserves, as is now the case with the Fed. Conceptually, with the ability to pay interest on excess reserves, a central bank could “go QE” and still peg a positive policy rate.

But that's a technicality without great substance at the moment, notably with the Fed, whose target range for the Fed funds rate is 0–.25%. Close enough to zero for me! Thus, the Fed is **practically** unconstrained in how big it can grow its balance sheet.

Which, in turn, sets the stage for the Fed to voluntarily work corporately with the fiscal authority—Congress and the Treasury—to monetize longer-dated Treasury securities, facilitating a huge expansion in Treasury debt issues at exceedingly low interest rates. Ordinarily, we would be aghast at such a prospect, as every bone in our bodies would scream that such an operation would, in the long run, be inflationary.

And our bones would be right. The very reason for central bank independence within the government—but not **of** the government—is precisely to prevent the central bank from being the handmaiden of the fiscal authority, who inherently wants to spend more than it taxes, running deficits, overheating the economy in an inflationary way.

But if and when the dominant macroeconomic problem is a huge output gap, borne of deficient aggregate demand, fattening the fat tail of deflation risk, the argument for strict central bank independence goes into temporary submission. Note, I said temporary, not permanent. There is no more sure way, in the proverbial long run, to destroy the purchasing power of a currency than to let vote-seeking politicians have the keys to the fiat-money printing press.

But there can be extraordinary and exigent circumstances when it does make sense for a central bank to work cooperatively, if not subordinately, with the fiscal authority to break capitalism's inherent debt-deflation pathologies. Indeed, none other than Chairman Bernanke made the case forcefully in May 2003, speaking in Japan about Japan (my emphasis, not his):

*The Bank of Japan became fully independent only in 1998, and it has guarded its independence carefully, as is appropriate. Economically, however, it is **important to recognize that the role of an independent central bank is different in inflationary and deflationary environments.** In the face of inflation, which is often associated with excessive monetization of government debt, the virtue of an independent central bank is its ability to say "no" to the government. With protracted deflation, however, excessive money creation is unlikely to be the problem, and a more cooperative stance on the part of the central bank may be called for. Under the current circumstances, **greater cooperation for a time between the Bank of Japan and the fiscal authorities is in no way inconsistent with the independence of the central bank, any more than cooperation between two independent nations in pursuit of a common objective is inconsistent with the principle of national sovereignty.***

Thus, the Fed's announcement just yesterday that the central bank would be buying up to \$300 billion of Treasuries, primarily in the two- to ten-year maturity range, is fully consistent with both what Mr. Bernanke said six years ago and with evident debt-deflationary pathologies, both here in the United States and around the world.

Indeed, what intrigues me the most right now is the concept of global Competitive QE, rather than competitive tariff hiking or competitive currency depreciation. If all countries, or most major countries anyway, "go QE," then the global game changes from fighting for bigger slices of a too-small global nominal aggregate demand pie to actually correlated efforts to enlarge the nominal pie.

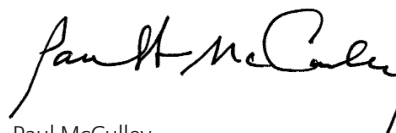
Note I said "correlated" not "coordinated." There need not necessarily be any explicit coordination between countries, because those that choose not to play will likely experience a rise in their real effective exchange rate, a deflationary impulse to their underutilized economies.

Thus, there need not be an explicit enforcement mechanism to propel Competitive QE, merely individual countries acting in their own best interest. This is the best kind of cooperative behavior, explicitly because it need not be coordinated, but rather brought about by, you guessed it, Adam Smith's invisible hand!

To be sure, the ECB (European Central Bank) has difficulty with the concept of QE, in part because Euroland represents monetary union without political union and, thus, fiscal policy union. Put differently, if the ECB wants to be accommodative of more Keynesian fiscal policy stimulus, *de facto* monetizing it, what fiscal authority does the ECB call to cut the deal?

It's an open question, but my sense is that about ten big figures higher from here for the Euro, the ECB would find the answer!

Thank you, again, for the great honor of being here tonight.



Paul McCulley
Managing Director

1. *"Comments Before The Money Marketeers Club: A Brave New World," Global Central Bank Focus, May 2004.*
2. *Or if you prefer, unemployment is at its full employment level.*
3. *"Chasing the Neutral Rate Down: Financial Conditions, Monetary Policy, and the Taylor Rule," Global Central Bank Focus, February 2008.*

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The target federal funds rate is the interest rate published by the Federal Open-Market Committee (FOMC) of the Federal Reserve Board as a target for overnight, inter-bank loans. The rate is a leading economic indicator of interest rate movements and Federal Reserve monetary policies. Gross Domestic Product (GDP) is the value of all final goods and services produced in a specific country. It is the broadest measure of economic activity and the principal indicator of economic performance.

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