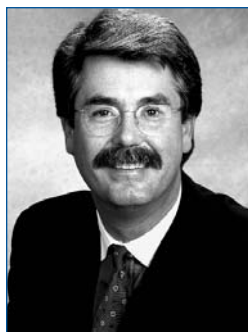


Global Central Bank Focus

by PIMCO's Paul McCulley

In the Fullness of Time



Paul McCulley

This was my third year attending the Kansas City Fed's annual Jackson Hole Symposium. As always, I was honored to be invited and found the event, both the formal meetings and the informal discussions, to be engaging. But, quite frankly, I found this year's confab to be the least intellectually satisfying of the three I've attended. Why? Policy makers, and even more so academics, just don't seem to collectively "get it" when it comes to understanding what is unfolding in the capital markets right now, and the implication for a whole array of policies, not just monetary policy.

Note I said "collectively." Many policy makers, led by Chairman Bernanke, do "get it"—perhaps he more than any other, as both a student of the Great Depression as well as a theoretician on the transmission mechanism of monetary policy, notably the "credit channel" with its associated "accelerator." But regrettably, there has yet to be a collective recognition of what is unfolding. As evidence, only two of the five papers presented even had the name Minsky in them and even in those cases, only in passing or in a footnote. I'll come back to that in a few paragraphs.

Neutral Is as Neutral Does

But first, let me touch on the most obvious source of cogitative dissonance: the hawks vs. the doves regarding inflation. The hawks scream that the Fed must tighten sooner rather than later, so as to burnish the Fed's anti-inflation credibility, but do so without any discussion whatsoever of the monetary policy transmission mechanism; they simply look at the negative prevailing real Fed funds rate and say it's too damn low and should be raised.

Really, that is essentially their entire story. The only good thing about their story is that it is so easy to refute using standard macroeconomic and finance theory. But unfortunately, not even that seems to get them to shut up.

All sensible discussion of the "right" real Fed funds rate logically must begin with the proposition that the putative "neutral" equilibrium real Fed funds rate is not constant, but rather time varying, a function of financial conditions, notably whether levered financial intermediaries—conventional banks, as well as *shadow banks*, a term I coined last year at Jackson Hole—are ramping up or ramping down their leverage. The former will lift the "neutral" real rate while the latter will reduce it. Thus, a high Fed funds rate may not be restrictive at all while a low Fed funds rate might not be stimulative at all.

This should be a self-evident truth, but somehow, it hasn't penetrated the gray matter of the inflation nutters, who view a negative real Fed funds rate as *prima facie* evidence of monetary laxity at best, and moral bankruptcy at worst. It is not. The whole concept of "neutral" is best defined by the famous economist Forrest Gump: neutral is as neutral does.

And right now, a 2% Fed funds rate is not doing much at all to stimulate aggregate demand relative to aggregate supply, reducing resource slack in the economy, engendering increased pricing power by capital or labor, or both. To the contrary, resource slack is going the other way, notably in the labor market, with the

unemployment rate up over a full percentage point since its cyclical low. Thus, if anything, a 2% Fed funds rate is restrictive, not stimulative.

And the reason is simple: the economy is caught in the paradox of deleveraging, as I detailed in this space two months ago.¹ Terms and conditions for private sector credit creation, the fuel for private sector aggregate demand growth, are tighter, much tighter than when the Fed funds rate was 5¼% a year ago. Thus, the current 2% Fed funds rate is not providing any tinder whatsoever for an inflationary fire.

Rather, the ongoing deleveraging of levered credit creators is fueling asset price deflation in a vicious downward spiral, known in central bank circles as a “negative feedback loop.” And, as long as that loop is looping, it would be a colossal policy mistake to get wrapped 'round the axle about the fact that the real Fed funds rate is negative. It is, as it should be.

Unless, of course, as Goldman Sachs Chief Economist Jan Hatzius pointed out in this morning’s New York Times, you somehow believe that the United States economy is not throwing enough people out of work and/or not throwing them out of work quickly enough. I don’t. And neither does the intellectual center of the Federal Open Market Committee, I can assure you. Yes, headline inflation is presently higher than the Fed would prefer. It’s higher than I would prefer.

But it’s also the consequence of a negative real terms of trade shock, which the Fed can do nothing about in **real** time. I’ve been to the Fed’s headquarters in Washington and believe me, there are no oil derricks on the property. Sometimes, you just have to live with things that you don’t like because trying to fix them will give you something you like even less. It’s time for the inflation nutters to understand and accept that.

Macroprudential

In turn, it is also time for those who ignore the Minsky framework for understanding current financial turmoil to quit ignoring his work, getting over their visceral disdain for the man who declared financial capitalism to be inherently unstable. Minsky pointed the corrective finger at high church believers in the efficiency of markets and the rationality of market expectations. And they simply don’t like it, even though Professor Minsky passed away over a decade ago.

An important subplot to the Jackson Hole discussions this year was that somehow, the Fed urgently needs to restore a separation between its monetary policy mission and its financial stability mission. In contrast, I’m increasingly convinced that while the two missions can be viewed intellectually as distinctly different, they are in reality forever joined.

Not as much as at present, I certainly hope, but not nearly so separated as many in the Tetons advocated, including some card carrying members of the financial conditions-driven intellectual center. Yes, I’m an equal opportunity chop-buster, not just a critic of the easy-mark inflation nutters. Fortunately, Chairman Bernanke’s opening address, a powerful forward looking commentary, not just a retrospective on the last year, suggests that I should exempt him from any chop-busting.

Therefore, I do. Specifically, Mr. Bernanke put squarely on the table the need for “macroprudential” regulatory arrangements, **designed to temper the inherent pro-cyclicality of existing regulatory/capital requirement arrangements**. If established and successful in implementation, a macroprudential approach would temper the Minsky-esque boom-bust tendencies of banking and the capital markets.

Such an outcome would, in turn, have direct implications for monetary policy. More specifically, if the transmission mechanism between the Fed funds rate, financial conditions and aggregate demand could be made more tightly bound, it would reduce the overall cyclical range the Fed would need to pursue for the Fed funds rate.

Thus, an effective macroprudential supervisory/regulatory approach would tighten the relationship between the Fed’s traditional monetary policy mission and its financial stability mission. This outcome would be counter to the consensus view at Jackson Hole, that the two missions should be kept as far apart as possible.

Specifically, here’s what Chairman Bernanke said:

“A systemwide focus for financial regulation would also increase attention to how the incentives and constraints created by regulations affect behavior, especially risk-taking, through the credit cycle. During a period of economic weakness, for

example, a prudential supervisor concerned only with the safety and soundness of a particular institution will tend to push for very conservative lending policies.

In contrast, the macroprudential supervisor would recognize that, for the system as a whole, excessively conservative lending policies could prove counterproductive if they contribute to a weaker economic and credit environment. Similarly, risk concentrations that might be acceptable at a single institution in a period of economic expansion could be dangerous if they existed at a large number of institutions simultaneously.

I do not have the time today to do justice to the question of the procyclicality of, say, capital regulations and accounting rules. This topic has received a great deal of attention elsewhere and has also engaged the attention of regulators; in particular, the framers of the Basel II capital accord have made significant efforts to measure regulatory capital needs 'through the cycle' to mitigate procyclicality.

However, as we consider ways to strengthen the system for the future in light of what we have learned over the past year, we should critically examine capital regulations, provisioning policies, and other rules applied to financial institutions to determine whether, collectively, they increase the procyclicality of credit extension beyond the point that is best for the system as a whole."²

That, my friends, was beautiful music to my Minsky-tuned ears! I've long believed that asset price cycles should have a much greater role in Fed policy than has been the case. Note, I said "asset price cycles," not asset prices. Chairman Bernanke has long advocated that the Fed eschew "targeting" asset prices. I have felt less strongly about that than he has. But with his new advocacy of macroprudential policies aimed at enhancing financial stability, I think we've reached the point where our differences are but noise.

Regulatory arrangements—notably restrictions on leverage, liquidity and capital restrictions—that procyclically turbo-charge asset price cycles are an anachronism that need to be not just re-examined,

but fixed. Ben Bernanke just told us that he will be the presiding physician. And I have no doubt that the spirit of Hyman Minsky will be in the re-examination room.

Bottom Line

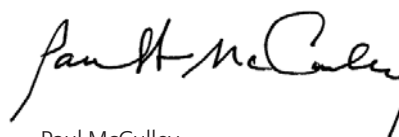
Jackson Hole is a very special place. And the Kansas City Fed's annual symposium in Jackson Hole is a very special gathering. The Tetons are good for the soul, especially when soul searching for the answers to the critical economic questions of our time. This year, there was no table-pounding consensus as to how to right all that is wrong with the world. Humility, except perhaps for the inflation nutters, was very much on display.

And that is all to the good, I think. Finding the right answers sometimes requires conceding that yesterday's answers were actually wrong. In the money management business, I live with this reality every day. It was good to see those who don't feel similar pains to the wallet to at least feel them to the ego.

The most important conclusion, at least to me, was Chairman Bernanke's open call for a shift to macroprudential regulatory arrangements, not to supplant microprudential regulation, but to enhance it, notably by reducing its procyclical character. The time for such a shift is long, long overdue, as surely Hyman Minsky would agree.

In the fullness of time there does come a time when time is full.

Now is such a time.



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1. *Global Central Bank Focus, July 2008.*
2. <http://www.federalreserve.gov/newsevents/speech/bernanke20080822a.htm>

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