PIMCO's Global Central Bank Focus

Paul McCulley
PIMCO
Managing Director,
Portfolio Manager

"Because I Said So…"

Most parents have, at some point or points, responded to the incessant whining of a child asking "Why, why, why, why?" by retorting "Because I said so." And for those that haven't, they are either saints or possess DNA unfamiliar to me. It's not that we don't feel a duty to explain in as rich detail as we can the logic of our decisions. Most of us do.

But at some juncture in the dialogue with the child, we run into one or both of two problems:

- The child simply refuses to acknowledge our well-articulated logic; and/or
- We admit to ourselves that our logic may not be all that tight and that the decision at hand is a function of our fuzzy instincts, rather than our un-fuzzy brains.

I've been there and done that, and I have only one, 20-year old Jonnie. For my colleagues and friends with larger families, I'm sure the urge to say, "Because I said so" surfaces even more often.

Such is the case with central bankers, too, and they have many children:

- Their political overseers, who may be also their enablers;
- The financial markets, given to wanting instantaneous results when that is impossible and certainty of intent when uncertainty abounds;
- Ivory tower academics who know all about how the financial world is supposed to work, but with few having actually worked in it;
- International players, who lack familiarity of what is economically desirable relative to what is politically feasible in foreign environs; and perhaps most important,
- The general public, who instinctively understand microeconomics (what is in it for me?) better than macroeconomics (what is in it for us?).

Accordingly, central banks have a long history of wrapping what they do in varying degrees of opaqueness, if not secrecy, on the proposition that some things are simply just too complicated, or delicate, for all their "children" to understand.

Glasnost Is Only As Good As The Reaction Function

Fortunately, the last couple of decades have been a period of evolving central bank glasnost. The Fed did not lead the charge, but rather foreign central banks, starting with the Reserve Bank of New Zealand, where legislation was passed in 1989 requiring the central bank to adopt an official inflation target, including regular reporting on performance. Many other central banks followed. The Fed didn't, in part because it has a legal dual-mandate of both low inflation and low unemployment, while many other central banks have a sole legal mandate to pursue low inflation.

Nonetheless, the Fed has made remarkable strides over the last couple decades in both announcing and explaining the rationale for its actions. Former Fed Chairman Greenspan got the Fed on the glasnost train, even if begrudgingly at times, while current Fed Chairman

Bernanke has always had a reserved seat in the formal dining car. In academia, he was a vocal proponent of the Fed announcing an official inflation target, and since becoming a Fed Governor in 2002, and especially since becoming Fed Chairman in 2006, has successfully pushed for ever more transparency in both the logic and the actions of the central bank.

The reasons have been straight forward. Philosophically, accountability in a democracy demands that the secrets of the monetary temple be revealed. And practically, the more transparent is a central bank as to the ways and means of what it does, the more efficient will be the markets' transmission of the central bank's actions to the real economy. Thus, central bank transparency is not just a virtue in its own right, but also a virtue in enhancing the efficacy of central bank policy.

Or so the logic goes. I certainly philosophically buy it. But clearly, increased transparency did not prevent the worst financial crisis (in the developed world) since the 1930s. Thus, we ineluctably must conclude that good monetary policy, or more appropriately, good monetary and financial policy, is not just about central banks revealing their objectives and reaction functions, but more fundamentally about designing the correct objectives and reaction functions.

Or returning to my analogy at the outset, good parenting is not just about explaining the logic of reaction functions to children, but starting with fundamentally–sound reaction functions. Logically explaining a decision derived from a poorly-founded reaction function may satisfy a child for a time, but it is unlikely to serve the long-term well being of the child. Or the parent.

Taylor-like Rules Can't See Systemic Risks

Such is the case with the Fed's reaction function over the last decade: flexible, implicit inflation targeting, using a Taylor-like rule as a reference guide grounded on the proposition that the Fed could and should fine tune aggregate demand to exploit the economy's Phillips curve—the cyclical trade-off between the inflation rate and resource utilization rates, notably labor market utilization rates.

To be sure, there has long been a raging debate in the economics community—in academia, in policy circles and in the markets—as to the "best" specification of Taylor-like rules. Indeed, former Fed Governor Larry Meyer and John Taylor himself are presently debating in public the "right" co-efficients in a Taylor-like rule.[1] But where there has been little debate at all is what should go into a Taylor Rule, so as to compute the "appropriate" nominal policy rate:

- A constant, which is assumed to be the "neutral" real rate, which would hold if the inflation and unemployment were both at "target".
- The inflation rate itself.
- The gap between the actual inflation rate and the target inflation rate.
- The gap between the actual unemployment rate and the full-employment unemployment rate, commonly known as the NAIRU (non-accelerating inflation rate of unemployment), which can also be viewed as the "target" rate.

Nowhere in such Taylor-like rules is there a term for the state of financial conditions, or more specifically, asset prices. The argument for not including such a term—made famously by Fed Chairman Bernanke and Professor Gertler in their 1999 paper[2] presented at Jackson Hole—has been that changes in financial conditions and asset prices are indirectly "picked" up when implementing a Taylor-like rule, because they influence aggregate demand relative to aggregate supply potential and thus, the unemployment gap, which cyclically drives inflation.

More to the point, ebullient financial conditions stimulate aggregate demand, arguing for a smaller output gap and thus a higher policy rate while depressed financial conditions do just the opposite. Thus, so the argument goes, there is no need to include financial conditions in a Taylor-like rule, because to the extent that financial conditions influence aggregate demand, the rule will point to changes in the policy rate in the "right direction".

To be sure, this intellectual edifice has not been religiously followed. Indeed, a favorite analytical means that is used to show this is the pattern of deviations in the actual policy rate from that prescribed by Taylor-like rules. And when using Professor Taylor's own specification of his rule, computing such deviations is actually very easy, because Taylor used historical data for the independent variables, rather than forecasts of those variables. Such deviations of the actual policy rate from the "Taylor-prescribed" policy rate are viewed as the central bank being both forward looking and engaged in risk management, tilting policy relative to the rule in a judgmental fashion (hence, one of the reasons the paradigm is called "flexible" inflation targeting).

As a factual matter, the sum of the deviations—as shown in the graph on the next page—over the last decade has been for an actual policy rate meaningfully below the Taylor-prescribed level, because the dominant "fat tail" in the Fed's forecasts has been unacceptably low inflation rather than unacceptably high inflation. Professor Taylor takes great umbrage with the Fed for having systematically tilted policy to a more accommodative stance than prescribed by his rule, arguing that such a tilt in the middle years of this decade was a dominant—if not **the** dominant—cause of the housing and housing finance bubbles that formed during that period.

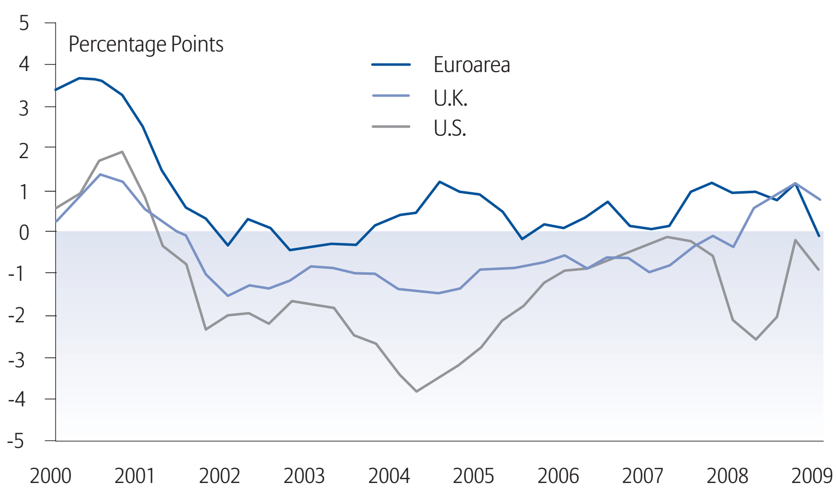
Intuitively, there must be some validity to Professor Taylor's argument because by definition, running policy in risk management mode, biased to cutting off the fat tail of excessively low inflation, if not deflation, means an easier monetary policy that would be "appropriate" if the Fed looked only at the central tendency of the probability distribution of its forecasts. Many economists—myself included—would argue that this was the right thing to do, given the imperative of avoiding a Japanese-style liquidity trap. Did this low interest-rate deviation from Taylor's specification of the Taylor rule really cause the asset bubble?

On this point, I think John Taylor takes his argument further than the evidence. To be sure, there is a correlation between low interest rates and rising home prices, but that correlation is not equivalent to causation. In my view, the evidence is much more persuasive that the primary villain in the bubble was ever-more lax underwriting standards for mortgage creation, facilitated by the unholy trinity of the originate-to-distribute business model, explosive growth in the shadow banking system, and complicit rating agencies. Had it not been for these enabling factors, the bubble would not have inflated—or subsequently deflated—as violently as it did.

But at the same time, bubbles are also endemic to human nature and behavior of markets. Old fashioned animal spirits, with optimism that housing prices could never fall propelling momentum-driven buying that drove up prices, re-enforced and turbo-charged the momentum from financial innovation and poor underwriting standards. Such is the nature of bubbles.

And conventional Fed wisdom for well over a decade has been that the central bank should not be directly concerned with such bubbles, because (1) they are devilishly difficult to pre-emptively identify and because (2) following a forward-looking Taylor-like rule "automatically" leads to a policy of leaning against bubbles. Rather than trying to pop putative bubbles, which would only definitively prove their existence by blowing up, conventional wisdom favored a "mop up strategy"—if and when bubbles did blow up.

Chart 1 | Deviation of Rates from Taylor Rule



Sources: OCED

To be sure, this conventional wisdom was not shared in all circles. Most notably, the Bank for International Settlements, the BIS, consistently warned that central bankers could and should identify nascent bubbles and could and should lean against them by more than what would be implied via their impact on aggregate demand, viewed through a Taylor-like rule. The BIS's Bill White—and guest lecturer at PIMCO's 2009 Secular Forum—led this great research and advocacy work.[3] He was essentially ignored.

But no longer, following the greatest economic and financial downturn of the post World War II period. The analytical community—again in academic, policy and market circles—has no choice but to embrace that something went wrong, very wrong. And it is only natural that some of the re-examination take place with respect to the flexible inflation-targeting regime, implemented via a Taylor-like rule. That's not to suggest that there was nothing right about that regime; it did indeed provide an analytical foundation for fine-tuning the economy to both low inflation and low unemployment, summarized in the motto, the Great Moderation.

But that regime left no room for the insights of Hyman Minsky, drawn from John Maynard Keynes, that financial capitalism is inherently given to endogenous boom and bust cycles, what Minsky called his Financial Instability Hypothesis. The tumult of the last two years ensures that the analytical community, in forming a new consensus around a new central bank reaction function, will incorporate Minsky's insights, as suggested by San Francisco's Fed President Janet Yellen.[4] This process is still in its infant stages, but in my view, the doctrine of hands-off as to bubbles on the way up, to be followed by mopping up, is in ineluctable retreat.

None of the Fed's five constituents—or children—presented at the outset will accept continuation of a regime that culminated in the drama of the last two years. Asset prices do matter. And policy makers will have no choice but to include them in their reaction function. Indeed, where the debate is most fertile is to whether asset prices, or financial conditions more generally, should (1) be added as an additional independent variable in Taylor-like rules, and/or (2) incorporated in a new regulatory reaction function, commonly called Macro-Prudential Regulation. The latter refers to a comprehensive revision of the regulatory framework to strengthen capital requirements; remove the pro-cyclicality of capital requirements that encourages banks to lend ever-more into booms and cut back ever-more in busts; and to modify compensation schemes to remove incentives for short-term gains at the price of long-term losses.

Bottom Line

Consensus opinion at Jackson Hole, as best as I can glean from the formal papers and informal write-ups of participants, is for the need to develop a robust, internationally harmonized framework of Macro-Prudential Regulation. Such a framework will have many objectives and features, but, in my view, the core objectives must be (1) counter-cyclical capital/margin arrangements, replacing the pro-cyclical paradigm that has been in place, which has turbocharged the inherent boom-bust pathologies of financial capitalism that Minsky so richly identified; and (2) a robust resolution regime, outside the disorderly bankruptcy process, for **all** systematically important financial institutions.

There are many, many steps to go before consensus—both analytical and political—will form as to the details of a Macro-Prudential Regulatory regime. And as Charles Bean, Deputy Governor of the Bank of England, noted in a powerful speech last week in Barcelona,[5] in the absence of such a regime, central bankers will have to consider seriously the "second best" option of incorporating asset prices more explicitly into their Taylor-like rules, being willing to accept somewhat larger deviations from "target" for both inflation and unemployment, if that is necessary to enhance prospects for systemic stability.

What we can say with high confidence is that central bank transparency of its reaction function is not a holy grail in its own right. Getting the reaction function right, including having different reaction functions for different problems, is the Holy Grail. And in my view, central bankers need not wait until a new consensus is fully formed, fully buffed with academic logic and empiricism, before pursuing new paths.

Yes, that will sometimes mean taking action that is not fully anticipated, based on old rules of the game. But just like parents, central banks must exercise judgment, and sometimes, good judgment does involve making decisions on the basis of where the gut says the brain is going. Yes, sometimes, "because I said so" is the right answer to a child's question.

Paul McCulley
Managing Director

About the Author

Mr. McCulley is a managing director, generalist portfolio manager, and member of the investment committee in the Newport Beach office. In addition, he heads PIMCO's short-term bond desk, leads PIMCO's cyclical economic forums and is author of the monthly research publication, Global Central Bank Focus. Prior to joining PIMCO in 1999, he was chief economist for the Americas at UBS Warburg. During 1996–98, he was named to six seats on the Institutional Investor All-America fixed-income research team.

He has 26 years of investment experience and holds an MBA from Columbia Business School. He received his undergraduate degree from Grinnell College.

1 "Dueling Taylor Rules"

2 "Monetary Policy and Asset Price Volatility", http://www.kansascityfed.org/publicat/sympos/1999/S99gert.pdf

3 See, for example: "Making macroprudential concerns operational"

4 "A Minsky Meltdown: Lessons for Central Bankers", http://www.frbsf.org/news/speeches/2009/0416.html

5 "The Great Moderation, the Great Panic and the Great Contraction", http://www.bankofengland.co.uk/publications/speeches/2009/speech399.pdf

27157