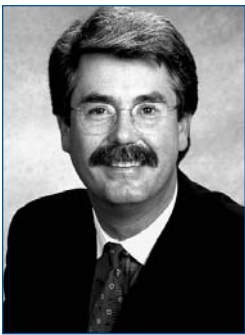


Global Central Bank Focus

by PIMCO's Paul McCulley

The Paradox of Deleveraging Will Be Broken



Paul McCulley

I've only written this essay once since the Kansas City Fed's annual symposium in late August.¹ But it hasn't been because I've been lazy. Rather, I've been working virtually around the clock ever since, in my day job as head of PIMCO's Money Market and Funding Desk. On Wall Street, this desk is frequently viewed as a backwater, a temporary home for new MBAs getting their feet wet before moving on to higher-value-added desks, or a retirement home for those with more senior moments than fresh ideas.

That's never the case here at PIMCO, even though a number of now PIMCO partners spent their first days trafficking in the money markets and I, of ever-graying hair, still make my home here in the early hours of the day. Money markets frequently are a backwater, except when they are not, in which case they are cascading rapids. Liquidity pressures inevitably are the precursor of solvency and/or going-concern problems. Just ask Wall Street's independent investment banks.

We here at PIMCO have always known this. Accordingly, we've always been conservative beyond conservative in our money market operations, on both sides of the balance sheet—no asset-backed commercial paper (ABCP) for us, and no tri-party repo without regard to collateral types or haircuts either. Meat and potatoes only, no fancy garnishes necessary. But the meat and potatoes must be cooked properly.

Hence, the work load of PIMCO's money market and funding desk. My new deputy, Jerome Schneider, hit the ground running in early August, a most propitious time, just before the global money markets became not just cascading rapids, but roaring waterfalls. The financial world will never be the same after the U.S. Treasury and Federal Reserve's fateful decision of the weekend of September 13–14 to stand aside as Lehman Brothers plummeted to death on the rocks below.

Whether that decision was the right one or not, we will never know. Yes, I know that many are quick to take the Treasury and the Federal Reserve to task, maintaining that the on-going global financial crisis – and, thus, growth crisis—would not be nearly so severe if Lehman had been tossed a life line. I simply don't know. What I do know is that the global financial system was fundamentally broken long before Lehman's watery death.

Thus, I believe the powerful, systemic policy responses that have unfolded in the post-Lehman world were destined to come about. Lehman was but the unfortunate tipping point. My heart still aches for the pain suffered by my many friends there. Fate is not always fair and at times, is arbitrary and capricious.

But what ailed Lehman was but a manifestation of what ailed, and ails the global financial intermediary system: **the presumption that grossly levered positions in illiquid assets can always be funded, because those doing the funding will always assume the borrower is a going concern.**

To understand the nature of this systemic malady, we need to return to first principles. Bear with me, please; this is going to be a bit academic. But, I submit, it was the loss of understanding of first principles that lies at the heart of the on-going paradox of deleveraging, which is the proximate cause of the on-going downward spiral of asset and debt deflation.

The Nature of Banking

When I studied the origins of banking in college, we started with the Medici Family of 15th century Italy. I'm quite sure banking existed long before then, just that I haven't studied it. But regardless of the origins of banking, its founding premise has always been the same: In normal times, the public's collective, *ex ante* demand for access to at-par, immediately-available bank money is always **greater** than the sum of the public's individual, *ex post* demand for access to such liquidity.

Thus, the genius of banking, if you want to call it that, is simple: a bank can take more risk on the asset side of its balance sheet than the liability side can notionally support, because a goodly portion of the liability side, notably deposits, is ***de facto* of perpetual maturity**, although it is notionally of finite maturity, as short as one day in the case of demand deposits.

It's the same alchemy that permits mutual funds to commit to next-day redemption at tonight's NAV, even though all reasonable people know that a mutual fund—with the possible exception of a money market fund—could not possibly liquidate all assets on the wire tomorrow at tonight's NAV marks. Systemically, it's the illusion of liquidity, as so elegantly described by John Maynard Keynes:

"The spectacle of modern investment markets has sometimes moved me towards the conclusion that to make the purchase of an investment permanent and indissoluble, like marriage, except by reason of death or other grave cause, might be a useful remedy for our contemporary evils. For this would force the investor to direct his mind to the long-term prospects and to those only. But a little consideration of this expedient brings us up against a dilemma, and shows us how the liquidity of investment markets often facilitates, though it sometimes impedes, the course of new investment.

For the fact that each individual investor flatters himself that his commitment is 'liquid' (though this cannot be true for all investors collectively) calms his nerves and makes him much more willing to run a risk. If individual purchases of investments were rendered illiquid, this might seriously impede new investment, so long as alternative ways in which to hold his savings are

available to the individual. This is the dilemma. So long as it is open to the individual to employ his wealth in hoarding or lending money, the alternative of purchasing actual capital assets cannot be rendered sufficiently attractive (especially to the man who does not manage the capital assets and knows very little about them), except by organizing markets wherein these assets can be easily realized for money."²

Yes, liquidity **for all** at last night's marks is an illusion. But for banks, unlike mutual funds, it's not so much an illusion after all, for two simple reasons: banks have access to deposit insurance underwritten by fiscal authorities and to a discount window underwritten by the monetary authority (and one step removed, the fiscal authority). Thus, banks are unique institutions, providing a "public good:"

- ▶ Liquidity on demand at par for their depositors, because of the safety net underwritten by the sovereign, yet
- ▶ The ability to invest in longer-dated, more risky, not-always-at-par loans and securities, because the existence and credibility of the public safety net systemically renders the public's *ex post* demand for liquidity at par below the public's *ex ante* demand.

Yes, banking with a sovereign safety net against deposit runs is a really cool business. Indeed, the difference between the public's *ex post* and *ex ante* demand for at-par liquidity could be called the banking system's "float," similar to that of a Buffet-style insurance company.

But since it's a really cool business and since the sovereign providing the liquidity safety net is a *de facto* equity partner in the business, the sovereign quite rationally wants a say in how the business is run—the degree of leverage, corporate governance, risk management controls, etc. Kinda like I do when I pay the insurance premium on my 19-year old son's car. Jonnie doesn't like it, and neither do bankers. Or would-be bankers.

Thus, both bankers and would-be bankers have, from time immemorial, sought to get the benefits of the sovereign's liquidity safety net without shouldering the associated regulator nuisance. And I'm sure that 19-year old sons and daughters, too, have been doing the same for just as long.

Over the last three decades or so, the growth of “banking” outside formal, sovereign-regulated banking, has exploded, in something that I dubbed the Shadow Banking System.³ Loosely defined, a Shadow Bank is a levered-up financial intermediary whose liabilities are broadly perceived as of similar money-goodness and liquidity as conventional bank deposits. These liabilities could be shares of money market mutual funds; or the commercial paper of Finance Companies, Conduits and Structured Investment Vehicles; or the repo borrowings of stand-alone Investment Banks and Hedge Funds; or the senior tranches of Collateralized Debt Obligations; or a host of other similar funding instruments.

The bottom line is simple: Shadow Banks use funding instruments that are not just as good as old-fashioned sovereign-protected deposits. But it was a great gig so long as the public bought the notion that such funding instruments were “just as good” as bank deposits—more leverage, less regulation and more asset freedom were a path to (much) higher returns on equity in Shadow Banks than conventional banks.

And why did the public buy such instruments as though they were “just as good” as bank deposits? There are a host of reasons, not the least of which was lust for yield. But most fundamentally, Keynes again gives us the systemic answer (his italics, not mine):

“In practice we have tacitly agreed, as a rule, to fall back on what is, in truth, a convention. The essence of this *convention*—though it does not, of course, work out quite so simply—lies in assuming that the existing state of affairs will continue indefinitely, except in so far as we have specific reasons to expect a change. This does not mean that we really believe that the existing state of affairs will continue indefinitely. We know from extensive experience that this is most unlikely.

The actual results of an investment over a long term of years very seldom agree with the initial expectation. Nor can we rationalize our behavior by arguing that to a man in a state of ignorance errors in either direction are equally probable, so that there remains a mean actuarial expectation based on equi-probabilities. For it can easily be shown that the assumption of arithmetically equal probabilities based on a state of ignorance leads to absurdities.

We are assuming, in effect, that the existing market valuation, however arrived at, is uniquely *correct* in relation to our existing knowledge of the facts which will influence the yield of the investment, and that it will only change in proportion to changes in this knowledge; though, philosophically speaking, it cannot be uniquely correct, since our existing knowledge does not provide a sufficient basis for a calculated mathematical expectation. In point of fact, all sorts of considerations enter into the market valuations which are in no way relevant to the prospective yield. Nevertheless the above conventional method of calculation will be compatible with a considerable measure of continuity and stability in our affairs, *so long as we can rely on the maintenance of the convention.*

For if there exist organized investment markets and if we can rely on the maintenance of the convention, an investor can legitimately encourage himself with the idea that the only risk he runs is that of a genuine change in the news *over the near future*, as to the likelihood of which he can attempt to form his own judgment, and which is unlikely to be very large. For, assuming that the convention holds good, it is only these changes which can affect the value of his investment, and he need not lose his sleep merely because he has not any notion what his investment will be worth ten years hence.

Thus investment becomes reasonably “safe” for the individual investor over short periods, and hence over a succession of short periods however many, if he can fairly rely on there being no breakdown in the convention and on his therefore having an opportunity to revise his judgment and change his investment, before there has been time for much to happen. Investments which are “fixed” for the community are thus made “liquid” for the individual.

It has been, I am sure, on the basis of some such procedure as this that our leading investment markets have been developed. But it is not surprising that a convention, in an absolute view of things so arbitrary, should have its weak points. It is its precariousness which creates no small part of our contemporary problem of securing sufficient investment.”⁴

And so, Keynes provides the essentia—and existential—answer as to why the Shadow Banking System became so large, the unraveling of which lies at the root of the current global financial system crisis. **It was a belief in a convention, undergirded by the length of time it held:** Shadow Bank liabilities were viewed as “just as good” as conventional bank deposits not because they are, but because they **had** been. And the power of this conventional thinking was aided and abetted by both the sovereign and the sovereign-blessed rating agencies.

Until, of course, convention was turned on its head, starting with a run on the ABCP market in August 2007, the near death of Bear Stearns in March 2008, the *de facto* nationalization of Fannie and Freddie in July, and the actual death of Lehman Brothers in September 2008. Maybe, just maybe, there was and is something special about a real bank, as opposed to a Shadow Bank!

And indeed that is unambiguously the case, as evidenced by the on-going partial re-intermediation of the Shadow Banking System back into the sovereign-supported conventional banking system, as well as the mad scramble by remaining Shadow Banks to convert themselves into conventional banks, so as to eat at the same sovereign-subsidized capital and liquidity cafeteria as their former stodgy brethren.

The new conventional wisdom: levered capitalism is good, and made even better with a bit of socialism to protect the downside.

Well Maybe

I’m quite sure that last sentence is not going to sit well with some of you. It’s not supposed to sit well. It doesn’t sit well with me, I must acknowledge, nay confess. Like most of us, I’ve always had a separation in my mind between strictly capitalist activities and strictly public activities. Not that the demarcation is always clean. But it’s a useful way of thinking.

As far as I know, the place where I buy my fishing tackle is a capitalist outfit. If we customers don’t buy enough rods and reels, the owner will go broke; his operation is simply not systemically important enough to be bailed out by the taxpayers, including my neighbors who don’t fish. In contrast, the local Department of Motor

Vehicles, sometimes called the DMV, is unambiguously not a capitalist outfit, but a public outfit. It cannot go broke, as evidenced by our tolerance of its fluctuating service level, because it provides a public service that the private sector can’t provide. To be sure, AAA can get you new plates for your car, but you can’t renew your driver’s license at the AAA; for that, you have got to go to the monopoly called the DMV.

Well actually, that’s not entirely true, either. The DMV is actually an oligopoly, with offices in many surrounding neighborhoods. And rumor has it here that the service is a lot quicker at the San Clemente office than the Costa Mesa office, which serves Newport Beach. So the consumer does have the choice of driving to San Clemente, a form of time arbitrage versus going to the Costa Mesa office. However, rumor also has it that this rumored better service in San Clemente is so widespread that, as Yogi Berra might say, the San Clemente office has become so popular nobody goes there anymore.

But you get the point: there is private enterprise and there is public enterprise. And then there is banking, a hybrid of the two. There is no way ‘round this, for good or bad, because fractional reserve banking depends upon the sovereign’s safety net against liability runs, a safety net that the private sector definitionally can’t universally supply. In this sense, the safety net is like national defense: we all need it, but since nobody individually has the incentive to pay for it, we collectively tax ourselves to pay for it.

Yes, sometimes we collectively end up paying \$800 for military toilet seats, as was the case about 25 years ago. But that doesn’t change the proposition that public goods do exist, and a stable system of intermediation of private savings into private investment is indeed a public good. The maturity transformation power of a fractional reserve banking system provides an unambiguous benefit to society and as such, must be underwritten by society.

Bottom Line

I could regale you yet again about the power of the analytical thinking of Hyman Minsky, complete with his Forward Journey turning into his Moment, followed by his Reverse Journey.⁵ But I don't need to do that any more: we've collectively lived it and are now caught in the debt-deflationary pathologies of "the paradox of deleveraging."⁶ Not everybody in the private sector can delever at the same time without creating a depression. Accordingly, the sovereign must go the other way, leveraging up the public balance sheet. And Washington has finally started to do so with appropriate vigor and enthusiasm.

It's not a pretty picture. In fact, it's repugnant, giving proof to the proposition that breaking the paradox of deleveraging does involve socializing the downside of previously profitable private sector activities. In a recent speech, I called it "creeping socialism" and was interrupted by an irate, older man in the back of the room bellowing, "It ain't creeping socialism, it's galloping socialism!" I really didn't have a soothing come back, noting that many things are what they are only in the eye of the beholder. But his point wasn't lost on me or anybody else in the room.

And it is not lost on Washington, DC either, I can assure you. If the sovereign must backstop a private sector activity that produces a public good, then the sovereign will, at least in a democracy, rightfully demand both bottom-up and macro-prudential rules to harness the greed that lubricates the invisible hand of capitalism.

Yes, the visible fist of government and the invisible hand are presently engaged in a massive arm wrestling contest in the provision of financial services. And the fist is winning.

At least for now. Capitalism, and especially financial market capitalism, brought this outcome upon itself through greed and hubris. Capitalism is now re-grouping and learning how to play by new rules, which are still being written. And ultimately, I'm sure, capitalistic bankers will once again bend those rules in the pursuit of higher profitability. And that's okay, I think. In the end, we really don't want to turn our banking system into the DMV. At the same time, we also don't want our banking system to be nothing more than a betting parlor.

Or, in the famous words of Keynes again:

"Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done."



Paul A. McCulley
Managing Director

1. "In the Fullness of Time," *Global Central Bank Focus*, September 2008.
2. The General Theory of Employment, Interest and Money, Chapter 12, Pages 160–161, John Maynard Keynes.
3. "Teton Reflections," *Global Central Bank Focus*, August/September 2007.
4. The General Theory of Employment, Interest and Money, Pages 152–153, John Maynard Keynes.
5. "Comments Before the Money Marketeers Club. Minsky and Neutral: Forward and in Reverse," *Global Central Bank Focus*, December 2007.
"Credit, Markets, and the Real Economy: Is the Financial System Working? A Reverse Minsky Journey," *Global Central Bank Focus*, April 2008.
6. "The Paradox of Deleveraging," *Global Central Bank Focus*, July 2008.

Investors should consider the investment objectives, risks, charges and expenses of any mutual fund carefully before investing. This and other information is contained in the fund's prospectus, which may be obtained by contacting your financial advisor. Please read the prospectus carefully before you invest or send money.

Past performance is no guarantee of future results. This is not an offer or solicitation for the purchase or sale of any financial instrument. It is presented only to provide information on investment strategies and opportunities. The material contains the current opinions of the author, which are subject to change without notice. Statements concerning financial market trends are based on current market conditions, which will fluctuate. References to specific securities and issuers are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations to purchase or sell such securities. Forecasts are inherently limited and should not be relied upon as an indicator of future results.

©2008 Allianz Global Investors Distributors LLC, 1345 Avenue of the Americas, New York, NY 10105-4800, www.allianzinvestors.com, 1-888-877-4626.

AA860_23813

Investment Products

Not FDIC Insured | May Lose Value | Not Bank Guaranteed

Allianz 
Global Investors