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Global Central Bank Focus

PIMCO

July 2008

The Paradox of Deleveraging

Back in college, most of us took microeconomics before we took macroeconomics. In fact, at Grinnell College where I went, microeconomics was a prerequisite for macroeconomics. The reason was simple: microeconomics begins with the concepts of supply and demand, an essential starting point for the study of macroeconomics. But you only know you've mastered both when you intuitively grasp that macroeconomics is not just the summation of microeconomic outcomes, but rather the interaction of microeconomic outcomes.

For me, a simple concept brought this realization: the paradox of thrift. For those of you who might not recall, the paradox of thrift posits that if we all individually cut our spending in an attempt to increase individual savings, then our collective savings will paradoxically fall because one person's spending is another's income – the fountain from which savings flow.

This principle is part of a whole range of macroeconomic concepts under the label of the paradox of aggregation: what holds for the individual doesn't necessarily hold for the community of individuals. Understanding this paradox is absolutely vital to understanding macroeconomics and even more so to understanding what is presently unfolding in global financial markets.

Double Bubbles Bust

Once the double bubbles in housing valuation and housing debt burst a little over a year ago, everybody, and in particular, every levered financial institution – banks and shadow banks alike – decided individually that it was time to delever their balance sheets. At the individual level, that made perfect sense.

At the collective level, however, it has given us the paradox of deleveraging: when we all try to do it at the same time, we actually do less of it, because we collectively create deflation in the assets from which leverage is being removed. Put differently, not all levered lenders can shed assets and the associated debt at the same time without driving down asset prices, which has the paradoxical impact of increasing leverage by driving down lenders' net worth.

This process is sometimes called, especially by Fed officials, a negative feedback loop. And it is, though I prefer calling it the paradox of deleveraging, because the very term cries out for **both** a monetary and fiscal policy response, not just a monetary one. Lower short-term interest rates via Fed easing are, to be sure, useful in mitigating deflating asset prices, particularly if they serve to pull down long-term rates, which are the discount rates for valuing assets with long-dated cash flows.

But monetary easing is of limited value in breaking the paradox of deleveraging if levered lenders are collectively destroying their collective net worth. What is needed instead is for somebody to lever up and take on the assets being shed by those deleveraging. It really is that simple.

Time to Lever Up Uncle Sam's Balance Sheet

As Keynes taught us long ago, that somebody is the same somebody that needs to step up spending to break the paradox of thrift: the federal government, which needs to lever up its balance sheet to absorb assets being shed through private sector delevering, so as to avoid pernicious asset deflation. That's a fiscal

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policy operation and, fortunately or unfortunately, fiscal policy is not made by a few learned technocrats above the political fray of the democratic process, but is squarely in the hands of the legislative branch, consisting of 535 politicians, with far more lawyers than economists among them.

Yes, I know that Congress passed a properly Keynesian stimulus package earlier this year, the benefit of which we are feeling now, sending over $100 billion in rebates to the citizenry, borrowing the money to do so and levering up the Treasury's balance sheet with debt in an equal amount. So, yes, I may be too harsh when I challenge the economic literacy of Congress: they do understand that Uncle Sam should borrow and spend, directly or indirectly through tax rebates to citizen spenders, to truncate the paradox of thrift (even if they don't know what that is).

But levering up Uncle Sam's balance sheet, to buy assets to break asset deflation resulting from the paradox of deleveraging still seems to be a foreign, if not a sinful proposition. This need not be, and should not be. Yet we hear endlessly that any levering up of Uncle Sam's balance sheet to buy assets must be done in a way that "protects tax payers." By definition, levering Uncle Sam's balance sheet to buy or guarantee assets to temper asset deflation will put the taxpayer at risk – but will do so for their own **collective** good!

This was *de facto* what the Federal Reserve did when it put up $29 billion on nonrecourse terms to buy assets so as to facilitate the merger of Bear Stearns into JPMorgan. As I said at the time, and wrote about two months ago[1], this was a fiscal policy operation, conducted by the Fed. Logically, it should have been conducted by the Treasury using appropriated spending power from Congress. But alas, that "right" solution was not legally available to the Treasury, whereas the Fed did have the power to act: Section 13(3) of the Federal Reserve Act of 1932 gave the Fed the power to lend to essentially anybody against any collateral, so long as it declares it is necessary to do so because of "unusual and exigent circumstances."

But make no mistake, it was a fiscal policy action demonstrated by (1) the fact that the Fed sold a similar amount of Treasuries from its portfolio, increasing the supply of Treasuries in the market by the same amount, and (2) the fact that any losses the Fed experiences on that $29 billion will reduce dollar-for-dollar the amount of seigniorage profits that the Fed remits to the Treasury. At the end of the day, there are $29 billion more Treasuries on the open market than otherwise would be the case, and the Treasury is, one small step removed, on the hook for any losses the Fed experiences on the $29 billion of non-Treasury assets it now *de facto* owns.

Yes, that $29 billion is actually a loan to a Limited Liability Corporation (LLC) set up to hold the Bear assets, with JP Morgan providing a $1 billion subordinated loan (sometimes called the "first loss" tranche) to the LLC. But that is merely a technical detail – the bottom line is that we the taxpayers bought $29 billion of Bear's assets.

To their credit, legislators did figure that out – albeit after the fact. And they were none too happy about it, despite accepting the Fed's and Treasury's logic that it simply had to be done, for the greater good of the citizenry. Legislators rationally guard their constitutional powers over the federal purse.

And Now to Freddie and Fannie

Which brings us to Mr. Paulson's request to Congress to give him – and his successor – the power to spend unlimited amounts of taxpayers' funds to buy the debt or equity of Fannie Mae and Freddie Mac. I confidently predict that he's not going to get unlimited authority; it will most likely be checked by counting any such deficit-financed injections into Fannie and Freddie against the Treasury's statutory borrowing limit, which can be lifted only by Congress. But Mr. Paulson is going to get most of what he wants, if only because legislators are too fearful of the consequences if they stiff arm him.

Between now and then, the Federal Reserve stands ready to lend to Fannie and Freddie, again using Section 13(3) as its enabling authority. But unlike the case with the $29 billion spent for Bear's assets, any Fed lending to Fannie and Freddie is explicitly being billed as a "bridge" to Treasury lending or investing in the agencies. This is the way it should be: bailouts and backstops with taxpayer funds should be legislated by Congress and placed on the Treasury's, not the Fed's, balance sheet.

In fact, I envision that legislation will explicitly direct the Treasury to "buy out" any lending that the Fed does to Fannie and Freddie. Indeed, in what might be a bit of wishful thinking, I believe it would be highly appropriate for Congress to authorize the Treasury to buy out the Fed's $29 billion loan to the LLC holding Bear's assets, putting it on the Treasury's balance sheet, where it belongs.

Section 13(3) should be used only when it is absolutely necessary to avoid systemic financial turmoil. That's not to say that the Fed shouldn't be cooperative in any necessary bailouts or backstops. The fact of the matter is that the Fed is the only entity in Washington able to spend money without prior Congressional approval. Thus, when the stuff is truly hitting the systemic oscillator, the Fed has to unplug it.

But Section 13(3) should be considered sacred, used only in *extremis*, so as to ensure the Fed's operational monetary policy independence in the pursuit of sturdy growth and low inflation. It's never been a good idea to have the monetary authority and the fiscal authority housed under the same decision-making roof.

That's not to suggest that there is no room for coordination between the monetary and fiscal authorities. This is particularly the case when the economy is experiencing asset deflation, begetting debt deflation and deleveraging. Indeed, none other than Chairman Bernanke made this case when he was Governor, first in November 2002 in his famous speech titled "Deflation: Making Sure 'It' Doesn't Happen Here"[2], and then in May 2003, in a speech titled "Some Thoughts on Monetary Policy in Japan"[3].

In the first speech, the economic menace at hand was the risk of goods and services price deflation in the United States; in the second speech, the menace was the reality of goods and services price deflation in Japan. Currently, in the United States, asset price deflation is the menace at hand, not goods and services price deflation.

But make no mistake, asset price deflation can be every bit as nefarious as goods and services deflation. Indeed, asset price deflation in the context of deleveraging is, in my view, much more nefarious than modest goods and services price deflation, since asset price deflation undermines the capital base of levered financial intermediaries, begetting yet more deleveraging and further asset price deflation.

Harkening back to those two speeches from Mr. Bernanke, it is very clear that he sees the role of the central bank as different in deflationary times than inflationary times. Specifically, in the speech on Japan, he said (my emphasis):

> *The Bank of Japan became fully independent only in 1998, and it has guarded its independence carefully, as is appropriate. Economically, however, <u>it is important to recognize that the role of an independent central bank is different in inflationary and deflationary environments.</u> 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, <u>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</u>.*

Again, I'm aware that he was speaking in the context of both goods and services price deflation **and** asset price deflation in Japan, not just asset price deflation. So the parallel is not complete with current circumstances in America, which involves elevated goods and services inflation in the context of asset price deflation.

In fact, I believe the Fed faces a more daunting challenge now than the Bank of Japan did back then, in that the Fed has to balance the risks of both goods and services inflation and asset price deflation, whereas the Bank of Japan did not have to do so. Put differently, Japan faced both the paradox of thrift and the paradox of deleveraging, screaming for the Bank of Japan to subordinate itself for some time to the fiscal authority. This is not the case now in the United States, which is experiencing only the paradox of deleveraging, not the paradox of thrift, though the latter malady is certainly a fat tail risk if the former malady is not ameliorated, notably in house prices.

Bottom Line

Conventional wisdom holds that when an economy faces a paradox of private thrift, it is appropriate for the sovereign to go the other way, borrowing money to spend directly or to cut taxes, taking up the aggregate demand slack. Indeed, that is precisely what Congress did earlier this year, sending out $100+ billion of rebate checks, funded with increased issuance of Treasury debt. Good ole fashioned Keynesian stuff!

Concurrently, conventional wisdom is struggling mightily with the notion that when the financial system is suffering from a paradox of deleveraging, the sovereign should lever up to buy or backstop deflating assets. But analytically, there is no difference: both the paradox of thrift and the paradox of deleveraging can be broken only by the sovereign going the other way.

Fortunately, Congress is finally grappling with this reality, as it moves towards passage of Mr. Paulson's plan for backstopping Fannie and Freddie with taxpayer funds. It's not a fun thing to do, particularly following the use of $29 billion of taxpayer funds to facilitate the merger of Bear Stearns into JPMorgan. But it is the right thing to do. And it is further the right thing that Congress is doing it, not the Fed under Section 13(3), except as a possible bridge to Treasury authority.

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July 22, 2008
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[1] *http://www.pimco.com/LeftNav/Featured+Market+Commentary/FF/2008/Global+Central+Bank+Focus+5-08+Monetary+Policy+Conducts+Fiscal+Policy.htm*

[2] *http://www.federalreserve.gov/boarddocs/speeches/2002/20021121/default.htm*

[3] *http://www.federalreserve.gov/boarddocs/speeches/2003/20030531/default.htm*

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