Paul McCulley: The Reverse Minsky Journey and the Way Back

By Robert Huebscher
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The late economist Hyman Minsky is widely known for his observation that, over the long-term, "stability leads to instability." Less recognized is Minsky's explanation for the phenomenon – stable economic systems break down because they encourage increasingly risky debt financing.

In a talk on April 4 at the Altegris Strategic Investment Conference, Paul McCulley, a Managing Director with PIMCO, discussed the application of Minsky's research to the current financial crisis, its implications for identifying future asset "bubbles," and his prescription for restoring order to the world's financial markets.

"Bubbles can be identified by the nature of the marginal source of finance," McCulley said, as he explained the course of financing within the housing market and the shadow banking system.

Home financing followed Minsky's progression, beginning with the "hedge" unit, followed by the "speculative" unit, and ultimately ending with the "Ponzi" unit. With a hedge unit, the borrower has adequate cash flow to pay interest and principal, unlike the speculative unit, where the borrower can make interest but not principal payments. In the housing market, the transition from hedge to speculative financing coincided with the spread of interest-only loans.

Use of the speculative financing unit increases leverage throughout the system, pushing up asset prices which, in the housing market, began to rise at an accelerated pace in the late 1990s.

Investors, or in this case homeowners, eventually got bored with the speculative unit, McCulley said, and they moved on to the Ponzi unit. With a Ponzi unit, borrowers cannot fund either interest or the principal payments, and they are merely betting that the value of the collateral will not go down. In 2006, the housing market's version of the Ponzi unit became popular – the "pay option loan with no money down."

"When you have Ponzi units, you are in a bubble," McCulley said. He added that there is no mystery to identifying bubbles – you merely need to understand the structures used to finance asset purchases.

McCulley said these pay option loans were really just “at the money call and put options.” If home values went up, homeowners would exercise their call option and refinance or, if they went down – as was the case – they mailed in the keys, defaulting on their mortgage and exercising their put option.

Each Minsky journey has a Minsky moment – the point at which excess leverage cannot be sustained and the system unravels. For the housing markets, the Minsky moment came in August of 2007, when BNP Paribas “raised the gate” on two of its structured investment vehicles (SIVs), informing investors it had insufficient liquidity to meet its cash flow requirements.

An avalanche of de-leveraging commenced, otherwise known as the reverse Minsky journey, and it proceeded at a far more rapid pace than had the forward Minsky journey.

Investors quickly discovered what McCulley calls the “paradox of de-leveraging” – what holds for the individual cannot hold for the market. Market participants cannot simultaneously sell assets to pay off debt without depressing asset values to such an extent that they end up more levered than when they began. The government must step in and either provide additional equity or act as the “bid side” when investors attempt to sell assets. These actions were, at various times, part of the TARP program.

McCulley faults the Fed for initially failing to grasp the underlying nature of the problem, instead believing the markets were suffering from a lack of liquidity. By orchestrating the takeover of Bear Stearns by J.P. Morgan, the Fed provided what McCulley characterized as a “fiscal solution,” which gave the markets a false sense of serenity.

Not until the Lehman bankruptcy and the enactment of the TARP program did the government respond appropriately to the problem, McCulley said.

“Since last September, I am a whole lot more optimistic,” McCulley said. “There are no more pretenses about a liquidity program, and the government now understands this is a solvency problem.”

McCulley characterizes the PPIP as a public sector private equity fund, and is confident this is the right “architecture” to break the paradox of de-leveraging. He expects the government to use “overwhelming force” – to quote Colin Powell – to restore order in the financial system. Overwhelming force ensures that the “fat tail” (a highly unlikely event with severe adverse consequences – in this case a Depression) will not happen.

“We are putting the taxpayer at risk,” he said. “Without that there is no solution. But this is not the same as losing taxpayer money.”

With the PPIP, the Fed is “subordinating itself” to the fiscal authority in order to repair the banking system, McCulley said. By using non-recourse loans with 6-12x leverage, McCulley is confident that the private sector will bid up the prices of toxic assets to their underlying value.

"The fat tail risk will shift from Depression to inflation," McCulley said. He is not concerned about possible dollar devaluation, since no other countries "have the appetite" to allow their currencies to appreciate against the dollar.

McCulley's recommended strategy is "global competitive quantitative easing (QE)," where countries follow the path set by the US and increase money supplies. Such a policy does not require careful coordination, he emphasized, since any country not choosing to participate will face deflation in its domestic economy.

"Global competitive QE has the promise of increasing the pie," he said, referring to the potential for the policy to allow world economies to grow simultaneously.

Global inflation is precisely the objective of this policy, which McCulley said is not necessarily a problem. "All fiat currencies will be devalued against stuff," he said. By "stuff," he meant gold.

"Inflation is part of the solution, not the problem," he said, noting that the current break-even rate between 10-year TIPS and Treasury bonds is 1.3%. Clearly, that rate needs to be higher, McCulley said, recommending a trade out of Treasury bonds and into TIPS.

"We may have too much of the solution," McCulley said, and of advocated strategies that will perform well with an inflationary bias. "Look for markets that presume low inflation and get out of assets that win in deflation."

I asked McCulley which asset classes – other than TIPS – he recommends. He likes bank loans, despite their fixed rates, and investment grade corporate bonds, where he expects contracting spreads to be offset by increased real yields.

But what I really wanted to know was whether he likes equities. He expects them to do well in a moderately inflationary environment, he said, but he was less confident that equities would perform well a highly inflationary environment like that of the 1970s.

McCulley closed his talk with a succinct summary of his recommendations: "The objective of our policies is to turn deflationary swamp water into inflationary wine."