



## Managing It Forward

We've all experienced the phenomenon of ending up at some place we really didn't want to be, but must be because of prior promises that seemed rational at the time. It could be a routine dental appointment made long ago that turns out to be on an outrageously busy day at the office. It could be getting to bed at 2, when the plan at 10 was to simply go for a nightcap. Or it could be buying a hot air balloon trip weekend for two at a charity auction, when all you planned to do was cut a generous check.

Life doesn't always go according to plan, despite the best-laid plans of mice and men, Robert Burns sagely wrote. Things change. New information becomes available. Old information becomes outdated. Short-term imperatives sometimes require action in contradiction to long-term exigencies. Stuff happens. And when it hits the oscillator, you sometimes have to unplug it, even though you'd really rather continue enjoying the fan's cooling breeze.

### Saving Capitalism From Its Deflationary Self

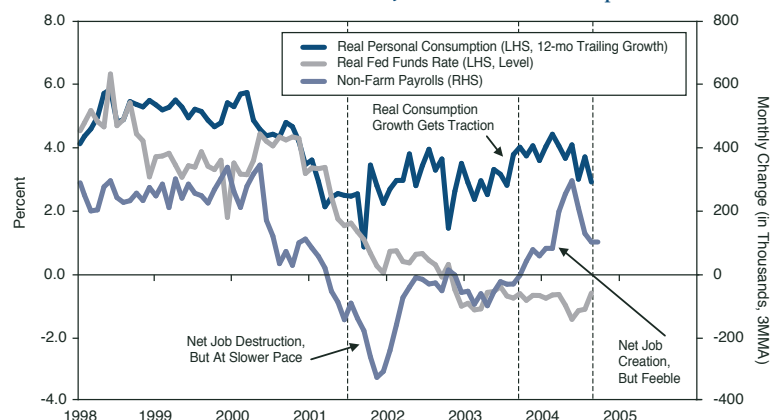
Such was the case with the Fed policy in 2002 and 2003. Despite aggressive and massive easing in 2001 – from 6½% to 1¾% for Fed funds –

monetary stimulus was simply not getting sufficient “traction,” notably in fostering job creation and tempering disinflation expectations. The record of history said that such massive easing should be “working.” And, indeed, it was in stimulating aggregate demand, notably in the household sector. But there was a large slip between the aggregate demand cup and the job-creating lip.

Corporate America just wasn't in the mood to meet indications of rising demand with more job supply, choosing instead to meet rising demand by goosing the productivity of the existing work force. Boosting profits by exploiting operating leverage is, of course, a time-honored tradition of capitalists. But this time 'round, would-be employers had an overriding reason to exploit operating leverage: a concurrent need to reduce financial leverage.

This was particularly the case in 2002, in the wake of revelations that there were crooks – yes, crooks! – among the capitalist class, who had been blowing heinous smoke up the back-sides of both stock and bond holders alike. Stock holders took their losses abjectly. But corporate bond holders didn't, blowing out corporate bond

Traction Ain't Traction 'til Job Creation Gets A Grip



Source: Bureau of Economic Analysis, Bureau of Labor Statistics and Federal Reserve

spreads and *de facto* refusing to finance or re-finance any but highest grade issuers. Simply put, corporate bond investors demanded that Corporate America check into the Betty Ford Center for Balance Sheet Rehabilitation, most urgently those on the rating cusp between investment grade and junk.

This “seizing up” (to borrow a favorite Greenspan phrase) of the corporate bond market threatened to morph into a debt-deflation spiral (which I dubbed a Minsky Meltdown, way back in January 2001<sup>1</sup>). Such a spiral is the nefarious nexus between microeconomics and macroeconomics: the rational micro decisions of firms to de-lever their balance sheets and/or term out their debt cumulate to the irrational macro result of asset price deflation, which systematically undermines all balance sheets. Simply put, not everybody can de-lever at the same time, because for every asset seller there must be an asset buyer.

But that doesn't stop everybody from trying when infected with irrational gloom. And so it was in the summer and fall of 2002, with capitalism itself being called into question as a going concern. In such self-feeding, deflationary circumstances, it is the unambiguous duty of the central bank to:

- Publicly commit to use the printing press for (high-powered) money to reflate; and then, putting action to words,
- Continue to print money until asset prices go up and stay up.

The Fed recognized this duty and courageously rose to the challenge in November 2002, with Chairman Greenspan and Governor Bernanke declaring that the Fed recognized the deflationary beast and, if necessary, would use all available weapons in its arsenal to kill it.

And the FOMC backed up those fighting words with action, on November 6, 2002 slashing the Fed funds 50 basis points from 1¾% to 1¼%, declaring loudly that the surprisingly large (to consensus, not PIMCO<sup>2</sup>) easing was in context of self-feeding risk aversion:

*“In financial markets, risk spreads on both investment-grade and non-investment-grade securities have widened.”*

It was a magical day, one I will never forget: the Fed dropping its anti-inflation sword and joining the reflationary cavalry. It was also, of course, a most propitious time to buy corporate bonds, which were being priced as if American capitalism would be consumed by its deflationary pathologies. Not on our watch, the FOMC declared!

*“Ya gotta believe”* in the power of our printing press, FOMC members soothingly intoned, reminiscent of Tug McGraw's mantra for the 1973 Mets. If we all believe that the Fed won't let deflation happen, then we will all act in fashion so that it won't happen!

The FOMC's November 2002 declaration of war – in word and deed – against deflation risk clearly fits under Chairman Greenspan's mantra that Fed policy is really a risk management game, in which policy must occasionally be directed at truncating remote risks, if the realization of such risks would be extraordinarily pernicious. Such was the case with the risk of deflation in the fall of 2002, as Fed Chairman Greenspan openly discussed: a low probability event but one with sufficiently negative consequences that the FOMC wanted to take out an “insurance policy” against it.

As events unfolded, the FOMC decided in the spring of 2003 to take out a second insurance policy against deflation risk, cutting the Fed funds rate from 1¼% to 1%, while declaring that it stood ready to take the Fed Funds rate all the way to 0%, if necessary, to defeat deflationary pressures. It was another magical day, though ironically an unpleasant one for markets, in that they had too exuberantly believed that the FOMC didn't just stand ready to use unconventional anti-deflation tools, but that the Fed would actually use them – notably, directly pegging lower long term interest rates.

Many Fed officials argue that we the markets got wrong-footed because we weren't listening properly to the Fed. I personally don't buy that. At a minimum, the culpability for the miscommunication between the Fed and the market

lies with both parties. And my personal view is that Chairman Greenspan carries much of the blame, since he could have stuck a rhetorical stick into the markets' putatively-clogged ears at any time, and chose not to do so.

### Conditionally Yours

Ironically, however, the communications snafu of the spring of 2003 ushered in a delightful new policy and communications tool: **the conditional pre-commitment strategy**. On August 12, 2003, the FOMC famously promised to stay accommodative for a "considerable period." On January 28, 2004, the FOMC changed this pre-commitment to a promise to be "patient" in removing accommodation. On May 4, 2004, the FOMC changed the pre-commitment yet again to a promise to remove accommodation only in a "measured" way.

Since then, the FOMC has hiked the Fed funds rate in three measured 25 basis point steps, to 1¾%. These steps have been rapid fire, at consecutive FOMC meetings, I believe, because the FOMC's primary mission this year has been to appropriately celebrate its victory against deflation risk: the easing actions of 2002 and 2003, followed by a year of steady 1% Fed funds rate worked! Deflation is no longer a credible risk-case scenario (at least on a cyclical horizon).

Thus, the FOMC has wanted to quickly unwind the easing actions that would not have been taken in the absence of deflation risks. The FOMC did not end up at 1% Fed funds because it planned to go there, but because unplanned events – in the context of a risk management paradigm – took the Fed there.

There are critics who argue, of course, that the Fed really shouldn't have let events take them where they really didn't want to go. Deflation never really was a significant risk, they argue, as evidenced by the fact that the putative risk has passed. I ain't a buyer of this criticism.

In the matter of truncating deflation risks, the barometer of the need for action must be the corporate bond market. Systemic deflationary viruses definitionally start with the inability of levered businesses to collectively convince their lenders that they are going concerns, worthy

of continual refinancing of debt as it matures. Such a virus was unambiguously on the loose in the summer and fall of 2002. The Fed reacted appropriately.

Indeed, if anything, the Fed, in my judgment, should have fired its anti-deflation weaponry sooner than it did, with more gunpowder. In the matter of fighting deflation risks, the Mae West Doctrine applies: if a little is good, more is better and way too much is just about right. The Fed's 75 basis point cumulative easing in 2002 and 2003 was somewhere between better and just about right.

And so, too, has been the FOMC's rapid-fire unwinding of those 75 basis points of easing in recent months. In a risk management paradigm, policy actions taken to truncate "fat tail" risks should be **quickly** unwound when the offending tail is no longer fat. Such has been the case so far in the FOMC's ongoing tightening journey to neutral.

### Stage Two Will Depend on Job Creation

In the context the FOMC's new conditional pre-commitment strategy, the time has come for the FOMC to declare the obvious: the anti-deflation easing moves of 2002 and 2003 have now been unwound and, accordingly, **the markets should no longer presume that the FOMC has the Fed funds rate in a place that it does not want it to be.**

An excellent time for the FOMC to make this declaration would be after the November 10<sup>th</sup> FOMC meeting, after hiking the Fed funds rate to 2% (kinda like the "one more for good measure" paradigm employed for corporal punishment in my youth). And, believe it or not, I actually expect the FOMC to do this. I'm not just whistlin' Dixie, but forecasting!

While the FOMC clearly didn't like being at 1% Fed funds without a compelling risk management reason for being there, 2% Fed funds is not necessarily in the wrong neighborhood, given that

- Inflation is both well contained and within the Fed's implied 1%-2% implicit target zone for the core PCE deflator, and

- Unemployment is well above that consistent with full employment (NAIRU), presumably 5% or below in the sacred corridors of the Fed.

The Fed funds rate should **not** presently be at neutral, but **below** neutral, whatever your estimate of neutral (unless it's 2%, in which case you should fire off a note to Mr. Greenspan telling him how it would be a mistake to swing his tightening paddle one more measured time on November 10!) Theoretically, the Fed should arrive at neutral for Fed funds just as the unemployment rate is hitting the NAIRU.

Between here and there, policymakers should seek to make the unemployment rate fall. And for that to happen, the economy must grow not just at potential, but faster than potential! But what is GDP potential? It depends on your assumptions about productivity growth, labor force growth and the labor force participation rate. The Fed reckons that potential GDP growth is about 3½%, and I have no serious quarrel with that. Thus, the Fed should be pegging the Fed funds rate at a level specifically aimed at stoking **faster** than 3½% GDP growth.

Accordingly, with the Fed's anti-deflation easing of 2002 and 2003 fully removed, as it will be and then some on November 10, the FOMC has a duty – under its conditional precommitment strategy – to communicate that it will continue its journey toward neutral **if, and only if**, unemployment is falling rapidly toward NAIRU. And where is NAIRU?

Like Greenspan with respect to the neutral Fed funds rate, I don't know where NAIRU is, but I know where it isn't. And 5½% unemployment, as currently the case, is not consistent with full employment! If it were, corporate profits as a share of GDP would not be at a multi-decade high. Likewise, the labor force participation rate would not be falling, as it is, but rather rising. And finally, President George Bush would not be the first president since President Hoover to have served a term with net job destruction, worried about his own job.

### Bottom Line

The Fed never planned to visit 1% Fed funds. The Fed also never planned to confront the risk of deflation in 2002 and 2003. But it did, and 1%

Fed funds was the right response. With the risk of deflation now relieved, the FOMC is appropriately unwinding the extraordinary easing – emergency, or insurance easing, if you will – that it took to address that risk.

The fact that deflation risks were never realized in no way suggests that the Fed should not have taken the extraordinary easing steps, as some critics argue. To the contrary, unfolding reflation is testimony to the success of those actions. In the end, the proof of rolls made with yeast is in the rising thereof.

But now, with anti-deflation easing moves unwound – and then some, after a further 25 basis point hike to 2% for the Fed funds rate on November 10 – it is time for the FOMC to stress that it is no longer driven by risk management exigencies, but base case economic fundamentals. More specifically, it is time for the FOMC to declare that further tightening beyond 2% Fed funds, while still likely to be at a measured pace, will unfold **if, and only if**, job creation is sufficiently strong to consistently reduce unemployment (for the right reason of job creation, rather than the wrong reason of a falling labor force participation rate). I expect the FOMC to make just such an announcement on November 10.

Such an announcement (I'm happy to volunteer my wordsmithing services, if the FOMC would like!) would be consistent with the FOMC's "new" tool of a conditional precommitment strategy, in play since August 2003. As demonstrated by falling volatility in financial markets ever since, a forward-communicating, not just forward-thinking, FOMC makes for the best transmission of monetary policy impulses from the Fed to Wall Street to Main Street.

The FOMC's job is not just paying the Fed funds rate spot, but managing it forward.

Paul McCulley  
Managing Director  
mcculley@pimco.com

<sup>1</sup> *Capitalism's Beast of Burden*, Fed Focus, January 2001

<sup>2</sup> *The Morgan le Fay Plan*, Fed Focus, November 2002.