

## Spotlight

October 2009

### Scott Mather and Bruno Lettich Discuss the Potential Sequencing of Fiscal and Monetary Stimulus Removal Around the Globe



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*In the wake of the massive fiscal and monetary policy response during the global financial crisis, a growing number of investors are asking how, when the time comes, both fiscal and monetary stimulus will be removed. In the following interview, Scott Mather, head of global portfolio management, and Bruno Lettich, global portfolio manager, discuss PIMCO's views on the timing and sequence of stimulus removal around the world, along with the investment implications and the risks to the forecast.*

**Q: Let's start by looking at the financial and economic picture around the globe prior to the crisis – the initial conditions. While the worst of the crisis seems squarely in the past, there's still a lot of fiscal and monetary stimulus in place around the world. How do we now start to sift through and analyze economies to determine how policymakers will proceed with its potential removal?**

**Mather:** The global crisis revealed a lot about the interconnectedness of the world's economies and financial markets. Despite having dramatically different initial conditions, almost all economies suffered a massive setback in the fourth quarter of 2008. The financial pain was transmitted through capital markets and trade flows to countries with vastly different economic structures and vulnerabilities. However, while the plunge into recession and the policy reaction were coincident and highly coordinated, it seems likely that the exit from recession and financial crisis will be much more differentiated across countries.

The differentiation is justified by variances in initial conditions, by specific vulnerabilities accumulated from years of unbalanced growth, the extent of dependence on the financial sector and the different way the economies have responded to stimulus. Each country entered the crisis with a unique set of conditions related to private and government sector indebtedness, exposures to the financial sector, housing bubbles and overdependence on either consumption or exports as the primary growth driver. Policymakers responded forcefully with massive monetary stimulus, cutting interest rates aggressively, incorporating credit easing to facilitate interbank liquidity and quantitative easing. This was coupled with dramatic fiscal easing around the globe, and although the overall sizes of packages enacted have been similar in many countries, the composition of the stimulus and multipliers on economic activity have been varied.

The next few years are likely to be much more about differences than similarities between recoveries in various countries and regions, and fiscal and monetary stimulus is likely to unwind in a much more differentiated way than it was applied. Moreover, given the range and scope of post-crisis uncertainties, there is a real potential for policy slippages: Some

**Spotlight**

October 2009

countries may be proved to have done too little while others may stay overly accommodative for too long.

**Lettich:** Adding to what Scott said, another important issue about initial conditions is the differentiation across varying regions with respect to what was economically feasible in terms of application of fiscal policy. Certainly the effects of policy support differed according to each economy's dependence on the financial sector, because that was the sector that was hardest hit. In some countries, like the U.S. and U.K., a large part of the stimulus was aimed at reinvigorating a very sick financial system, which is a far more challenging task than what other economies faced when their efforts were primarily aimed at stabilizing the real economy.

In this sense, it is also interesting to note that the effect of fiscal stimulus on an economy depended largely on how it was deployed. In countries like Australia and China, which have had a larger share of stimulus in the form of government investment in infrastructure, the fiscal impulse and resulting economic growth should last more than just a couple of quarters. But in the U.K. and U.S., where the fiscal impulse has come mostly from tax rebates or government-induced consumer incentives, the impulse seems to be very short-term and indeed has the potential to become a drag on economic growth should the rate of change for spending and tax cuts start turning negative, which seems likely in late 2010 to 2011.

**Q: Can we look at some more examples of the distinctions you're describing?**

**Mather:** We can start by looking at Europe. Aggregating across the common currency zone can sometimes be helpful but it can also mask important regional differences.

Ireland, for example, has high private sector debt levels, an overly large financial sector and an overinflated housing market, giving it much more in common with the U.S. and U.K. than it has with many of its euro zone neighbors. And, despite large doses of monetary and fiscal stimulus, it is emerging from the crisis in a relatively fragile state with high unemployment, high debt and low growth prospects compared with many European neighbors.

The same can be said of the U.S. and U.K., based on a global comparative basis. It is little wonder that the policy responses have been very similar among these three countries. In addition, the initial vulnerabilities combined with the policy responses have interacted to test the limits of policy-induced growth going forward. All three now face record fiscal deficits accumulating in the double digits annually.

The U.S. and U.K. are likely to be slow in withdrawing monetary stimulus since additional fiscal stimulus – although it may be warranted – looks increasingly difficult from a political perspective. Ireland faces the extra challenges as a member of Europe's Economic and Monetary Union (EMU) and has lost important tools of adjustment (currency devaluation and independent monetary policy). On the opposite end of the spectrum, consider Germany, which suffered severely in the downturn but for very different reasons. Given its reliance on exports, the downturn in global trade was the primary transmission mechanism to lower German growth. Germany does not suffer from the same levels of indebtedness or housing deflation that is plaguing the other three countries, hence it is little surprise then that Germany plans to withdraw fiscal stimulus earlier than much of the rest of the developed

## Spotlight

October 2009

world. In addition, it seems likely that Germany will be successful in pushing the European Central Bank (ECB) to withdraw monetary stimulus earlier than the U.K. or the U.S.

**Lettich:** We can also look at a different set of circumstances in Australia, which basically escaped the global downturn without a recession and on October 6 became the first G-20 central bank to raise interest rates. Within this unique set of circumstances for Australia, there was a household sector similar to the U.S. because Australians were reliant on housing as an investment and housing represented a formidable debt burden. But there were also big differences, particularly the strong and immediate response with rate cuts, one-off tax rebates, housing buyer allowances and infrastructure spending, which have had a much more positive knock-on effect for economic growth. In addition, Australia's financial system entered the period with much sounder balance sheets, so the monetary stimulus filtered into the economy much more quickly. Consumer and business sentiment never plumbed the same depths and has recovered nicely. The Australian labor market also outperformed the rest of the developed world and suffered comparatively few job losses.

Additionally, Australia has the commodity linkage that allowed it to continue exporting commodities to Asian emerging markets. So although Australia had a few of the same vulnerabilities as other harder-hit countries, it was able to perform much better throughout the downturn. Some of it was luck – in the form of having one of the biggest stimulators in the world, China, as a key trading partner – and some of it was good policy.

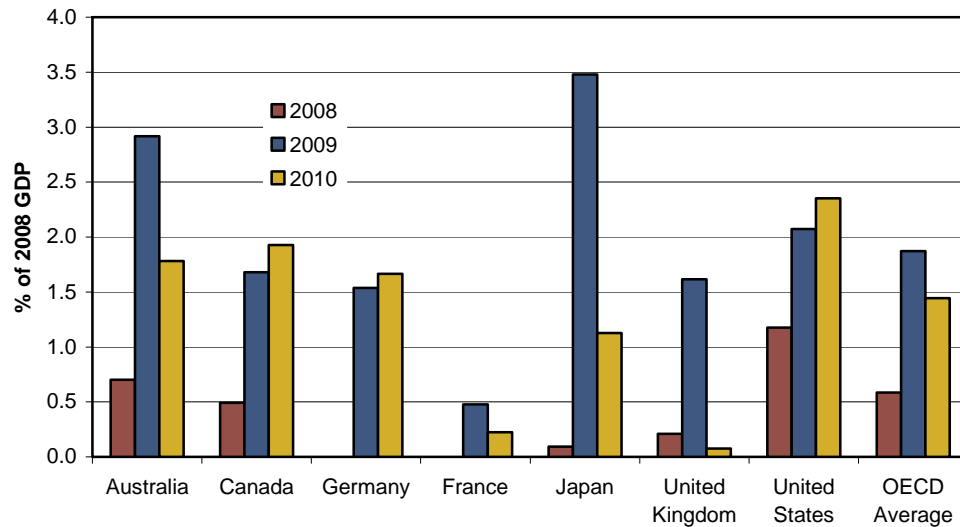
**Q: In nearly all global economies, the stimulus has had a pretty dramatic effect, stemming the crisis and setting the stage for a rebound in risk asset prices. Why is it important to start thinking about when the stimulus is going to be removed?**

**Mather:** When and how stimulus will be removed is an extremely important question for investors as it will be an important determinant of asset market returns. When the worst of the crisis was gripping the global financial system, most countries responded similarly with some form of dramatic monetary policy easing and a variety of forms of fiscal stimulus. But on the other side of the crisis – in the removal phase – policy responses will be much more varied. Through this exit process, there will be key opportunities for investors but also a new element of risk as the withdrawal process will need to be more delicate than the application process.

Certainly, policymakers are beginning to think critically about the process of withdrawal, and in the case of Australia, we've already seen action from a monetary perspective. In many other places – even the U.S., where PIMCO expects rates to stay low for some time – we've seen increasing confidence among policymakers in talking publicly about the process of withdrawal of both fiscal and monetary stimulus. And in the U.S., a stealth withdrawal of monetary easing is already occurring with a wind-down of special liquidity programs and the diminishing use of quantitative easing.

But this is not just about interest rates and bold conspicuous actions; there will be stimulus withdrawal that will come stealthily as spending programs expire or run their course. For much of the world, the fiscal impulse should begin to fade and actually subtract from economic growth on a year-over-year basis toward the end of 2010 due to the fact that most discretionary fiscal stimulus in the developed world is heavily concentrated within 2009 (see below chart). This raises the potential for a bumpy handoff from policy-induced growth to private demand-induced growth.

## Discretionary Fiscal Stimulus



Source: Organisation for Economic Co-operation and Development (OECD), March 2009 Estimate

**Q: When we look at the global economy in aggregate, does the world seem ready to grow without economic life support?**

**Lettich:** For some areas, yes. Gradual removal will likely be the key, since normal levels of private sector demand from normal sources seems unlikely to be revived.

When you look at what is happening globally in the real economy, compared with past recessions, it becomes apparent that what is different today is that monetary stimulus has had minimal effect in increasing the consumer's demand to borrow. Banks, also, have generally been cautious in their lending practices, but in essence excess leverage has restricted a re-levering of the household and corporate sector's balance sheet. So this rally in risk asset prices, as much as it can be attributable to a rebound in the inventory cycle, has also been actively supported by policy action, both monetary and fiscal, which helped stabilize the global economy and financial markets. Policy induced liquidity, plus a dramatic lowering of cash rates, provided the impetus for risk markets to correct the gross negativity we saw back between September and December 2008.

**Q: Do these challenges tie into what PIMCO has termed the "New Normal?"**

**Mather:** This definitely ties into the New Normal, where growth in the developed world will likely remain lower for a longer period ahead. In the "old normal," the typical path out of a recession involved robust credit growth to induce heavy doses of consumer and investor demand. But in the New Normal, consumers are already uncomfortably indebted, overhoused and looking to raise savings rates and deleverage. Critical financial institutions are also trying to cut leverage, increase capital, and reduce the riskier portions of their lending books. It

## Spotlight

October 2009

seems unlikely that we will get the normal cyclical response in the cycle for these reasons. In the New Normal, the handoff from policy-induced growth to the private sector happens at a lower level of economic activity.

An additional, partly related, element of the New Normal is that we believe there is vast potential here for policymakers to make mistakes. They, and markets, may misjudge the speed and pace of the recovery as they see a couple of quarters of attractive GDP growth around the world, and begin to respond in textbook fashion – instead of anticipating the New Normal environment – by removing stimulus at just the wrong time as economic activity starts to slow down into the new year.

### **Q: Which central banks are likely to move earliest? Would these moves raise those risks of being “too early?”**

**Mather:** Before we discuss rate hikes, it is important to note that there will be significant amounts of stimulus removed (something we have called stealth tightening) without any policy announcement, rate hikes or active decision, due to the fact that there are so many special liquidity programs expiring or winding down in the next quarter or two. Some of this will be readily observable in the shrinkage of central banks’ balance sheets, and is something we are starting to see already.

**Lettich:** Rate hikes, however, will be more widely publicized. Looking at the G-20, we basically break down the individual economies into three categories. The economies where growth has already started to pick up and the central banks have started to hike or are hinting at rate hikes fall in the first camp. We’ve already seen Australia raise rates in early October by 25 basis points, and the Reserve Bank of Australia is expected to continue on this hiking path to achieve a more “neutral” policy rate from current levels of 3.25%. Also, the Norwegian central bank, the Norges Bank, has begun making rumblings on rate hikes and we believe they too will move rates higher when they meet at the end of the month. On this front, one thing to note especially when looking at Australia is that due to their relatively strong fiscal position, and longer-term government investment spending, monetary policy is really the only avenue to remove stimulus initially. In this regard, it is not a surprise to see Australia move first.

The second group is on the opposite side of the spectrum and comprises the countries that we see really being forced to be on hold for an extended period of time due to general fiscal pressures; this includes the U.S., the U.K. and Japan. It’s interesting to note that the U.S., the U.K. and Japan are the three economies that are currently engaged in some form of quantitative easing. In this sense, they’ve got an extra burden to overcome because there are many ways for them to begin tightening monetary policy before they actually get to moving overnight rates higher.

The third group sits somewhere in the middle and consists primarily of the Eurozone and Canada, which we feel have the potential to move sometime during 2010 if economic conditions continue to stabilize. Europe has publicly supported a continued period of stimulus, though due to the ECB’s “credit easing” in place via Long-Term Refinancing Options (LTRO), removal of liquidity may come via a change in refinancing operations (by adding a spread to the Refinancing Rate on December’s one-year LTRO) or by changing the ECB’s repo allotment process from January 2010. Canada, on the other hand, may continue

## Spotlight

October 2009

to find removing monetary stimulus difficult with the recent strong appreciation of the Canadian dollar and due to their position of trade with the U.S. being weaker than in previous recoveries.

The risk is that some of these central banks will move earlier because of a false sense of security that there can be a shift to sustainable private demand-driven growth or that their fragile financial systems can grow on their own. This will clearly have implications for future growth and for the investment climate.

### **Q: If the global economy and financial system remain fragile, what will be the rationale for raising rates?**

**Letlich:** It will differ by central bank, but the one key theme is that central banks will likely see their actions over the past year as special circumstances – crisis aversion – and they ideally would want to return to what is considered normal policy as soon as they can.

If we look at the ECB, for example, and think of their inflation focus and concerns about distortions and asset bubbles created from abnormally low rates, it's easy to see that they would want to put their extraordinary measures behind them.

It's fair to say that rates at or near zero are certainly much lower than the potential growth rate of any given economy. It's an unnatural state for a central bank, and it can raise worries about creating imbalances in an economy. In the U.S., for example, there are a lot of people who feel that the seeds of the crisis were sown in the period of abnormally low rates earlier in the decade. Nobody wants to repeat that in their own country, and it's just in the DNA of central bankers that to have rates near zero for too long is dangerous. Even if core inflation has not quite picked up yet, it may not prevent some countries from beginning to move to a more normal rate.

That's not to say that they'll ultimately be moving overnight rates to where they were before the crisis. Part of our theory of the New Normal is that global growth will be muted in the developed world over the medium term. With slower growth, a "normal level" of policy rate will probably be lower too, but in the immediate future there is a desire to normalize rates from emergency levels.

### **Q: What are the implications for investors and how should they position for these moves?**

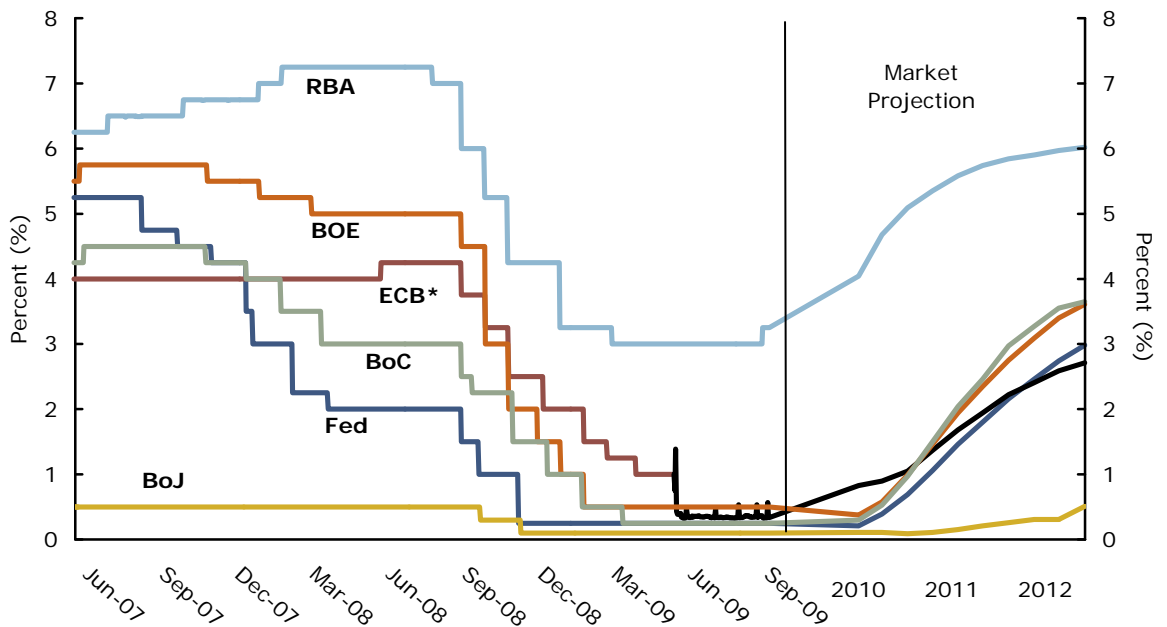
**Mather:** Markets will begin to behave very differently once it is clear that central banks will begin to raise rates, so it's extremely important for investors to position ahead of time. Indeed, forward curves are already reacting. But it's not just about positioning for central bank moves; it's also about looking at the path of what the market is priced for and comparing that to the path of pricing that we expect. This has everything to do with our understanding of the central banks' reaction functions and knowing what will drive them to move, as well as other vulnerabilities and linkages with the rest of the world.

In general, we have to recognize that the rates markets are now pricing a hike in almost all economies, outside of Japan, into 2010 and beyond (see chart below). Although we respect that there is an element of term premium built into all curves, we think that it still makes sense

**Spotlight**  
October 2009

to own duration at the front end of certain curves that are very steep and have very good roll-down parameters where we think policy will not reverse as quickly as the market expects.

**Global Central Bank Rates**



Source: Bloomberg.

\*ECB rate from June 09 is the EONIA rate due to EONIA trading substantially lower than current Refinancing Rate. RBA: Reserve Bank of Australia; BOE: Bank of England; ECB: European Central bank; BoC: Bank of Canada; Fed: United States Federal Reserve, and; BoJ: Bank of Japan.

**Lettich:** Let's take the U.S and Europe as examples. We feel that the U.S. is going to be less willing and able to hike rates than Europe, where there is more potential for earlier rate hikes, at least in terms of removing liquidity out of the banking system via the ECB's Open Market Operations, and seeing a commensurate rise in the rate of EONIA (Euro OverNight Index Average). Comparing what is priced into the markets, there are presently more rate hikes priced into the U.S. than Europe, so we feel more comfortable going longer on duration in the front end of the U.S. curve than we do in Europe. A similar analogy can be made with respect to the front end of the U.K. in comparison to Europe.

Currencies should also be evaluated with respect to the relative changes in yield curves. The yield differential between two countries plays an important part in determining potential movements between currency pairs. We have already seen the currencies from central banks closer to hiking move significantly versus the U.S. dollar, the pound and the yen, and there could be much more to come.

## Spotlight

October 2009

### Q: What are the risks to your outlook? Would a double-dip recession change the view?

**Mather:** The withdrawal of monetary and fiscal stimulus will be riskier than usual given the scale of application during this downturn. The world economy is still suffering from years of accumulated imbalances and will remain in a fragile state. So there is definitely a large body of risks associated with the period ahead. The risk of a double-dip recession is especially concerning since it would be difficult to apply yet more fiscal or monetary stimulus for many countries. The political environment in much of the developed world has certainly shifted in that it would be much more difficult to apply stimulus in another downturn, even if serious economic analysis indicated the need. Indeed, we anticipate that policymakers will be inclined to attempt a premature withdrawal of stimulus, and that presents a serious risk to the downside in our economic outlook. Should the larger developed economies take a turn for the worse in 2010, we think that will at least stop the withdrawal of monetary stimulus, but fiscal withdrawal seems a near certainty and this will slow the global recovery.

### Thank you, Scott and Bruno.

#### About the authors:

**Scott Mather:** Mr. Mather is a managing director in the Newport Beach office and head of global portfolio management. Previously, he led portfolio management in Europe, managed euro and pan-European portfolios and worked closely with many Allianz-related companies. He also served as a managing director of Allianz Global Investors KAG. Prior to these roles, Mr. Mather co-headed PIMCO's mortgage and asset-backed securities team. Prior to joining PIMCO in 1998, he was a fixed-income trader specializing in mortgage-backed securities at Goldman Sachs in New York. He has 15 years of investment experience and holds a master's degree in engineering, as well as undergraduate degrees, from the University of Pennsylvania.

**Bruno Lettich:** Mr. Lettich is an executive vice president in the Newport Beach office and a portfolio manager in the global portfolio management group. Prior to joining PIMCO in 2008, he was with Merrill Lynch for more than 13 years, most recently as a managing director in Tokyo and head of Japan liquid rates and currencies, trading and sales. Mr. Lettich previously held various positions at the firm in derivatives trading in Tokyo, London and Sydney. He has 16 years of investment experience and holds a bachelor of economics degree from Macquarie University in Sydney, as well as a postgraduate qualification in finance and investment from the Institute of Actuaries of Australia.

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