

Viewpoints

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Short-term Stability at the Cost of Longer-term Instability? The Federal Reserve's Very Delicate Balancing Act

By Mohamed El-Erian
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The message from the FOMC is clear: let's not rock the boat in the anticipation (or hope) that the U.S. economy can transition to more robust low-inflationary growth. To this end, the announcement at the end of the two-day FOMC meeting reiterates that policy interest rates will stay "exceptionally low" for "an extended period;" it welcomes the continued pickup in economic activity; and it enhances future policy optionality by listing a mix of variables that would be considered to assess whether inflationary pressures remain contained.

The FOMC is trying to strike a very, very delicate balance; a major question is whether markets and, more importantly, the real economy will be appropriately accommodating.

Markets welcomed the FOMC statement by initially doing more of what they have done in recent months: piling even more into the momentum trade for risk assets, and further increasing the dollar-funded carry trade that Nouriel Roubini wrote about in the FT on Monday. As a result, U.S. equity markets rose initially before succumbing to some profit taking; the dollar weakened substantially; gold surged; and the yield curve steepened.

It is totally rational for risk markets to rally in the very short term when the FOMC flashes a green light for the dollar-funded carry trade. The challenge is that, in the process, they accentuate what is already a wide gap between valuations and the outlook for economic fundamentals in 2010.

The risk for the U.S. is that, absent a sustainable and robust resumption of growth (driven by genuine private sector activity rather than stimulus and inventory cycles), the underlying economic and financial conditions are getting more unstable and not less – in other words, the Fed runs the risk of inadvertently pursuing short-term stability at the cost of longer-term instability.

Look for all this to re-ignite the difficult policy discussions on whether the Fed should lean against the wind in the context of market overshoots; to fuel concerns about the standing of the dollar as the global reserve currency; and to impart greater market volatility down the road.

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CEO of Harvard Management Company, the entity that manages Harvard's endowment and related accounts. Dr. El-Erian also served as a member of the faculty of Harvard Business School. He first joined PIMCO in 1999 and was a senior member of PIMCO's portfolio management and investment strategy group. Before coming to PIMCO, Dr. El-Erian was a managing director at Salomon Smith Barney/Citigroup in London and before that, he spent 15 years at the International Monetary Fund in Washington, D.C. Dr. El-Erian has published widely on international economic and finance topics. His book, *When Markets Collide*, was a New York Times and Wall Street Journal bestseller, won the Financial Times/Goldman Sachs 2008 Business Book of the Year and was named a book of the year by The Economist. Dr. El-Erian has served on several boards and committees, including the U.S. Treasury Borrowing Advisory Committee, the International Center for Research on Women, and the IMF's Committee of Eminent Persons. He is currently a board member of the NBER and the Peterson Institute for International Economics. He holds a master's degree and doctorate in economics from Oxford University and received his undergraduate degree from Cambridge University.

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