



My Best Shot

I rarely watch movies on airplanes. If I'm not sleeping, which I can do rather easily, I usually listen to country music and read. On a long flight home from Europe last week, however, I did watch a movie: Bull Durham.

I had seen the film long ago, and given recent publicity about it involving a snafu at the Baseball Hall of Fame, I thought what the heck, let's watch it. Not much to it, really; won't see it again. But there was one passage I had forgotten about, and I loved it.

Crash, the veteran, says to Nuke, the rookie:

*Learn your clichés. Study them.
Know them. They're your friends.*

Write this down.

"We gotta play 'em one day at a time."

*"I'm just happy to be here and hope
I can help the ball club."*

*"I just wanta give it my best shot and,
Good Lord willing, things'll work out."*

Clichés are indeed part of every profession, and baseball players play the rhetoric game with the best of them. Only economists in the Fedwatching game are better.

October 1979: The War Starts

Way back when I first got into this business, studying the Fed's balance sheet was hugely important. Indeed, Fedwatching as a profession in its own right did not really begin until October 6, 1979, when Paul Volcker engineered a **regime change**, making growth in the Fed's balance sheet – specifically, growth in the “nonborrowed reserves” component – the instrument of policy. Prior to that, the Fed had used the Fed funds rate as its instrument.

I was in graduate school at the time, and it was fascinating to be studying the plumbing of the Fed just as the Fed was rearranging the plumbing! Paul Volcker declared all-out war against inflation, and prepared to fight it with what ever level of interest rates that was needed to induce a

blood-curdling recession. He and the Fed didn't say that, of course.

Rather, in October 1979, the Fed announced that it would henceforth follow the “monetarist” doctrine of rigidly controlling the **quantity** of money, ditching the “Keynesian” doctrine of pegging the **price** of money. Both doctrines have enough clichés to make a baseball player blush. As an undergraduate, I had learned them all, when I had written reams of “compare and contrast” papers and exams, reciting the dueling clichés of Friedmanites and Keynesians. I was ready!

Studying Fed plumbing became my passion. The Fed functions as a government-sanctioned monopolist. And a monopolist can do one of two things: peg the price of his product, or peg the quantity supplied of his product. A monopolist **cannot**, however, do both at the same time. If he pegs the price, the quantity supplied becomes a function of demand at the pegged price. Alternatively, if he pegs the quantity supplied of his product, the price is whatever level that rations/ expands demand to equal the pegged supply.

It's important to note that prior to Volcker's drinking of the monetarist kool-aid, the Fed was already targeting growth in the money stock. Indeed, the Humphrey Hawkins Act of 1978 explicitly required the Fed to establish targets for growth in the money stock. The Fed did, and tried to hit them by pegging the Fed funds rate at a level where the demand for money would equal targeted supply of money.

But money growth continued to exceed the Fed's targets, “accommodating” accelerating inflation. Technically, the Fed could have addressed this problem by simply lifting its peg for the Fed funds rate, until money demand slowed to equal targeted supply. The Fed did not, however, have the political flexibility/courage to do so, because the “necessary” higher level for the Fed funds rate was massively higher than what the Fed had been pegging.

Thus, in October 1979, Mr. Volcker sagely announced that the Fed would no longer peg the Fed funds rate, and would simply supply the

quantity of reserves consistent with its money stock target (via the reserve multiplier, which comes about because of the Fed's monopoly power to set reserve requirements, thereby creating statutory demand for reserves). In this Brave New World, the Fed funds rate would be market-determined: whatever rate that was necessary to ration/expand money demand growth to equal pegged growth in bank reserves.

As a practical matter, this change meant that the Fed could "let" the Fed funds rate rise to over 20%, while claiming "look, Mom, no hands!" The Fed wasn't driving up interest rates; the Fed was just prudently restraining growth in the money stock. It was all a ruse, of course, to induce a recession – the only tried, proven and true path to breaking an insidious spiral between rising inflation and even faster-rising inflationary expectations.

The Fed's twenty year campaign against inflation was underway. And so, too, the career of most Fedwatchers, who followed daily flows in the Fed's plumbing, forecasting who was flushing what or whom, in order to forecast day-to-day movements in the Fed funds rate. Every Friday night, the Fed released data on the money stock and its balance sheet, and the Fedwatching community crunched numbers all night to figure out what the new data meant for the Fed funds rate for the following week. Frustrating work for me, like trying to forecast the precise number of kegs at a frat party that will elicit a visit from the police, at the precise time.

August 1982: The Monetarist Ruse Ends

Fortunately, the game changed in August 1982, when the usuriously-high Fed funds rate of the "monetarist" charade ended. Mexico went broke and Volcker did what he had always had the power to do: in a series of quick steps, he slashed the Fed funds rate by over 1000 basis points and blew smoke about how the Fed's money growth targets were being distorted by financial deregulation. It was, of course, the right thing to do, the right Keynesian thing to do!

The Fed didn't, however, put the Fed plumbing aficionados out of business. Rather than admitting that it was returning to pegging the Fed funds rate, and letting the money stock be demand-determined rather than supply-determined, the Fed began to target "the degree of pressure on reserve positions," defined as a discount window borrowings target.

It was, as the late great Fed Governor Henry Wallich declared at the time, only one small step from pegging the Fed funds rate. Technically, the higher the discount window borrowings target, the higher the Fed funds-discount rate spread; and vice versa (as long as the discount rate is a subsidy rate, which it was until early this year, when it was transformed into a penalty rate).

We in the Fedwatching community spent enormous amounts of time and energy trying to specify the precise relationship between the Fed's discount window borrowing target (which it did not tell us about in real time, but with a 6-8 week lag, with the release of FOMC minutes and the Fed funds discount rate spread). I was pretty good at this!

After the Crash of 1987, the Fed gave up on indirectly targeting the Fed funds rate via a discount window borrowings target, as banks' became ever more reluctant to "be seen" at the window. The Fed had to "go back" to directly pegging the Fed funds rate, and acknowledge that was what it was doing. But we Fedwatchers still had jobs, because the Fed still didn't announce when it changed its Fed funds peg; we still had to read policy changes in the chicken innards coming out of the Fed's plumbing.

This all changed in February 1994, when the Fed announced that it was starting a tightening campaign. This was a **regime change** in communications, which spawned a whole new set of clichés over the following decade. And with that change, Fedwatching died as a plumber's job, and became an economist's job. We properly re-focused our attention on the real economy and became masters of the high-frequency economic data releases, the firepower of real-time changes in Fed policy. It was no longer necessary to teach the youngsters coming up in the economics profession on Wall Street how to read the Fed's weekly H4.1 release: its balance sheet!

Balance Sheets Matter

As the twentieth century drew to a close, nobody's balance sheet seemed to matter anymore, as triple bubbles developed in equity valuation, business investment and corporate leverage. Return on vision replaced return on invested capital as the consensus metric of corporate financial calculus.

When those visions plunged to a watery death, the bubble in corporate debt raised its hand, like Carrie in Stephen King's great film, demanding

redress. Corporations were ordered to the Betty Ford Center for Balance Sheet Rehabilitation. And the program for renewal would be simple: become cash flow positive by slashing capital spending and employment; paying down and refinancing debt; and hanging equity paper when it could be hung.

In January 2001¹, I labeled this process a Minsky Moment, and declared:

*"The mere promise of monetary reflation will not fix things; monetary reflation itself is needed. Put more bluntly, the Fed must turn cash into trash – real short rates must come down a lot, and stay down! And if the dollar goes south along the way, so be it. The objective of monetary policy must be to ease until capitalists **regain their animal-spirited urge to act like capitalists, fleeing liquidity for the hope of capital gains.** Sustainably higher stock prices and sustainably tighter credit spreads will be the appropriate gauges for determining when enough Fed easing is enough."*

In contrast, the Fed policymakers and the majority of the Fedwatching community spent most of 2001 trying to convince themselves that the economy was just suffering from flesh wounds. This could not be Carrie that we were watching; it had to be Monty Python in the Search for the Holy Grail. Flesh wound, flesh wound, flesh wound!

The Fed did, to be sure, do exactly what it was supposed to do: slash the Fed funds rate to a negative real level. But it wasn't comfortable, and in 2002 started muttering about "taking back" some of that easing, just as soon as the corporate flesh wounds healed, as they surely would soon. Or, as Alan Greenspan himself said in April 2002:

"To be sure, over time, the current accommodative stance of monetary policy is not likely to be consistent with maintaining price stability. But prospects for low inflation and inflation expectations in the period ahead mean that the Federal Reserve should have ample opportunity to adjust policy to keep inflation pressures contained once sustained, solid, economic expansion is in view."

Greenspan was painting the tape with open mouth policy, trying to get market players to start discounting a resumption of the Fed's **secular** war against inflation, just as soon as sturdy **cycli-**

cal growth returned, as it surely would. The Fed had not yet embraced monetary reflation **itself**.

November 2002: The War Ends

By November of last year, the Fed finally accepted the obvious: the economy was experiencing a Minsky Moment. We were watching Carrie after all, and her hand dripped with deflationary blood. She must be stopped! To do that, it would be necessary to declare that **the secular war against inflation had not only been won, but more than won: the inflation rate was too low!**

The Fed couldn't quite bring itself to do that last November. But it was close enough for government work. Alan Greenspan hinted, and even more importantly, new government employee Fed Governor Bernanke declared to the world that the reflationary printing press would still have magical powers, even if the Fed funds rate were cut to zero. "Unconventional easing" became the new cliché on the tip of every Fedwatcher's tongue.

For many, the possibility of **regime change** in the Fed's game required an immediate remedial tutorial in the Fed's plumbing. Indeed, I've been amazed by some of the rubbish I've read and heard regarding what the Fed can/could/will do "unconventionally." This stuff isn't that hard!

Here's the skinny: the Fed remains a government-sanctioned monopolist, and as such, can peg either the quantity of bank reserves or the nominal price of bank reserves. But it cannot do both at the same time. And in no case can the Fed, as a practical matter, peg the monetary base; to be sure, it can peg the bank reserve component of the monetary base, but not the monetary base itself, which is dominated by currency in circulation, which is entirely demand-determined.

The Fed also has the power to peg the prices (yields) of various assets other than bank reserves – like longer term Treasuries – while pegging either the quantity or price of bank reserves. To wit, the Fed can have a positive peg for both the Fed funds rate **and** longer-dated Treasuries yields, by "sterilizing" any reserves created in buying longer-dated instruments (technically, reverse repo-ing them out); but if it does, it cannot have a peg for growth in bank reserves. Alternatively, the Fed can have pegs for longer-dated Treasury yields and growth in the bank reserves; but if it does, it cannot have a peg for the Fed funds rate.

Stay with me here! This stuff is important; it bears directly on a huge investment question: does the Fed “have to” let the Fed funds rate go to zero, in order to peg long-term rates, as some are contending? The answer is: No! The Fed would have to let the Fed funds rate go to zero **if, and only if**, it were to decide to target a specific, higher growth rate for bank reserves – to wit, “go monetarist.”

I see no earthly or heavenly reason for the Fed to do that. As Japan has taught us, a bunch of excess reserves sloshing ‘round the banking system are not an anti-deflation panacea. To reverse deflationary expectations, a central bank must **credibly** commit to pursuing a higher inflation rate. Note, I said **credibly**! Reflating is all about **convincing the public to believe that their cash really will be turned into trash, inducing them to spend their cash to buy things – goods, service and assets – before it loses value, in the process generating rising inflation.**

If the Fed wants to preempt deflation risk, as it most assuredly does, it does not need to drive the Fed funds rate to zero, which would blow up the money market fund industry and create dislocations in the commercial paper market, as such credit was “re-intermediated” back into bank loans. What the Fed needs to do is what it has been doing ever since May 6, 2003, the magic day when the Fed “officially” declared the secular war against inflation to be over: repeat early and often that the Fed will **prevent** an “*unwelcome substantial fall in inflation.*” Note, I said prevent, not reverse.

Bottom Line

So, what do I think is going to happen?

- The Fed does not need to – and, I firmly believe, will not – drive the Fed funds rate to zero. Another 50 basis points of easing, to a 75 basis point Fed funds rate, is the most I can envisage, and that’s far from a done deal. What the Fed is going to do is hold the Fed funds rate down here for a long, long time – until inflation is higher, well north of 2% year-on-year for the core PCE deflator.
- The Fed does not need to – and, I firmly believe, will not – adopt any “quantitative” target for the money stock, bank reserves or God forbid, the monetary base. When it comes to fighting deflation risk, Keynes is King.

- The Fed will continue to fan market “fears” that it might buy longer-dated Treasuries and/or peg longer-dated Treasury rates, inducing a flattening bias to the Treasury curve from two years on out. Assuming this open mouth policy “works,” as I do, the Fed will never have to openly target or peg longer-dated rates – which it does not want to do, because it doesn’t know how to exit such a policy once started.
- The Fed might – I’m agnostic about this – make noises about lengthening the duration of its Treasury portfolio, now that the Treasury is issuing more paper and not buying any back. This would be a non-pegging operation, but I’m quite sure it would incite traders’ mojo, reinforcing the Fed’s open mouth policy aimed at a bullish flattening of the (coupon) yield curve.
- The Fed will privately bask in the dollar’s fall, but publicly say little, with the little being clichés with no policy meaning. America’s strong dollar policy is dead: the Morgan Le Fay Plan² is in play! Treasury Secretary Snow’s job now is to replenish as needed a pool of fools to buy it all the way down.

There you have it: My best shot and, Good Lord willing, things’ll work out.

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May 27, 2003
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¹ Fed Focus January 2001, “Capitalism’s Beast of Burden”
http://www.pimco.com/ca/bonds/bonds_commentary_fed_focus_0101.htm

² Fed Focus November 2002, “The Morgan Le Fay Plan”
http://www.pimco.com/ca/bonds/bonds_commentary_fed_focus_1102.htm

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