

Q&A
April 2006

Chris Dialynas Urges the Federal Reserve To Adopt a Zero Interest Rate Policy



Chris P. Dialynas

Managing Director, Portfolio Manager and Senior Member of PIMCO's Investment Strategy Group

Mr. Dialynas joined PIMCO in 1980. He has written extensively and lectured on the topic of fixed income investing. He served on the Editorial Board of The Journal of Portfolio Management and was a member of The Fixed Income Curriculum Committee of the Association for Investment Management and Research. He has twenty-five years of investment experience and holds a bachelor's degree in economics from Pomona College and an MBA in finance from The University of Chicago Graduate School of Business.

PIMCO Managing Director Chris Dialynas has often challenged the conventional wisdom with papers such as 2004's "Trouble Ahead-Trouble Behind: Restructuring the Global Economy – A New Marshall Plan". In his latest paper, coauthored with PIMCO Senior Vice President Saumil Parikh, Mr. Dialynas urges the U.S. Federal Reserve to adopt a Japan-style zero interest rate policy (ZIRP) as a remedy for global imbalances that threaten the well-being of not only the U.S. economy but economies around the world. In the interview below, Mr. Dialynas discusses the basics of this proposal, but interested readers are urged to see the full paper: "A Zero Interest Rate Policy (ZIRP) Remedy to Global Imbalances" on PIMCO.com.

Q: Chris, you and Saumil Parikh propose that the U.S. Federal Reserve cut interest rates to zero in the same way that the Bank of Japan cut rates to zero as a cure for deflation. Why should the Fed adopt a zero interest rate policy?

Dialynas: Like Japan did with the adoption of the zero interest rate policy in 2001, the U.S. needs to look beyond conventional macroeconomic policy tools to address its large and growing fiscal and trade imbalances. The current mix of fiscal and monetary policy is only fueling these imbalances. Restrictive monetary policy is raising interest expenses on the national debt while expansionary and asset-inflating fiscal policy is a disincentive to savings. The time to throw out conventional policy is long past.

These trade and fiscal imbalances need to be eliminated in a way that increases the U.S. savings rate without either inducing an asset-deflation driven economic recession or explicitly legislating protectionism that would reverse the progress of globalization. We believe the remedy is a zero interest rate policy by the Fed combined with strategic fiscal tightening, which would create a synthetic trade tariff for foreign exporters of capital and effect a redistribution of wealth from asset-rich savers to debt-laden consumers in the U.S.

Q: How would a zero interest rate policy by the Fed result in lower trade and fiscal deficits?

Dialynas: A zero interest rate policy in and of itself would not work. A carefully constructed set of contractionary fiscal policies are required to complement the zero interest rate policy. Together, they would curtail growth in the fiscal and current account deficit by lowering the financing cost on the existing stock of debt. In 2003, U.S.

Q&A

April 2006

Treasury issues maturing within 12 months represented 35% of the outstanding U.S. Treasury debt and yielded a grand sum of 1% per annum. Outstanding U.S. government debt was about \$4 trillion, and the total interest cost of servicing this debt consumed \$215 billion. In 2005, Treasury issues maturing within 12 months yielded in the neighborhood of 4% per annum. In other words, the Fed's rate hikes essentially quadrupled the interest expense on government debt. With U.S. government debt rising to \$4.7 trillion in 2005, expenditures on interest expense alone were \$270 billion, up 26% from the \$215 billion in 2003. In 2006, a conservative estimate suggests that the interest expense on the existing stock of U.S. debt will increase by \$100 billion, or 0.7% of GDP.

The increasing amounts of interest paid to service U.S. debt are crucial. Because foreigners hold much of this debt, interest paid to service the debt represents an outflow of wealth from the U.S. to the rest of the world. A zero interest rate policy would create a synthetic trade tariff on those who export to the U.S. and then recycle dollars back into U.S. bonds, because bonds would yield close to zero percent rather than five percent as they do today. Thus, instead of the current situation, in which foreign savings are "crowded in" by relatively high and rising U.S. interest rates, the zero interest rate policy would "crowd out" these foreign capital flows

Reduced foreign capital flows would cause the U.S. currency to gradually decline, raising the cost of foreign goods and reducing U.S. consumption as well as the cost to foreigners of U.S. goods. Eventually, these trends would reduce the U.S. trade and current account deficits.

Q: You recommend that zero interest rates be combined with strategic fiscal tightening. How would this work?

Dialynas: Fiscal tightening would be needed to offset the stimulative monetary effect and redistribution effects that zero interest rates would have on U.S. asset prices. Strategic fiscal tightening would require cuts in government spending as well as tax increases on gains associated with financial assets and real estate. Fiscal policy should be aimed at deterring investment in non-productive financial assets and increasing productive capital spending and domestic employment. We need more engineers and fewer real estate agents.

The fiscal package would include a tax on real estate that will prohibit a further escalation in prices and speculation normally associated with low interest rates. It will also include a tax to mitigate price gains in equities. As with the increased tax on equities, the real estate tax provides for a wealth transfer from those in society that are asset-rich to the federal government. This one-time domestic tariff on accumulated asset appreciation is expected to accrue to the U.S. government.

It is important to note, however, that this proposed policy is not meant to finance an expansion of the government. Federal spending must be cut substantially and, at a minimum, match the wealth transfer to the government for the tax on assets. In fact, substantial debt reduction must occur to ensure an eventually successful exit from zero interest rates. Because the asset taxes would be imposed upon sale, the wealth

Q&A

April 2006

transfer would be gradual, so the spending cuts should also be gradual. In this way, the zero interest rate policy and tight fiscal policy would avoid a recession brought on by the negative multiplier effects that normally accompany asset deflation in an over-leveraged economy.

Q: How likely is the Fed to go along with a plan that involves coordinated monetary and fiscal policy?

Dialynas: This marrying of fiscal and monetary policies would necessarily require that the Fed suspend its independence. The sacrificing of independence is well justified given the present U.S. protectionist sentiment. Current Fed Chairman Ben Bernanke argued in 2003 that the Bank of Japan should relinquish its independence to better enable the coordination of Japanese monetary and fiscal policies and avoid further deflation. The zero interest rate policy in Japan required that the Bank of Japan sacrifice its autonomy. The Bank of Japan, in announcing the end of zero interest rates, is now retrieving its independence. In the same vein, the U.S. Fed should welcome the chance to participate in a coordinated policy to restore international stability and avert direct tariffs.

Q: What are the risks if the current mix of fiscal and monetary policy continues?

Dialynas: The ongoing imbalances in global trade and financial flows are the direct externality of misguided policies, based on conventional wisdom that a mistaken, overly restrictive monetary and fiscal policy in the U.S. created the Great Depression and led to global sovereign defaults by debtor nations in the 1930s. It seems equally, if not more likely, to us that an imbalanced global trade system, jarred by restructuring in Germany and Great Britain and by prior revolutions against free markets in Russia and China, may have been the initial and crucial culprit. The global constriction of trade was the result of several dependent and independent political and economic upheavals during the decade following World War I.

The global economy is going through a similar upheaval today and the growing imbalances will ultimately lead to extreme global economic hardship over the next two decades if not corrected. History suggests that this hardship will be concentrated in debtor nations, however creditor nations dependent on debtor-nation aggregate demand will suffer just the same. The U.S. is the world's largest debtor nation today, with China the world's largest creditor.

Q: Thank you, Chris.

Singapore
PIMCO Asia Pte Ltd
30 Cecil Street #23-01
Prudential Tower
Singapore 049712
65-6491-8000
Registration No. 199804652K

Q&A

April 2006

Regulated by the Monetary Authority of Singapore as a holder of a capital markets services license in fund management. The services and products provided by PIMCO Asia Pte Ltd relate to advisory accounts, which are available only to accredited investors as defined in the Securities and Futures Act. The investment management services and products are not available to persons where provision of such services and products is unauthorized.

Past performance is no guarantee of future results. This article contains the current opinions of the author but not necessarily those of the PIMCO Group and does not represent a recommendation of any particular security strategy, or investment product. The author's opinions are subject to change without notice. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. This article is distributed for educational purposes and should not be considered as investment advice or an offer of any security for sale.

No part of this publication may be reproduced in any form, or referred to in any other publication, without express written permission. Copyright 2006, PIMCO