



Paul McCulley

Global Central Bank Focus

P I M C O

March 2008

Not Good Times

But Debt Deflationary Spiral Can Be Short-Circuited, McCulley Says

The “Reverse Minsky Journey”¹ you wrote about last October certainly has been unfolding in all its “glory.”

Yes, though there’s a great deal of cognitive dissonance in the economy, in the markets and also in policy. We have got, unambiguously, a domestic deflationary spiral going on in the property market. Anybody who’s denying that has not looked out the window recently. We have asset deflation in the most important asset in the American household’s balance sheet. Then we have debt deflation in the credit markets. At the same time, we’ve got sturdy global growth, particularly in the emerging market space and particularly in China. As they grow, they increase their standards of living and become naturally bigger buyers of commodities, energy and food—while concurrently we’ve got a declining dollar. Therefore, the dollar-denominated prices of commodities, particularly energy and food, are going up quite rapidly.

Isn’t it wonderful? Stagflation.

Sometimes we live in the world of the second best. What we’d *like* to have is robust growth with very low inflation, but sometimes you don’t get what you want.

So my mother told me, often.

Didn’t the Rolling Stones sing about it, too? But better stagflation than what they

Listening In

Don’t mess around with this Minsky moment is the straightforward message of PIMCO’s normally optimistic economist, Paul McCulley. Step 1 is to recognize the fix we’ve borrowed ourselves into, a debt deflationary spiral, anchored by depreciating property prices on the backside of triple bubbles in housing, mortgage finance and the shadow banking system and complicated by the soaring weak-dollar-denominated prices of food and energy. Step 2 is to pull out the monetary and fiscal stops to arrest this vicious self-feeding cycle. There aren’t any good options, just less-bad choices. Now is not the time for finger-pointing or moralizing. Digging out of this mess will require even more sizeable and focused policy responses than we’ve seen in recent weeks—and lots of time. There will be plenty of shared sacrifice to go around. Blame can be apportioned and the rules revised...later. Read on, for more of Paul’s pragmatism and reason, in his own words.



—Kathryn M. Welling

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had in Japan for the decade of the '90s. Stagflation isn't optimal, just better than the alternative. Goldilocks is the first best, but we can't attain her.

Isn't the dollar's weakness calling into question whether we can even have second-best?

I don't think the inflationary impulse of the dollar will be all that nefarious. Clearly, it's having an impact on commodities prices, but commodity prices are in their own bull market, based upon real demand and energy prices are in their own little world, too. Granted, the weaker dollar is turbocharging the bull market in commodities, and in that sense does pose an inflationary risk. But with the U.S. economy weakening, you're not going to see a great deal of pass through of import prices, ex-commodities, to final goods here. The retail sector in America doesn't have much pricing power now because the consumer doesn't have much real purchasing power. So the laws of arithmetic prevent too much pass through. Rising commodities prices are truly nefarious, though, for corporate profits in sectors that are very heavy users of commodities. Your heart goes out to the trucking industry, for instance. They can't increase their fees in a very competitive business, but the cost of a tank of gas has doubled on them. These are not happy times, and the inflation pressures are probably going to continue on a secular basis, not just on a cyclical basis—maybe not the falling dollar—but the rising real prices of food and energy, which reflect basic supply and demand. As people pull themselves up by their bootstraps in the emerging markets, they do two things: Increase the protein

in their diet and move from a bicycle to a motorcycle to a car. That's the natural order.

But it's also amplified by China's refusal to allow free market pricing of either within its borders.

That's probably true. Part of their reason is to maintain social stability. But there's no question they're at the stage in their economic development in which they're naturally increasing their real demand for commodities, particularly energy and food. Put in a more technical way: Their demand for those things is very income-elastic and not particularly price-elastic. It's like when you get your first job, you buy a car and then you've got to put gas in it. But you buy the car because of your rising income; that's the real motive, and the gas purchases simply follow. That's what's going on there; that's why there's a secular story on commodities prices. But for a country like America, it's a negative terms-of-trade shock. We've got to give up more things in trade to get what we import, notably energy. Since we have a global market in foodstuffs, we have to pay more for them, as well—although, there is an offset in that American farmers are doing awfully well these days. So we have both deflationary pressures and inflationary pressures. They're just in very different things, driven by very different forces. Now, there's not a whole lot policy makers in America can do about the forces driving the inflation pressures. The Fed doesn't have the ability to tell the more affluent Chinese citizen that he shouldn't have more protein in his diet.

It sounds to me like you're buying the decoupling argument?

I buy it in loose form.

That's a squishy answer, Mr. Economist.

Well, it depends on what areas you're talking about. The decoupling story between China and the United States is pretty powerful. I don't think that China is totally immune to a slowdown in domestic demand in the United States. But China has a vigorous investment boom going on domestically, funded by its own savings, so they have a lot of homegrown ability to weather very nicely what's going on in the weakening side in the United States. In contrast, if you look to Europe and to Japan, I'm not a buyer of the decoupling story. Those two areas still are heavily dependent upon export-led growth and America is the global consumer of last resort. So I'm a buyer of the decoupling story in some places, but not in others. That's why I gave you the two-armed-economist-type of answer.

If Japan and Europe are still attached to us at the hip, slower growth in all three places has to take some of the pressure off of commodities prices—and even off the poor old greenback—

Yes, I think that's right. The yen is flirting at 100 and we're over 1.50 on the euro; those currencies have become *very* strong; and the dollar has become weak. If the decoupling story is wrong and those countries weaken in lagged response to the United States, then that should top out their currencies; and the same thing holds for the U.K. So I don't think that dollar-denominated commodities price inflation is going to be as severe going forward as it has been over the last 18 months. I mean, it has been absolutely wicked, in part because of the fundamentals that we're talking about. Also, because, in this decade,

commodities have become accepted as an asset class, so you've got institutional investors making strategic allocations to commodities as an asset class, creating financial demand as well as real demand. That has become particularly pervasive in the last year because financial demand tends to be reflexive, as **George Soros** says. People make allocations in asset classes that have done well, which then turbo-charges them and can push them into bubble territory. There's a distinct possibility that could happen in the commodities markets, particularly if the downturn in the developed countries really pulls back the fundamental real demand for the basic commodities.

Considerably more than a possibility, I'd say.

I am not enthusiastic about commodities after this incredible run, though I'm not saying it's over. What we've learned time and time again is that reflexive markets don't top out until they've become absolutely crazy. Which is what our property market was.

You're skating close to calling the commodities markets bubbles but can't quite seem to pull the trigger—even though there's been an enormous amount of leveraged money flowing into those markets?

They're bubbly; there's no question about that. The issue is: How much bubblier are they going to become? But at the same time, we are unambiguously on the backside of a bubble in housing. Well, actually, the fallout from triple bubbles is bedeviling the United States. We had a bubble in property prices; we had a bubble in mortgage finance, and then we had a bubble in what I've dubbed "the shadow banking system." In other

words, in all of the non-bank levered-up intermediaries. The whole alphabet soup of CDOs and SIVs and CDO squareds, etc. Those triple bubbles are imploding and it's creating a classic debt deflation, or what I called a "reverse Minsky journey" in that column you referred to at the start of this conversation. The Fed prefers to call this an "adverse feedback loop." But in plain language it's a debt deflationary spiral that feeds upon itself in an accelerating fashion. That is literally what we've been seeing in the last few days and weeks.

Falling prices begetting margin calls, begetting more selling, and around it goes.

Exactly, and it doesn't endogenously correct itself. It endogenously *feeds itself*. In order to stop a debt deflationary spiral, you have got to have a policy response.

Why is that? A virtuous cycle, like dot.coms in the late '90s or real estate more recently, eventually sows the seeds of its own destruction. Those bubbles popped themselves when there was virtually no one left to drink the Kool-Aid.

I think that's right. What pops bubbles is that they run into some sort of valuation wall. With the tech stocks, it was P/E multiples of half the distance to the moon.

Only half?

Okay, three-quarters of the distance to the moon. It got to the point that you could only justify those P/E multiples if you said that the growth rates and profits of a tech company were going to equal to approximately 100% of GDP within 15 years. The absurdity of it all finally caused it to crash. Remember Cisco's announcement that its order book

was plummeting? That was a very important signal that the implicit growth rate in that whole complex made absolutely no sense. You had the same phenomena going on in the telecom space, when the price of a long distance phone call effectively went negative. It's really hard for companies to make profits in the long run if they are losing money on every unit that they sell. Virtuous cycles run into fundamental valuation issues that reveal these absurdities and then they burst. That's what happened in '07 in the property market. The price-to-rent ratios, the price-to-income ratios reached a point that totally destroyed affordability for the marginal homebuyer; most notably for the first-time homebuyer, who is the plankton in the sea of the property market.

Plankton? All life in the housing market depends on the supply of new buyers?

Exactly. Your natural demographic growth gives you household formations and then, when the young married couples who have been renting buy their first homes that effectively keeps the demographic-driven growth in housing going. But if you have a bubble where price-to-rent ratios and price-to-income ratios get totally out of whack, the only way that you can keep the plankton in the game is to reduce underwriting standards to the point that they're non-standards. That is what happened in '05 and '06, which kept the bubble going. But then you got into '07. Particularly in the first quarter, you got compelling evidence that what had been driving prices in the last couple years of the bubble was not fundamentals, but simply expectations that home prices would go up forever. At the end of the bubble, the

subprime loan, at teaser rates with no money down, with no documentation, potentially with payment option features and with negative amortisation, those were the “evil soldiers” on the field. It got to the point that the marginal borrower, conceptually, was not a borrower at all, but was receiving from the lender a combination of an “at the money call” and an “at the money put” on the property market—for free, because he wasn’t putting any payment down. He controlled the upside on the house. If its price went up, then effectively “the buyer” had a call option that was going in the money. Now, to keep his call option, he had to make some token teaser payments, which he would do, as long as his call option was in the money. However, when his call option went out of the money, meaning house prices started going down, then his *put option* went in the money. But the only way that he can exercise his put option is to default—or, to borrow from the wise words of **Paul Simon**, “Drop off the key, Lee, and set yourself free.” Remember that one?

You bet. So the irony is that the underwater “home owner” —

You actually have something valuable if your house is underwater, because you have an in-the-money put. That’s because in most states, California being a primo example, the lender can *either* go after your house *or* go after you. In most cases, 99.9% probably, they go after the house. Therefore you get to extinguish your loan *at the amount that it was contracted at*, even though the market value of the collateral has fallen below that amount. That means that you’re effectively exercising a put to sell the house at the mortgage amount—but you can only exercise

it by dropping off the key. We started seeing something in the first quarter of ‘07 that was an unambiguous signal of that.

Which was?

Something labelled the “early payment default” or “early payment delinquency” rate started rising. That’s where someone would be late on or would miss one of their first three mortgage payments. That told you that the game was over because people *don’t* miss those payments if they have skin in the game. When I bought my house, I had to put 20% down. The notion that I was going to miss one of my first three payments would have been absurd.

Moi, aussi. But we’re relics.

When you have no skin in the game and the call option goes *out* of the money and the put option goes *in* the money, then it’s eminently rational to go into early payment default.

Unfortunately. It’s not even rocket science.

It’s not. Because you have *to pay* to stay in the game with the call option, but it’s out of the money. And you can exercise the put option *for free*. It’s not a matter of morality, as some people try to frame it; it’s a matter of rational economics. If someone gives me a call and a put, structures the money for free and the call goes out of the money while the put goes in the money, but only way I can exercise the put is to default, good-bye!

It’s absolutely rational. Is that why the folks in Washington don’t understand what’s going on?

I think the Fed Chairman *fully understands* the game. He knows that exercising that put is rational and he’s fearful that a lot of people

are going to be whistling Paul Simon down to their loan servicer's office. Therefore, he effectively has endorsed the concept that the mortgage servicers should think in terms of which is the worse of two evils. The guy who has negative equity has a put *which is in the money*. If you reduce the amount of his mortgage principal, then his put is *not as deep* in the money. If you reduce it *far enough*—and **Ben Bernanke** actually suggested this—you can reduce it enough so that you actually restore some degree of equity in the home, meaning that his call option is pushed back in the money. At that point, the guy has something worth making payments on. So he doesn't default. In other words, the servicer should think in terms of what is the net present value of these two alternatives. "I can let him drop off the key and then I can try to sell his house. I'd have to maintain it over that time and then I'd have to pay a broker's fee and all that sort of stuff. What is the *realised value* I'm likely to get on the collateral?" Ben was suggesting that may be 50 cents on the dollar. Whereas, if you write his mortgage down to 75 cents on the dollar, you've lost 25 cents on the dollar. But then you've also effectively gained a guy *who is not going to exercise his put*. So it could be rational for the servicer to say, "75 cents is better than 50." After all, if the guy is in negative equity, those are your two choices, because he is not going to indefinitely pay the interest rate on a negative equity loan. So I am not going to criticise Ben on this. He was just suggesting lenders consider which is the worse of their two options. He's not suggesting either option is a *favourable* thing.

Okay, but taking big haircuts on all the upside down loans out there clearly isn't something the financial sector is eager to do—or maybe isn't able to do.

Oh, it's absolutely a nefarious thing; I agree with you 100%. We *shouldn't* be where we are at right now and Mr. Bernanke and all the people in Washington and on Wall Street are dealing with problems with no easy solutions. There are only hard solutions—and hard solutions that have lots of what my friend **Mohamed El-Erian** likes to call "collateral damage," or what I call "negative externalities." There are no easy solutions, only complex solutions with unintended consequences associated with them, so I'm not trying to put a positive spin on any of this. *We shouldn't have gotten here*. We should have had *preemptive, prophylactic regulation*, three to four years ago, on the creation of these junk mortgages. The Fed had the power to do it and it chose not to do it.

Instead its then-Chairman went out and suggested that everybody load up on adjustable-rate mortgages.

Mr. Greenspan maintains that he wasn't advocating that, that he was simply observing that those who could have used ARMs over the prior decade would have come out better. Whether or not you want to take that at face value is—

Not a chance. I remember very well reading that speech at the time, and thinking those comments were outrageous. There certainly weren't a lot of caveats prominently attached. He's trying to rewrite history.

You can say that; I'm not going to. Remember, Mr. Greenspan is a colleague of mine. But I think he has a lot...[to answer for]. If you

were trying to round up *all* the contributors to what should have not been, you could point to monetary policy and to regulatory policy, but you can also point a very large finger at the rating agencies. All of this crap couldn't have been securitised without the blessings of the rating agencies. The shadow banks, the SIVs, the CDOs, etc., couldn't have been constructed without the blessings of the credit agencies on their asset-backed commercial paper or without the agencies' blessings on the monoline insurers. And you can say that the monoline insurers effectively debauched their own franchises when they moved beyond their monoline businesses in municipals into putting their wrappers on exotic new securitisations. So if you wanted to round up the suspects, it would take a big room and lots of seats.

What a surprise, there's plenty of blame to go around. Greed takes control in a bubble.

Yes, it's human nature. I come back to **Hyman Minsky** and his financial instability hypothesis: The longer people make money by taking risk, the more imprudent they become in risk-taking. While they're doing that, it's self-fulfilling on the way up. If everybody is simultaneously becoming more risk-seeking, that brings in risk premiums, drives up value of collateral, increases the ability to lever and the game keeps going. Human nature is inherently pro-cyclical, and that's essentially what the Minsky thesis is all about. It's also what the Soros thesis of reflexivity is all about, and it's real. Human beings are *not* inherently given to equilibrium. They're inherently given to manic depression—

And therefore, so are markets.

Exactly. **Charles Kindleberger's** book ["Manias, Panics and Crashes"] lays it all out. In fact, Kindleberger and Minsky collaborated a lot.

I didn't know that.

All you have to do is look through the annals of history, as Kindleberger did, to realise what the nature of the beast is, which is why I'm such a strong proponent of regulators, broadly speaking, trying to have counter-cyclical regulatory responses. But clearly that has not been the M.O. in recent years. In fact, during the whole development of the originate-to-distribute business model for mortgages and the creation of all the securitisations and the shadow banks and conduits, etc. (particularly CDS and synthetic CDOs), you had a great deal of cheerleading by the regulatory authorities. That's my criticism.

It was only possible because so many of the banking and financial regulations erected in response to the Depression were dismantled, piece by piece, over the last couple decades of the 20th Century.

Yes, and what we find is that some behaviours—and some endeavours in life—*inherently need a policeman on the beat*. When the policeman says, "You don't need me, I trust you to behave yourself," it's going to come back to haunt you and him. I've always felt that way, and history is proving it again: Absolutely laissez-faire capitalism *can't* be applied to the financial system because the financial system has, at its core, the banking system, which is a massive, levered lender with access to Federal Deposit Insurance as well as to the Fed's discount window. I think

levered financial innovators are different. They're *not* like a tool and die maker out in Moline, Illinois. If you're going to have direct or indirect access to the safety nets of FDIC insurance and the Fed's balance sheet, then you *need* to be regulated. My son is a freshman in college. When he went off in the fall, I gave him a credit card. It has a limit on it and every month I get a copy of the statement. There *is* regulation. He doesn't get the credit without having an observer over his back and from time to time I've had to call him up and say, "Son, what was that \$300 for?" Have you ever had to go through that with yours?

Please, let's not even go there!

Exactly. But if you're supplying your card, you have a fiduciary duty to look after it.

It *should* be as basic as the survival instinct.

So essentially banking regulators, since they are the agents of we the people, with respect to the public safety net for banks, have a fiduciary duty to us, the taxpayers, to see that the institutions with access to this safety net are not abusing it and to call them out if it looks like they are engaged in reckless risk-taking.

Obviously, they totally abdicated that responsibility and now we have a multi-billion—make that trillion—dollar credit mess.

Yes, we do. First, we reintermediated the shadow banks, or a lot of them, back into the real banking system, and now the real banking system is trying to delever itself. The shadow banks that still exist, including hedge funds, are being put under the screws of higher margins and reduced credit availability from the real banking system, because the real banking system saw involuntary

growth in its balance sheet at the same time that the book value of its equity fell sharply, reducing capital ratios. So we have the modern-day credit crunch.

Implying it's somehow different this time?

I say "modern day" because it's different than the credit crunches going back to the days of our youth, particularly the days before the elimination of Regulation Q. Back in the days before Regulation Q was eliminated (around 1980/'81), when the Fed drove short-term interest rates above the Reg Q levels that thrifts could pay on deposits, deposits would flow out of the thrift industry and into T-bills. Literally, the thrifts would be left without any money to lend. That was a credit crunch in the old days. This is the modern-day credit crunch: "I ain't got no balance sheet. You may be a guy I like and I've been lending to you for years, but I haven't got balance sheet room for you anymore. Therefore, I'm going to call the loan." "Well, sir, if you call the loan, I can't pay off the loan unless I sell the asset." "Well guess what, Harry; you're going to have to sell the asset." Then Harry sells the asset and price goes down and then the next day the same phone call goes to Larry: "Larry, you have the same type of asset that Harry did; Harry sold yesterday; the price is down two points. I think we need a margin call here." It's called a spiral.

So the banks are going to end up with a lot bigger balance sheets than they either want, or have the capital to really support—

Or you can price assets cheap enough so that unlevered investors are willing to buy them for cash.

We're starting to see a little nibbling, I think your buddy Bill Gross said he was getting tempted by some beaten down munis—

That's true. You have a whole spectrum here. At your very far end, you had your structured finance vehicles levered 50- to-1. They would look at an asset and say, "What's my return on equity at 50-to-1?" With that leverage, they would accept very skinny risk premiums. You have to reprice that risk when you take it back into the banking system because the banking system can't run with that type of leverage ratios; you have to widen out spreads. But you are still, in the banking system, looking at your return on equity *on a levered basis*. However, if the banking system doesn't want to balloon its balance sheet because it has a shortage of equity, then you have to reprice it again. Until someone can say, "I don't need to use leverage on this. I'll just buy it for cash."

Which can mean a lot of repricing.

Like for instance, when you get California general obligation bonds yielding 5.5%, I'll just take some of those for cash. I don't need to lever them up.

I guess not, yielding more than Treasuries. And tax-free to a Californian like you.

Looking at it on a tax-adjusted basis, you're talking 8% – 9%; that's a good absolute return. So the whole process is that you are delevering the system and you have to mark down prices, therefore lift yields, to the point that they become attractive to progressively less-levered investors and ultimately to unlevered investors, such as a PIMCO. The issue from a finance perspective is pretty easy to lay out. We just have to think in terms of what kind of levered hands have balance

sheet issues versus unlevered guys' demands for returns on equity. From a macro perspective, however, the issue is entirely different in that this has an absolutely nefarious impact on the economy. You've got some 10% of Americans already in negative equity on their home and you will probably have 20% within the next year. That is an absolutely foreboding type of headwind. Therefore you have to have a policy response. And the policy response so far is good, but it's still not sufficient. You have the Fed easing; you have your temporary fiscal package; you have the Fed now using its own balance sheet more aggressively, including the very good announcements made this [Friday, 3/7] morning with respect to expanding the TAF and doing term repo operations for the broker-dealer community focused on MBS collateral. All of that stuff the Fed is doing is good, but what we still need is a program directed at trying to abate the deflation going on in property prices. Until that problem is addressed directly, I don't see prospects for turning this thing around.

[When the Fed rocked the markets Tuesday (3/11) with announcement of another \$200 billion plus in lifelines for banks and brokers, I called Paul and asked, is it enough?

The Fed played a hugely important card while we will never know the counterfactual, it was clearly a bold, aggressive, appropriate step. My hat is off to them. They are putting up to \$200 billion of Treasuries that the Street desperately wants into their hands and taking off of their hands \$200 billion of what they have difficulty financing. Now, the Fed is not taking the risk of the mortgages, just providing financing on the mortgages, where the private sector doesn't want to do it.

But they are essentially allowing the broker community to finance their mortgages at the same rate as Treasuries.

But this is all still just a short-term lending facility as far as the Fed is concerned, and while they're going to take mortgages as collateral, nothing junkier than "triple-A."

*Correct. It's not a silver bullet, it's not a panacea; it is, as I put it around here, part of a whole portfolio of policy actions that have been done and that will have to be done. It has cut interest rates and done the TAF and the 28-day repos, now this new Term Securities Lending Facility, so the Fed is being very active. Really, what we need is for fiscal policy to become very active. **Barney Frank** has been working intensely on a bill, but whether or not they can get it passed anytime soon is difficult to call. Philosophically, the Republicans are not on board in the Senate and you have the White House rolling the dice that the tax rebates are going to be miraculous when they hit in the May-August period. I don't think they are going to do a damn thing for stopping the deflation in property prices, but they will probably give you a one-quarter bounce in GDP. I don't think the White House is fully engaged; doesn't recognise the severity of the housing price deflation.*

It's kind of a theme. At least Hank Paulson has finally figured out that maybe regulation was a teeny bit lax.

Hank Paulson has been a day late and certainly a dollar short, straight down the line. He hasn't put a single dollar of Uncle Sam's money up. This is cause for strong fiscal policy action, if there ever was one.

You're still pulling for some sort of bailout of underwater homeowners?

Everyone hates the notion of a "bailout" but

history is littered with examples where we have bailed people out. The Fed's latest move addresses the problems in structured finance, but could indirectly make houses more affordable if it brings down mortgage rates relative to Treasury rates, tightening up that spread. The bottom line is that what's ailing the property market is not so much interest rates but the fact that prices are falling. People usually don't put leverage on assets that are falling, it just doesn't pass the human nature smell test.

Speaking of rates though, what's your bet? Do they lower rates 50 basis points next Tuesday?

I think so. Remember, the Fed funds rate is at 3% right now and the 2-year Treasury is at 1.75%, so the money market curve is inverted, even though we have a steep yield curve from 2 years to 10 years. Effectively, he's got to continue easing to validate what the term structure has already priced in. I think he'll go to 2%, but be reluctant to go below there.]

And now, back to the main interview:

You don't see the housing market naturally hitting a place that will attract cash buyers, like California GOs?

Not nearby, if you will. Because you know that California GOs are money good; it's a pretty straightforward calculation to make. But with the property market, you don't have a terminal value known at par. So you're catching a falling knife. Unlike a bond that's going to mature at par, the falling knife in the property market doesn't have a maturity date on it. So you only get to that point, conceptually, when you get price-to-rent ratios down sufficiently that somebody could buy the house and rent it out and have positive carry. With me there? That would only work when I

could buy a house for a carrying cost of 1,300 bucks a month and rent it out at 2,100 bucks a month. That's not the case in America now. It's all negative carry on property relative to what you can rent for. That would conceptually be your floor, but that is so far away from here that the economy would have to go through absolute hell to reach that point. Remember, if you're thinking, "Maybe I want to buy a property here," you're second line of thought is probably: "Well, if 10% of people have in-the-money puts now because they have negative equity, and they're exercising, the very exercise of those puts is going to drive prices down, so you will have another 10% of the people whose puts will go into the money."

That deflationary spiral again.

It makes no sense to try to get in front of it, if you know that it's a self-feeding process on the way down. The key issue is that so much of the marginal lending in the last years of the boom was done with no skin in the game. It smells to high heavens and I'm sure that Mr. Bernanke didn't like having to say the words, but the only way that you can stop the process is, effectively, to write down the principal to the point that the guy's put is no longer in the money and his call actually is marginally back in the money. It smacks of a bailout, of socialism, communism and all the other mean and nasty things. But it's better than a depression.

It doesn't smack of bailout of the mortgage lenders, not that they necessarily deserve one.

No, the lender is going to take his hit. Under a proposal such as the one Barney Frank is

making, the lender has to eat the principal writedown and then you would refinance into an FHA loan—

So lenders would get at least some of the liquidity they so desperately want now.

And that actually would, at the margin, put the taxpayer at risk. Suppose you marked the loan down to 75. The FHA then wraps a mortgage at 75 but the property market keeps falling and the guy defaults—

So taxpayers are the ultimate bag-holders. What else is new?

That's right, the taxpayer would be at risk. You could say that, because the FHA would be wrapping the reduced value refinancing, that Frank's proposal has some characteristics of a bailout that could involve taxpayer money. But in my example, the guy who's taking the first hit is the lender who's getting 75 cents as opposed to par. But there's another societal issue here that makes this very hairy from a political perspective: Essentially, we're all trying to dream up schemes to keep the irresponsible guy from exercising his put—and to keep him in his home. His next door neighbour, who put down 20 cents on the dollar as a down payment, is not getting anything.

Well, he avoids having a boarded-up and abandoned house next door—

Still, the inequities smell to high heaven, and that is one of the huge problems in dealing with it. It runs against the streak of basic fairness in a lot of Americans. You're going to provide a handout to the fool. The fool is going to be rewarded and I, the taxpayer, will be put at risk at the margin for that handout to the fool. When all I did was exactly what

I was supposed to do. Where is the fairness here? It's a hard question to answer.

It would have to be cast in terms of the greater good. And I suspect you could put some makeup on it by requiring the fool, should he ever see a capital gain on the property, to split it with the taxpayers.

Well, all of these proposals that I've seen would involve the original lender, who in my example wrote down the mortgage from par to 75 cents, getting what is known as a negative equity certificate, what I would call a warrant. In effect, if the house is sold in the future for more than 75 cents on the dollar, the original lender would get, or share in, the appreciation.

I might argue that the FHA, or taxpayers, should get that warrant instead. They'd be the ones stepping up and taking a fresh risk. The original lenders would take a hit, yes, but a smaller, and much less open-ended one than their negligent lending practices set them up for.

I can see your point there, and probably, if something along these lines comes to fruition, there will be some type of split, so some of the warrant goes to FHA and some to the original lender as a carrot to get him to write the mortgage down by 25%. But he made a loan; it was a dud loan and that's reality.

The originator and distributors and investors who couldn't get enough no-doc payment option liar's loans a couple of years ago were speculating every bit as much—and probably more aware of that—than many of the irresponsibly foolish home buyers who took them up on their offers.

You can very well be right there. How to split up the warrant, I don't profess to know. As

a taxpayer I think that Uncle Sam should get the warrant, if he is going to wrap the refinanced mortgage. The precedent for that would be the Chrysler bailout. Uncle Sam backed Chrysler's paper, but got warrants in Chrysler and eventually made money.

Thank you, Daimler.

What the FHA would be doing would be roughly analogous. Anyway, something of this nature is going to unfold, I think, in the months ahead. Some type of fiscal policy action directly aimed at trying to put a floor under property prices so that these puts don't keep going deeper and deeper into the money to the point that it becomes economically rational for the guy to whistle Paul Simon.

You have an amazing amount of faith in regulators and lawmakers, who have been asleep at the switch for years, suddenly doing the right thing. Not to mention in Wall Street going along—

I don't see that anyone will have much choice. The gravest danger is that people will ask, "What are the lessons that we should learn from our deregulation folly?" Then swing too quickly to the other side—while we are still trying to work out of the debt deflation.

So you're not saying we shouldn't learn from these mistakes.

No, only that a "never again" sort of mentality could actually exacerbate the problem right now. Longer term, regulatory changes are in order on a number of fronts. The proposals that the Fed put out late last year for public comment will probably be implemented pretty much as they are.

They effectively define what is an acceptable underwriting practice for *all* originators, not just the banks traditionally under the Fed's regulatory umbrella. They have always had that power, but they have never used it to define what constitutes a kosher loan. That will involve documentation; it will involve demonstrating that the borrower has the ability to pay, not just now but at the fully indexed rate; a minimum standard for every originator of loans. The whole issue of Basel II and how risk management is conducted in banks will have to be revisited. Under Basel II, a bank can effectively set its own standards for risk management and, clearly, "best practices" right now would *not* be what I'd want to have as *my* standard. Then there is the whole issue of the rating agencies. Besides the whole inherent conflict of interest issue, there's the issue that they have a separate rating scale for corporates versus municipals—and the rating scale for municipals is *much* tougher than for corporates. Ironically enough, that's why you ended up with the monoline mess. Those insurers were rated on the corporate scale, not the municipal scale. Most municipalities would be at least a letter higher, if they were rated on the corporate scale. There needs to be something done there. Essentially, if you rated municipalities on the corporate scale, there would be no need to have insurance. Then there is also the issue of how the ratings are applied to structured finance. I think applying the old-fashioned corporate rating scale to structured finance was an abomination and a reach. It was born of greed on the part of the rating agencies, but clearly—

Only the rating agencies? I'd say the creators and issuers of all that funny paper bear some burden.

They were clearly at the scene of the fraternity party. But it was the rating agencies that were providing the kegs. You couldn't have played the game without the rating agencies.

I'd say Wall Street and the banks provided the kegs and the rating agencies provided the false IDs.

Touché. Good analogy.

Not that the rating agencies weren't utterly craven, but at least they were doing what their clients were paying them to do.

Well, we've always known that there's an inherent conflict of interest there; but it wasn't particularly egregious in their traditional corporate ratings business because corporations are under SEC regulation and have to make public filings. There are all sorts of information sources an investor can use to evaluate the creditworthiness of a corporation. Whereas, when you get into the structured finance arena, the opaqueness of everything—

Thank you for mentioning that—

It is absurd. There has to be a different rating scale for structured finance, assuming that structured finance is a going concern—and we could have a debate about that.

That is a big assumption.

I suspect structured finance is going to be a very different business than it has been the last several years; I can guarantee you that.

How much shrinkage do you expect in the "shadow credit system," or whatever you want to call it?

The shadow banking system is shrinking before our eyes. Just think in terms of all the SIVs that Citi had to take back on their balance sheet and all the other banks who are doing it; we got, up in Canada, the whole issue of their locked-up SIVs, which is a very large number. There's a fair amount more to go. Remember, levered hedge funds are also shadow banks because they're funding themselves with something besides deposits. That's really how I define a shadow bank: Somebody who doesn't have a deposit base and doesn't have access to the Fed's discount window. If he doesn't have those two things, he's in a scramble for liquidity right now. Because investors are saying, "I want to have access to the safety net." Clearly, the auction-rate preferred market demonstrated that. It had always been an instrument that the investor thought was a de facto money market instrument. Now he's found out that it ain't. So the shadow has got more room to shrink, and the pace at which it shrinks will be determined, in many respects, by how quickly the real banking system can recapitalize itself so that it doesn't feel a need to shrink its balance sheet. Because if you've got everybody trying to shrink their balance sheets at the same time, that's the moral equivalent of a bank run.

Even if it's not nearly as good a photo op as Northern Rock was in the U.K.

No. But how the recapitalisation of the banking system is accomplished and also how innovatively the Fed's balance sheet is used—how all of that comes together—that's what will determine how nasty it is. What you do know is that if you have one sector in your system that is systematically

delevering, somebody else has got to lever up, or else asset prices are going to deflate with a vengeance. Not everybody can delever at the same time. It's the financial version of Keynes' old paradox of thrift. Each individual can say, "It's rational for me to delever." But if we all try to do it at the same time, who will we sell the assets to? Who's going to take the other side of the trade?

Good questions. You're really suggesting Uncle Sam should step into the breach?

Well, Uncle Sam's going to be levering up directly with respect to the stimulus package, and maybe indirectly by effectively guaranteeing private sector debt. People still have no problem owning the debt of Uncle Sam. That's the debt that people want right now, as we've been seeing, obviously, in its price action.

Except that they're not so crazy about his dollars—

That's a different issue. Among dollar-denominated investors, there clearly has been a desire for Uncle Sam's paper. The value of the dollar, however, *naturally should fall* in this type of environment. Remember, you have currency risk and you have interest rate risk. They're different risks and an investor whose currency isn't pegged to the dollar can separate them. Still, there's no question that the dollar naturally will be weak in this type of environment—and particularly weak against the emerging market countries, because they are net creditors to the developed world. This is an upside-down world, where the poor are lending to the rich. So the emerging market currencies should appreciate. But again, since I think the coupling, not the decoupling, story is pretty strong on

Europe, the U.K. and Japan, those currencies are probably in the last throes of their deep move into overvaluation.

Well, RMB aren't a terrifically investable asset in this part of the world.

You actually can buy the non-deliverable forwards, but they already anticipate pretty hefty appreciation, and it's not an easy thing to do. But you can invest in the other Asian currencies that move in sympathy with the RMB. You can play the RMB directly or you can play all of its neighbours that have floating or convertible currencies. It's just not a good time for America. We've got a debt deflation in our property market and in our financial system. We've got a negative terms-of-trade shock with respect to food and energy prices, and we're mired in the quagmire of Iraq. None of those three things constitutes what I'd consider a good report card for the State of the Union.

Meanwhile, pension funds and similarly brain-dead investors are herding en masse into very small markets (grandiosely dubbed "asset classes") called commodities—

So they are. Which is turbo-charging the negative terms of trade shock, obviously, coming from the energy complex. I could go on and on, reciting a whole laundry list of things that are pretty mean and nasty. But at the same time, as you know, I am an eternal optimist about America, and I wouldn't want to end without singing a little bit of the *Star Spangled Banner*. I don't want to sound like a perma-Armageddonist.

Because solutions to these sorts of crises, in our system, tend to emerge when things look really bleak?

That's right. That is one of the beauties of our system, in contrast to what happened in Japan in the 1990s. We have an amazing ability to make colossal mistakes, but we do tend to recognise them and get on with trying to fix them, through some combination of the invisible hand of the market and the visible fist of the government, so we can get on with life. It's what Alan Greenspan calls, "The remarkable flexibility of our economy." We have a huge asset in the recuperative powers of our economy. What we've got going on right now in the debt deflation and property deflation is probably the most nefarious problem we've had in 25 years or more. (You have to go back to the late 1970s, when it looked like we were no longer controlling our own destiny, to find a period, in my view, that was as bleak.) But we do have the will and the means to get on with life. America is very much a going concern. Some people are going to be a lot poorer than they thought they would be. But then, as John Kennedy said, "Life ain't always fair." In general, I remain a card-carrying optimist on the United States economy. Bill Gross laughs all the time around here that I'm the house optimist.

That's not saying much, in a bond house.

No, but I've never advocated owning canned green peas and small firearms.

Let's end on that optimistic note.

Thanks, Paul.

Kathryn M. Welling

March 7, 2008

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