

VOLUME 7
ISSUE 14
JULY 22, 2005

INSIDE

Listening In
Greenspan's
Avowed Persistence
In Raising Rates
Despite
Modest Growth,
Supine Inflation
Means Fed
Is Targeting
Property Bubble

PAGE 1

Guest Perspectives

Hunt Taylor:

*Too Much
Of A Good Thing:
In Hedge Funds,
That's Called
"Efficiency Capital"*

Louis-Vincent Gave:

*The RMB Revalues
... Or Does It?*

Talk Back

Jim Rogers:

*Funds Of Funds
Are The Next
Scapegoats*

Acute Observations

ALL ON WEBSITE

listeningin

Greenspan's Watershed

Latest Testimony Shows Fed Head Is Targeting Asset Prices, McCulley Says

Paul McCulley is Pimco's official Fed Watcher; still finds time to manage billions of short-term funds, and keep a sharp eye on the economy. He's also been known to talk, in the wee hours, to his pet rabbit—and to write about. Lately, he's even admitted contemplating adding a dog to the mix. But when we chatted last week, Paul was eagerly awaiting Alan Greenspan's Humphrey-Hawkins swan song—now delivered. Paul didn't hear everything he wanted, but did decipher what amounts to a watershed shifting of Fed targets... KMW

How's life, Paul?

Not too bad, considering that I just got back last night at 10:30 from a 2-day trip out to the middle of Missouri, to the Ozarks, to give a speech. It is hard to get there from here. You fly to Dallas and then fly to somewhere else and then you take a two-hour car ride. So I left I here on Wednesday morning and I got back on Thursday night and most of that time I was in transit. But it was fine.

You must have been invited by a very good client.

It was the annual convention of all of the state and city retirement plans of Missouri—and there are a number of plans among that group that are clients. Some are big clients. They wanted me to do a keynote. Put all that together and you say, "Just got to do it." Besides, I had never been to that part of Missouri.

I imagine you rediscovered the Southern accent of your youth.

I guess. It did remind me of the way the rural area where I grew up was—25 or 30 years ago.

When you weren't exactly a little kid. But let's focus on the here and now. I know you've been contemplating Mr. Greenspan's prospective departure from the Fed, when you had a chance, in between your travels—and shopping for a new pet.

It is amazing the amount of feedback I have gotten in the last week since I released my latest Pimco Fed Focus piece. [Keeping the Rabbit at Home and the Dog at the Office, www.pimco.com]. I get a lot of email after every column; people either praising me because they agree or calling me a buffoon because they don't. Except that this month most of the feedback was on

the nature of dogs and the pros and cons of various breeds. So many readers wanted to help me out with this whole decision. Actually, we had been thinking about getting one.

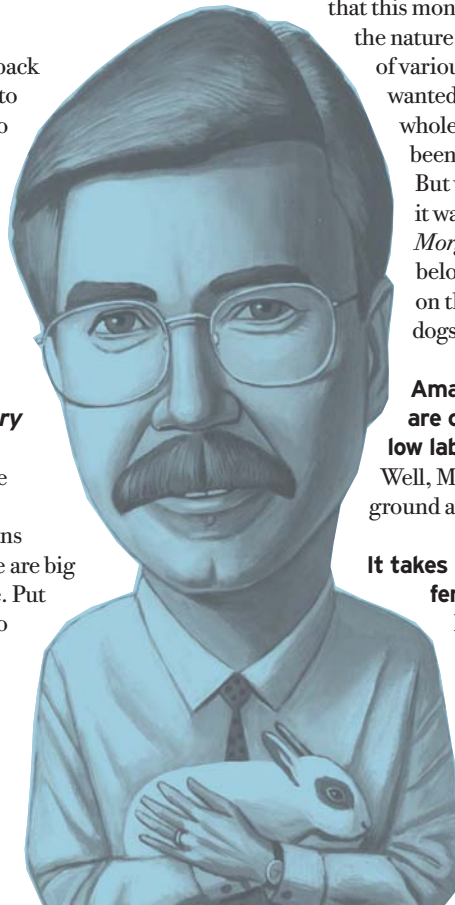
But we hadn't even really thought it was viable as long as we have *Morgan le Fay* [pictured with Paul, below], until we had friends over on the Fourth. They had two little dogs who got along with Morgan.

Amazing. Your canine visitors are clearly nothing like our yellow lab.

Well, Morgan was in her fenced playground and they were on the outside.

It takes a lot more than a little fence to deter Cassie.

Not our friends' dogs. In fact, the magic moment was when one of the little dogs went up and put his nose through the rail and rubbed noses with *Morgan*. Which got me thinking. And things that get me thinking usually become fodder for an introduction to something sub-



Kathryn M. Welling
Editor and Publisher

Jean M. Galvin
Business Manager and
Webmaster

Karin-Marie Fitzpatrick
Editorial Assistant

Alexander Isley Inc.
Graphic Design

Weeden Securities Corp.
Board of Directors

Donald E. Weeden

Barry J. Small

Robert A. Cervoni

Timothy McDonald

Robert DeMichele

Daniel V. Panker

Richard Sharp

Richard Schmaltz

Craig Hetherington

Christopher Mahler

Todd Trimmer

welling@weeden, an exclusive service for clients and prospective clients of Weeden & Co. LP, is published biweekly on Friday mornings, by welling@weeden, a research division of Weeden & Co. LP. Editorial and partnership offices are located at 145 Mason Street Greenwich, CT 06830. Telephone: (203) 861-9814 Fax: (203) 618-1752 Email: welling@weedenco.com jean_galvin@weedenco.com

First-class postage is paid at Stamford, CT

Copyright warning and notice: It is a violation of federal copyright law to reproduce all or part of this publication or its contents by any means. The Copyright Act imposes liability of up to \$100,000 per issue for such infringement. welling@weeden does not license or authorize reproduction by clients or anyone else. However, multiple copies are available to clients upon request and limited reprint arrangements are available. Copyright 2005, K.M. Welling and Weeden & Co. LP. All rights reserved.

Charles Powell

Page 1 McCulley Illustration

Clay Bennett

Page 1 Ribbon Illustration

[Clay Bennett cartoon© 2005 The Christian Science Monitor (www.csmonitor.com). All rights reserved.]

stantive in Fed Focus .

As your pet quandary did in your last piece, leading you into a neat explanation of why Greenspan's long-rate conundrum "dog don't hunt."

And next week [July 20 & 21] is going to be a watershed for Chairman Greenspan for a whole bunch of reasons. No. 1 is that it is his last semi-annual testimony before Congress.

Assuming he actually departs the Fed—

Assuming that he steps down at the end of his term and doesn't accept a lame duck continuation, which is something the White House has the right to ask him to do. The *Washington Post* was speculating that the White House might do that, back a couple of months ago. But my gut, and it is only my gut, is that it won't unfold that way, for a couple of reasons. No. 1, Mr. Greenspan doesn't strike me as a man who would want to live in a lame duck set of clothes. I mean, people who make the case for that tend to point out that if he stayed through next May or June, he would break the longevity record for a Fed chairman, which was set by William McChesney Martin, Jr. But that is the *only* reason I can think of for him to want to stay around. Away from those issues of Greenspan's personality and legacy, it seems to me that the White House has a duty to keep from having a lame duck at the Fed—and having an orderly transition process with an appropriate lead time should be a part of that. In my best-case scenario, this whole process of who will succeed Greenspan will heat up pretty intensely in the fall and a decision will be made before the end of Greenspan's official term. So this will be his last trip to the Hill to deliver Humphrey-Hawkins testimony.

His last hurrah, in a sense.

Under ordinary circumstances, it should be. So it is important in that context.

But you said it's a watershed on a number of other counts, too?

It should also be a watershed because his testimony should show us what Greenspan's current feelings are about the economy versus the property market.

Versus? Is there antagonism there?

What I mean is that, theoretically, they have been tightening monetary policy over the last year to do two things: One, to normalize back from accommodation towards neutral. Two, to pre-empt any incipient cyclical inflationary pressures. Well, if you look at the data for recent months, you clearly see that the incipient inflationary pressures have dissipated, with commodity prices down, with the PPI pipeline rolling over in response to the commodity prices being down in many respects, with the purchasing managers price index falling to 50. Or with the very sturdy dollar. So when you look at all your traditional inflationary indicators, the natural response is, "Where is the beef now?" There just ain't no beef to inflation now. They can say there *were* incipient pressures six months ago, but those infla-

tionary pressures have dissipated. So the Fed no longer has the inflation justification for continuing to beat us about the head and shoulders with rates. Besides, they've moved short rates up from 1% to 3.25% and that is a very material increase in short-term interest rates. Therefore, the putative problem of inflation pressures has been pounded down—that's pretty good alliteration!

And tripped so lightly across your silver tongue—

Okay. They've materially increased both nominal and real short-term interest rates. And, what's more, you have had a very material flattening of the yield curve. So when you put all that together, logic would suggest that a reasonable man would conclude enough is enough. As a matter of fact, that would be a very reasonable thing for Mr. Greenspan to do next week. The tricky thing is that in recent months he has been given to talking about froth in the property market—though he walks all around the whole issue. The man has difficulty actually mouthing the word "bubble," I think.

It is just not part of his lexicon.

It is *really* difficult for him to form that word. It is kind of like a Baptist ordering a beer. He just can't utter the word. But he has been talking about the issue. He *is* saying it is not a *national* bubble. But then again, he has also been talking about his "conundrum" ever since February. So this whole issue of whether, notwithstanding all of your traditional indicators saying enough is enough on the tightening, he is going to articulate that "I am going to override those signals and tighten some more," is fraught. If that's what he says [*as he did*], this will be taken by the marketplace as an indication that he is actually targeting asset prices, longer-term bond prices and property prices. [Paul's succinct comment, *Wednesday after the hearings: "If the glove fits, you can't acquit, but must find guilty."*] That is why this testimony will be intensely watched; it could mark a watershed. Fundamentally, it should reveal if the man has changed his stripes from targeting the traditional business cycle indicators of inflationary pressures (which are flashing everything is okay) to implicitly or, (even more of a watershed) explicitly, going after targeting these two asset prices. That is the key issue for Humphrey-Hawkins. Now, our elected representatives don't tend to ask about long-term bond prices. They ask about long-term interest rates, which actually leaves me bemused more than anything else, given that the reality is that long-term interest rates and long-term bond prices are one and the same. You can't talk about *puzzlingly low* long-term interest rates without talking about *puzzlingly high* long-term bond prices. Which means that if Greenspan says, "I am going to tighten monetary policy more to get those long-term interest rates up," he is effectively saying, "I am going to tighten monetary policy more to push down long-term bond prices." And that is called asset price targeting.

True, but you know enough about populism and politicians to know that it's far more palatable for them to talk in terms of getting long rates up than it is express any concern about the fat cats in the

bond market.

I don't blame Congress so much. Congressmen always asks him about everything *except* monetary policy.

It is almost comical.

Hopefully in the new regime that will unfold eventually under a new Fed Chairman, his bosses in Congress will ask him about his day job. It is really kind of interesting. When I have a performance review, I get asked about how I am doing my day job.

How strange is that!

Really, I don't get asked about whether you should grill salmon for two minutes or three minutes on each side. (Not that I don't have an opinion about that because I grill all the time. But Bill Gross really doesn't focus on my salmon-cooking skills.) But when Greenspan goes to the Hill, they don't ask him about his day job. They instead ask him about fiscal policy and all other sorts of things. My point is that, independent of what Congress asks him, if Greenspan is going to target asset prices, he has to figure out some means to either admit that is what he is doing or come up with some subterfuge, some justification for doing that without admitting it. That is the bottom line. If we go back to the stock market bubble, he said, "I can't see the sucker." But then he kept on tightening interest rates until the sucker broke.

You're saying "Mr. Magoo" could see better than he was admitting?

Back then, he had the foil of your traditional cyclical indicators saying that he could be justified in tightening. In particular, he talked about the wealth effect stimulating demand greater than supply, and so acting to pull down the jobless rate. Which, remember, was down in the low 4% range.

Right, that was his excuse for turning the screws.

So he could effectively try to indirectly go after the stock market by saying that we were drawing down excessively on the pool of available workers. That was a phrase that he invented about that time to say that he wasn't targeting excessively low unemployment; that he was concerned about "a diminution of the pool of available workers." I always liked that phrase.

It's very cute—and flew right over the heads of most folks, in and out of Congress.

Right. It is a clever way of saying, "Too many people are working," which is really difficult, obviously, for a Fed Chairman to actually say.

Even if that is the trade-off. But that does offer neat proof that if your language is dense enough, you can get away with uttering very politically unpalatable truths, even in Washington.

I am not sure how far you would want to push that. Try it out the next time you have a barbecue on a Saturday afternoon. Holler out the back door, "Hey, boys, I'm concerned about a diminution in the available pool of adult beverages." I suspect the reply would be a very quick, "Kate, are we running out?"

Even more likely: "Hurry, run to the store." But now you're talking about something near and dear, and understood viscerally. Greenspan depends on the fog of economics.

I don't know. I'd say jobs are about as visceral as, "We are running out of beer here, men." But now the situation is different because the unem-



ployment rate is a full percentage point above the low it made back then. And even more importantly, the year-over-year change in annual wages looks like a dead man's electrocardiograph.

Utterly flat.

And going nowhere fast. At the same time, we have the reality that corporate profits as a share of GDP are as high as they have been in over three decades. Which is telling you that capital is getting a disproportionate share of productivity gains. That is axiomatic. We have had strong productivity gains. Meanwhile wages are going nowhere at the speed of light and corporate profits as a share of GDP are the highest level in thirty years.

So labor is getting stifled.

Well, you could say that. It would be a value judgment, however. I am careful about making value judgments since I am already known as a principled populist. But just as a practical matter, it is hard to argue that the labor market has become so sufficiently tight that the Fed should try to knock job creation on its head.

Clearly, tight is the last word you'd use to describe this labor market. This expansion has really lagged at job creation.

Nonetheless, too many new jobs is your traditional justification for tightening monetary policy: Somebody somewhere may be getting a job and, God forbid, he also may be getting a raise.

Heaven forbid, because that might stir up inflationary pressures.

Right. But that is a really hard case to make, fundamentally, when corporate profits are at a multi-decade high as a share of GDP and while you are also arguing about the glories of this positive structural shock to productivity. Now, if anybody *can* make that case, it is Greenspan, because he is *that clever*. I take my hat off to him. That is not a criticism but a compliment. Or rather, it is a criticism as a citizen but a compliment as a fellow analyst. When you can convince somebody that *Cold Duck* is actually *Dom Perignon*, you are good.

Or they are very gullible.

One or the other, or both! But in all seriousness, this whole concept of does labor ever get to share in the fruits of its productivity growth is a very legitimate public policy issue. It is also a very legitimate macroeconomic issue. In public policy terms, we have always said that in the long run, rising standards of living are a function of rising productivity.

listeningupdate

Greenspan, in Wednesday's Humphrey-Hawkins testimony: *"The trend reduction worldwide in long-term yields surely reflects an excess of intended saving over intended investment. This configuration is equivalent to an excess of the supply of funds relative to the demand for investment. What is unclear is whether the excess is due to a glut of saving or a shortfall of investment. Because intended capital investment is to some extent driven by forces independent of those governing intended saving, the gap between intended saving and investment can be quite wide and variable. It is real interest rates that bring actual capital investment worldwide and its means of financing, global saving, into equality. We can directly observe only the actual flows, not the saving and investment tendencies. Nonetheless, as best we can judge, both high levels of intended saving and low levels of intended investment have combined to lower real long-term interest rates over the past decade."*

McCulley: Finally, it would appear, Greenspan has read Chapter 14 of Keynes' General Theory: *"Savings and Investment are the determinates of the system, not the determinants. They are the twin results of the system's determinants, namely the propensity to consume, the schedule of the marginal efficiency of capital and the rate of interest. These determinants are, indeed, themselves complex and each is capable of being affected prospective changes in the other. But they remain independent in the sense that their values cannot be inferred from one another. The traditional analysis has been aware that saving depends on income, but it has overlooked the fact that income depends on investment, in such fashion that, when investment changes, income must necessarily change in just that degree which is necessary to make the change in saving equal to the change in investment. "Nor are those theories more successful which attempt to make the rate of interest depend on 'the marginal efficiency of capital.' It is true that in equilibrium that rate of interest will be equal to the marginal efficiency of capital, since it will be profitable to increase (or decrease) the current scale of investment until the point of equality has been reached. But to make this into a theory of the rate of interest or to derive the rate of interest from it involves a circular argument, as Marshall discovered after he had got half-way into giving an account of the rate of interest along these lines. For the 'marginal efficiency of capital' partly depends on the scale of current investment, and we must already know the rate of interest before we can calculate what this scale will be. The significant conclusion is that the output of new investment will be pushed to the point at which the marginal efficiency of capital become equal to the rate of interest; and what the schedule of the marginal efficiency of capital tells us, is, not what the rate of interest is, but the point to which the output of new investment be pushed, given the rate of interest.*

"The reader will readily appreciate that the problem here under discussion is a matter of the most fundamental theoretical significance and of overwhelming practical importance. For the economic principle, on which the practical advice of economist has been almost invariably based, has assumed, in effect, that cet. par, a decrease in spending will tend to the lower the rate interest and an increase in investment to raise it. But if what these two quantities determine is, not the rate of interest, but the aggregate volume of employment, then our outlook on the mechanism of the economic system will be profoundly change. A decreased readiness to spend will be looked on in quite a different light if, instead of being regarded as a factor which will, cet. par, increase investment, it is seen as a factor which will, cet. par, diminish employment." –John Maynard Keynes, 1936

And yet?

McCulley: "Greenspan comes up with the 'right' answer, then says he doesn't understand. It's beyond me!"

Exactly, a rising tide floats all the boats.

Yes. So we have gotten incredibly robust productivity growth in the last number of years, as Mr. Greenspan tells us early and often. But the benefit of that productivity growth has not passed through, if you will, into rising real wages. That creates the public policy question: Why hasn't it?

And the answer is?

I think I know why it hasn't, which is because we have effectively globalized the labor market. In other words, the marginal price setter for labor demanded in America is not American labor.

I've heard tortured arguments to the effect that American labor is better off because their dollars are going so much farther than they used to, thanks to quality gains, hedonistic adjustments and all that rot.

Sure, and I suppose that if you take a bottle of *Cold Duck* and replace its screw top with a cork, you *could* argue that it is better champagne. At least, you could *try*.

Nonetheless, the whole public policy issue of shares of GDP to labor versus capital is philosophically important in a democracy. And on a more practical level, the shifting of shares of GDP from labor to the corporate sector has real macroeconomic import, because the corporate sector is showing an amazingly muted propensity to spend its cash. Which therefore raises the issue of a shortage of aggregate demand. Because if you are shifting share of GDP to someone with a low propensity to spend, that makes it more difficult to get the self-sustaining properties of the economy to work. This has shades of Keynes' *Paradox of Thrift*.

Precisely—as depressing as is that thought.

This is an extreme example—and I use it strictly as an example—But if you shift 100% of GDP to profits at Microsoft, you are going to have an aggregate demand problem because Microsoft can't find someplace to spend all of the cash. What they do is very logical, issuing special dividends and such. But those special payouts don't tend to go to people with a high propensity to consume.

Rather like Bush's tax cuts.

Yes, but let's stick to my example. God bless him, Bill Gates gets *his* special dividend and immediately turns around and gives it to his foundation. I applaud him for that and it makes me feel good that he is doing that. Still, from the standpoint of the flow of that payout into the aggregate demand flow, there is leakage.

Definitely.

The more you shift shares of income in an economy to the top, the more leakage there is from the aggregate demand flow. So this whole issue of shares of GDP— or, put differently, will labor ever catch up in sharing in the fruits of its productivity— is a public policy issue as well as a macroeconomic issue that I would like to see Mr. Greenspan address. Quite frankly, I would not be surprised to see him address it, because he is a very smart man and he knows these are key issues. Granted, we economists often talk about things in the economy that are inherently unsustainable. Anything that is not in accounting balance is something that is an imminent problem. But *this* is a really important macroeconomic issue: How do we effectively maintain aggregate demand over time, if labor never gets the fruits of its productivity? Especially because that creates a distribution of income issue that is very skewed.

And only getting more skewed over time.

It goes back to that famous one-liner from a quintessential Keynesian (even though he didn't know it), Henry Ford: "I have got a problem in my business if the guys who make these motor vehicles don't have sufficient income to buy that which they are making."

Exactly. Mass production is pointless if the masses can't buy what's produced—

Henry Ford's \$5 a day wage was the most beautiful Keynesian thing ever invented. It was based on a very simple insight: "If the guys making these cars can't afford to buy cars and there is a limited number of rich people, how can I grow my company?"

It's called enlightened self-interest.

Right, he set the wage not because he thought that the guys deserved the raise, but because if he didn't give them raises, he couldn't sell his damn cars. Obviously, we don't know his precise thought process but that was its essence. And it has application as we look at the broad economy these days: Ultimately, workers have to be able to buy the fruits of their work. If they lose income in the process and that lost income effectively goes instead into idle cash balances—which is essentially what has happened in recent years (there is more cash on corporate balance sheets than we have seen in our adult lifetimes)—the dynamic recycling character of a capitalist economy is dramatically constrained. Hopefully, Greenspan will be talking about these things. Or alternatively, he could spend 95% of his time on the Hill talking about the need for Congress to re-institute pay-as-you-go rules on fiscal policy.

Before he segues into a discourse on the correct valuation of the Chinese currency.

That certainly will have to come up because it has become a *cause célèbre* and Greenspan—and here my heart does go out to him, though it doesn't all that often—is an absolutely difficult situation. He knows, like any competent macro analyst knows, that there is not going to be a sufficiently material revaluation in the Chinese currency to change the pattern of trade flows between America and China.

Of course not, that would have to be huge.

It would have to be so huge as to be—I don't know what the right word would be—nonsensical. Because the starting point, the wage differential between here and China, is massive. The fact is that the world is undergoing a globalization of the labor force, bringing in tens of millions of people who previously weren't in the global labor force. We are bringing them in one step removed, by importing their products, which embody their labor. America can't compete with that labor. That is the reality of the deal. Unless we do something silly and say that we will make our country poorer by not allowing Americans to shop in China's store, the current account deficit and the trade account deficit with China are going to be more or less what they are now—or bigger. Greenspan has articulated that beautifully and, again, I pat him on the back for speaking the truth on this whole issue. He has also commented that if you nonetheless try, if you have any impact whatsoever with respect to China, it will be only at the margin. All you would do is shift some sourcing to another place with cheap labor—like Vietnam, sitting right there next door. I stress that while you may be conceptually able shift a little, it will only be at the margin, so you'll just be shifting from which country you'll be sourcing, one step removed, the cheap labor. You can't change the fact that global labor is cheap versus American labor. That is the simple reality. But it has all become a matter of trying to head off Sen. Charles Schumer's Smoot-Hawley II protectionist bill—which is the only thing that you can call Mr. Schumer's bill.

In polite company—

The irony for me is that Mr. Greenspan and Treasury Secretary John Snow effectively said that just a few weeks ago. Yet the fact that Mr. Schumer is still there with his bill is leading the Administration and, one step removed, Mr. Greenspan, to continue beating up on China to “do something.” Even though they know and you know that Mr. Schumer's bill would be terribly bad economics, it is still having an impact.

A political impact, most definitely. The scary part is that it could also have an economic impact.

Absolutely. It reminds me of a one-liner that Dick Nixon used way back when, regarding *realpolitik*. He said, “In matters of global diplomacy, it is useful if your adversary might conclude that you just might be a little bit crazy.”

The ultimate irony is that Nixon was crazy...at least on some levels.

My point is that what we are effectively doing with this whole Schumer bill is letting the world know that we just might just be crazy enough to shoot ourselves in the foot—and to shoot the world in the foot in the process. Therefore, we can ask, “As a prophylactic against us actually being crazy would you please move your currency up a little bit?” That is the game that is being played. So that issue certainly will come up. But I certainly hope that Mr. Greenspan doesn't make any news on that whole issue because the currency brief is unambiguously a global financial diplomacy brief. Which resides over at Treasury.

Since when does that make any difference in DC?

Well, Mr. Greenspan already has spoken the truth on the issue: It is only sound and fury, unless we do something stupid. And if we do something stupid it is very bad. He has made his position quite clear. But it will be interesting to see how that unfolds, particularly with the media now speculating, evidently with fairly good sourcing, that before China's new honcho comes for his September visit, he will give America a token prophylactic against craziness. [*As he did Thursday, revaluing the RMB against a basket of currencies. See Guest Perspective by Louis-Vincent Gave in current issue of w@w.*]

You think? He has little reason to do anything that could be interpreted in China as a sign of submission.

He is in a difficult bind. While China is a developing country, they are not nearly as poor as they used to be. They are also a sovereign nation and they would like to have a bit of respect for the fact that they *are* a sovereign country. Also for the fact that they have \$700 billion plus of currency reserves. So they are not just stubborn. On the geopolitical stage, they can rightfully expect and also demand a bit of respect as a sovereign nation. They also deserve respect for the development plan that they are carrying out and for the fact that it is a mutually winning situation for them and for the rest of the world. They represent effectively a positive supply side shock to global capitalism. To me, that is a beautiful thing. Actually, it is hard for anybody to argue with a straight face that it is not. They are effectively moving from a socialist economy towards a capitalist economy. To do so, they have to move their resources into areas that pass a global market test—and they don't have a legacy or a history of market-directed resources in China. So, in order for them to grow up to be capitalists, they have had to go to school on the capitalist world. Which is what they are doing. The buildup of their huge reserves is nothing more than the tuition they are paying to attend the global capitalist school. They are making wonderful grades. Clearly, their labor—deployed in export-oriented industries—is producing goods at a price that the world wants. That is called capitalism. On the flip side, in the process of building up their reserves—which is nothing more than providing vendor finance for their customers—they are building up wealth, which de facto operates as collateral to attract foreign direct investment. China itself is not very good—in fact, they are very bad—at intermediating their very high savings rate. (China has always been a very high savings country. Traditionally, they have intermediated those savings (very poorly) through a state-owned banking system.) In many respects, what they are doing now is outsourcing the intermediation of their savings. On one side, they use a chunk of their savings to provide vendor financing for the customers of their export-oriented industries. And because their export-oriented industries have to compete in a capitalist world, providing vendor financing for their customers makes a lot of sense. Meanwhile, in the act of providing that vendor finance, they build up a huge stock of currency reserves which effectively emboldens global capitalists to make direct foreign investments in China. And, since those global capitalists are driven by the profit-seeking motive,

that activity is also governed by global market prices. So on those two fronts, they are connecting themselves to the global capitalist pricing mechanism. It is a beautiful system that they are employing.

Unless you are an unemployed American or European worker.

Granted, it has some externalities, like putting downward pressure on global wages. But it also puts upward pressure on global purchasing power. They have a strategy that makes a great deal of sense for them. The issue at the end of the day comes back to the fact that their strategy inevitably will price American labor down in low-value-added pursuits. Therefore American labor will seek protection from that source of competition. "If you can't compete with them in the marketplace, compete with them in Washington."

It's one of this country's less-proud traditions.

I understand that—even though, as a macroeconomist, I find it foolhardy. As a political analyst, I understand why Washington is responsive to pleas for protectionism, even though intellectually I think most people—even in Washington—would conclude that it is inconsistent. The problem is that in the political process, the *benefits* of protectionism accrue to single-issue voters, whereas the *costs* of protectionism are spread via a thousand nicks to consumers. You pay more than the global price for a pound of sugar. I doubt seriously, however, that doing so will turn you into a single-issue voter. You might not *like* it, but there are probably lots of products that you don't even know that you are paying above the global price for, because of protectionism. It is a diffused cost that doesn't turn the people who are bearing it into single-issue voters. But what makes protectionism extremely attractive in a political context is that *those who are protected, know it and become single-issue voters.*

And there's no one a pol wants more on his side.

I remind my colleagues around here all the time that just because a politician says something favorable about protectionism doesn't mean that he is morally bankrupt. He *may* be morally bankrupt, but that is not evidence of it. It is merely evidence that he is a rational individual seeking re-employment. That is all. Because a rational politician wants to have as large a block of single-issue voters on his side as possible.

Put differently, it's a no-brainer that no-brainers attract.

I leave the cynicism to you. A politician is simply acting rationally. He may or may not be morally bankrupt. That is an entirely different issue. So the fact that he is acting rationally can't be taken as evidence that he is lacking in moral fiber. Which is why I fear protectionism so much. If I were sitting in Washington as a politician, as a rational man who wanted to be gainfully re-employed every two years or every six years at the ballot box, I would do the same thing. The squeaky wheel does get the grease because the squeaky wheel is the single-issue voter. That is the issue that I worry most about because of the momentum of this thing. I hope it will be diffused in the next few weeks, few months. So we won't change anything fundamentally in the years ahead. You may want your adversary to think that you might be a little bit crazy, but you don't want to give him *evidence* of it.

Well, the other question Greenspan is sure to get will be about the real estate bubble.

My guess is that the top of the agenda for Greenspan's last visit with Congress will be, "Sir, are you trying to target property prices?" [*Which was answered, if not asked, in no uncertain terms, as Paul sees it, when Greenspan said he'd persist in raising rates.*] Then, "Sir, what about China?" Then there will probably be a lot of discussion of fiscal policy. After all, in February, most of the questions were all about the President's Social Security reform plan—and Greenspan put himself out

there pretty far, in getting behind the President. Of course, in the interim, it looks like the President's plan to carve out a portion of the payroll tax for private accounts has taken a long walk on a short pier.

That is one way to put it!

I am not protesting that is *not* going to pass any time soon. Do you know anybody who is? I think the American people figured out pretty quickly the difference between assuring the system's solvency and a desire to privatize the most important public safety net we have. I also think the American people are willing to indirectly accept some form of means testing, which is the solution to the solvency question—and progressive indexing is a form of means testing. That is how you deal with the solvency of a defined benefit pension scheme. By contrast, effectively taking a portion of the payroll taxes to fund private accounts had nothing whatsoever to do with solvency. It would change the fundamental character of the program—and the American people said no. Quite frankly, I understand why. No. 1, the American people like the insurance character of Social Security. "Insurance" is actually in the title of the whole thing; and people understand it is not just a retirement scheme. It is an insurance scheme. And the single biggest worry that most Americans have is that they will live longer than their money.

No doubt.

From an analytical perspective, Social Security allows us to pool that collective worry and diversify it across ourselves, so that no individual has to worry about outliving his Social Security benefits. That is a positive gain for society at large—to have society at large underwrite the risk that you live too long. And I think the American people intuitively understand that. I think too, and maybe it is hard to separate these two things, that a good chunk of American people also recognize intuitively that money management is not their day job. I have been in this business long enough, as you probably have, to recognize that a lot of Americans are not exactly what you would call financially literate. But they understood, basically, that to privatize Social Security would be to take away the insurance benefit associated with pooling the risk of people outliving their money. And that would amount to a dead-weight loss to society, because each individual would decide, "Now I have to underwrite that risk myself, that I live too long."

So up goes the savings rate—and down goes consumer spending—

That would be the logical implication if you took it to its logical conclusion. It would be a dead weight loss on society because we now pool that risk, just like we pool the risk of any individual bank in the country going belly up, through the Federal Deposit Insurance Corp. After all, eliminating FDIC coverage would be a dead weight loss to society because you would have to spend a good chunk of your day trying to figure out whether the management of your bank was doing a good job.

I don't know, off the top of my head, the answer is no.

Instead, I think we all agree that FDIC insurance provides the closest thing you can get to a free lunch from a societal perspective. Granted, it *is* laden with moral hazard, but we know that. Moral hazard is the lubricant of civilized society—anytime you pool risks in a society at large, you expose moral hazard.

I can't help myself. I'd love to hear you say, "Moral hazard is the lubricant of civilized society," on Fox News or someplace like that—and then just step back and watch the fireworks—

But it's true! And if we as a society are going to pool a risk and insure against it, then we the people, as the provider of that insurance (through our government) have a duty to erect regulatory structures against moral hazard. That is how you deal with moral hazard. And that

is, for instance, the whole justification for the Fed regulating banks. “If you are too big to fail, then we have a right to get in your face about what you are doing. It is a very simple sort of logic.

And the reason, to cite a current example, Citicorp has been told to cool it on the acquisition front until it gets its house in order.

That’s a specific, but in general, any pooling of societal risk creates a moral hazard—and regulatory tools are required to deal with that. With Social Security, the pooling of the risk that you outlive your money creates all sorts of moral hazards, the biggest one of which is that rich people double dip. It is that simple. Rich people, who by definition are not going to outlive their money, still enjoy the insurance protection. That’s the *prima facie* case for means testing it, as I see it.

Still, you don’t expect the Chairman to have to handle many tough questions, do you?

No, I would imagine these will probably be pretty friendly hearings. Remember, he is an idol up on the Hill and this is their last chance for idolatry.

Diabetics, you’re suggesting, shouldn’t tune in?

Either that, or wear fish waders and pack an extra supply of insulin. But on a very practical level at the end of the day as a portfolio manager, I have to hope that the questioning comes back to this whole issue of asking Mr. Greenspan, “What is your game plan moving forward? You have increased rates *a lot* and now you have *demonstrable evidence* that the incipient inflation threat has been diffused. Given those two facts, sir, when are you going to stop declaring policy accommodating and call off the beatings? We have taken beatings nine times in a row. Let’s say they were justified. But let’s look forward: Given the evidence we have now, are you going to continue beating us?” It is that simple.

Or not, if he disputes your facts.

I don’t think he can argue with either one of those as facts. He has tightened short rates a lot and we have rolled over the cyclical inflationary pressures.

Isn’t that still the question? There’s no indication, in their latest minutes or anywhere, that Greenspan is ready to call off the anti-inflation dogs.

“The beatings will continue until morale improves.”

Exactly.

Which gets back into the whole issue of the “conundrum.” The question for Mr. Greenspan is, “Sir, the bond market is saying that you are no longer accommodating. When will *you* stop saying that you are accommodating? The dollar is saying you are no longer accommodating. Commodity prices are saying you are no longer accommodating.”

Your latest Pimco Fed Focus piece even did a pretty deft job of unraveling his “conundrum” for him. And its subtext was that he almost invariably has followed the markets, not led them.

I could be wonderfully pleased if he basically says, “I have substantially removed the accommodation.” He said something like that at one point during the 1994 cycle. It did not mean he was *finished tightening* at that juncture. (After he said that he had removed the accommodation, he decided that he needed to go *restrictive*.) But right now, what the marketplace wants to know is, “Sir, have you finished removing the accommodation?” Then we can have a separate debate about whether there is justification for moving to restrictive. I mean, it is one thing to take away the beer, it is another thing to serve up castor oil. That is a

demarcation called neutral. At neutral, you are serving neither.

But nobody knows what neutral is—

Exactly, all I know is that if you grab a can of cold beer and it turns out to be castor oil, that is truly an unpleasant experience. So the very practical issue that Greenspan’s swan song on the Hill should answer is whether or not he declares victory. The incoming evidence gives him plenty of room to do that. Commodity prices rolling over, tame wages, the PPI pipeline rolling over, the most recent PPI and CPI data being incredibly benign, friendly, low—all that sort of stuff. The strong dollar, the flat yield curve. I mean, there are a whole lot of things he could point to, if he wants to say, effectively, “I told you a year ago that I was going to take away the emergency accommodation I had put in place to truncate the risk of deflation. We did truncate the risk of deflation. I now have taken away the emergency accommodation that was required to do it. So I can pat myself on the back once for having taken care of that deflation risk and once again for having removed the tool that I used to create that deflation prophylactic. Therefore I walk on water.” There is plenty of room for him to do that. The big issue is, though, is whether he is after the property market? And I just don’t know.

If he is, he won’t declare victory.

I know what I think he *should* do. But what I think he should do is entirely irrelevant to my day job of figuring out what he *is* going to do. So this is one of those situations where I will have to be reactive.

You’re going to wait and see. Despite evidence all around you in Southern California that the real estate market has gone bonkers?

There is no question that Orange County real estate is unambiguously in a bubble. But I don’t think the *macro* tool of the Fed Funds rate is the right tool to use to deal with that *micro* problem. It is very similar to how I felt, as you know, six years ago. The best way to deal with the 10 stocks in the Nasdaq 100 that were driving everything would have been to increase margin requirements. It would have sent a signal that the Fed indeed had seen a bubble. In like vein, no down payment, no salary-check loans—and all manner of other creative mortgage lending products of that ilk—are supporting a bubble in property markets. I don’t like them. It would be easy for the Fed to tell lenders to cease and desist.

What? It wasn’t long ago that Greenspan was actually praising innovations in mortgage finance—

Be that as it may, it is the creativity of the mortgage finance industry that is furnishing liquidity to the speculative elements. And if you need to deal with that, you should deal with that using *micro* tools— that’s what you should use for micro problems. And as Greenspan has said repeatedly, if there’s a real estate bubble, it’s a micro problem; it’s localized, it’s in second homes. It is in condominiums. He pounds the table that it is not a national bubble. Well, if it is not a nationwide bubble, why use a nationwide tool to deal with it? If it is a local problem, varying geographically as well as by the type of residence, then use a surgical tool. But hope springs eternal.

So you are pretty concerned he’ll keep bludgeoning the market?

Actually, at the margin, I would be somewhat more optimistic that he would be willing to consider the micro tool in this instance than he was back in the stock market bubble.

Why?

Because this time he *could* with a straight face argue that taking action is related to the soundness and safety of the banking system. In fact, the regulators have already started the moral suasion game to get banks to

tighten their underwriting standards. Telling them that it really is a step too far when mere rumors that the borrower is breathing are a sufficient basis for underwriting a loan. There's actually a new loan in the marketplace now, known as the liar's loan. It requires no verification of a borrower's income!

Now that's truth in lending!

In any event, even though most of these sorts of loans are packaged and sold into the capital markets globally one way or the other, so that the risks are not concentrated in the originating bank, it would still be easier (as already demonstrated via the warnings to banks to be careful about their underwriting standards) for Greenspan to justify using a micro tool to temper property speculation because of risks to the banking system than it would have been for him to justify raising margin requirements back in 1999. Doing that would have amounted to him admitting that he was attacking speculative elements in the stock market. He simply did not want that on his resume. He didn't want to be remembered as the father of a bear market in stocks. He wanted an immaculate correction. So, while it's not my base case scenario, it is easier to conceive of Greenspan using a micro tool now than it was six years ago.

[Nonetheless, a letter from Greenspan to the chairman of the joint economic committee of Congress (New Jersey Rep. Jim Saxton), released by the Republican's office on July 18, shows the Fed head still adamant in his refusal to contemplate employing micro tools.

(<http://www.house.gov/jec/hearings/testimony/109/ag06-09-05questions.pdf>)

Yes, in those comments, Alan once again castigates those who advocated hiking margin requirements during the NASDAQ bubble (which is the approximate reason I will never be invited to Jackson Hole while he is Fed Chairman!). And while that's important to me, personally, what's far more important are the letter's (negative) implications for the possibility that he'll use regulatory tools in current circumstances to address "froth" in the property market. I have only one thing to say on this, which is to repeat Mr. Greenspan's own words of Sept 24, 1996:

"We do have the possibility of raising major concerns by increasing margin requirements. I guarantee that if you want to get rid of the bubble, whatever it is, that will do it. My concern is that I am not sure what else it will do."

Besides, going on record saying that real estate prices are too high would be even more unAmerican than saying the stock market has risen to ridiculous levels.

True, in saying that he sees froth in the property market, Greenspan would effectively be taking a shot at the most important asset in the average American's portfolio. I think

the statistic is that 70% of Americans own their own homes now. So he could actually be perceived as being more of a skunk at the picnic than he would have been, had he attacked the equity market bubble. It is tricky politically. But one way he could do it is by not attacking the primary residence. He could say, "Yes, I see froth and speculation, but it is not in the market where responsible citizens are putting roofs over the heads of their families. It is in the second-home market and the condo-flipping market." Which is actually the truth. That is where the speculation is. And the reason you can get speculation in the second home market or the condo markets is that those transaction costs don't involve you moving. As Greenspan has said time and again, it is hard to get speculation in the primary residence market because you have to live somewhere. But a second home or condo, you can buy and then flip out six months later. So he might just use micro tools on housing. That is the big issue for me. Will he do that, or are we going to water our potted plants with a fire hose? We won't know until he testifies.

Where does that leave you as a portfolio manager?

There are not a lot of easy choices for a bond manager here, or for an equity manager, either. You just don't know when they are going to stop, or on what basis they are going to stop. For me, on what basis they're going to stop tightening is actually more important than the precise number. I am constantly reminding my younger colleagues that it is not sufficient to pick a number. You have to pick the context in which that number works. Because markets care far more about the context than they do about the precise number, longer term. (Short-term they do care about the precise number regardless of the context.) But longer-dated, forward-looking markets care whether the context is responding to traditional business cycle indicators of inflationary pressures or is it an attempt to break a "conundrum" in bond prices and/or speculation in the property market? Those are two very different contexts. Until we have a definitive answer as to which it going to be, you want to be on the defensive side of neutral in fixed-income portfolios. That doesn't mean being a screaming bear—and I stress that because if the Fed overdoes it, which is the distinct risk if they go after the property market, there will be collateral damage. I mean, if you try to water your potted plants with a fire hose, there will be collateral damage and you will have to come back with a mop.

And buy new plants.

Sure. Now cleaning up collateral damage is usually associated with the provision of warm and fuzzies for the fixed-income market—given its typically macabre state of mind. So you don't want to be too defensive, for the simple reason that the more mistakenly nasty they are, the greater will be the pleasantness for bonds on the other side.

Thanks, Paul.

W@W Interviewee Research Disclosure: Paul McCulley is a managing director of PIMCO, and author of its monthly *Fed Focus*. He is also portfolio manager of *Pimco Short-Term Institutional*, its ultra-short-term bond fund. Past performance is no guarantee of future results. This article contains the current opinions of the author and such opinions are subject to change without notice. This interview has been given for informational purposes only and is not a recommendation or offer of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. Each sector of the bond market entails risk. The guarantee on Treasuries is to the timely repayment of principal and interest, shares of a portfolio that invest in them are not guaranteed. Duration is a measure of price sensitivity to interest rates and is expressed in years. Any simulated portfolio example is a hypothetical illustration for educational purposes only. It does not represent actual results of any portfolio or particular investment. The selection of a different proxy for this illustration could produce different results. No representation is being made that any account, product, or strategy will or is likely to achieve profits, losses, or results similar to those shown. Hypothetical or simulated performance results have several inherent limitations. Unlike an actual performance record, simulated results do not represent actual performance and are generally prepared with the benefit of hindsight. There are frequently sharp differences between simulated performance results and the actual results subsequently achieved by any particular account, product, or strategy. In addition, since trades have not actually been executed, simulated results cannot account for the impact of certain market risks such as lack of liquidity. There are numerous other factors related to the markets in general or the implementation of any specific investment strategy, which cannot be fully accounted for in the preparation of simulated results and all of which can adversely affect actual results. No part of this article may be reproduced in any form, or referred to in any other publication, without express written permission of Pacific Investment Management Company LLC. ©2005, PIMCO. For further information, please see www.PIMCO.com. Paul can be contacted at McCulley@pimco.com.

Welling@Weeden Staff Conflicts Avoidance Policy Disclosures

In keeping with Weeden & Co. LP's reputation for absolute integrity in its dealings with its institutional clients, welling@weeden believes that its own reputation for independence and integrity are essential to its mission. Our readers must be able to assume that we have no hidden agendas; that our facts are thoroughly researched and fairly presented and that when published our analyses reflect our best judgments, not vested pocketbook interests of our sources, colleagues or ourselves. Neither Weeden & Co. LP nor w@w engage in investment banking; w@w's mission is strictly research.

All information gathered by welling@weeden editorial staff in connection with her/his job is strictly the property of welling@weeden. It is never to be disclosed prior to publication to anyone outside of welling@weeden. Editorial staff (a group broadly defined to include Kate Welling's immediate family) will not buy or sell any security mentioned in the journal for at least one week after publication. Staff will avoid not only speculation but the appearance of speculation and may not engage in short-term trading, the short selling of securities, or the purchase or sale of options or futures. Staff may not be otherwise compensated for securities recommendations in these pages. No w@w staff will serve as an officer or director of any publicly traded company. All securities positions entered into by w@w editorial staff will be held for at least six months unless dispensation is received, in extraordinary situations, from Weeden & Co. LP's compliance officer. Any securities position in any company, mutual fund or partnership portfolio featured in welling@weeden that was acquired by staff in advance of the publication decision will be specifically disclosed at first mention. [No such reportable positions exist.] And that position will be frozen for six months from date of publication, again, absent extraordinary dispensation from compliance.

Weeden & Co. LP's Research Disclosures

This material is based on data from sources we consider to be accurate and reliable, but it is not guaranteed as to accuracy and does not purport to be complete. Opinions and projections found in this report reflect either our opinion (or that of the named analyst interviewed) as of the report date and are subject to change without notice. When an unaffiliated interviewee's opinions and projections are reported, Weeden & Co. is relying on the accuracy and completeness of that individual/firm's own research disclosures and assumes no liability for same, beyond reprinting them in an adjacent box. This report is neither intended nor should it be construed as an offer to sell or solicitation or basis for any contract, for the purchase of any security or financial product. Nor has any determination been made that any particular security is suitable for any client. Nothing contained herein is intended to be, nor should it be considered, investment advice. This report does not provide sufficient information upon which to base an investment decision. You are advised to consult with your broker or other financial advisors or professionals as appropriate to verify pricing and other information. Weeden & Co. LP, its affiliates, directors, officers and associates do not assume any liability for losses that may result from the reliance by any person upon any such information or opinions. Past performance of securities or any financial instruments is not indicative of future performance. From time to time, this firm, its affiliates, and/or its individual officers and/or members of their families may have a position in the subject securities which may be consistent with or contrary to the recommendations contained herein; and may make purchases and/or sales of those securities in the open market or otherwise. Weeden & Co. LP is a member of NASD and SIPC.