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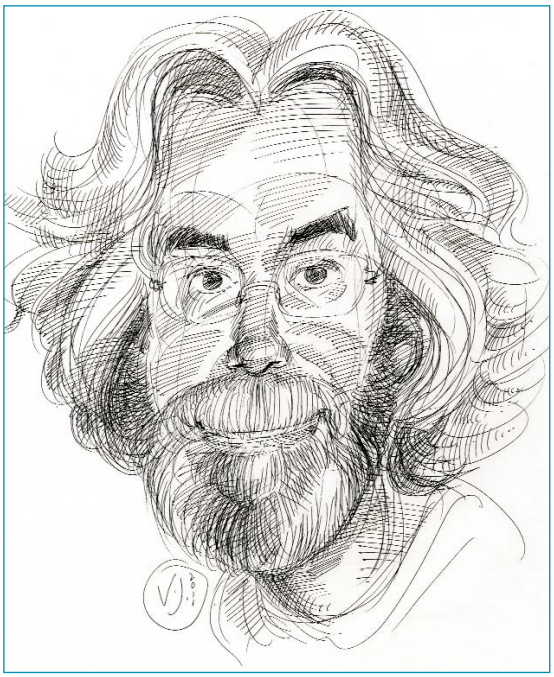
INSIDE

listeningin

Trapped

Greatest Moral Hazard, Says Paul McCulley, Is Austerity Here And Now



*Is **Paul McCulley** feeling liberated by his retirement from **Pimco**? A mere glance at the accompanying likeness, drawn from a snapshot I took of him at "Kamp Kotok" (**Cumberland Advisor**'s annual Maine economic conference and fishing party) in early August says it all. Not that Paul has ever been one to hide his light – or his views – under a bushel basket. But his new life style clearly agrees with him. What just as clearly does NOT agree with the economic realm's leading disciple of **Hyman Minsky** are the incessant calls for fiscal austerity filling the airwaves. It's precisely the wrong response to the liquidity trap in which the economy is ensnared. Or, as Paul might, but didn't say, "Moral hazard be damned, the anorexic economy needs to be fed." Keep reading for what Paul DID tell me during an afternoon chat that was even better than the fishing.*
KMW

How are you adjusting to all of your new-found leisure time in "retirement" – when you're not fishing, that is?
Well, I've actually been doing quite a lot of fishing – but my retirement was no spur of the moment thing, either. It's not like I was unprepared to make adjustments.

I knew you had been planning it for quite a while; had set up your foundation –
There was a lot of strategic planning involved – I say that in a positive way, not in a wonkish one – about what my life would be after PIMCO – not that I wasn't ecstatic there. But I spent a good chunk of my life anticipating that my next stage would be in Washington, as a Fed governor. I came close, but that didn't happen. Anyway, I'm pursuing a very satisfying life now. I'm still very engaged intellectually. I've been a supporter, via my foundation, of the **Global Interdependence Center** for a number of years. I am good friends with **David Kotok**, the Chairman and CIO of Cumberland Advisors, and **Bill Dunkelberg**, the Chief Economist of **The National Federation of Independent Business**, who head the GIC. We sat down last year and developed a new wing, if you will, of the GIC called the **Global Society of Fellows**. I am the first fellow, my foundation has funded the endowment, and we're excited about doing new things there.

I want to hear all about that. But first,

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Page One Illustration

let's talk about what's happening in this crazy economy. You started saying we're in a liquidity trap some time ago. Where are we in that process?

I like how you ask the question as, "where are we in this liquidity trap" because that allows me to fine tune the diagnosis. Most of the marketplace, and the policy makers even more so, are still debating the diagnosis: Are we, or are we not, in a liquidity trap? To me, it's absolutely critical that this diagnosis is made correctly. Because if you conclude that you're in a liquidity trap – and I do unambiguously embrace that conclusion – it has profound implications for the right set of policies. It also has profound implications for how markets will discount the policies. What this means is that policy is not a matter of a large menu, encompassing, "Well, we might know we're in a liquidity trap and we also might not be in one, therefore we'll do –

A little of this and a little of that–

Right. There are clear-cut things that you *do* if you're in a liquidity trap. A liquidity trap is simply defined as when the private sector is in a deleveraging mode, or a de-risking mode, or an increasing savings mode – all of which you can also call deleveraging phenomena – because of enduring negative animal spirits caused by legacy issues associated with bubbles. In that scenario, the animal spirits of the private sector are not going to be revived by a reduction in interest rates *because there is no demand*. It's not the price of credit driving the deleveraging. It's "I took on *too much debt* during the bubble. I have *negative equity* in my home. I *don't care* what the *price* of credit is, *I already have too much outstanding*. I am paying down credit!" That can be entirely rational for an individual household. It can be rational for an individual firm. It can be rational for an individual country. However, *in the aggregate*, it begets the paradox of thrift. What is rational at the micro-level is irrational for the community, or at the macro level, and I'm amazed that this is not assumed as a given description of what we've got going on right now. The paradox of thrift and the liquidity trap are fellow travelers that are functionally intertwined.

Could it be that people are confused because of all the attention paid to the liquidity the Fed has pumped into the system via quantitative easing – even though most of that only flowed into the most speculative and unproductive pockets in Wall Street?

That could very well be the case. But that diversion of attention is unfortunate because it clouds people's vision of the larger picture, which is pretty straightforward. It's really textbook sort of stuff. My friend, [Nobel Laureate, Princeton Economics professor and *New York Times* columnist] **Paul Krugman**, has been writing a great deal about it recently. If the private sector is delevering and derisking and you're caught in the paradox of thrift, *the public sector is supposed to go in the exact opposite direction*. The exact opposite direction.

"Putting somebody who is suffering from anorexia *on a diet* doesn't make a lot of sense to me. But essentially that's what the austerity folks are preaching."

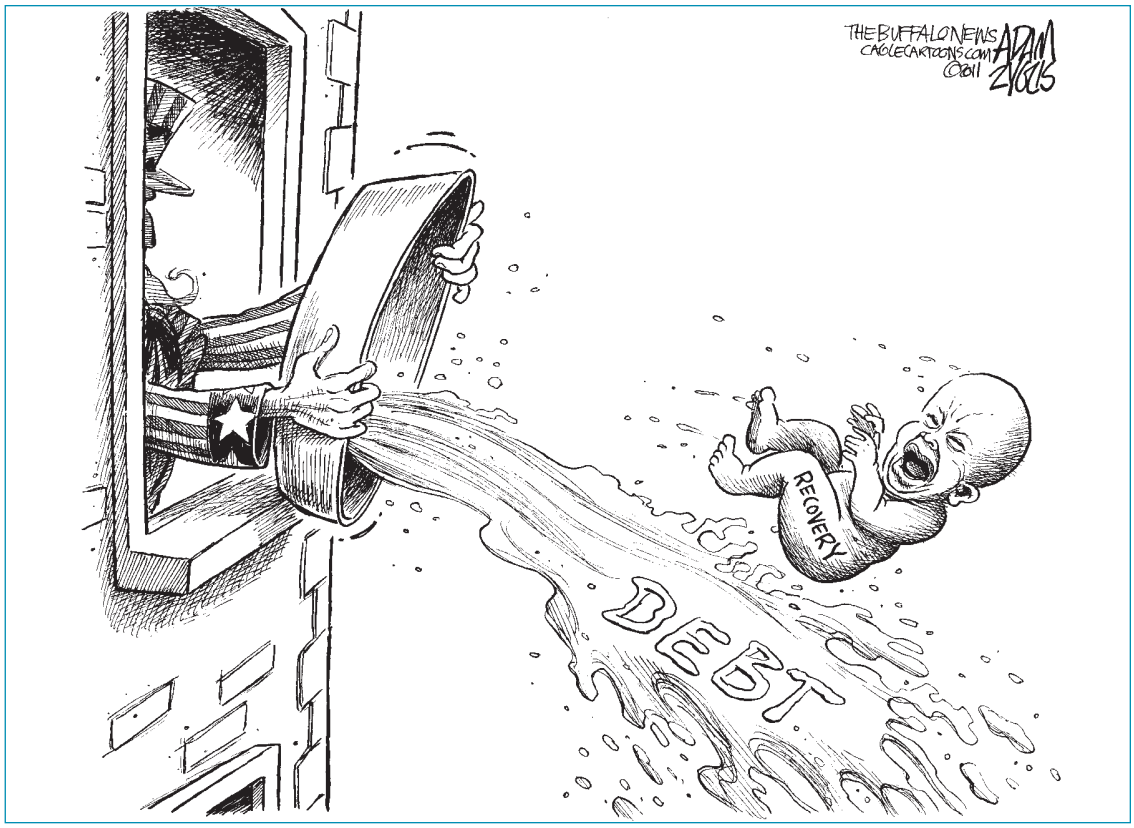
You mean that cutting federal spending in a liquidity trap, like we're in, is absolutely counterproductive?

Yes, it's *ludicrous* and I don't use that word too often. There's a large range of opinions about most issues, and rightfully so. But if you are in a liquidity trap and you are advocating front-loaded austerity–

The Tea Party is really talking about killing the economy –

Again, it's absolutely *ludicrous*. And if we need an example, we can just look across the pond and see what's going on in Euroland. Putting somebody who is suffering from anorexia *on a diet* doesn't make a lot of sense to me. But essentially that's what the austerity folks are preaching and that's what we've been grappling with here in the United States.

Of course, the proponents of austerity are worried that this country's debt load is already too much for future generations to handle.
"We have to go on a diet for our long-term well-being. The only question is how severe of a diet?" – That is the question being asked. As opposed to what we *should* be discussing, which is, "Gosh, we're talking about someone who is *underweight* here! Why do we need to be on a *diet*? Maybe we should have *more* food!" *Incredibly*, to suggest such a thing is to be considered *a heretic* these days.



Paul actually gets more wound up about it than I do. I enjoy reading him now with the luxury of doing it whenever I get around to it during the day. I just smile. Though on any given day, I have to admit to a bit of envy, from the standpoint of thinking Paul's piece was really good, but that if I were still in the arena, I could have upped his ante. But his is a really good ante, in just calling out the silliness. That's what worries me the most about the domestic economic scene – and the global economic scene, too – this presumption that seems to be in currency that government is the problem. Therefore, if we can simply reduce the government, the problem will go away. That is not the case *at all*, when the problem is actually the combination of a liquidity trap and the paradox of thrift. If you take the government out of the picture, you *exacerbate* the pre-existing conditions. Yet that seems to be where the body politic conceptually has gone.

Are you implying that the Tea Party has been sold a bill of goods?
Yes, they have. I mean, the historical parallel that a lot of us point to would be 1931, when **Andrew Mellon** said, essentially, liquidate, liquidate, liquidate and assets will be transferred to moral hands, and we'll live a more moral life.

Until we starve to death.
Right – but we will live a moral life.

Mellon was quite the Austrian–
Absolutely, that was in 1931. Then in 1937, when it looked like the economy might have been having "a decent" economic recovery, we decided to slap it in the face with monetary and fiscal policy tightening.

And it only took World War II to lift us out of that extension of the Depression.
Yes. What I mean is that the war in effect forced the application of the government's balance sheet to a deficiency of aggregate demand – and it worked. Some might call that Keynesianism, and I would. But you could describe it more simply by saying that the government's balance sheet – *including the central bank's balance sheet* (because the Fed was subordinate to the fiscal authority during WWII) – was used to stimulate aggregate demand. *And it absolutely worked*, although I don't think anyone would applaud going to war to accomplish that. However, it is interesting that after World War II the biggest concern in economic policy circles was that we would fall back into a depression because we were taking away all of the government demand, for the war machine. But what we found out was that this didn't nec-

essarily have to be the case. Partly, the post-war recovery came about because of the infrastructure and the technologies, etc., that had been developed during the war. But another important ingredient after the war was the GI Bill.

The GI Bill and the Marshall Plan basically saved the West.
And they both used the government's balance sheet, I'll point out. My dad went to college on the GI Bill. He was one of the youngest WWII veterans – he's 85 now but he went into the service in '44.

Same as mine.
So he went to college on the GI Bill, bought his first house on the GI Bill – and he didn't consider either one of those to be welfare.

No doubt, he thought he earned it.
Yes, and the payoff to society of the Marshall Plan and the GI Bill were absolutely monstrous. The private sector simply can't internalize the rate of return on that sort of thing. So this presumption that somehow government investment is bad and private sector investment is good–

Hold on, you're using the term "investment" and that's not politically correct. You're supposed to call it, "spending, waste and fraud."
Okay, so my dad's education and the house that I grew up in were, what were those words? "Waste and fraud?"

Yes, according to the conservative meme, it was "wanton government spending" allowing your family to live above your means. The argument that a family has to live within a budget and therefore so does the government, is so specious–
Absolutely. The irony of all this is that I now hear my dad ranting and raving about "big government" at 85 years old– and *it was big government that paid for his education and put him into his first home*. The real notion that people have is that government is bad – unless it's helping me!

That's clearly endemic and epidemic. My dad did the same, until he passed away.
There obviously are a lot of inconsistencies that we have to deal with in a democratic society. But what really puzzles me is how the concept of public investment is being perceived as an oxymoron. *That's just wrong*. The notion that if we just would quit subsidizing idleness, that the unemployed would go to work, is another thing that is just ludicrous. I don't know a lot of people who want to be subsidized in idleness. Nor do I know a lot of who want to subsidize it. But there are just *no jobs out there*. There aren't jobs because *we had a bubble in housing*. We went from 2 million housing starts to half a million housing starts. The notion that you could monetize equity in your home with a second mortgage *is an oxymoron*. Nonetheless, we had a housing sector bubble and everything that goes with it. Actually, if housing starts were our only problem, that wouldn't be a big deal. *But the house became the magic genie that made up for the fact that we've had stagnant real wages in our country for a long time – and then the genie died*.

The housing ATM is definitely busted!
It ain't there anymore. And now, if you happen to have a factory job making boat trailers, you've got a problem. Because the guy who had been buying a boat trailer was able to buy it – and the boat that went on it – only because he took a second on his "appreciating" home. He could have never afforded a boat otherwise. Now most likely the guy at the trailer factory has lost his job because people can't buy boats in that fashion. That's reality. And we're not going to restimulate the housing market so that people can take out seconds to buy boats.

Not when the problem is too much debt.
That's true. It wouldn't make a lot of sense. We need to deleverage the private sector and we can do that without a depression *if we are not afraid of levering the government sector.* And from my perspective, there's *no reason to be afraid* because we have a huge output gap and the risk that public investment will overheat our economy is a risk that I'm more than happy to underwrite. Overheating of our economy and too few workers for available jobs would be *very* high quality problems. So I'm not worried about overheating from an inflation perspective at all.

What? Despite all the money that's been created? All the debt we're piling on future generations?
Monetary claptrap! Money is as money does, as the famous economist *Forrest Gump* once sort of said. And it ain't doing nothing. So I don't

worry about inflation and I don't worry about interest rates. In fact, the lower the interest rates go, the *more* I worry – because the easiest way to have super-low interest rates is to have a depression. Interest rates *are* low, but they're low in many respects for unhealthy reasons. There's absolutely no private-sector demand for credit and so there is no crowding out. I mean, that's the old textbook notion –you aren't supposed to want to add government debt because that supposedly would crowd private sector investment out of the market. But, *excuse me,* exactly what are we crowding out right now? Where is the evidence that the marketplace for credit is tight and that government borrowing is displacing private sector borrowing? There's zero evidence for it. Yet this "crowding out" dogma keeps being invoked when people claim that we can't have government deficits because they're going to crowd out private sector investment. God, I wish it were so, because that would mean that private sector investment was doing fine, just fine. And that we were going to overheat the labor market. As I said, that would be a very high-quality problem.

What about the argument that our foreign creditors are going to stop lending to us?
That's the notion that if we run deficits, the rest of the world will refuse to fund us. But we have a *shortage of global aggregate demand* and *nobody wants their currency to go up*. Therefore, the idea that we are going to suffer a buyer's strike for dollar-dominated debt is *preposterous*.

China's sure making noises about wanting a new international reserve currency.
Right, with their mercantilist economic model! If you're building a mercantilist economic model, by definition, you are piggy backing on somebody else's demand. Why would you even contemplate having freedom in your currency until you have sufficient homegrown demand to eat the fruits of your own production? You wouldn't. Therefore, I don't worry about that one, either. Essentially, the path that we're on right now is one of intellectual paralysis, born of inertia of dogma. Risk assets, including the equity market, have kind of figured it out. I don't want to get into details necessarily about day-by-day market moves because I don't do that anymore. But during that event at the end of July – that whole debt ceiling theater of the absurd – I was hearing that if we could just reduce uncertainty over the debt ceiling, we would have spontaneous combustion of animal spirits and all would be well with our economy. Excuse me! I didn't see any spontaneous combustion of animal spirits, when the deal was struck.

What I heard were Wall Street's "capitalists" whining for more QE the next day.
You saw the same thing that I did. It was what I dubbed a few years ago, a "reverse Ricardian notion." Ricardo *doesn't work in reverse*. **Bill Gross** [PIMCO founder and co-CIO] recently wrote about this in one of his monthlies: Just how many families sit around and say, "We have to cut back on our spending today because the out-years' government budget deficits are going up and our future taxes are going up?" That would be the reverse Ricardian notion in action. Likewise, if Ricardian equivalence operated on the household level, we'd hear people saying, "Well, they're cutting out-year government spending. That means our future tax liability is going to be lower, so we can spend more money today. Let's go out to *Ponderosa* for dinner." I just don't see that conversation happening, either. I would say average Americans don't know who Ricardo was.

I would bet you're right. And reducing prospective government deficits years in the future is not going to get them back in Walmart (WMT), buying the large economy sizes, either.
I don't think the average American spends a whole lot of time navel-gazing about the budget deficit in 2028. I just don't.

No, but they get worried when they see noxious and nasty gridlock in DC, supposedly over deficits.
Sure, to the extent that they had already-existing negative animal spirits, because they've got negative equity in their homes, the sorry spectacle in Washington probably exacerbated that. It certainly did not relieve their existing negative animal spirits. It turned, "Honey, we can't afford a vacation this year," into, "We can't afford a vacation for the rest of our lifetime!" We can exacerbate a bad situation with the notion that cutting future government debt is going to magically turn around the thinking of someone who has negative equity in his home. That is beyond comprehension to me.
I actually spend a lot of time thinking about these things these days with the benefit of not having fiduciary responsibility for a large, large pile of somebody else's money. As a money

manager, I was paid to have informed opinions about how the dealers should be dealing the cards. But I had to manage the money based upon the cards that I was playing with. I had to play the cards adroitly, even if I thought it was a silly game that the dealer was dealing. Whereas now, since the only cards that I'm working with are my own personal cards, I can actually feel – and do feel – liberated to say that the dealer is calling a *lousy* game!

Because –

I don't think it's a game that is productive. What's more, he's selling the game with hokum – and risk assets, including the equity market, are going to break the code. I can say that now without someone accusing me of talking my book, quite frankly, and that is *liberating*. It is wonderful to have the fiduciary responsibility for significant amounts of other people's money, but it is a very sobering experience of responsibility. It really, really is. Those who are good at it take that as a sacred responsibility and act accordingly. That's why our business is such a tough business from the standpoint of your physical health, mental health, etc. So not having that immediate fiduciary responsibility is liberating.

A great weight off your shoulders, I would imagine.

Definitely. I spent a great deal of time on macro issues during my money management career because that was the fountain from which money-making ideas flowed. But one of the things I want to take advantage of in my retirement is that I can spend a little more time analyzing the fountain as opposed to figuring out what size bottles to put the water in.

So tell me, is there a way to address the housing problem within this liquidity trap?

I think there is. It's been pretty clear cut for a long time that we need to reset the mortgages that are massively under water. This is sometimes known as "principal forgiveness" and the words are usually uttered with a pejorative lisp.

But wouldn't that be terribly unfair to everyone who has faithfully made their mortgage payments?

Yes, exactly. I can't argue with the proposition that it would be unfair. But the only way that I can respond is that life is not necessarily always fair.

Indeed, sometimes foolishness is rewarded.

It is – and as long as we hold to the existing pretense that a large chunk of our housing stock is worth the debt on it, we're going to be stuck in this liquidity trap. So the reason we're going to be stuck here is this issue of moral hazard. There's a reluctance to do anything because, you know, restriking mortgage terms would be letting people off the hook. There's a moral overtone that we can't deal with, so therefore we will just live with it. Actually, in that camp, you also have those who are genuine liquidationists. But society is not going to stand for the wholesale liquidation of 25 million families in America, so they're not going to follow the Mellon prescription. In other words, if you're not going to recast the mortgages to get rid of the negative equity, and you're not going to force people out of their homes and liquidate them, then the market gets stuck in suspended animation. And that's where we are. I'd like to think that for mortgages held by Fannie and Freddie, this should be pretty easy to deal with because we, the taxpayers, are already taking the credit risk on all of those mortgages. So to recast those, conceptually, is simply to recast the credit risk that we've already assumed. I mean, if I'm the taxpayer and we've lent you $100,000 to buy a house that's now worth $75,000, I'm nonetheless on the hook for the $100,000. Since your house is worth $75,000, this is *an existing loss*, whether I crystallize it or not. Conceptually, this should not be that big of a deal – but it is a *huge* deal.

Because the banks, which the taxpayers have already bailed out, have been allowed to extend and pretend –

Exactly. And I understand how the bank bailout – necessary as it was – left a sour taste. But putting families out on the curb doesn't make sense, so we're not going to take the Mellon route out of this liquidity trap; we're not going to have liquidation and more liquidation. But we're also not using the recasting of mortgages route, either. I'm clearly against the Mellon route, but if you're also not going to go the recasting route, then you've gotten yourself into a cul-de-sac, going around and around and around. Capitalism doesn't function in a cul-de-sac. It just doesn't. Folks don't have positive animal spirits when going around and around in a cul-de-sac. And especially when they're going around and around in a cul-de-sac and their political leaders are telling them they are in a roundabout. That makes me feel like I'm being lied to. "Sir, this is *not* a roundabout.

I don't come out on the other side. *This is a cul-de-sac*. I go round and round and round. If our leaders could just see the significant difference between a roundabout and a cul-de-sac, we'd be making major intellectual progress in Washington – one of these days.

First, you'll have to find an intellect or two on those environs.
Touché. So I'm pessimistic.

Why am I not shocked? But *how* pessimistic?
Well, I don't think we're going to have an Armageddon outcome. I don't necessarily think we're even going to have another recession. We're just going to be stuck in a high-unemployment, low-ambition, discouraged economy *for a long period of time* – and that doesn't work well for capitalism, certainly, because that doesn't imply positive animal spirits. And it doesn't work well for the welfare, broadly defined, of our country, either. Our children are the first generation to face the reality that they will not be able to achieve as much as their parents did, as a generation. Certainly, I know that my grandparent's generation wanted more for their children – and their children could realistically expect that they'd do better. And our parents felt the same way. There was a sense that the future was limitless – and that's not the case anymore, I don't think. Or, to the extent that it still exists, that sense is very bifurcated in this society. The income distribution, the division between the "haves" and the "have nots" in our economy is as great as at any time in my 54 years.

Greater, I'd venture, and I have a few years on you.
Okay, greater. And I'm not a socialist by any stretch of the imagination. Therefore, I *don't* think that the notion of equal incomes is a valid idea at all. But I do believe that our country was founded and has prospered on the notion of *equal opportunity*.

Hear, hear!
And to say we have equal opportunity right now is to be speaking with forked tongue. That discourages me as a citizen. Let me be plain: My own circumstances are fine; my son's circumstances are fine. So I'm not talking in the particular. I'm talking as a citizen and it makes me discouraged going forward about the vibrancy of our economy and our society and I think the valuation of assets, including the damn stock market, is going to reflect that. The P/E level of the stock market is tied to a lot of things. But fundamentally it's tied to – and it's interesting that I used the word "*fundamentally*" there, because many people would think I am making a statement about behavioral economics here. But I do think that behavioral economics has a lot of fundamental truth to it. And I do think the stock market's multiple is tied to the notion of whether or not we have optimism about the future. If we do have optimism about the future, it can be a self-fulfilling optimism – *if we believe we can, we can*. That's what I'm *not* seeing out there on the horizon anymore. Let's go back to the equity market, where this is working in reverse. Defeatism is also self-feeding – and fiscal austerity in a liquidity trap, my favorite hobbyhorse these days, is *defeatism on broad display, naked*. It's really unfortunate. I'd be ecstatic to be able – a year from now – to look back and say that I underestimated the ability of our political system to transform itself. I would be ecstatic to reach that conclusion.

Join the very large club.
I'm not so sure how large it really is. That is another way of saying that I will be delighted to be proven wrong. You hear that all the time from people on Wall Street who are managing money or making explicit forecasts. They'll say, "This is my forecast and this is how I'm structuring my portfolio, but I would like to be wrong." Nonsense! Money managers have fiduciary responsibility and if you think that you're going to be wrong, then restructure your portfolio *right now*. Otherwise, you don't have credibility with me. Not if you've got billions of dollars riding on this viewpoint and you say "but I hope I'm going to be wrong"!
In contrast, I *have* credibility in my forecast of enduring grinding pessimism on the part of the American people – because I *don't* have billions of somebody else's money on the line –*and I really want that forecast to be wrong*. I don't have a bet, that's my genuine wish as a citizen. But as an analytical person who has spent more than a little bit of time in this arena, I don't have an analytical basis for hoping that. I really don't. This whole sorry notion that we can achieve prosperity via austerity and its accompanying zero appreciation for the paradox of thrift, or the liquidity trap, drives me about as bonkers as it does Paul Krugman. And the fact that we both have beards now is not the reason!

It's not a hippie-dippy notion, as, say, Rush Limbaugh, might proclaim?
No, it has nothing to do with facial hair, and everything to do with appreciation for basic macroeconomic principles that we learned many, many years ago and that still endure. In my case, it has a lot to do with the fact that I've been the mantle carrier for [economic theror-ist] Hyman Minsky for so long – and Minsky essentially was a disciple of **John Maynard Keynes.** Krugman, of course, is Keynsian. So we don't start with the notion that government is inherently bad – and when we're in a liquidity trap, we *pray* that governments choose wisely. Austerity is a very good antidote to an overheated inflationary economy. But applying austerity to an economy trapped in a liquidity trap is probably *not* just an ineffectual idea but actually a *toxic* idea.

And this is the antithesis of an overheated, inflationary economy, that's for sure.
The big thing is here is that fiscal austerity can always give you a boost to the economy, *if you can offset it with easy monetary policy*.

But if you can't –
Then you're up the creek and you're a paddle short. When you look at episodes historically in which austerity has been a path to success, you find that *universally,* they have involved at least one of two things. One, you can have austerity with monetary policy ease that leads to a positive wealth effect and greater private sector demand in interest-rate-sensitive sectors, particularly housing. *And/or* – and I stress that because you can have both – you can have austerity that begets a weaker currency and so you can steal somebody else's demand. Only then does fiscal austerity work. But if you don't have the conditions in place to have those two countervailing offsets, then you're doing austerity for the sake of austerity – and you're starving an anorexic.

You're saying fiscal austerity won't work. And the Fed is pushing on a string. But what's the likelihood of Bernanke coming forward and volunteering to get behind some big fiscal effort? The pols love skewering the Fed.
That's true. Ben's in an *incredibly* difficult situation. I mean, I've been looking at his full range of academic and analytical work, and he is truly *one smart dude*. You can infer very logically that he *can* do the diagnosis. The issue is that the political climate is such that he can't do what he would do in the textbook. In fact, if you laid out our current set of conditions in an exam, he would *know* all the right answers. But he would have to deliver a "B" blue book, because an "A" blue book wouldn't be politically acceptable. It must be incredibly discouraging and frustrating for him to know that "the only way I can continue to be matriculated in this university called Washington, D.C. is to turn in "B" blue books." *Because Ben Bernanke has never turned in a "B" blue book in his entire lifetime!* But he's being asked by the political system to do exactly that right now. One of the things that I think a lot about – and I think others do, too, because you often hear it said – is that Washington only comes to its senses when it has no other choice. Wasn't it **Winston Churchill**'s famous contention that America ultimately can be trusted to make the right decisions – but only after exhausting all other possibilities? Nonetheless, intellectually, I have difficulty with the notion that you need to do something stupid in order to reach enlightenment. It just bothers me, intellectually. There must be a path to enlightenment besides the bitter experience of stupidity –

Perhaps you expect too much of fellow humans–
I hope not. I'd hate to have to see enlightenment as a fruit stupidity. But let's say that doctrine is correct, for the moment, anyway. If that is the truth, then let's see 3,000 points taken off of the Dow, in order to enlighten the stupid. Then Washington would respond. Nothing concentrates minds in Washington like 3,000 points in Dow – on the south side. Now, whether that *really* matters or doesn't matter is an open question. But it does tend to concentrate minds. We saw that in the first vote on the TARP bill – remember that one? Congress voted it down and then three days later, they passed it. The American public said, "Hell no, don't pass that bailout," but it didn't even take dropping 3,000 Dow points, for them to turnaround and say, "Okay, Harry, vote for it. I can't take this pain in my 401k anymore." So actually maybe I *do* understand the doctrine that enlightenment comes through stupidity – and maybe we need a little bit of that in this country right now, unfortunately.

Well, if one thing's *not* in short supply –
Yes, but let's not go there. We should close this interview on a note of optimism. Ask me a ques-

tion I can give you an optimistic answer to.

That's tough—
You can ask me about fishing, about my plans for the next three months.

Okay, so tell me what you're focusing on for the Global Interdependence Center —
We are focused on creating content for the GIC.

Isn't that kind of circular?
Not really. The GIC has been around since 1976. **Larry Klein** [Nobel Laureate, founder of **Wharton Econometric Forecasting Associates** and emeritus professor of economics at the **University of Pennsylvania**] was one of the first people involved with it, along with one of the major banks in Pennsylvania. The organization, long most active in the Philadelphia area, has been a convener of conferences on global issues, especially free trade and international cooperation, for a long, long time. But we wanted to branch out from being a convener of conferences featuring international authorities to having conferences from time to time that spotlight original economic research produced by the fellows that I am going to ask to join the GIC's Society of Fellows. It doesn't mean that the existing mission of the GIC will not continue. We are going to expand it, by adding new conferences that are content driven, focusing on the original work of the Society of Fellows. The architecture we're working with now is that the fellows will partner with a rising-star academic in the economic or financial field or even some other academic field. What we are driving at is having gray bearded practitioners as fellows partnered up with rising-star young academics to write original papers on relevant topical issues that connect to global interdependence. In other words, the fellows will be not people who have the title as an honorific, they are expected to actually *work*.

Actually do something? That's novel.
Right. But we're planning on that framework producing a major paper from our fellows and their rising-star partners every two to three years.

That's pretty ambitious.
Yes, which is why I don't really have too much leisure time. We will have an annual event. Our first will be in Paris in March of next year.

Not bad. I like your thinking on where to hold GIC conferences, by the way. Even if my expense account has only stretched to ones in Philly.
Banques de France has graciously invited us. **Christian Noyer**, its governor, will personally be hosting this event. The first two papers, the inaugural papers kicking off the Society of Fellows output, if you will, will be presented at that time. I'm writing one of them.

I should hope so, as the first fellow.
And the soon-to-be-announced fellow No. 2 is writing the other. We don't anticipate getting beyond maybe 8 to 12 fellows over time because as I said, we expect it to be a job. "Job" is probably not the right word, but I'll use it anyway because being a fellow actually involves work.

You keep insisting it's not just an honorific.
That's because it's not a matter of having your name on the masthead of a piece of bond paper. Not that there's anything wrong with that, particularly. But we actually anticipate it over time becoming an active collaborative effort between people who really want to contribute at the fellow level and to collaborate with up-and-coming members of the academic community, such that being asked to participate will be a very attractive proposition for young academics. In addition to the prestige, there will be a very nice stipend involved for the academic.

That should be an effective hook.
Right, for young academics on the path toward tenure, a stipend matters.

And so does publishing—
They've *got* to publish. And what they'll be doing with the Society will be the kind of research that will get them noticed. We are effectively creating a new place for them to publish on topical issues along with prominent economic practitioners. I've found so many academics write to impress–

Other academics—
Exactly. So they take wonk and make it wonk squared. We're not going to be either wonk or wonk squared. Well, we may be wonk because I can't deny having some of that in my personality. Certainly, I bring some of that to the game, because I strongly believe if you don't have an analytical framework for analyzing a problem, maybe you should stop until you have one. It's a nasty habit of mine, one that's only been reinforced by my experiences over the last 30 years.

I cannot tolerate – I don't have a lot of patience for those who have opinions and can't explain to you the framework from which they drew those conclusions. Whether I agree with you or don't agree with you, I can appreciate your analytical framework. But if you give me conclusions with no intellectual architecture, then I am less-than-satisfied – unless you're inspired by God.

Spoken like a preacher's son.

Well, that *is* a framework. But we're not walking in those shoes in economics. "It came to me while I was shaving this morning," is not something that constitutes an intellectual framework. "It came from a higher power," is a framework, I concede. But "it came to me while I was shaving this morning," doesn't quite do it for me. Anyway, we want to create an opportunity for young academics to get to have their day in the sun. It's going to be a one-year assignment working with a fellow to produce the paper. We will have two – probably eventually three papers a year – but the inaugural year will be two. That's where the work for the fellows will come in, co-authoring papers with the academics at that rate. That's why I'm thinking in terms of appointing maybe nine fellows on a three-year rotation. So you can see it will be a significant commitment for our fellows to work with, mentor and learn from the young academic stars we choose to involve. And I stress *learning from* the academics!

It sounds like it should be a brilliant opportunity for young academics to actually work with real world practitioners in economics and finance.

It should be a two-way street. We want it over time to be recognized in academia and more generally as a great honor to be selected to work with GIC, quite frankly as a fellow, but even more importantly as an academic co-author. That will only be a one-year assignment for the academics, but it will be a significant one. The payoff will be that they get to publish in a global forum with an established name in the business. That should be pretty attractive in itself, but when you add the notion of an all-expense-paid-trip to Paris and getting to hob-nob with household names–

Anyway, we want to institutionalize the selection process for both the fellows and the academics. For the fellows, it's easier. We want to be quite rigorous in designing how we pick the academic co-authors, so that we draw from a wide array of universities and colleges. Co-authors could be grad students working on their dissertations or young assistant professors looking for a fast track toward tenure. Obviously, we don't have a fully baked idea of their qualifications yet; we want to cast a wide net. Bill Dunkelberg and his wife, Sharon, are working on creating our co-author selection process now, because they both come from the academic arena. My idea is that we want to find the most promising young academics that nobody knows yet to be our co-authors. In effect, we want to create a prestigious competition over time. It's going to be fun. That said, in the first year, with me doing one paper and our soon-to-be-announced Fellow No. 2 doing the other, we will not be able to cast an enormously wide net for co-authors because we haven't institutionalized this process yet.

How are you going to find them?

Well, we're going to have to use a more informal selection process to find co-authors this time around because of our time constraints. I have not yet selected who is going to be my academic co-author, and neither has my fellow-to-be, but we are both searching on a bespoke basis to find our partners. I've been doing some sounding out of various people, whom I actually plan to visit since I have time. So I'll see who would be willing to work with this old gray bearded guy.

Can you give away the topics you are planning to write about?

The topic I'm taking on is, Does Central Bank Independence –

Does it exist?

No, not quite. That's almost a metaphysical question; whether or not central bank independence exists. It shouldn't be, if you take the question literally, because the central bank is independent *within* the government. But it is not independent *of* the government. Anyway, the topic I'm taking on is, Does Central Bank Independence Interfere With Pursuing An Optimal Monetary/Fiscal Policy Mix In A Liquidity Trap?

Gee, no controversy there.

Well, a liquidity trap is what I think we're in. And the doctrine of central bank independence in many respects requires a temporary suspension when in a liquidity trap because, by definition, a liquidity trap is a place where monetary

policy is ineffective.

No argument, monetary policy seems to have met more than its match in this sorry economy.
It's completely ineffective in a liquidity trap. I start with the presumption that if you religiously maintain central bank independence when you're in a liquidity trap you will get a sub-optimal monetary/fiscal policy mix. That's because if you want to increase aggregate demand and output in a liquidity trap, you have to do it with fiscal policy. You can't do it with monetary policy alone, so fiscal and monetary policymakers have to work together. I've been preaching this for quite some time. Actually, when I go back and read **Ben Bernanke**'s work of a decade ago about Japan, it's clear that he has the same questions as I do about the sanctity of central bank independence in the context of a liquidity trap. But he's obviously in a different situation now because he actually is the head of an independent central bank. It's a very rich area for research, first, on a time series basis, looking at it over time – including during the period when we were on the gold standard, in which the gold standard could dominate fiscal policy and lead you into a liquidity trap, in other words, into a deflationary phenomena. Then we'll also be looking at it on a cross-sectional basis in various countries. We're going to try to pick topics you can look at historically and also across countries. That's what my academic co-author will be doing: A great deal of old-fashioned shoe-level work in the library. Although I guess "library" is an old-fashioned term now. Most academic research is in front of the computer these days. Back in the day, we literally had to go to a library.

You're dating yourself. Have you decided what your fellow fellow will be writing about?
His topic is "Are Central Banks Innocent Bystanders In Wealth and Income Distribution Outcomes?"

Not too loaded a question.
Almost universally, and I understand why. If I were an active central banker – which I'm not – but if I were, I would know the catechism, which holds that, yes, income inequality or wealth inequality matters for society. But that's not something that monetary policy can or should affect. It's the role of the democratic process to make societal decisions. So central banks understandably have a "What me, mon? It's not my job" attitude. So we'll be asking the heretical question, Are they innocent bystanders or not? But you notice, I'm not writing that paper. Our other fellow is doing that paper. Anyway, those are the two topics that will be presented in March in Paris by the GIC Society of Fellows.

So you're trying to stir up a little trouble?
I certainly hope for some reasoned debate. In fact, we are also working to select the discussants for the papers. We will do the program following the model where the authors formally present a paper, and then we'll probably have two discussants for each paper do a panel. We will try to be even-handed about having discussants who have opposing ideological perspectives but who are willing and capable of truly addressing the issue in the context of the paper.

Good luck in finding those.
Actually, they don't know it yet, but I've got a couple of guys and two women in mind, who will be getting phone calls from me at some juncture in the not-to-distance future to see if they're willing to participate. Really, an event next March seems a long way off to me, compared with the speed at which my whole work life operated. But I actually like this pace. I don't look at what I've been doing since I retired from PIMCO as leisure as such, but the pace of this work does give me time to let things unfold. I don't have to force an outcome. I don't have to decide on a discussant by noon on Monday. I have three or four people in mind and I'll give them a phone call and we'll chat about it. I don't have to reach a conclusion overnight. And that's kind of fun. I don't have to necessarily sum up how many decisions I made at the end of the day.

Nor is anyone pressing you incessantly for explanations of why some market moved a couple of bips.
Oh God, that I do *not* miss. I've done TV interviews a couple of times in the last few weeks. And I actually had to sit down beforehand and think a little bit about exactly how to do it again. I hadn't done any live TV in a talking-head framework for a while.

So you had to practice your sound bites.
Right. Especially when you've got 90 seconds and you're lucky enough to be asked to explain the global macro economy since WWII.

No mean feat–
I do it reasonably well, I think. What the talking-head line of work involves is essentially taking your framework of how the world works and putting whatever the most recent data or policy maneuver is into that context. Effectively expressing that as if on a bumper sticker or as a one-liner. I like that better than thinking of them as takeaways, which has a rather pejorative ring to me. Anyway, I can come up with talking-head bumper stickers when I'm required to do so, but I actually find now that I like being able to express myself in slightly more than 90 seconds.

I guess you're not on *Twitter*.
I'm not. I'm not on *Facebook*. I haven't got a *BlackBerry* and I still have an old-fashioned cell phone.

And I thought *I* was a technophobe.
I do have an automatic transmission on my motor vehicle, which is a *Volkswagen* by the way.

A classic hippie-mobile – but you told me you're doing more walking than driving.
Yes. I drive maybe 40 miles a week and I probably walk 60 miles a week. Walking is one of my new pleasures in retirement, not as a mode of transportation but as a mode of life. It's exercise as well as wonderful contemplative time. And I treasure that these days.

It must be great to take walks without worrying about getting back for your next appointment.
It is. There is only one exception to that. I still mind the clock on walks with **Mohamed El-Erian** [PIMCO's CEO and co-CIO]. He and I have walked on weekends, very early, usually at 5:30 or 6:30, for an hour or two for 10 years. We do it whenever we are both in the same time zone. Just because of the pace of our lives, we actually do have to think in terms of the time then – somebody's family is getting up and breakfast needs to be fixed. But those are delightful times with my dear friend Mohamed, even if we do have to be aware of the time on Sunday mornings. Especially when we were both working, the weekends were our only time to do anything with family. But in general, long walks are one of my new passions.

Does your bunny go with you?
Both my bunnies passed away.

The second one, too? Sorry to hear that.
Yes. **Morgan LeFay**, I had forever; she's the famous bunny, if you will. Then I had Bun-Bun for two years; she passed way of a heart attack on the 4th of July. I found out the hard way that animals are vulnerable to shock from firecracker noise. I didn't know that. I haven't gotten a new rabbit. But Morgan LeFay will be around for a long time. My charitable foundation carries her name, the **Morgan LeFay Dreams Foundation**, so she gets to write checks and that's kind of cool.

Do you sign them "Morgan LeFay"?
Actually I sign my name as president of the Morgan LeFay Dreams Foundation. But I've got to talk with my banker. I bet I could get checks made with a paw print on the left hand side just for fun. I would still have to sign them. I'll dare my banker to turn me down on that!

They'll do anything for a fee.
Touché.

So your enthusiasms now are walking, fishing and your work with GIC?
I am excited and optimistic – have a sense of boyish enthusiasm – about what I'm doing with the GIC. And I'm glad that I can experience boyish enthusiasm about something that matters; I will be even more involved in the next few months. Fishing has been great here in Maine. And it was fantastic in the Caribbean, where I've just spent a few months. I am looking forward to fishing again in Southern California because the tuna are coming up from Mexico soon I can get on my fishing boat and catch yellow tail and dorado. I am really looking forward to deep sea fishing on the *Moral Hazard*, which is the name of my boat.

No way!
Actually, yes. My boat's name generates some funny stories from time to time, when I pull into harbors. People tend to think its name is a statement about activities onboard the boat! But it's simply a one-liner, stemming from my 30 years of working on Wall Street, the *Moral Hazard*.

Sailors have such dirty minds –
But it's a strictly moral boat.

Did you take the *Moral Hazard* down to the Caribbean?
I did not. I like going maybe 40 miles. My boat's

only a 32-foot boat and also at the end of the journey, I have to clean it. In the Caribbean, on somebody else's, I didn't have to clean.

That's what chartering is for.
Absolutely. There is great pleasure in owning a boat and also great pleasure in chartering a boat, and I do both.

I'm with you there. Thanks, Paul, and good luck fishing, for your young co-author, as well as tuna.