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"…maybe, maybe actions by the Central Bank"

During his testimony to the Congress today, Greenspan pointed to the potentially serious consequences of deflation paired with the low probability of its occurrence. The emphasis was that the 'cost of insurance' against deflation was (currently) quite low and that had motivated the Fed to be aggressive in its monetary policy actions. He closed with the statement that the consequences of deflation could cause the Fed to take further action. **"…maybe, maybe action by the Central Bank."** It seems so obvious, but then we have to contend with the fact that the FOMC did not move its target downward on May 6th, even after its clear acknowledgment of the risk and consequences of deflation at its last meeting. Subsequent to that meeting, the bond market responded to the FOMC's statement of risk by causing a bull flattening. On the surface that would suggest that jawboning is a substitute for affirmative monetary policy actions. Does that seem sensible? Is the case for potential deflation a sound one? Is the Japanese experience a suitable parallel? What are the implications for other major Central Banks? Is it wise for the Fed to belabor itself with a contradiction?

1. Japan's economic history over the past decade threatens markets with the possibility (no matter how small the probability) that the deflationary disease could spread here. Both countries had Booms and both have had Busts. Both had excess capital investment over a long period, stimulated by the low cost of capital, and a resulting overhang of capital stock. Japan is clearly in a deflationary period, and some observers (perhaps only a minority at this stage) feel the U.S. could be entering one. Current fears maybe worse than what a strict, expected value calculation might imply, but markets operate at the margin. In addition, anyone familiar with Japan has to be concerned that Central Bank capabilities to offset deflation may be limited particularly as the nominal rate approaches zero. That is not the view of the Fed, but concern will grow until or unless the U.S. economy's data points move substantially to the positive side in the next few weeks. Like it or not, the Fed is sitting on a ticking bomb, and the bomb ticks for the FX market and other major Central Banks as well. Jawboning long rates downward seems to have worked, at least so far. The issue is

<HELP> for explanation. N161 Govt C15

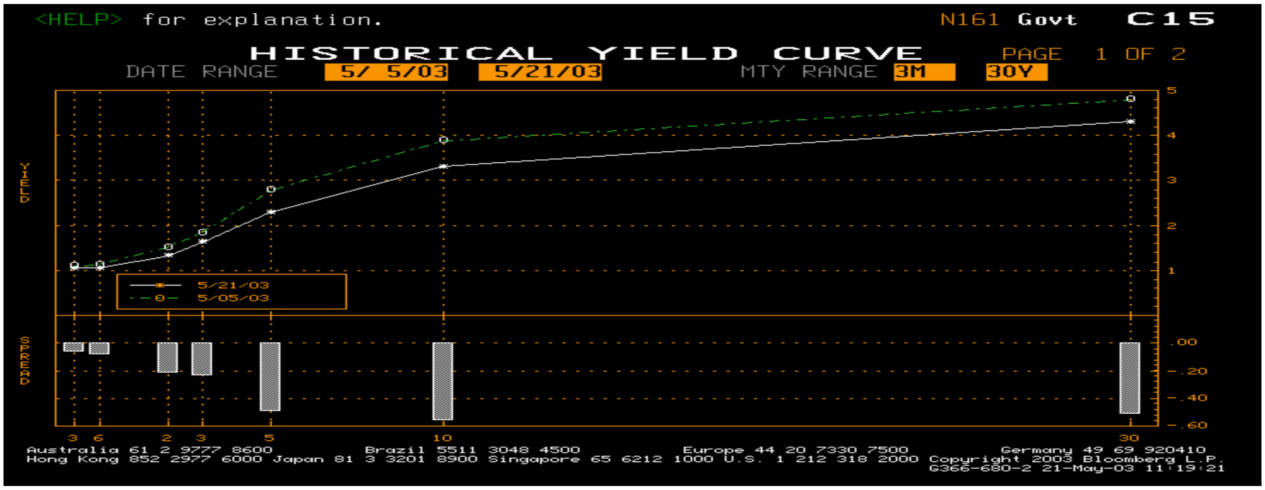
HISTORICAL YIELD CURVE PAGE 2 OF 2

DATE RANGE 5/ 5/03 5/21/03 MTY RANGE 3M 30Y

	5/05/03	5/21/03	CHANGE
3 MONTH	1.098	1.037	-0.0610
6 MONTH	1.135	1.053	-0.0820
2 YEAR	1.529	1.314	-0.2147
3 YEAR	1.852	1.623	-0.2291
5 YEAR	2.792	2.304	-0.4876
10 YEAR	3.884	3.327	-0.5574
30 YEAR	4.800	4.295	-0.5052

Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 920410
Hong Kong 852 2977 6000 Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000
G366-680-2 21-May-03 11:19:45

sustainability of low long rates and ultimate economic recovery.



2. The consensus judgment of economists is that Japan's monetary response was a case of too little and too late. The Fed's own research study published nearly a year ago concluded that one of the lessons from the Japanese experience was the risk of doing **too little too late.**[1] Further, several Governors and other astute observers of monetary policy, have pointed to the risk of being behind the curve on deflation. That same study pointed out a roadmap that doing something early and vigorously posed a smaller risk than doing something insufficient and belatedly. It is thus a bit ironic that the FOMC did nothing at its last meeting after drawing attention to the dangers of deflation. True, a new statement of risk was trotted out, but nothing substantive followed from the statements. The real risk is that the current data could mislead the Fed into complacency and that deflationary forces do take hold. The Fed seems to be trying to influence expectations through its continued commitment to do something unorthodox if necessary. How jawboning will play was the subject of a strong statement by a major player in the bond market, today. Paul McCulley, chief economist for PIMCO, spoke affirmatively of the Fed's jawboning, but other than talking up a large bond player's 'book,' there is the scientific question of whether jawboning is a sustainable long run policy? Ultimately, tilting market expectations requires ratification of the market's move through positive open market operations at some end of the yield curve. Failing that, long-term interest rates in other principal financial centers will remain as incentives for capital movements.

3. The Fed, by its own new criteria, has to make a risk assessment, which means it has to make an assessment of the likelihood of deflation, and no less, the potential costs of such circumstances. The latter would not be trivial. The dog that didn't bark in the May 6th statement was that while the risk of deflation was highlighted, nothing substantive was done about rates. The Fed left the market to do the Fed's work, and that is not a sustainable long-term policy. Clearly they wished the market to draw the inference that short rates would not

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[1] "Preventing Deflation: Lessons from Japan's Experience in the 1990's," International Finance Discussion Paper Number 279, Board of Governors of the Federal Reserve System, June 2002

be rising in the very near future. In light of the Fed's own research staff's findings on Japan, it would seem that the Fed is taking an unnecessary risk. Who is watching the store?

4. Analogies drawn between the U.S. and Japan (historic and economic) are very much less than perfect. The banking sectors in each country (post Boom) are not at all similar. Two days ago, the fifth largest bank in Japan, Resona, hit the wall and the estimates of a bailout are running about $17 billion dollars, an astronomical amount considering the size of the BoJ balance sheet. Labor markets in Japan have little horizontal mobility of labor. Corporate governance is truly weak because equity holders have little ability to cause changes in management, even after substantial losses, and bankruptcy procedures are cumbersome and rarely used. In addition, for the past few years at least, the BoJ has had its credibility impaired because the deflation in Japan has not been alleviated. Whether that is true is far less important than the common view that the BoJ has been tagged as one (perhaps the most important) of the responsible parties to that deflation.

5. Until the recent slowdown in the U.S., the Fed and its Chairman, had unbelievable credibility in U.S. markets. In contrast to Japan, the fiscal authorities in the U.S. have left the Fed to itself, and not even a very popular President dares to recommend monetary changes in public despite the Fed Chairman's public doubts over the President's tax plan. The same Fed Staff study on Japan suggested that in the event of a deflationary circumstance, both fiscal and monetary policy should be used, including expanding the Government fiscal deficit. Greenspan's reservations on the implications of larger deficits on long term interest rates conflict with his researchers' findings. Who's on first?

6. One difference between the two countries comes from the respective roles played by the foreign sector in the two macro-economies. Even though the U.S. current account deficit has long been regarded as unsustainable, the high value of the dollar was not seen as blocking recovery, at least until recent months when the efficacy of monetary measures began to be questioned. In Japan, the trade sector is seen as the key growth driver of the economy. Now, long after forecasts of its demise by official and to academic economists, the dollar has depreciated, particularly against the Euro. The U.S. Treasury and the Fed appear to be in agreement that a 'stealth strategy' to reduce the value of the dollar in world markets should be in play. This creates difficulty for the Japanese with their export led growth dependence and with Japan's persistent trade surplus. Many economists think that was a fallacious strategy because the encouragement of strong domestic demand was in the long run the only viable macro-balance strategy for Japan and that would require appreciation, not depreciation of the yen. With monetary policy in Japan attenuated in a zero interest rate environment, the yen seems a natural target for an anti-deflationary strategy. It will be hard for both countries to pursue these foreign exchange policies simultaneously since much of the pressure will then fall on the Euro. The underlying issue---another dog that has not barked---is whether targeting exchange rate expectations will lead to massive capital outflows in both Japan and the U.S. In Japan, sharp rises at the long end of the bond market will cause great difficulty with the insurance sector, and rises in long dated bonds in the U.S. would create stronger investment disincentives. Maybe that is why the Fed has been keeping its powder dry in order to have some ammunition in the event of a massive flight from the dollar assets. Capital withdrawal from U.S. markets (both bonds and equities) will create even larger headwinds to recovery. It has to create some concern in some sectors of the financial markets that rates will have to rise at some point because of the fear of capital withdrawal. The Fed's 'tilt' strategy, jawboning the long end by telling the market that the short end will not rise for the indeterminable future, is a credibility tester, to be sure.

7. There is another difference that stems from the dollar's role in the international monetary system. The dollar is a key currency, widely used in international trade and as a reserve currency in the balance sheets of Central Banks all over the world. Since the U.S. largely does not intervene in the FX market with a view to preserving some particular price of the dollar, the value of the dollar can only make a difference if its decay causes too much inflation or the process of capital outflow in the U.S. wreaks havoc in the U.S. bond or equity markets. Yet, the U.S. has also not wished to be involved in a coordinated FX policy move with other Central Banks (or Ministries of Finance). While there have been exceptions to this rule during the Rubin years, the "tool" of the U.S. treasury has been to tilt at market expectations with the "Strong Dollar" mantra. In Japan, the FX rate has been and will likely be a target variable, even if it is in the province of the MoF. Yen devaluation is a faulty strategy from an overall macro – balance situation given that Japan runs chronic surpluses. Export dependency has made the yen's value into a short-term policy target. The MOF has a habit of trying to move the market when it wishes to "direct" the market, and on occasion, the U.S. has been 'dragooned' into supporting Japanese FX policies on an incidental basis (1998 for example) even when the U.S. really prefers to stay out of the FX market entirely.

8. Current thinking in academic monetary policy circles is that targeting the FX market in Japan would be a good way to effect monetary policy in the zero bound environment but that strategy takes the Japanese father away from external balance. Some other views have been to introduce a set of taxes on holdings of short-term monetary instruments in order to break the "liquidity trap" that makes injection of High Powered Money result in very low expansion of the overall money supply. We don't have a history of several countries going into deflation at the same moment, except for the competitive devaluations of the 1930's. That is also not an encouraging precedent.

9. To draw the parallel, if the US doesn't want to have an explicit FX policy, it has to have another channel in a zero bound situation. It may have one in the long end of the yield curve. It also can try to create negative expectations about the dollar in the FX market. The Snow Press Conference appears to have done just that. The question now is the Fed prepared to move toward Unconventional Monetary Policy?

10. At the end of the day, we believe the Fed has chained itself into a contradiction. It uses its credibility rather than what its own staff findings suggest. Sooner or later, too many tealeaf readers will expose the fallacy that lies at the root of the jawbone strategy. Watch out! The dog will bark again. Greenspan did not allay that contradiction today.

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