



Saumil Parikh

The Return of State Capitalism

Is this the return of big government?

In the third of a series of Q&A articles accompanying the recent release of PIMCO's Secular Outlook, portfolio manager Saumil Parikh delves into the politics driving changes in financial regulation as well as related global trends in government and economics and what they might mean for investors.

Q. PIMCO has theorized a new model of state capitalism is forming. What is meant by that and why is it happening now?

A. The rising trends of re-regulation and de-globalization that we identified during PIMCO's 2009 Secular Forum are slowly manifesting themselves, leading to what we call state capitalism. Let me explain further with a little history: Before the start of the 20th century the word "economics" didn't really exist as we now know it. Academics and market practitioners used to talk about "political economy," which was the study of government and government policies and their impact on real economic factors of production. So to some degree, state capitalism today is about the return of "political economy," where the free hand of markets is taking somewhat of a back seat to the visible fist of government. State capitalism is on the

rise because balance sheet deleveraging in combination with structural imbalances are forcing markets to take that back seat.

Q. PIMCO says governments of developed nations will increase their hold on financial markets, and yet there seems to be an anti-government sentiment in several nations, including hostility to incumbents. How might these trends play out?

A. It's important to separate the anti-incumbent sentiment from one of anti-government. Typically, when there is economic stress and a high level of unemployment, incumbent governments are removed as people who do not have real control over their own economic situation express their unhappiness by voting for the other guy. That trend is what we are witnessing now, and it doesn't necessarily mean people want less government.

Consider that workers in nonfinancial sectors of various economies feel they have suffered unfairly due to the excesses and subsequent correction in financial markets. The only concrete way most people can express that frustration is by supporting governments that re-regulate either the financial system or the broader economic system.

Q. What form do you see all this proposed financial regulation taking in developed nations, and how will the oversight affect markets and investors?

A. The way things are progressing in the U.S. and Europe, we believe financial sectors will be forced to become smaller as a percentage of their respective economies. Financial firms also will be forced to operate with higher liquidity levels and with less leverage. Such changes will decrease the probability of another financial crisis, and if another crisis strikes, it should be less severe.

Yet, one cannot reduce leverage in the entire global financial system at once. Governments need to accommodate the deleveraging with some protective measures, such as providing liquidity facilities in case of accidents. Japan has been a good example of this; the Japanese government has been deleveraging its banking system and household sector, but the process has taken a very long time. We are just beginning this process in other developed countries.

Of course, the issue of derivatives is also very much on people's minds. I think moving derivative trading to exchanges would go a long way to addressing counter-party risk. However, the leverage imbedded in derivatives is something that can only be controlled at the investor level, and that's where having an investment manager who understands imbedded leverage and who manages for it becomes vital to investors.

Q. Let's focus more on the U.S. for a moment. The hodgepodge of government agencies regulating U.S. banking appears largely intact under

proposed reforms. Would such regulatory reform change risk taking by financial firms?

A. It depends upon what you think is the real problem with the system. You could easily start with a different hypothesis: That we have the right agencies, but they were asleep on the job. It's not a question of more or fewer agencies; it's making sure that the agencies are doing their job in regulating financial stability and leverage in the system. We would also posit that the more agencies government creates, the more critical it becomes that communication and coordination between agencies is maintained.

Q. The U.S. government arguably is the mortgage market today, making it an interesting case study of state capitalism. How long should the government stay so involved, and what should be done with Fannie and Freddie?

A. Fannie and Freddie have fulfilled two purposes. One is that they have behaved like banks: They issue liabilities, they buy mortgages, and they hold those mortgages on their balance sheet. But because they have had an implicit (now nearly explicit) support from the U.S. Treasury, they've been able to run a lot more leverage than a traditional commercial bank. This role is diminishing and should diminish – post-crisis legislation requires them to reduce the size of the balance sheet over a ten-year period.

The other aspect of their business is to simultaneously behave similar to an insurance agent and a credit rating agency by guaranteeing principal and interest payments on mortgage-backed securities that they underwrite – even though the U.S. government

has not explicitly guaranteed the securities. That agency role is expected to remain for a time, and, in fact, needs to remain until the private market for mortgages is reformed and reinstated. The private mortgage market hasn't revived since the crisis ended, because some problematic issues remain, such as rights of creditors vs. debtors, rating regulations, and loan-level transparency.

Q. When will governments return to balanced budgets, and how will that impact the global recovery?

A. Mervyn King, a governor with the Bank of England, recently said something very enlightening. He noted that when the banking crisis occurred globally in 2008, it was easy for governments to solve the crisis because their sovereign balance sheets were available to absorb some of the problems of the private sector. However, when sovereign balance sheets become infected, there is no backstop.

We believe the U.S. is perhaps the best positioned of the major global economies to withdraw public support and return the economy to the private sector. Europe and the U.K. are clearly having problems with this transition; they have been unable to achieve a substantial growth rate in 2009–2010. Also, Japan has been battling this transition for a long time and has not really achieved it. We are all monitoring the situation closely and hope the U.S. can make the structural changes necessary to achieve a growth model that allows it to grow out of its debt as opposed to having to restructure its debt.

Thank you, Saumil.

Past performance is not a guarantee or a reliable indicator of future results. Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk. Mortgage and asset-backed securities may be sensitive to changes in interest rates, subject to early repayment risk, and their value may fluctuate in response to the market's perception of issuer creditworthiness; while generally supported by some form of government or private guarantee there is no assurance that private guarantors will meet their obligations. Derivatives may involve certain costs and risks such as liquidity, interest rate, market, credit, management and the risk that a position could not be closed when most advantageous. Investing in derivatives could lose more than the amount invested.

This material contains the current opinions of manager and such opinions are subject to change without notice. This material has been distributed for informational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Statements concerning financial market trends are based on current market conditions, which will fluctuate. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. Pacific Investment Management Company LLC, 840 Newport Center Drive, Newport Beach, CA 92660, 800-387-4626. ©2010, PIMCO.

Newport Beach

Pacific Investment Management Company LLC
840 Newport Center Drive
Newport Beach, CA 92660
USA
800-927-4648
949-720-6000

Amsterdam

PIMCO Europe Ltd Amsterdam Branch¹
(Registered in The Netherlands,
Company No. 24319743)
Registered Office
Schiphol Boulevard 315
Tower A6
1118 BJ Luchthaven Schiphol
The Netherlands
+31 (0) 20 655 4710

Hong Kong

PIMCO Asia Limited²
24th Floor
Units 2403 & 2405
Nine Queen's Road Central
Hong Kong
+852 3650 7700

London

PIMCO Europe Ltd¹
(Registered in England and Wales,
Company No. 2604517)
Registered Office
Nations House
103 Wigmore Street
London W1U 1QS
England
+44 (0) 20 7872 1300

Munich

PIMCO Europe Ltd Munich Branch¹
(Registered in Germany, Company No. 157591)
Registered Office
Seidlstraße 24-24a
80335 Munich
Germany
+49 (0) 89 1221 90

New York

Pacific Investment Management Company LLC
1345 Avenue of the Americas
New York, NY 10105-4800
USA
212-739-3000

Singapore

PIMCO Asia Pte Ltd³
501 Orchard Road #08-03
Wheelock Place
Singapore 238880
+65 6491 8000
Registration No. 199804652K

Sydney

PIMCO Australia Pty Ltd⁵
ABN: 54 084 280 508
AFSL: 246862
Level 19, 363 George Street
Sydney, New South Wales 2000
Australia
+61 2 9279 1771

Tokyo

PIMCO Japan Ltd⁴
Toranomon Towers Office 18F
4-1-28, Toranomon, Minato-ku,
Tokyo, Japan 105-0001
+81 3 5777 8150

Toronto

PIMCO Canada Corp.⁶
120 Adelaide Street West
Suite 1901
Toronto, Ontario, Canada M5H 1T1
416-368-3350

Zurich

PIMCO (Switzerland) LLC
(Registered in Switzerland,
Company No. CH-020.4.038.582-2)
Dreikoenigstrasse 31a
8002 Zurich
Switzerland
+41 (0) 44 208 3867

PIMCO provides services only to qualified institutions and investors.

¹ PIMCO Europe Ltd, PIMCO Europe Ltd Munich Branch, and PIMCO Europe Ltd Amsterdam Branch are authorised and regulated by the Financial Services Authority in the UK, 25 The North Colonnade, Canary Wharf, London E14 5HS. PIMCO Europe Ltd Munich Branch is additionally regulated by the BaFin in Germany in accordance with Section 53b of the German Banking Act and PIMCO Europe Ltd in Amsterdam is additionally regulated by the AFM in the Netherlands.

The services and products provided by PIMCO Europe Ltd are available only to professional clients as defined in the Financial Services Authority's Handbook. They are not available to individual investors, who should not rely on this communication.

² PIMCO Asia Limited is licensed pursuant to the Securities and Futures Ordinance in Hong Kong.

³ PIMCO Asia Pte Ltd is regulated by the Monetary Authority of Singapore.

⁴ PIMCO Japan Ltd's Financial Instruments Business Registration Number is Director of Kanto Local Finance Bureau (Financial Instruments Firm) No.382. PIMCO Japan Ltd is a member of Japan Securities Investment Advisers Association and Investment Trusts Association.

Investment management products and services offered by PIMCO Japan Ltd are offered only to persons within its respective jurisdiction, and are not available to persons where provision of such products or services is unauthorized.

The value of assets fluctuate based upon prices of securities in the portfolio, market conditions, interest rates, and credit risk, among others. Investments in foreign currency denominated assets will be affected by foreign exchange rates. All profits and losses incur to the investor. There is no guarantee that the principal amount of the investment will be preserved, or that a certain return will be realized; the investment could suffer a loss. The fee charged will vary depending on the investment trust acquired or the investment advisory agreement entered into; these materials do not set forth specific fee amounts or their calculation methodologies.

⁵ PIMCO Australia Pty Ltd, AFSL 246862 and ABN 54084280508, offers services to wholesale clients as defined in the Corporations Act 2001.

⁶ PIMCO Canada Corp provides services only to accredited investors within certain provinces or territories in accordance with applicable law.

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

© 2010, PIMCO.