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**FRANCINE LACQUA, BLOOMBERG:**

Now, joining us is Richard Clarida, Global Economic Advisor at PIMCO, Former Vice Chairman of the US Federal Reserve. Richard, what a day to have you on.

**RICHARD CLARIDA, PIMCO:**

What a day!

**LACQUA:**

I don't know whether you miss being a central banker, whether at least you're just relieved you were never part of the ECB because they have a tough time today.

**CLARIDA:**

I think they do. I think it is finally balanced. And I think your reporter did a good job checking off the issues. In fact, I would say now that apparently Bloomberg has confirmed that story. I do lean in the direction that I think they will go today. I do think it's finally balanced. I think President Lagarde was at Jackson Hole and I did not take any particular lean. But I think we have to take this report seriously. What I would say, Francine, is if they don't go today, I do expect them to go later this year. I don't think they're done. I think they're close to done. But the data in Europe has definitely been going south and I think it is a balancing act.

**LACQUA:**

Richard, is there a danger that actually central banks, in the eye of credibility; because they want to be credible because of what's happened in the last three years, will over tighten? And then there's going to be a big slowdown as the effects of this tightening start taking ahead with the 12, 18 month laggard.

**CLARIDA:**

Francine, I think they want to avoid over tightening, but certainly at the Fed, Chair Powell and other committee members have said many times the risk of doing too little on inflation, exceeds the risk of doing too much. I do think central bank credibility is paramount. I think so far, credibility has been maintained. But yes, I think if there is a risk and there's always a risk in the real world in policy, the risk will be over tightening relative and tightening too little.

**LACQUA:**

So what would you do if you were at the Fed today?

**CLARIDA:**

Well, I think today it will be appropriate to deliver what I would call a “hawkish pause”. I don't, not- well, they'll be moving next week, but I think they'll be inclined to deliver a “hawkish pause”. They have gotten good news on inflation. Yesterday, a mixed report, but if you look at the underlying trends, core inflation is moving in the direction they want. So I think what we'll see next week is a pause, but an indication that they're prepared to do more. And I would expect them, I think it's finally balanced, but I would expect them probably to get one more hike in this cycle.

**LACQUA:**

And then stay for longer?

**CLARIDA:**

Yes, I think the new mantra will be, we heard “lower for longer” in the last decade. And I think “restrictive for longer" may become the new mantra, not only for the Fed, but for the ECB and Bank of England.

**LACQUA:**

How risky is that for markets? They don't see- and we hear Christine Lagarde. We also heard the Bank of England governor keep on telling the markets that we can be here for a while. They don't quite believe them.

**CLARIDA:**

They don't, and I do think that there's an element of disconnect. I've written about this before that central banks will stay higher or restrictive for longer and markets will price in the cuts. Now, Francine, in the Fed's case, the Fed offers projections of its rate path, the so-called dots. As I learned, as Vice Chair, you can't live without them, we can't live with them, but we're stuck with the dots. We'll get a new set of dots next week. And most likely, they'll show as they did in June, the Fed expecting that next year, it can begin to cut back and to cut rates. But that will be a balancing act for the Fed, because the markets will tend to take what the Fed gives and then move it even further. So I think we'll see more of that.

**LACQUA:**

Do you think that Rich, that US bond yields have peaked?

**CLARIDA:**

Great question. We've been trading in a range, really, for about 10 months now. We've moved above that range. I'm still at the view that we're more or less in the range for treasuries that we're going to see. If rates do move up, I don't think it's going to be because of the Fed. It's going to be because of the fiscal dysfunction in Washington. So even though the Fed's very powerful, it's not the only driver of rates. And fiscal policy is also a factor as well.

**LACQUA:**

Do you think we're underestimating the impact of QT? We focus so much on interest rates. I mean, this could be the big one.

**CLARIDA:**

Well, you know, Jay Powell and the Fed's hope, Francine, is that QA operates- QT operates in the background. In fact, I think Chair Yellen at one point said, it's like watching paint dry. But as I learned when I was Vice Chair in the fall of 2018, it's in the background until it's not. And markets can suddenly start paying a lot of attention to QT. I don't think we're there yet, but it's obviously something the Fed will have to be attentive to.

**LACQUA:**

So what do you think at this juncture in time, is there something that markets are misunderstanding about what the Fed is trying to do or how the economy will evolve?

**CLARIDA:**

I think the markets are under appreciating that the Fed has to take into account not only the baseline view, but the balance of risk. And I think there is a scenario next year, where the labor market continues to be hot, low unemployment, and the progress on inflation stalls. And at that point, the Powell Fed has a tough choice. Inflation is running in the threes next spring. They don't want inflation in the threes. They want it heading to two. And so I think markets are under appreciating that if inflation remains sticky and stubborn, in certain scenarios, we may see more from the Fed.

**LACQUA:**

You don't think they'll live with 3% at the margin for a while longer?

**CLARIDA:**

No, I've said before I'll repeat on air. I think the destination before they start considering cuts is “two point something” on inflation and “point something” might be point eight or point nine, but they definitely want inflation year over year under the core measures in the two’s before I think they start thinking about what's next.

**LACQUA:**

Richard, do you think we're importing deflation from China?

**CLARIDA:**

Well, certainly a surprise to me, although not to my PIMCO colleagues because we got the call right. Typically when you have reopening or stimulus in China, you do see it putting upward pressure on global prices. This year, inflation's going in the opposite direction in China, so- but offsetting that Francine, is the fact that we have a real push here for front-shoring, off-sharing, de-risking, whatever the favorite term is. And that can only be moving in one direction. It's going to put upward pressure on prices that supply chains readjust.

**LACQUA:**

Welcome back, everyone. Still with us, Richard Clarida, Global Economic Advisor at PIMCO and former Vice Chair of the US Federal Reserve. Rich, thank you so much for staying with us. We talked a little bit about the Fed, bond yields, what you're expecting, maybe some of the pitfalls and we're just getting started to talk about China. What do we not understand well about the China economy that could actually hurt, I guess, even Europe a lot more? We know that no matter what political spectrum you're from in the US, you want to go after China. Does that translate economically?

**CLARIDA:**

Oh, it really does. I guess to answer the first part of your question, what do we not know about China? I think about almost everything. It's an enormous economy. But it's opaque. It's hard to follow. I guess sometimes even for folks in China. But clearly what we do know is that the reality of the 30 years before the pandemic, globalization, China supply chains, driving global disinflation, that's definitely in the past. We're in a world where we're going to have more complex regional trade arrangements, more complex trading arrangements, obviously supply of minerals, including lithium for batteries in China. So a very complex, not only economic, but geopolitical relationship, which all of us in markets are navigating.

**LACQUA:**

But Richard, from where we are now, right? Which is de-globalization and the ensuring of supply chains, how much more can that still go on? Are we really talking about a trend that can continue for years to come from de-globalization?

**CLARIDA:**

Oh, well, I would say more re-global- I don't think we're de-globalizing, but we're re-globalizing, for example, with our relationships with NAFTA, with Mexico enhanced, and some production in China moving to other countries. And so, yes, at PIMCO, we think this is what we call a “super-secular trend”, which means a decade or more.

**LACQUA:**

So what does this mean? Going back to the US, are you expecting a soft landing or the chances of recession quite- you know, at 20%?

**CLARIDA:**

At PIMCO, we do think markets are a little bit over optimistic on a really soft landing. I think I would characterize us as thinking of a soft-ish landing. Perhaps some modest rise in unemployment, perhaps a technical NBER recession, but not a deep, persistent downturn. But we do think markets have gotten a little bit ahead of reality on the soft landing narrative.

**LACQUA:**

Do you think there's a perception across all, actually, jurisdictions that we've now, you know, won the fight against inflation, and that's premature, be it in Europe, UK, or US?

**CLARIDA:**

Well, yes, because for the following reason, I think central bankers, in particular, will be very reticent to either communicate or even think themselves about “mission accomplished”. You know, that doesn't end well, as we've seen historically. And in particular, given that central banks, including the Fed, and I were members of Team Transitory, it's important for them to be darn sure that when they say that inflation's on the way back to 2%, it is. And so I do think that they've underestimated probably the resolve to keep rates restrictive for longer.

**LACQUA:**

Why did we get transitory so wrong? It feels like, I mean, we could actually argue that it's transitory, but over years.

**CLARIDA:**

Well, you know, I'm open to that, since I said I was a charter member of Team Transitory. Look, in the spring of 2021, what we knew at the Fed, and I was a Vice Chair then, was that the vaccines had arrived, reopening was occurring. And initially, the inflation that we saw was really concentrated in just a small number of reopening categories. Used cars, for example. So I think what central banks got wrong, what the Fed got wrong, is that we had multiple large, unprecedented shocks. The pandemic was a shock. Reopening was a shock. Russia's invasion of Ukraine was a shock. And adverse supply shocks complicate monetary policy, because they push up inflation, which is bad, but they also tend to depress activity, which is bad. And so I think it took a while, but I think the Powell Fed and the Lagarde ECB and the Bailey Bank of England recognized what they needed to do, and they're doing it.

**LACQUA:**

How much do we need to start talking about fiscal space, right? Of countries–

**CLARIDA:**

I think we need to talk about it.

**LACQUA:**

But markets are not really looking at it.

**CLARIDA:**

Well, I think they will start to look at it at some point, because if you just look at simple measures, like the amount of government debt relative to GDP, in most countries 20 years ago, that number was less than 50%. It's now around or north of 100%, including in the US, many countries in the Eurozone, not Germany. And I do think that fiscal space is going to be more limited going forward. Economists aren't very good at giving us the exact point at which you run out of it, but whatever your views were on fiscal space before the pandemic, there's less fiscal space available now.

**LACQUA:**

And talking about fiscal space, we're almost at the one year anniversary of that pretty disastrous mini budget here in the U.K. Are we over that? Is the U.K. really more solid?

**CLARIDA:**

Certainly, yes, I think. But I think that was a very important example of how quickly fiscal confidence can be eroded, and how that can spill over into markets and require interventions. And so, yes, I don't want to necessarily invoke the “canary in the coal mine” analogy, but that may be the first of other episodes that we're going to see in the years ahead.

**LACQUA:**

Could it happen elsewhere? Could something like that even happen in the US?

**CLARIDA:**

Well, we've had disruptions in the Treasury market. You know, in September of 2019, we had the “repocalypse”, when the repo markets in the US were disrupted. Now, the Fed acted promptly in that case. We also saw the Treasury market challenged in the spring of 2020. You know, I think we do have an issue in global sovereign markets in that the infrastructure for clearing and trading Treasury securities, for example, was designed 40 years ago. And the amount of intermediation that I have to do in markets today is vastly larger. And so, I think there is always the risk of hiccups and dislocations that cannot be completely eliminated.

**LACQUA:**

Richard, as always, thank you so much for coming on.

**CLARIDA:**

Look forward to the next time.

**LACQUA:**

Me too, Richard Clarida there, PIMCO’s Global Economic Advisor and former Vice Chair of the Federal Reserve.