Viewpoints
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Hobble and Muddle

By Mohamed El-Erian

Colleagues from around the world recently gathered at PIMCO's headquarters in California for our annual Secular Forum, when we leave behind high-frequency issues for a few days and, instead, debate what the next 3-5 years hold for the global economy. The perspective is global, informed by the insights of outside speakers, and the focus is on what is likely to happen, as opposed to what should happen.

The last two Secular Forums projected that, after the global financial crisis, the world economy would not reset in its traditional, cyclical manner. Instead, it faced multi-year re-alignments of both a national and global nature. The world economy would heal, but in a slow and uneven fashion, as advanced economies muddled through while the more dynamic emerging world gradually closed today's income and wealth gaps.

Developments since then have been consistent with this characterization. The G-7 recovery has been unusually sluggish, notwithstanding large and unprecedented policy stimulus (particularly in the US). As a result, unemployment has surged, now exceeding that of emerging economies. Meanwhile, deficit and debt indicators have worsened, both in absolute terms and relative to emerging economies, and the average risk premium on advanced economies' debt now exceeds that for emerging economies.

These are outcomes that fall well short of policymakers' expectations, be it in America or in Europe. Indeed, for most of the post-crisis period, all of them have been understandably fixated on stimulating growth.

Some have even embraced explicit policies to boost asset prices (e.g., the US Federal Reserve's second round of so-called "quantitative easing"). Yet, along with "good" asset-price inflation, aimed at making people feel richer and spend more, these approaches have delivered "bad" inflation, owing to surging commodity prices, which impose a tax on both inputs and consumers. In Europe, every balance sheet available has been tapped to forestall a debt crisis in the periphery, resulting in large bailout packages for Greece, Ireland, and Portugal, and the contamination of the ECB's balance sheet.

Looking ahead, some signs point to the global economy's accelerated healing and growing resilience, which bodes well for an orderly retreat from unconventional policies. There are also signs suggesting that emerging economies' breakout is well anchored, and that China, in particular, will be able to navigate its complicated middle-income development transition.

Unfortunately, other signs point to an uneven, faltering global recovery. In advanced economies, projected rates of growth are not sufficient to avoid mounting debt and deficit problems. For some, such as Greece, this means more difficult choices between restructuring and socialization of losses. For others, like the US, future sacrifices are already required, most likely through a combination of higher inflation, austerity, and "financial repression," as governments seek to impose on savers negative real rates of return. Needless to say, demographic transitions, commodity constraints, and geopolitical uncertainties complicate all of this.

Most importantly, too many government and household balance sheets remain out of equilibrium in an excessively asset-based global economy. As a result, many long-standing promises will come under pressure over the next 3-5 years. Specifically, a variety of social contracts – for example, health-care and pension entitlements, as well as unemployment benefits – will come under greater strain. At the international level, the standing of US-supplied public goods (including the dollar as the global reserve currency) faces gradual erosion.

To the extent that this scenario holds, the next few years will follow the same multi-speed dynamics that we have seen recently. Specifically:

- Advanced economies will face sluggish (call it 2%) growth and persistently high, increasingly structural (and therefore protracted) unemployment. Already-large disparities in income and wealth will continue to deepen, amplified by higher inflation and financial repression. And debt and deficit concerns will remain, with the virtual certainty of at least one sovereign-debt restructuring in Europe.
- Emerging economies will achieve higher growth (in the 6% range), and their income and wealth levels will continue to converge with those of advanced economies. But this will create its own challenges, including recurrent inflationary pressures and surges in capital inflows, leading to greater policy experimentation.
- Sovereign creditworthiness will continue to diverge, with a further deterioration in advanced countries and continued improvement in emerging markets.
- Inflation convergence – between high headline and low core rates, as well as between high emerging-market and low advanced-country rates – will occur at levels higher than currently anticipated.
- The global economy overall will hobble along, continuing its gradual transition from a uni-polar to a multi-polar world.

This baseline scenario is subject to two-sided risks that could well increase over time. On the upside, the US could have a "Sputnik moment": a sense of national unity, common purpose, and shared sacrifice leads to structural reforms that

focus on re-aligning balance sheets over the medium term, enhancing job creation, and improving competitiveness. Europe could re-engineer the eurozone to enable debt sustainability and high economic growth. And emerging economies could unleash their consumers, boosting global demand.

The chances for such “grand bargains” have increased in recent months, but, at this stage, they can at best only offset the global outlook’s downside risks. Above all, liabilities have simply been shifted around the global economy, which cannot continue indefinitely. Meanwhile, excessive income and wealth inequalities are weakening the fabric of societies; persistent joblessness in advanced countries is undermining productivity and skills; policy effectiveness and flexibility are deteriorating; and the world economy is facing increasing challenges in accommodating the development breakout phase in systemically important emerging economies.

Multi-year re-alignments are messy and complex, especially when they occur simultaneously at the national and global levels, and when multi-speed growth, inflation, and credit dynamics are at work, as is the case today. Parameters become variables; balance sheet repairs proceed in a slow and uneven fashion; and policymakers experience an uncomfortable shift in the balance of benefits, costs, and risks.

As much as we may wish for a more reassuring outlook, the world economy will remain unusually fluid in the coming years. What appears as a systemically interconnected world will also turn out to be increasingly fragmented cognitively, with weak global governance and policy coordination. This is a global economy that must be navigated carefully, lest those that seek to benefit from change find themselves falling victim to it.

About the author:
Dr. El-Erian is CEO and co-CIO of PIMCO and is based in the Newport Beach office. He re-joined PIMCO at the end of 2007 after serving for two years as president and CEO of Harvard Management Company, the entity that manages Harvard’s endowment and related accounts. Dr. El-Erian also served as a member of the faculty of Harvard Business School. He first joined PIMCO in 1999 and was a senior member of PIMCO's portfolio management and investment strategy group. Before coming to PIMCO, Dr. El-Erian was a managing director at Salomon Smith Barney/Citigroup in London and before that, he spent 15 years at the International Monetary Fund in Washington, D.C. Dr. El-Erian has published widely on international economic and finance topics. His book, "When Markets Collide," was a New York Times and Wall Street Journal bestseller, won the Financial Times/Goldman Sachs 2008 Business Book of the Year and was named a book of the year by The Economist and one of the best business books of all time by the Independent (UK). He was named to Foreign Policy’s list of “Top 100 Global Thinkers” for 2009 and 2010. Dr. El-Erian has served on several boards and committees, including the U.S. Treasury Borrowing Advisory Committee, the International Center for

Research on Women, and the IMF's Committee of Eminent Persons. He is currently a board member of the NBER, the Peterson Institute for International Economics and Cambridge in America. He holds a master's degree and doctorate in economics from Oxford University and received his undergraduate degree from Cambridge University.