

Return of the old ways of thinking threatens recovery

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Published: September 28 2009 20:23 | Last updated: September 28 2009 20:23

We are at the point of maximum confusion in the multi-year transition of the global economy, markets and policymaking. We have left the global growth regime that was driven primarily by debt-financed consumption in the US, but we have not as yet reached a position of more balanced, albeit anaemic, growth. Those who lack a robust anchoring framework, be they investors or policymakers, risk being misled and backtracking to outdated ways of thinking.

The signs of inappropriate reversion are multiplying. Confusing temporary factors for sustainable ones, a growing number of analysts have extended the ongoing stimulus/inventory bounce to a V-like recovery next year and beyond. The momentum for meaningful financial reform is stalling in spite of clear evidence that financial activities have far outpaced the regulatory infrastructure. And some banks are returning to the bad habits that almost destroyed them.

This reversion is intimately linked to the inadequacy of the anchoring analytical frameworks. Appropriate frameworks provide important protection against the short-termism that can contaminate markets and policymaking. By contrast, ill-designed frameworks can encourage short-term thinking, leading to market and policy overshoot on the way up and down.

Today's lack of appropriate anchoring frameworks appears to be exacerbating short-termism. The issue goes well beyond the still-limited appreciation of the multi-year realignment of the global economy, which is gaining momentum. It also relates to tendencies well-documented by behavioural economists – such as framing the problem wrongly and refusing to question past approaches.

Given all this, we would be all well advised to follow the admonition of Mervyn King. Last month, the governor of the Bank of England stated bluntly: "It's the level, stupid – it's not the growth rates, it's the **levels** that matter here." Investors have not yet accepted his insight that the absolute levels of income, debt, wealth and unemployment, not just the rates of change, are what matters today. They need to, and soon.

Analysis of key levels in the global economy points to important deviations between desired and actual levels. The outlook for major countries will continue to be driven by the levels of key variables, not their rate of recovery. Consider four examples.

First, consumer indebtedness is still too high relative to income expectations and credit availability, particularly in the US and the UK. This inconsistency will hold back any sustainable bounce in the most important component of aggregate demand.

Second, some banks' balance sheets are still too geared for the comfort of regulators or their own managers. This will inhibit them from lending to the real economy at a time when certain sectors (such as commercial real estate, but also residential housing) still require significant refinancing, and when consumers need time to work down their excessive debt loads.

Third, **unemployment** has risen well beyond expectations, and is likely to prove unusually protracted. It will take years for US unemployment to return to its natural rate, even after the natural rate shifted upwards. This will dampen the recovery of consumption and investment, stress social contracts that assume flexible labour markets, and endanger political support for essential structural reforms.

Finally, public **debt** has grown so rapidly as to spark concerns about future debt dynamics. This would inhibit the effectiveness of future stimulus measures, as well as complicating the formulation of exit strategies. It could also erode the medium-term ability of the US to fund cheaply its large deficits by undermining both the global standing of the dollar as world reserve currency and the attractiveness of US financial markets.

These factors work against the much needed handover from temporary growth impulses (which will bolster growth for the remainder of this year) to the permanent ones needed to sustain above-trend growth in 2010 and beyond. As such, the global economy may find it tough to attain Larry Summers' "escape velocity" – sufficiently high and sustained growth to propel the US (and the rest of the world) away from the contractionary drag of further debt reduction, risk aversion and reregulation.

These considerations serve to accentuate the inconsistency between market valuations and the reality facing companies and economies. Today's markets – be they industrial country equities or corporate bonds – have priced in vigorous growth for 2010. Valuations assume companies will be able robustly to grow earnings through higher revenues, not renewed reliance on the cost reductions that have propelled earnings in the past six months. For that, they are depending on what is likely to prove to be an elusive high-growth scenario for 2010.

The longer it takes for investors and the policy consensus to shift to the appropriate analytical framework – one that factors in levels rather than just rates of change – the greater the risk of disappointment in 2010. Mr King's insight will need to be more widely appreciated if the global economy is to avoid a growth and wealth relapse next year.

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