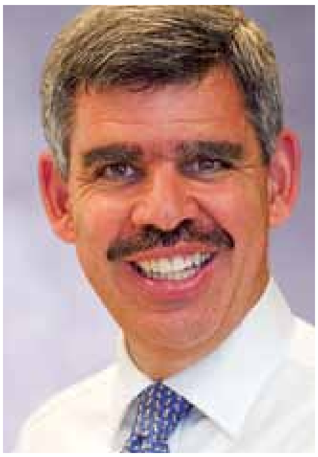
Today's Global Rubik's Cube *of* Frustration



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TIE *Founder and Editor David Smick sits down with Mohamed El-Erian.*

David Smick: What is the state of the world economy? It's as if we are experiencing a giant global economic Rubik's Cube of frustration.

Mohamed El-Erian: While the consensus baseline for the global economy points to a synchronized pick up in growth, albeit a still-muted one, it is subject not just to uncertainty but, to use former Fed Chairman Ben Bernanke's phrase, "unusual uncertainty" on account of four economic issues. And all this is before we consider geo-political risks and rather fluid domestic and, in the case of Europe, regional political landscapes.

The first economic uncertainty is the consistently sluggish behavior of productivity. The second is the persistence of "lowflation," despite a sharp fall in unemployment and years of ultra-loose monetary policy; or what current Fed Chair Janet Yellen has called the inflation "mystery." The third is weak wage dynamics, again despite significant employment gains—we recently saw an historically unusual call by European Central Bank President Mario Draghi on the German unions to step up their wage demands.

And then there's the fourth element which relates to what I call the global adding-up challenges—from virtually no country willing to live with a stronger currency to simmering protectionist threats and weak global policy coordination that no longer shares a common vision and a common objective. There is also the question of how the global economy would handle the eventuality of more than one systemically important

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central bank trying to normalize its monetary policy after many years of reliance on unconventional measures. It seems that one bank, the U.S. Federal Reserve, is able to deliver, borrowing a concept investor Ray Dalio used in another context, a "beautiful normalization." It is not clear what happens when several try to do so.

Smick: In the past, some industrialized economy somewhere was always willing to accept a strong currency. That appears to be changing.

El-Erian: Correct. Nowadays, the currency market has what I think of as "hot potato syndrome"—that is, virtually no one seems willing and able to live with a sustainably stronger exchange rate. This is not only due to the rather weak growth fundamentals that persist in the advanced economies and that have aggravated the inequality trifecta—of income, of wealth, and of opportunities. In addition, technological innovation, spearheaded by the increasingly powerful combination of artificial intelligence, big data, and mobility, is changing not just what we do, but also how we do things. On top of that, we have protracted policy over-reliance on central banks as the only game in town in terms of delivering macroeconomic outcomes.

Smick: Central bankers have completely ignored the fiscal side. They have let the governments off the hook.

El-Erian: And it appears that the politicians may have gotten too comfortable letting the central banks carry too much of the policy burden. This is a challenging time for central banking, whose policy tools are stretched while several systemically important institutions are subject to greater political scrutiny. In such a world, central bankers have two choices when it comes to basic policy orientation.

The first is to become highly data-dependent, retain maximum policy optionality, and keep waiting for the high-frequency data before making decisions; all this while also seeking to continue to suppress financial volatility, boost asset prices, and minimize any market disruptions. The second choice is to decide to develop a more definitive and confident vision as to where all this is going, then try and shape more actively the journey to a better destination.

Central bankers in the advanced economies are mostly in the first camp right now because they have a strong sense that the destination is not theirs to deliver. Rather, high and inclusive growth requires the deployment of additional tools relating both to supply responsiveness and demand management that central banks simply do not possess. In the process, we end up with rather short-term policymaking and a potentially unhealthy co-dependence between central banks and financial markets.

It is important to remember that this is not the fault of central banks. Indeed, if it weren't for their bold policy actions, the world would have fallen into a multiyear economic depression in 2008–2009 and, in the case of Europe, the eurozone would have collapsed shortly thereafter. Rather, it reflects continued delays in a much-needed policy handoff—from excessive reliance on central banks to a more comprehensive policy response.

The longer unconventional monetary policy has used the asset markets and financial valuations to try to deliver better economic outcomes, the lower the benefits have been, and the higher the costs and the risks.

Smick: I never would have imagined we'd see the political community more hawkish than the central bankers.

El-Erian: When Chairman Bernanke in August 2010 signaled that the Fed would use unconventional measures not to normalize financial markets as the central bank did very well in 2008–2009, but to pursue much broader macroeconomic objectives, he specified the policy equation in terms of "benefits, costs, and risks."

The longer unconventional monetary policy has used the asset markets and financial valuations to try to deliver better economic outcomes, the lower the benefits have been, and the higher the costs and the risks, including political ones.

No one envisaged that the U.S. Federal Reserve would remain in this policy mode for so long—over-relying, along with the ECB and the Bank of Japan, on an inherently narrow policy response. Remember, central banks cannot promote productivity-enhancing infrastructure. They cannot remove the anti-growth biases in tax systems. They don't have the means to improve the functioning of the labor market, pursue education reform, or enhance skill acquisition. And they alone cannot deliver the required level of global policy coordination.

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One of the particularly unfortunate consequences of protracted over-reliance on central banks has been to benefit asset prices and asset holders to a huge extent, inadvertently amplifying concerns about not just the inequality of income and wealth, but the inequality of opportunities. This has fueled a political backlash, with some people asking, wait a minute, why don't we have quantitative easing benefiting people and not just the rich holding financial assets? They argue that if central banks are going to expand their balance sheet, they should give money to people to consume, and not just benefit holders of financial assets. The central bank would then become an explicit fiscal agency, with all the potential political consequences.

Smick: Ten years from now, will we still be talking about GDP and the wealth effect? Will wages continue to be flat or decline? With so much of the wealth that has been produced coming from equity markets and real estate appreciation, inequality has greatly increased. Will this trend continue?

El-Erian: In the beginning of 2009, working closely with my PIMCO colleagues, I came up with the concept of the "new normal"—that your typical V-shaped cyclical recovery would face secular and structural challenges, for several reasons. Most importantly, society had overinvested in finance as an engine of growth, and hadn't invested enough in genuine drivers of growth. In fact, with the exception of Germany ten to twelve years ago, no other industrial country has seriously invested in infrastructure or reformed its labor markets and sufficiently improved its education and skill acquisition systems. It just didn't happen. Instead, countries over-relied on finance, competing to be financial centers and falling into the trap of believing that financial engineering was not just a risk mitigator, which proved wrong, but also an engine of sustainable growth.

So it was clear to us that most advanced economies didn't have robust enough growth models, and putting a new growth model in place takes time and needs political vision and sustained implementation. As a consequence, we were entering this period of "new normal" where growth would be unusually low, and for an unusually long period of time.

Now, some say the new normal—later labeled by others as "secular stagnation" and the "new mediocre" per the International Monetary Fund—not only is a good historical explanation for what's happened since the global financial crisis, but can also predict the next five years. The problem is that when a sophisticated market economy runs at low speed for a long time, structural stress increases and things start to break. The social consensus is pressured. The politics of anger start dominating. We start getting improbable or unthinkable outcomes—such as Brexit and, more broadly, an anti-establishment wave that mistrusts existing institutions and expert opinion—as the social and political consequences of low growth broaden. In short, we cannot continue to run the global economy at a low growth rate forever. At some point, it tips either to higher and more inclusive growth, together with genuine financial stability, or to recession and unsettling financial volatility.

Add to that, we are close to exhausting the asset channel as the principal vehicle for promoting growth. Asset prices have been fundamentally decoupled from economic fundamentals. As such, in the next few years, the new normal is likely to yield to something else, with economic governance being a major determinant.

Rather than a pure economic policy engineering issue, how we tip is a function of your political predictions. If you believe that political disruptions—the election of Mr. Trump here, Mr. Macron in France, Brexit in the United Kingdom—can unleash better economic governance, then you take an optimistic view that comprehensive policy reforms can push growth higher, make it more inclusive, validate elevated financial asset prices, and allow central banks to normalize policy in an orderly fashion.

If, however, you think the political system will remain highly polarized and hinder a comprehensive economic policy response, then low growth would become recession, asset markets would become highly volatile, and the political situation would get a lot trickier. I think that if you run it forward, the "new normal" is fueling its own contradictions, its own stresses. Otherwise, you cannot fully explain all these unthinkables that have occurred, be they economic, financial, or political.

Smick: Does that explain why the VIX remains low despite a U.S. president talking about preemptive strikes against the North Koreans? How do you explain the stock market? Is it liquidity-driven at a time when the market seems psychotically driven to buy the dips? Even if Fed Chair Janet Yellen tightens further, does it matter to equity markets, particularly if every other major central bank continues pumping out liquidity like mad?

El-Erian: The problem is not just low volatility and high asset prices. It's also that traders and investors are now conditioned to buy every dip in the market regardless of the cause of the dip.

It's a strategy that pays investors repeatedly. An investor who had bought every dip regardless of cause would have made a lot money. Why? Because looking at the expected risk-return equation, an important influence is how fat the tail is.

If you believe the central banks are in the business of repressing volatility, and will therefore make the bad tail very thin, the right strategy is to buy every dip because the central banks will always respond to repress volatility and boost prices. In the process, the markets end up essentially front-running central banks, decoupling asset prices more and more from the underlyimg fundamentals. I call it the "BFF syndrome," because the markets believe that the central banks are their best friends forever.

Despite North Korea and everything else, this year so far has seen the lowest daily maximum loss in the whole history of the S&P stock index. The danger is that this is not a destination, this is a journey, and you can have a fun journey that ends up in a really bad destination if you are not careful. But investors are betting that the journey will be very long. And, at least so far, this has been a very profitable strategy.

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Smick: The world's central bankers seem to be surprised by their inability to come to terms with disinflation and deflation. The truth is, central banks haven't had a great track record. They keep understating their inflation targets. To what extent has China's economy had a disinflationary effect on the world economy, particularly in the last five years? Should central banks be more concerned with developments in China? Where does globalization and technology fit into the equation?

El-Erian: Three important factors, some of which we don't yet sufficiently understand, have altered inflation dynamics. The first is globalization, including the role of China. The second is the impact of technology, which changes not just innovation and price determination but also the use of existing assets. The third is demographics.

These three factors together have fundamentally altered the inflation dynamic. Let me use a simple example to illustrate one of the deeper phenomena.

As of two years ago, it had taken Hilton Hotels one hundred years to offer 700,000 rooms to clients around the world. Yet it took Airbnb just six years to offer a million rooms, and they never built or managed a hotel. Indeed, they had a completely different playbook, disrupting the hotel industry from "another world."

What did they use? Existing assets. Airbnb put pressure on lodging prices by better using existing assets, much as Uber has put pressure on limousine and taxi rates.

This was made possible by the very powerful combination of artificial intelligence, big data, and mobility. Suddenly, in order to understand inflation behavior, it's necessary to realize prices are now being influenced by a different deployment of existing assets. And that's just one of a set of powerful forces in play that we don't yet fully understand. And globalization works with

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technology in continuing to bring in new resources that impact both supply and demand.

It is also worth remembering that the chosen quantitative inflation targets were somewhat arbitrary to start with—there was really nothing magical about the 2 percent target that so many central banks adopted. Yes, when specified, the figure was consistent with the recent history of inflation and, in the case of the later adopters, consistent with what other central banks had done. But they lacked, and still lack, rigorous forward-looking analytical underpinnings.

We are close to exhausting the asset channel.

Smick: Why are central banks so fixated on that number?

El-Erian: Because it is hard to predict the consequences of changing it, and these could well be quite broad and hard to control—from potentially undermining the anchoring of inflationary expectations to opening up central banks to political interference. Add to that, there is still no agreement as to the direction of change should the 2 percent target be put in play.

Some believe that, given how the structure of the economy has been changing, the "right" inflation target could well be less than 2 percent. Others favor a higher inflation target, either directly or by targeting a price level.

Smick: If you were devising a growth plan for the industrialized nations, how would you factor in the demographic headwind?

El-Erian: A question many years ago on my Cambridge University entrance exam was, "With every mouth, God sends a pair of hands. Discuss." That question is very relevant to our current demographic situation.

An aging population has significant influence not only on flows, but on stocks. As age expectancy goes up, the mouth remains in play but the hands are less productive, so other hands have to work harder and give up more.

It's no surprise to me that a segment of the young electorate has been attracted to left-wing politicians such as Bernie Sanders and Jeremy Corbyn. There's a sense that they are on the receiving end of our generation having over-consumed and over-borrowed, and now they will have to carry us for even longer.

Demographic change happens slowly. Yet the underlying dynamics can become self-feeding. For example, the longer the current period of low growth, the more potential growth tends to be pulled downward. The longer the labor participation rate remains low, the more difficult it is to bring people back into the labor force. The longer it takes to modernize skill acquisition and reform the education system, the more earning potential is reduced and the greater the inequality of opportunities.

With all that in play, it is no surprise that, for the first time, people in advanced economies are starting to worry that their kids' generation will not do better than their own. We have policies that can significantly reduce that risk, if only the political system can enable their sustained implementation.

Smick: Polling shows fewer young people believe in the free enterprise capitalist system.

El-Erian: Sure. People will tolerate wealth and income inequality up to a certain point, and that point is quite high in certain countries such as the United States. There's a fundamental belief that such inequality could in fact be a good thing. Incentives matter. If you can be a Mark Zuckerberg and you create and grow Facebook, yes, you should be rewarded handsomely for that. But what really matters is the inequality trifecta: not just income and wealth, but also opportunity. For example, the difference between public and private education has widened significantly. There's anger that the playing field is no longer level.

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Smick: Thirty years ago, an American from the bottom 25 percent in terms of income had a 25 percent chance of reaching the top 25 percent. Now the chance is 5 percent.

To what extent are the major cleavages in the economic debate are less right and left and more big and small? Part of the reason projected economic growth is so modest is the perception that the system, as Bernie Sanders says, is rigged. Large companies control the platforms, they control the patent system, and the complexity of the tax code is to their advantage. It's much tougher for the upstarts. Since the financial crisis, financing to sustain a business has been very difficult to come by, because community banks and regional banks have been ripped apart by the central bank fixation on large, systemically risky banks. Because of Citizens United and the vast flows of money into politics, it is difficult to get the political element to concentrate on the problems of smaller companies.

El-Erian: Do you think that has happened because there's a winner-take-all dynamic in place, or because the system has been co-opted in certain ways?

Smick: I think it has been co-opted because there's so much political money involved. I saw a recent campaign solicitation letter asking for a top contribution of $250,000. But the truth is that with super PACs included, there is no limit. The tech companies in particular have been effective at stifling competition through political muscle or outright purchase of potential competitors. The last thing a tech CEO wants is some Mark Zuckerberg wannabe sitting in his dorm room at Harvard coming up with a disruptive idea. But is this stifling of competition good for the economy in the long term?

El-Erian: There are some really interesting issues here. One is the notion that big tech, as it is now called, has become systemically important. It happened much faster than anyone was ready for, be it regulators, the public at large, or the companies themselves. These platforms throw off tremendous cash and are systemically important in the way people communicate, think, and access information. Now there's starting to be a backlash with governments looking to tax and regulate more.

Second, no matter which industry you're in, even if it's regulated like the financial services industry, you suddenly realize that you are likely to be disrupted by people who come from another world. They may not know what you know about your industry, but do know a lot about technology—particularly the combination of big data, AI, and mobility—and are willing to try to disrupt you.

Assuming they aren't in deep denial, companies have to make a really hard decision about how to respond to actual and potential disruption. First, they ask whether they can disrupt themselves in a positive way. That's really hard to do. Second, they ask whether they can buy the disrupter, bring them in house, and learn from them. Most companies who bring in disrupters struggle with the different culture and way of doing things, and risk ending up essentially crushing the disrupter. Third, companies try to meet the disrupter in the middle and get first access to the ideas through various joint venture arrangements. That's also hard because the access isn't perfect.

What is the right approach for an established company? It's yet to be determined which approach works best. I suspect it varies from industry to industry, and from company to company. And that speaks to a bigger issue.

There are more fundamental questions about how to organize a firm today. Look at the banking system. It's not clear that someone starting from scratch would organize a bank the way it's organized at present.

No wonder former Bank of England Governor Mervyn King used the phrase "radical uncertainty," and former Fed Chair Ben Bernanke talked about "unusual uncertainty." Whatever you call it, the operating environment is a lot more fluid today than in the past, including on account of political and economic issues. As such, the distribution of potential outcomes becomes much broader and less comforting.

In a normal distribution, we operate with a very high expectation of certain outcomes, and the tails, the possibility of a really good thing or really bad thing happening, are relatively thin. We lead the vast majority of our lives based on this distribution, real and perceived. Increasingly,

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however, the familiar is becoming less probable and the tails are becoming fatter.

From the work of behavioral science, including the behavioral economist Richard Thaler who was just awarded the Nobel Prize, we know a bit about how people react when you put them in this fundamentally uncomfortable world. Some are vulnerable to blind spots, which ends up by undermining timely responses. After all, part of our construct has blind spots and unconscious biases. These people will continue operating in the middle when really they should be thinking about what the tails look like.

A second group of people is going to do what married couples tend to do sometimes, which is reframe the issue to make it more comfortable. It's as if they need to leave for the airport, and I tell them today that, rather than depart at 2 pm, their flight is going to leave at either 8 am or 8 pm. These people have never been in a world in which the flight left at either 8 am or 8 pm, so they reason maybe I meant the midpoint between 8 am and 8 pm, which is 2 pm. They will operate as if the flight left at 2 pm even though they heard something completely different.

The third reaction is the most regrettable. It's called active inertia.

A person, or company, knows they need to do something different, comes up with a plan, then ends up doing more of the same thing. When an American tourist, for example, encounters someone who doesn't understand English, he will tend to repeat his question still in English, but louder. The tourist realizes that something is wrong and he needs to act differently, the active part of active inertia, but essentially reverts to what he has already been doing, or the inertia part.

Another example comes from the work of Donald Sull of the London Business School. He points out that IBM identified the PC revolution before it happened, and management and the board realized they needed to change. IBM needed to prepare for the PC world because some of their clients would migrate there and new clients would come in; and they needed to take their mainframe offering up the value-added curve.

In sum, they needed a bar-belled approach instead of staying in the belly of the curve. The right strategy was identified by management and approved by the board. But when it came to implementation, people were so uncomfortable operating there that IBM ended up concentrating too many of its resources in the wrong place.

Think of it. I would have bet on IBM on the eve of the PC revolution. They were the top technology brand. They had massive R&D budgets and were very profitable. Then, if I heard they had identified the right strategy, I would absolutely have bet on them. But they had problems managing the transition. If they hadn't completely

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reinvented themselves in the years since, they wouldn't even exist today.

The fourth reaction to an uncomfortable world is to do the right thing, mixing resilience and agility. You need both as the chance of making a mistake is quite high because we've been taken out of our comfort zone into areas that don't speak easily to our cognitive ability. This demonstrates the importance of having cognitive diversity, an open mind, and willingness to think about multiple scenarios.

Smick: You mentioned earlier the behaviorist theory of economics. To what extent is our deeply partisan, dysfunctional political system a factor in the minds of corporate decision makers? In other words, is Washington dysfunction contributing to the new normal?

El-Erian: If you look at economic risk-taking in the form of corporate investment, you're absolutely right. Companies are sitting on massive amounts of cash. They're not investing it in new plants and equipment, instead, they're giving quite a bit of it back to their shareholders through higher dividends. One of the puzzles is why corporate investment isn't higher, given that interest rates are so low and companies have so much cash.

The level of financial risk-taking, however, is high. Part of the difference between the two is that financial risk-takers believe they can reverse their decisions quickly. They'll be the first ones out. Economic risk-takers know that once they invest in plants and equipment, it's a five- to ten-year proposition.

Smick: Every trader thinks he'll be the first to sell when complications arise. Often that doesn't happen.

El-Erian: Charles Prince, the former CEO of Citigroup, said a few weeks before he lost his job in the global financial crisis something along the lines of, "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance." And the music stopped abruptly, and things got very complicated.

Smick: They sure did. ◆