New City Agenda

Dr Mohamed A. El-Erian: "Economic Prospects, Developments and the Role of Central Banks"

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Introductory Remarks

Lord Sharkey

Director, New City Agenda

Good morning ladies and gentlemen. Welcome to this New City Agenda event with Dr Mohamed El-Erian on Economic Prospects, Developments and the Role of central banks.

With central banks the idea was of course that we could delegate monetary policy to a group of expert economists and they would smooth out the peaks and troughs of the business cycle. Up until about 2007 this experiment looked to have been a great success. Economies went through a phase called the "Great Moderation", with steady growth, and lower inflation. Indeed some central banks thought that prior to the financial crisis the banking system was more resilient than it ever had been. However, that was not the case and in 2008 policymakers faced the potential that a dysfunctional banking system would lead the world into another great recession.

The central banks of course responded to the crisis by aggressively cutting interest rates to rock-bottom levels where they have stayed for the last eight years. Central banks have also experimented with new models of intervention, negative interest rates and dramatically expanding their balance sheets by purchasing Government debt; and the Bank of England now also has a programme of purchasing corporate bonds.

Despite this unprecedented level of intervention, economic outcomes have fallen short of expectation and there is a feeling that some groups of people have been left behind. However, as central banks have gained more responsibility, become occasionally more transparent, and comment more frequently on issues, they have also faced more criticism. On both sides of the Atlantic central banks now find their independence under threat or at least in question.

These developments have therefore raised a number of issues. The first is whether we have relied on central banks for too much and for too long. The second is whether we are entering the end of an era for central bank independence. Finally, we need to examine what actions policymakers can take to unleash growth, enhance prosperity, and deliver genuine financial stability.

We are delighted to have a world-class speaker here to work through those questions with us today. Dr Mohamed El-Erian is the Chief Economic Advisor at Allianz, the corporate parent of PIMCO, where he was CEO and Co-chief Investment Officer between 2007 and 2014. Prior to this he managed Harvard University's endowment, which was not a small sum, and has been a Managing Director at Salomon Smith Barney, and a Deputy Director at the International Monetary Fund. He is currently Chairman of President Obama's Global Development Council and we do not yet know whether he has received a call from the President-elect.

In May 2009 Dr El-Erian coined the term 'The New Normal' to describe the prolonged slow growth that followed the 2008 financial crisis. In 2008, he published his first New York Times best-selling book, *When Markets Collide*, which won the FT Business Book of the Year Award, was named a book of the year by The Economist, and one of the best business books of all time by The Independent. This year, he published the bestselling book about central banks, *The Only Game in Town*. Ladies and gentlemen please welcome Dr Mohamed El-Erian.

Economic Prospects, Developments and the Role of Central Banks

Dr Mohamed El-Erian

Chief Economic Advisor, Allianz

I. Introduction

Thank you. It is such an honour and a pleasure to be with you. My Lords, thank you very much for inviting me and for the kind introduction. Thank you all very much for taking time from your busy schedules. I cannot tell you how much of a thrill it is to be in the Houses of Parliament. Having studied Parliament in school and university in Britain, it is a special thrill to be here. Thank you very much for this wonderful opportunity.

As John said, I am here to have a conversation with you about what lies ahead for the global economy, and to do so from the perspective of central banks. Why central banks? These traditionally-guarded institutions have, as John mentioned, been pushed into taking a visible primary responsibility for economic policymaking after the global financial crisis. This was not a choice; this was a necessity.

In doing so, they took on many more burdens and responsibilities than they had ever had before. The good news is that they helped the world avert a multiyear depression, which would have been very painful not just for current generations, but for future ones too. The bad news is that no one envisaged them being in this mode – that of being the only game in town, policy-wise, for so long – and therefore they have had to experiment more and more.

We have now come to the point of asking the question: are central banks going from being part of the solution to becoming part of the problem? That is the question that we are going to look at and, in particular, we are going to look at what needs to be done to make sure that we have a smooth transition.

II. Predicting the Future

If I may, let me take you back a year. Specifically, let us assume that we are meeting 12 months ago, that I am sitting in front of you, and I that predict the following. Ask yourselves what you would have thought of me at that point.

- Prediction number one: Donald Trump would be the President-elect of the United States of America.
- Prediction number two: he would beat Secretary Clinton, who herself would be challenged very seriously by a self-declared socialist, Bernie Sanders.
- Prediction number three: you, in the UK, would vote to exit the European Union.
- Prediction number four: one of the most conservative central banks in the world, the European Central Bank, would adopt negative interest rates as a policy, as would the bank of Japan.
- Prediction number five, about 30% of Government debt would trade at negative yields, meaning that if you lend your money to governments in this case, you pay for that privilege; you do not receive interest, but you pay it.
- Next prediction: financial and economic globalisation would go from being accepted paradigms to being political liabilities.
- Another prediction: if you happen to be so called smart money, that is in the hedge fund community, you would find it very hard to out-perform, and you would be frustrated in part by the breakdown of asset class correlations – that is, correlations that you have relied on for a very long time.
- A final prediction: Leicester City would win the Premier League.

Ask yourselves what probability you would have given to any single one of these. Then ask what combined probability you would have assigned to all of them happening.

Most of us would admit to very low probabilities. And I am here to try to convince you that it is consequential when so many improbables, if not unthinkables, become reality. It is an indication that the world we live in is changing.

Every one of these once-improbables – except for Leicester City – is not noise, but part of consistent signals from the system that the road that we are on is coming to an end. I am going to try to convince you that if you were to solve the one common feature, it would be the following: the consistent failure of the West to deliver high and inclusive growth. We are in the midst of a crisis of growth. Growth is too sluggish and growth is insufficiently inclusive.

Because of that, there are tensions and contradictions building up underneath, and you see them erupt through these improbable events. They are shaking the foundation of what we are used to. It is part of what Ben Bernanke called not just uncertainty, but 'unusual uncertainty'. And it is a dynamic that calls on us to think differently.

III. The New Normal

Let us start with where the consensus is, and it is a relatively comfortable place.

Most economists predict more of the same for the global economy: that is, low but stable growth and central banks that are able and willing to repress financial volatility – so even though all of these strange things are happening, the economy and markets do relatively ok. Why? Mainly it is because central banks are able to insulate markets from the unusual uncertainty. Meanwhile, politics remains messy, but its impact is contained. And, yes, geopolitics relating to several factors, including Russia and the role of non-state actors, remains an issue but, again the impact is contained. In all this, consensus judges that central banks are able to continue to isolate the stability of growth and financial markets from the influence of improbable and disruptive events.

That, of course, is the essence of what my PIMCO colleagues and I called 'the New Normal' back in 2009. I remember going to Washington DC at that time and meeting with officials there to suggest that unlike the past, the western economies were not going to bounce back in the traditional cyclical fashion. It was not like an elastic band, where if you stretch it then it comes back. We would not have a V-like recovery. Instead, the western economies would experience something that is very uncommon to them, but very common to the emerging world, which is a structural headwinds as well as cyclical ones.

At that point I was told that the concept was idiotic. That concept has now become consensus and it has acquired two better names. The IMF calls it 'the New Mediocre' and the economists call it 'Secular stagnation'.

Whatever you call it, consensus believes that, just as we have been stuck for the last seven years in this low-growth world with relatively happy financial markets, we will continue to do so. But if you make a detailed assessment of underlying forces, you end up saying: 'Wait a minute. The world is being shaken from above and below, and you are telling me that this consensus will remain as is?'

IV. Impacts on the Current World

So what is shaking the world?

From above it is the high degree of fluidity in economic, financial, political, institutional and social factors. We live it every single day.

From an economic perspective, we are stuck in a low productivity world that not undermines performance today, but also it eats away at performance tomorrow. Your growth potential comes down, and this in a world constructed for high growth, and used to it. The longer that persists, the greater the pressure on the system itself.

Financially, ultra-low and negative interest rates eat away at the integrity of the financial system. The people that are hit first are providers of long-term financial protection services: life insurance, pension funds and other providers of retirement services. Should we care?

There is one side of me that says, 'Hell no, we should not care. They have had it so good for so long.' However, there is another side of me that says, 'Well what happens when the individual no longer has sufficiently comfortable access to long-term financial protection products? What happens to that individual?' That individual becomes more risk averse because she/he cannot pool their insurance and retirement needs. What happens to more risk-averse people? They opt for more self-insurance and they save more. What happens when they save more? It is another headwind to growth. Therefore, the fact that the integrity of the financial system is being undermined is yet another growth detractor.

Institutionally, as John said in the introduction, central banks are starting to be attacked by politicians. Most importantly, their political autonomy is being questioned.

Politically, what does low, non-inclusive growth deliver? It delivers the politics of anger. People start rejecting the established order, the establishment and expert opinion. In the process, single-issue voting becomes a lot more prominent.

I remember coming to the UK two weeks before the Brexit vote and I went to stay with my best friend from university. I asked him, 'What are you going to vote?' I said it in passing because it never occurred to me that he would vote anything but remain. After all, he is an economist, works in the financial sector, and is very global in orientation. To my great surprise, he replied, 'Leave.' I said, 'What do you mean you are going to vote leave? Do you not know about the potential risks involved in dismantling deep trading arrangements and links?' He said, 'Yes, I am aware.' I said, 'How could you vote leave?' and he said, 'Have you watched the news every night in this country? Have you seen the number of immigrants in Calais waiting to come here? I have become a single-issue voter and it is about regaining control', he said to me.

Of course, the single-issue voters also played an important role in the US presidential elections, contributing to Donald Trump's victory.

Our world is therefore being taken from above not just by economic financial institution issues, but also by the politics of anger which can deliver quite strange outcomes. Therefore, to argue that we are somehow going to maintain stability, with all of these things changing, is pretty hard.

Now, our world is also being disrupted from below. We are living through an amazing age that empowers the individual in ways that were hard to imagine. The drivers of this fundamental transformation related to innovation, mobility, big data, and artificial intelligence. And it is a phenomenon with considerable potential for disruption.

Let me give you an example. If you are a company today, your most threatening competitor could well come from another world, and a world that you hardly understand. Let me be more specific via an example.

Consider the Hilton Corporation. It took 100 years to provide 700,000 rooms to customers around the world. 100 years for 700,000 rooms. For Airbnb, it took six years for one million rooms. And what is also different about Airbnb is that the founders knew very little about accommodation and the hospitality industry. They had never built or managed a hotel. But they had a very simple idea: By empowering the individual and by using technological advances to match unused assets with potential demand, they could disrupt an industry.

V. The T-Junction

So the world is not just being shaken from above; it is also being shaken from below by the entrance of non-traditional competitors. I would argue that if you run forward this process, it tells you that the road that we have been on is facing growing disruption and, in my opinion, is gradually coming to an end. As such, it will become increasingly harder for central banks to maintain stable growth, and it will become increasingly harder for central banks to maintain financial stability, even if they experiment more using unconventional monetary policy tools.

Remember, already they have experimented a great deal. When Ben Bernanke announced in August 2010 that the Federal Reserve was pivoting from what it does well, which is to normalise disrupted financial markets, to taking on the burden of delivering economic outcomes singlehandedly, it was a time when US politics was dominated by the emergence of the Tea Party. The central bank felt an obligation to step in because political polarization paralyzed many aspects of economic policy. In defining the concept for QE2, he reminded everybody that it is about "benefits, costs and risks." The longer we stay in the mode of the unconventional monetary policy, the lower the benefits, the higher the costs, and the higher the risks. Few people, including Fed officials, imagined that we would be in this mode for so long and neither did most other people.

At a time where the burdens on Central banks have increased and done so in a protracted manner, their net effectiveness is going down. In other words, the benefits are declining and the costs and risks are increasing. In fact, if you could place the systemically-important central banks in advanced countries on a spectrum – from highly effective, to effective, less Effective, ineffective, and then counterproductive.

The Bank of Japan is, sadly, already somewhere between ineffective and counterproductive. Every time it does something it tends to get a counterintuitive outcome. Why? It has gone too far. Next is the ECB which is somewhere between effective and less effective. Next is the Bank of England. The one that is in the best position right now in terms of effectiveness, and is looking to exit this unconventional world, is of course the Federal Reserve.

The point that I am trying to make is that we are on what I like to call a T-junction. The road that we are on is going to end, but what comes next is not pre-determined. Instead, what comes next is up to the political choices that are to be made.

If the excessive policy burden remains on central banks – that is, the political class does not unleash the full range of available instruments -- then low growth will become recession; artificial financial stability will become unsettling financial instability; the politics will get messier; and so does your risk of a vicious cycle – what the economists call a 'Multiple Equilibria', which is that, rather than a process of mean reversion, one bad outcome leads to a higher probability of another bad outcome.

However, there is an alternative road and the good news is that the engineering of that road is understood. It basically involves a pivot, or a hand-off, from excessive reliance on Central banks to four policy responses.

The first is to go back to what really drives economic growth – things like investing in infrastructure, education, better labour market function – and to get over this romance with finance that we have had for such a long time.

Initially, it was a romance with private finance. Go back to the mid 2000s and the financial services industry was viewed as a very sophisticated industry that produced economic growth. In fact, it was so sophisticated that you did not really need to regulate it heavily; it could increasingly self-regulate according to conventional wisdom at that time. It was so sophisticated that its name changed from financial services to a standalone finance. It was also viewed as the place to be, and not just by bright young people. Countries competed to have their cities be financial centres for the rest of the world. London versus New York, versus Frankfurt. And if you were not big enough – if you happen to be Ireland, Iceland, Dubai or Switzerland – it didn't matter that much. You could grow your financial sector a multiple of your GDP.

In fact, some people even went as far as to say that it finance was the next stage of capitalism. You would go from agriculture, to industry, manufacturing, services, and, if you are really good then graduate to finance.

As a society, we fell in love with finance not only as an enabler, but as the main driver of economic growth. In the process, we forgot that that is not how it works. And it is a romance that we have not been able to exit. Indeed, coming out of the 2008 Global Financial Crisis, we replaced private finance with central banking finance.

Therefore the first element of getting to the right outcome is to go back to what we know generates economic growth. The second element is to become more balanced on demand management, and not rely excessively on monetary policy. Where there is room, let us also use fiscal policy.

The third element, and the most politically tricky, is to acknowledge pockets of debt that are crushingly excessive and that preclude meaningfully economic and financial recoveries. In such situations, forgiving debt may be in the interests of the system as a whole.

My first fulltime job after university was at the IMF during the 1980s. in the midst of the Latin-American "lost decade" of growth. An understanding emerged about the costs of "debt overhangs," that is when the debt burden is so big that it not only crushes activity, but it stops new capital from coming in. After all, why would new capital engage if a country is already massively over-indebted? It is like the concept of a very dark cloud outside your front door. Why would you go out? You would wait for it to dissipate.

We have massive pockets of excessive indebtedness in Greece, in certain segments of student loans in the United States, and in parts of China. Unless we deal with it now, it will eat away at the dynamism of the economy as a whole.

The fourth element is to improve cross-border policy coordination and the underlying architecture, be in the regional one or the multilateral one.

From a global perspective, policy coordination is at the lowest level that I have ever known. In Europe, this is compounded by an incomplete regional architecture.

Think of a stable Eurozone architecture as a stool with four legs. Currently it only has one and a half legs.

I do not know how you feel about sitting on a stool with one and a half legs, but it is very unstable. It has a leg of monetary union, and half a leg of banking union. It does not have fiscal integration leg, nor does it have a full political integration leg. If you want to have a stable Eurozone, you need to complete the architecture.

If the politicians move on these four areas then they will likely get a massive market response. In fact, we have already seen the potential.

Look at how the market has responded to Donald Trump's suggestion that he is going to increase infrastructure spending, de-regulation, and undertake corporate tax reforms. All major US stock market indices surged to all-time highs. Why? It is because they are hearing parts of the solution. And, remember, so far it has been just announcements. Design and implementation are yet to follow. But what is clear is that there is so much cash on the side-lines that, if politicians react, then they will get a response. And the real prize is in unleashing into productive use the massive cash being held on corporate balance sheets or used just for short-term financial engineering.

VI. Conclusion

Let me conclude please by a bit of a diversion, but a really important one, to behavioural science – that is, to partially understanding how hard it is to operate in this world of unusual uncertainty.

When I suggest that we are coming to a T-junction, I am also suggesting that the distribution of potential outcomes that faces us is something that will likely take us out of our comfort zones. It is a configuration that contrasts with what we are used to, and to what dominates most of what we do – that is, a world of normal distributions.

Normal distributions, also known as bell-shaped, are very comforting. Why? There is a very high likelihood of a certain outcome. Yes, there are tails – really good and bad things happening – but the tails are very thin.

Most of us – in fact, I would argue that probably all of us – operate in that world most of the time. You did so today. You turned up here in the expectation that there would be a meeting and a speaker. That was the most likely outcome, and it is the one that influenced what you actually did. Were there tails? Sure. There was a possibility that the meeting got cancelled and nobody told you, or there was a possibility that you would be offered a full fancy breakfast worthy of the Houses of Parliament, but you did not bank on either of these. You operated according to one high likelihood outcome.

That is no longer the world the global economy is facing. Instead, it is bimodal distribution where the tails get bigger and the centre gets smaller. That is an unsettling world to live in.

We know from the behavioural scientists something about decision making in a world like that, and it is not good news. Good decision making becomes much harder to deliver.

As a simple illustration, lets start please by assuming that the gathering today in this room is a representative sample of the population – and you probably are not, but let us assume that you are for a moment. Key insights from behavioural science suggests that we would likely divide into four groups.

One group would live in total denial. Its members are being shown something that is completely unfamiliar to them. But they have a blind spot – we all do – and they do not see it.

Group number two is what people sometimes do in a relationship. They hear one thing and they internalise something else completely; they reframe.

Humans are very good at reframing, and for good reason. It helps us navigate uncomfortable situations. If someone tells you something that is uncomfortable then you hear it, but you reframe it to something that is more comfortable.

For example, you thought that your flight from Heathrow left at 2 p.m.; I say, ‘Well it is not. It is a bimodal distribution. It is either going to leave at 8 a.m. or 8 p.m.’ What does a possible reframing look like? It says, ‘What does he mean 8 a.m. or 8 p.m.? Flights do not leave at either 8 a.m. or 8 p.m. They leave at a specific time. Maybe he meant the mid-point between the two. That is 2 p.m. Let me turn up for a 2 p.m. flight.’

You would be amazed at how we reframe.

The third group is going to do something even more dangerous, and even successful businesses can fall into this trap. That is, the trap of active inertia.

I will first give you the politically incorrect example (given that I am a US citizen so I am allowed to do it!) I will then give you the politically correct one.

The politically incorrect example is the American tourist who goes to France and asks a French person something. The French person either does not want to, or does not, understand English. What is the American tourist most likely to do? Repeat the question in English, but louder, right? That is typical active inertia. Your brain tells you that there is something wrong here and you have to be more active, but the inertia is so strong that you essentially end up doing the same thing over again.

Businesses do this all the time. Even successful ones do this.

Consider IBM on the eve of the PC revolution. Research done here in the London Business School by Professor Don Sull has shown that management and the board had identified the PC revolution in a timely and correct manner. Using a concept we have discussed today, they recognised that it was bimodal in its impact, so they needed a barbelled response. What would that involve? Two things:

First, doing less of what they did and, instead, moving into the PC world in order to capture clients that were going to migrate there, plus a lot of new clients; and also taking their mainframe business up the value added curve. They knew that they had to be more barbelled and to focus less on what they had done a lot of so far, and had served them extremely well.

There was little doubt as to what they needed to do. The strategy was specified. The decisions were made. However, when it came to implementation, they found it very hard to invest and operate with full conviction in the new areas. Instead, it was more comforting, and seemingly a lot easiery to continue what they were doing. As a result, their business was eaten alive by Compact and HP. Indeed, had they not subsequently re-invented themselves, IBM would probably not exist today.

There are many examples in the corporate world of this phenomenon of active inertia.

Only the fourth group will get it right. Fortunately, we know a few things about what you need in order to have a higher probability of being in this group. And, that is where I would like to end my presentation please.

We know that you need a lot of cognitive diversity – that is, you need a lot of different ways to look at the same problem. You are very unlikely to get that without gender diversity, cultural diversity and education diversity.

We know that you need to think in terms of scenario analyses and to ask, over and over again, the question of, 'What else can happen? What is the improbable? What is are the mistakes I may end up doing? And, within that, which are the ones I can afford to make and which am I not able to afford?

So back to where we started this presentation. One year ago we would not have guessed the improbables that have become reality. Should we not, therefore, be open to a much wider range of scenarios? Should we not go beyond the 'what' and 'why' we think by also being curious about how we think? Should we not be questioning more actively things that we take for granted.

Let me close with a rather painful personal experience from almost forty years ago.

I was at boarding school here in the UK and was going up for my interview at Cambridge. My economics master at school – and this is in the mid-70s – said, 'Read this book. I do not care what happens in the interview, but you have to bring it up as you will impress the interviewers showing that have read an influential economics book that has just come out.'

The book was called *Too Few Producers*. I read it and prepared a perfect monologue that I practised over and over again. Off I went to my interview.

I knew the interview was about 45 minutes. I was being interviewed by two people: one who was doing all of the questioning and the second one, whose rooms we were in, was taking notes. 40 minutes into the interview I had not mentioned the book and I was starting to really worry. We were talking about something that had nothing to do with the book and I said, 'That reminds me of…' and I pivoted to the book.

What I did not internalize us that the person taking note was smiling and had put down his pen. He said, 'Tell us about the book'.

Off I went on my rehearsed monologue, gaining confidence as I presented it. When I finished, he asked me one question that also demolished the whole hypothesis of the book. I stumbled. I could not answer. Then, to add insult to injury he got up, went to his bookshelf, pulled off an off-print, and threw it to me. It was his review of the book in one of the journals. He then said something very important to me: 'Do not believe everything you read in a book simply because it is printed and published.'

I would say to you: Question the consensus. Explore whether this consensus is a much better descriptor of what happened rather than what lies ahead.

I strongly believe that the global economy is heading to a T-junction. The road we are on is ending. With that, more improbables and unthinkables will likely become reality. This is not noise; it is a signalling process.

The good news is that we know what it takes to come out of the T on a road of high and inclusive growth, coupled with genuine political stability. The global economy, and the advanced countries in particular, need the political will to implement.

Questions and Answers

Lord John Sharkey

Thank you, Mohamed, for a very stimulating, and slightly scary, speech. I am sure that would have generated a lot of questions.

Question

You talk about the importance of improving infrastructure and education. What do you do if you are the British Government and you are already borrowing enormous sums of money now? We also seem to be threatened in the autumn statement today by promises of buying even more than we are already.

Dr Mohamed El-Erian

Britain is in a particularly tricky situation because when you ask your question about borrowing, you are asking about debt sustainability.

It is critical to remember that debt sustainability is related to a ratio, a fraction. Debt is the numerator and speaks to how much it costs to service the debt. But, critically, there is also a denominator, and it speaks to growth. The operational question relates to how much can you grow in order to service the debt and improve your living standards.

The reason why it is so hard in Britain is because predicting the denominator is especially difficult today. Why is it so hard? It is because the country has made a choice and, according to the Prime Minister, Brexit is Brexit – that is, dismantling longstanding trading relations and transitioning to another set of cross-border linkages.

That is really important because the UK is an open economy. I do know that you cannot replace something with nothing without major disruption, economic and financial. But I do not know what the UK is going to replace its current EU relations with. Until that question is answered, the denominator is unusually uncertain, and the numerator becomes more of a problem. That is where the UK is today.

If you assume away Brexit, or *alternatively*, if the UK were to magically transition to a new paradigm in which new trading relations are established overnight, then there would be room in Britain to invest in growth-creating infrastructure. What is being thought about – which is not just roads and bridges but also networks, links, etc. – is right. However, it is very important to get the design details right and to know what the overall institutional setup is.

I am not a complete pessimist about Brexit. I would have been a pessimist about Brexit if, on 24 June, the UK Government had decided to trigger the exit clause. Why? It is because you cannot replace something with nothing. However, we have ended up, whether it is hard or soft, it is a slow Brexit. As it is slow, financial markets are giving Britain time.

Having made this political decision, there is a certain silver lining. Once Britain gets through a difficult transition, it and Europe could be better off. Why? Because there was never a common vision as to what EU membership meant.

Looking from the outside, there were two very different visions. For the UK, the EU setup was a destination, that of a super-free-trade zone. Germany and France did not see it as a destination but, rather, as part of the journey. It is a journey towards an ever-closer political, social union.

These were fundamentally two different visions. They were never reconciled. Now, because of the Brexit vote, they can be resolved as long as you can deal well and rationally with the transition.

To bring this back to your question, you have to be more careful today than you would otherwise have been in Britain with your fiscal and debt issues until you get clarity on the setup and its growth implications. If you get that clarity and it is not very different from what it was before, then there is some room for infrastructure spending. However, without it, I would be cautious at this stage.

Question

Is the rising success of populous politicians part of the problem that takes us down the bad T-junction route or part of the solution that takes us down the good T-junction route? I ask because, as you have of course said, the market reaction seems to be that Donald Trump is part of the good T-junction.

Dr Mohamed El-Erian

That is a great question and the answer is that I do not know. It could be either.

It is definitely a part of the overall process of the exhaustion of the road the global economy has been on. The system is rejecting low and non-inclusive growth. As you point out, it could well be that you need an anti-establishment shock to do things that most people agree on.

In the United States there is general agreement on the need for Corporate Tax Reform. The tax law has not been properly reformed since the mid-80s. We have not really had an active budget process in seven years. The budget is the most fundamental element of economic governance and congress has been so divided that you have not been able to get responsive budget-making. Instead, the budget has been rolled over every year with one exception; a midyear agreement.

The Trump shock and he Republican majority in both house of Congress could make possible politically things that would not otherwise have been possible.

This is very important: there are two elements to the President-elect's campaign. One element the market loves and has heard it over and over since his election: tax reform; infrastructure spending; and deregulation. The second element that was very prominent in his campaign, but the market has heard very little about, is the anti-growth component – from slapping tariffs on Mexico and China to dismantling NAFTA.' Those are very different, anti-growth elements; and they get you to the other side of the T-junction. However, the President-Elect has not emphasised this recently. The only thing he has done is say that he would not go forward with TPP, but that does not have a huge impact because TPP was never ratified.

Therefore, yes, it is a part of the end of the current road that we are on. So far, markets believe that they allow a transition to something better because it could unblock policymaking in a pro-growth manner. Central banks have by the way welcomed elements of that, but it remains to be seen whether announcements will turn into careful design and sustained implementation.

Question

Thank you very much for your insightful address this morning. Were you surprised in the light of the analysis that you have shared with us that we have had the latest round of QE from the Bank of England this summer, and what would you say is the interaction between fiscal and monetary policy? What scope do you believe the chancellor has this afternoon, and what would you be doing if you were advising the chancellor on infrastructure investment see perhaps the productive potential in the United Kingdom economy if we were to do the right things?

Lord John Sharkey

There is still time for the chancellor to change his mind.

Dr Mohamed El-Erian

Let me start with the second question please, and with a non-answer. Why? Because speakers will tell you that it is a very thin line that separates courage and stupidity, and some questions tend to get you very close to that line. If I answered your second question with any pretence of authority, I would be crossing the line from courage to stupidity. I do not know enough about the United Kingdom to answer your question without crossing that line.

On the first question, no, the June QE did not surprise me at all. After the 23 June outcome there was a real risk that you would get a shock to the payments and settlements system, and the payments and settlements system is something that we do not think enough about, but if it is seriously disrupted then everything else can start to fall to pieces.

It is like the oil in your car. How often do you think about the oil in your car? I do not think about the oil in my car very often, but if the oil breaks down then nothing else will work.

After the referendum vote to leave the EU, with all of the uncertainty that is associated with, the UK faced a potential shock to its payments and settlements system.

These things operate in very funny ways. Let me give you a simple and silly example if I may.

I come from California, a state hooked on its car culture. We should not be, but we are. Part of your car culture is to be able to drive into a McDonald's and get out, within a minute or so, with your order. It is incredibly efficient. You drive up to a microphone. You order your meal. The stopwatch starts. You drive up to a first window, where you pay. You go the next window where you settle; you get the food and you are out of there.

It is also how our financial system works with its payments and settlement system. There is a gap for lots of transactions between payments and settlement. And it operates well if people trust the navigation of this gap.

Now imagine that you are at McDonalds. You drive up and order your Big Mac. You go to the first window and they say, '$5, please.' You have heard that there has been a Lehman event at Burger King and you are not sure how banks are going to interact with each other or what their relationship is going to be like, and you say, 'I remember when that happened there. Some people paid but never got to settle. So here is my $5 but where is my meal?' You will hear, 'Your meal is just 5 feet away.' While you are supposed to trust these 5 feet, this time around you don't because the overall payments and settlements system is strained.

So what happens? That is what Britain faced if the Bank of England had not come in and said, 'I will support the payments and settlements system.' You walk away hungry even though you had money. Meanwhile, the next window throws away the food even though they had prepared it. You therefore have to find a way to guarantee those 5 feet, which is what the Bank of England did through its action. It came out and said, 'I am here. I will do whatever it takes and, as a down-payment, here is what I will do right now.' It was very important to reassure and buy time for the system otherwise people would have become very risk averse.

It therefore did not surprise me that they did another round of unconventional measures in June. It would have surprised me if they had not done that.

Question

You set out a very clear agenda for reform. Given the policymakers today are relatively short-term office, very short-term media cycle. Can the system deliver a deep-rooted agenda or does that need reform?

Dr Mohamed El-Erian

That is a great question. It really comes down to whether capitalism is consistent with democracy, especially when the whole incentive structures tilts more and more towards short-term, not just among politicians, but among the private sector as well. It relates to the earlier question: given initial conditions, you need a shock to the political decision-making process, and the question is how big a shock you need and whether it comes endogenously or exogenously.

An example of the endogenous shock is the emergence of anti-establishment movements that shakes up the system. It realigns various things and you have the possibility of doing things that you could not do before. We are seeing such an endogenous shock starting to play out in the US. We shall see how it evolves.

You can also have an exogenous shock; the markets impose on you financial and economic disruptions. This may happen given the series of an Italian referendum and the French and German elections coming up.

To answer the question: without some sort of endogenous or exogenous shock, it is very hard to imagine the existing political system stepping up to the plate. You need a shock and the question is of how big and, in this context, what are the risks of collateral damage and unintended consequences.

Question

You mentioned the Eurozone and that France and Germany have always seen the European Union as a destination, which I am sure is true, but they never envisaged perennially paying for Greece to retire at 49 and on 80% of their salary?. There is no evidence yet that Greece is prepared to change that or can change it successfully. Is there any chance that the single currency can survive in its present form with its present membership?

Dr Mohamed El-Erian

There is no chance – and that is a strong statement – that Greece can grow at a high and inclusive level without debt forgiveness. And if Greece cannot grow then it is likely to exit the Eurozone. There is therefore a decision to be made and it is a decision that Germany, in particular, has been delaying for a very long time. Either it works to maintain the current membership of the Eurozone and you then have to do debt forgiveness and opt for greater fiscal integration; or, alternatively, if you do not want that then you start thinking about an orderly transition to a smaller Eurozone.

That is part of the T-junction in Europe. Member countries need to make some important fundamental decisions, otherwise they will be made for them

The problem with the Eurozone is that it has such a heterogeneous membership that you either believe in collective responsibility, hold hands and recognise that the ability to pay is very different, and you cross-subsidise; or, alternatively, you reformulate it to a smaller group of more like-minded people with similar endowments and financial situations.

Question

The premise for your argument is rooted in the absolute requirement for growth. Perhaps we can take the unusual uncertainty out of this and say that no growth, or next to no growth, is not unusual, and of that we can be pretty certain. Is there an argument to be made that there is a solution to your T-junction which is to explain to people that they are going to get poorer in the developed societies for all kinds of reasons; democratic, slow competition, changes in technology and so on? We are simply not going to grow as fast? Politicians need to explain that and address what is in many areas becoming almost entitlement culture; that there will be forever-increasing living standards. Do we just need to meet that head-on? It is quite interesting to look at the Japan model over the past 20 years. They are a very stable society. Their per-capita income is matching almost anywhere in the world. Per-capita growth of the workforce comparable with many large societies.

However, as a society as a whole, virtually flat growth, no inflation and free money. It seems to be a large homogenous society that works. Do we need to look at a post-growth political solution and will politicians have the courage to explain to their constituents that they are not going to get richer?

Dr Mohamed El-Erian

I suspect that if you asked the politicians in this room, 'Would you run on that platform?, they would tell you, 'If I did then I would not be elected.'

I am not as pessimistic on growth as you are. We have lots foregone opportunities, and are still living in a very dynamic and innovative society. There is a lot of cash on the side-line that has not engaged in productive activities. Instead, it is being circulated through high dividends, stocks buy-back, etc., but companies are not investing sufficiently in new plant, equipment and people.

Meanwhile, we have a set of innovations that are going economy-wide and there is growth that we can catch up on.

In sum, I am not a total pessimist. It does not mean that there are no super-secular challenges. There are. But there is scope in the years ahead for much better growth, in terms of both levels and inclusivity.

The first reactin to your question is that I am not as pessimistic as you are. The second is that, were I as pessimistic as you seem to be, it is not enough just for the politicians to go out and sell it to the people because you have a whole system that is inherently built on growth. If you do not deliver growth, the system will start breaking down – meaning that you would also need to restructure the important parts of the economic and financial system.

Finally, on Japan. The cultural setup is quite different, especially when it comes to the balance between individual and collective considerations.

If I may, a personal experience. After the earthquake and tsunami of a few years ago, I went to Tokyo a few day after the tragedy hit to check on our PIMCO colleagues in our Tokyo office. I met with different groups, asking them about what they experienced. There were horrific stories about what happened in the building, how difficult it was to get home, etc. I then came to the team pricing our mutual funds. I asked, 'What did you do?' and they responded something along the following line: 'The whole building started shaking and things were falling all over the place. We went down 19 floors and exited the building.' It was a Friday afternoon and I said, 'What did you then do?' I wanted to hear about how they had contacted their family members, where they met, etc. Instead, they told me, 'We waited for the shaking to stop. We went back into the building. We climbed 19 floors and we priced the mutual funds for that day's close.

I do not know of any other office where the people would have walked back in. There is something very special about Japanese society and their sense of collective responsibility. They are also a pretty rich society, as you pointed out. So I am not sure that you can extrapolate that easily from Japan.

Lord John Sharkey

It is now 10.30 a.m. I ought to say, thank you very much indeed Mohamed for an absolutely stimulating and wonderful address this morning. I want to say that our next event will also cover the subject of central banking. Claudio Borio, Head of Economic and Monetary Affairs at the Bank for International Settlements will be coming to speak to us on 29 November in Committee Room 14. The title of his speech is: "Uncharted Waters: Whither Central Banking?". He will talk about the economic, intellectual and institutional challenges faced by central banks.

In conclusion, I would like to once again say to Mohamed, thank you very much indeed for an absolutely splendid presentation and all of the insights you have shared with us, and questions you have answered this morning. Thank you very much.