Unedited Rush Transcript

Whitman Lecture
What Lies Ahead for the Global Economy: A BRICS Perspective

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Adam S. Posen: Good afternoon ladies and gentlemen and all the ships at sea watching on live streaming on the Internet, to combine old and new. My name is Adam Posen. I'm President of the Peterson Institute for International Economics and this is a very proud occasion for us on many levels to have this year's Whitman Lecture featuring Dr. Mohamed El-Erian.

More on him in a moment and on his topic, but first I just want to talk briefly about Marina and Robert Whitman. The Institute is very proud to have three, soon to be four, named lecture series. Once a year we have the Stavros Niarchos Foundation lecture series right before our board meeting. But the sort of substantive secret named lecture series is the Whitman Lecture Series that Marina and Robert have funded here out of their own pockets very generously at the Institute since 2001. And it's the secret substantive series because we get the people who are still making the transition usually from academic and policy wisdom to super stardom.

This year we've got somebody who's already made super stardom but we're letting him get transitioned back into some of his academic policy wisdom. So I hope you will enjoy it.

We've also had, the last couple years, the Sunrise Foundation lecture series for emerging market leaders, thanks to Antoine van Agtmaels, with us today. This is, thanks to Antoine's inspiration, is being transformed into something to allow us to multiple the number of emerging markets related events we have here and there will be more on that in the future.

And we just recently established a new annual lecture on Ethics and Economics named for my friend, John Olcay of AEGON and Fisher Francis, Trees and Watts, who just passed away. His friends have endowed a lecture on Ethics and Economics here at the Institute and the first lecture of that will be given early in 2015 by the Nobel Laureate George Akerlof.

So it's very proud that there are so many people who are investing not just money obviously, but their name, their commitment, their time, to keeping the kind of convening and intellectual discussion and open challenging voices that we have in these series at the Institute. And as Fred Bergston said when it was first funded and I just would echo, "It is a particular source of pride for us to have a lecture committed by Marina and Robert Whitman.

I think it's fair to say Marina and I have become friends through the years. She's obviously an inspiration to many of us. A ground breaker from a gender point of view, but more importantly in many ways, a ground breaker intellectually in breaking barriers down between business and academics and policy. And an incredible support to the work I and everyone here at the Institute does as a long serving Board member, as a member along with Jessica Einhorn of our Audit Committee, which keeps us audited and a source of wisdom and guidance for me. So I am just, thank you to Robert and thank you Marina for being with us and being here today.

The good thing about Mohamed El-Erian is he doesn't need much introduction because all of you follow him on Twitter, on Bloomberg, on television, 24 hours a day. He and I were exchanging notes about his Jets, ha-ha, and the Patriots last night. Obviously you know about his distinguished career in the financial world. What I want to emphasize today is we should all remember that Mohamed's had a distinguished career, 15 years at the IMF working on critical macroeconomic issues, including as an adviser, to then First Deputy/Managing Director Stan Fischer. I think we all agree that Stan doesn't need much advice but I think we can all know that one of the few people he took advice from was Mohamed, which is quite a statement in itself.

Mohamed is currently among his many other activities, at work on a new book called the *Rise and (Possible) Fall of Central Banks*, a topic which we also do a lot of work on here at the Institute. But today he's graciously agreed to talk about what lies ahead for the global economy, *A BRICS Perspective.* Mohamed thank you so much for joining us today.

Mohamed El-Erian: Thank you Adam. It is such a huge pleasure and honor for me to be here. I mean, you have no idea about what a great honor it is and also pleasure. It is also anxiety causing, which I'm going to come back to in a minute. But first I'd like to also thank Marina and Bob for providing me this opportunity, thank Adam also for inviting me and all my Institute colleagues and also thank all the friends and colleagues that I see in the audience.

It was particularly anxiety creating because not only am I appearing in front of you, but Adam Posen took to Twitter yesterday and clearly said the obvious thing, which is that I support a losing team and he supports a winning team and that he was going to use this occasion to remind me of this.

Now this notion of us being very barbelled is important because for me to live in this space where I continually support a losing team is not an easy endeavor. Unlike Boston fans, like Adam, who are fair-weather fans, the rest of us are loyal supporters, even though performance lets us down week after week.

I've also been a loyal follower of the Peterson Institute and this one has been much easier because performance has been completely opposite to my Jets team's performance. I remember meeting with Fred right at the beginning. He was kind enough to help clarify an issue I was working on in my PhD at the time. I met him right at the creation of the Institute. I have followed its amazing scholars, the accomplishments, the accolades. I have served on a few panels here and I even had the honor of serving on the Board of the Peterson Institute. So this is for me, has been a wonderful place and one that I respect. And this is why it's such an even bigger honor to be here.

But I was nervous. I was nervous because I thought to myself, what could I possibly bring of value and of interest to this place that operates at the frontier of knowledge? And I remember what a PhD advisor once told me, which is the best way you can do things is take a topic out of another area and apply it here and hope that no one knows enough about either area so that you can get away with it.

I didn't quite do that, but I did something unconventional. Instead of looking at the global economy from the conventional eyes of the advanced economies and particularly the US, the issue of the reserve currency, by far the most systemically important country. I decided to look at the global economy from the eyes of the BRICS; Brazil, Russia, India, China and South Africa.

Now that is not an obvious thing to do. The BRICS are a very arbitrary collection of countries. It is thanks to Goldman-Sachs that that phrase exists. But when you look at them they have very little in common. They neither have a culture in common nor a language in common nor politically things in common. And yet, if we step back and in the tradition of cognitive diversity and say, "What does the world look like for those sets of countries and what lies ahead?" I think we can gain insights. And one of the insights that I'm going to put on the table is how this group of countries that have nothing in common are now having summits and changing facts on the ground. What does that tell us about the system?

So that's the perspective I'm taking. I must tell you the risk-reward equation looked much better when I thought of it a few months ago. Now I'm not so sure it's such a good idea, but here it is.

So I'm going to pick on four themes. I'm not going to do the usual recent development and outlook. I'm going to pick on four themes that I think are instructive in terms of what lies ahead for the global economy.

The first theme comes under the heading of the vagaries of international capital flows and the problem of the tourist dollar. Simply put, it is very difficult to navigate your macroeconomic destiny in a world in which the issue of the reserve currency is pursuing unconventional market policy. That's the hypothesis. And when you try to do so, when you try to respond to the changes in the global capital flow paradigm two things happen. One is, you find it very difficult to adapt your policies in time and two, you appear as being sequentially inconsistent. You do one thing, then you do the other thing, then you do one thing and then you do the other thing, okay.

Now why does that happen? It is not because BRICS hasn't tried to look for the right policy response. There's a recent IMF report that goes through the whole list of measures that the BRICS have introduced on the macro credential side and on the capital flow measure side. And yet there's a sense that they are unable to protect themselves from the vagaries of capital flow.

During the good times capital comes flooding in, it is very hard to sterilize, it distorts your credit system, it creates all sorts of macro difficulties and then virtually overnight the capital will flow out causing issues on the other side of the challenge.

The reason why that happens is because capital to developing countries is still dominated by the tourist dollar and we have to understand that. Now the technical term for tourist dollar is a crossover investor. An investor that is maximizing an objective over here but is pushed somewhere else because the returns over here are too low. So the characteristic of a tourist dollar is that it is pushed to take risks as opposed to being pulled to take risks. And it behaves very differently from a dedicated dollar. A dedicated dollar understands the risk it's taking and is pulled into taking risks. So it doesn't overshoot on the way in, it doesn't overshoot on the way out.

Now why is that notion of a tourist dollar important? Because it's like tourists that go to developing countries. They get attracted by the brochure, they get attracted by the notion of the sun, the beach, et cetera, and they go to there. But unlike locals the moment something goes wrong, as inevitably it will, they head for the airport. So we're living in a world that inadvertently has encouraged a much larger flow of tourist dollars.

The result of that is part of the world is simply unable, not unwilling, but unable to adjust in time to the consequences of these hot flows. Now I don't need to take you all the way back to last year. If you remember last year on May 22nd a word got mentioned that many people in the marketplace had to go to a dictionary to find out what it meant. The word was taper. And then the market had its taper tantrum. For the next six weeks, not only did prices behave in a very strange manner of all asset classes, but the functioning of markets came under threat, including the most liquid markets in the world. Again, nothing changed other than a word got mentioned, taper. But that word was enough to change the paradigm that people expected for global liquidity.

We had another one just two weeks ago. Two weeks ago we had a five sigma move in US Treasuries. Now that is an exceptional move, an exceptional move. Again, it is very hard to identify a fundamental change. Now when your most liquid markets behave that way imagine what it's like if you happened to have as a habitat the less liquid markets, which is where the rest of the world lives. It is simply very complicated to be able to pursue what is viewed as a robust and responsive macroeconomic environment in the current context for global liquidity.

Now there's a good reason for that, which is the current context is not an end in itself. It's a means to something better and that is the explanation that you hear out of the Central Banks in the advanced economy. We know that we may cause certain movements in markets, but that is a cost that is worth taking for the much bigger benefit of stimulating economic growth, stimulating a recovery, and therefore reducing the future risk of financial stability.

But as Chairman Bernanke reminded us in his August 2010 paper at Jackson Hole, when you go unconventional you have, "Benefits, costs, and risks. And the longer you remain unconventional, the more likelihood that the marginal benefits will come down and the marginal costs and risks will go up. And at some point they cross over." So the first issue is just to understand why it is that it is so difficult to get the reaction in the policy side that you would want. It's not for a lack of willingness, but it's an ability issue.

Which leads to the second major theme, which is that there's been a tendency for the BRICS to go back to old bad habits. Now there's nothing strange about this. That's what human beings do. When you take them out of their comfort zone they will angle back to something that was a better time. Even if that better time is no longer applicable today. And what is that better time? It was a time of growth just 10 years ago. It was a time when everybody was looking to an incredible transformation in the outlook for the BRICS. It was also a time of enormous resilience and agility among the BRICS.

It came as a surprise to almost everybody how quickly they bounced back from the global financial crisis. Not only did they bounce back from global financial crisis much faster than any other countries in the advanced world, but they became the locomotive for global growth.

Now there's a good reason for that, which is if you're going to have a big, heart attack you hope you have a small one first. Because if you have a small heart attack there's a chance that you may change your behavior. A chance that you may eat better. A chance that you may exercise more. And of course, the developing world had a series of mini heart attacks; 94-95 in the case of Mexico, the Asian financial crisis of 2007, the Russian default of 2008, the Argentine default of 1997-1998. Then you had the Argentine default of 2001 and the near Brazil default of 2002. Those are all a series of mini heart attacks that actually changed behaviors in the emerging world. Therefore, when the big heart attack came in the global financial crisis they were better off.

Today that resilience and agility has been eaten up to a certain extent. And rather than forge forward with the next round of policy adaptations there has been a tendency to try to go back to what worked in the past and you see it across the board. Look at how Brazil reacted to the decline and growth rates. They went back to the old model of using the development bank as the main vehicle for investment. Look at the mindset that India got stuck in for quite a long time until the election of Prime Minister Modi and the jury is still out as to whether he's going to be able to deliver on the expectation of structural reforms.

It is certainly a mindset in South Africa and arguably even what Russia is trying to do in the geopolitical side is an attempt to go back to the old days. Even China, even China, the country that is most committed to going forward still has a tendency to try to get one more turn out of the old models.

So you have first just that it's extremely difficult to navigate this global macro-environment. Secondly a human tendency to go back rather than forward to something that used to work. And then the third them is the loss of external guidance. If you are sitting in the BRICS, if you are sitting in the emerging world, not only is there no star to follow, there are very few lighthouses to guide you. That is a fundamental change from what we used to have before.

It was not so long ago that we would have discussions in this room about the Washington consensus. It is not so long ago that we praised the G-20 for coming together in London in April of 2009 and having a coordinated and responsive policy adjustments. Today's reality is that the core of the global system, the core no longer acts as a conductor for the rest of the global system. So there are no north stars, there are very few lighthouses.

Now there are two reasons for this; one those who supplied that service have become much more insular. The recovery from the global financial crisis has been so disappointing that it is a natural reaction for countries like the US and Europe to become more inward and to pursue with less enthusiasm global coordination functions. Some will say they're less willing to do so, some will say they're less able to do so. All I know is when Ian Bremer came up with the notion of the G zero world, we're going towards the G zero world right, he captured well the fact that there's no longer a core in the global system that plays the role of a conductor. Now what is it when you lose your conductor, what happens? Well the orchestra, no matter how talented it is, doesn't sound as coherent as it would with a conductor. That's on one side.

On the other side the BRICS have become less interested in having a Western conductor. They view the system as outmoded. Whether they look at the governing structure, the representation, the voice, there's a real sense that this is a world that's stuck in the realities of yesterday, rather than the realities of today and tomorrow.

It is very hard, very hard to explain to the Chinese the voting power that China has in the IMF relative to small European countries. It is very hard. It is very hard to explain to the developing countries how a very limited set of reforms, the 2010 reforms, are blocked in Congress. Why? Well it's not because the US will lose any of its voting power. No, that's not going to happen and it's not because the US had to contribute financially anything more. And yet, even a limited amount of reforms are stuck.

So we have a situation in which, first it's hard to navigate the global macro. Second, countries are going back to old habits, bad habits. Third, the global system doesn't provide the guidance that it once did. Which leads to my fourth and final theme, which is we are modifying the global plumbing system in a very ad hoc and uncoordinated fashion, lacking confidence in the core of the system, feeling that you can no longer trust it to be responsive.

What we are seeing is a multiplying number of initiatives to build small pipes around the core, small pipes. They're not major pipes, but they're small pipes. We are altering the design of the global system, not in a coordinated fashion, not in a holistic fashion, but basically trying to bypass through small pipes the middle that seems to be less responsive. And it's accelerating.

Over the last six months we have seen the formal establishment of a new development bank at the BRICS summit in South Africa. We are seeing a new China-led initiative to develop an Asian infrastructure bank. Another 100 billion has been devoted to contingent reserve arrangements. And behind the scenes we are seeing a very large number of bilateral payment agreements. Payment agreements that are bilateral in nature. When I was at the IMF, that was a big no-no. Today 40% of Chinese trade settles in a [inaudible 00:24:40]. And most of that is due to bilateral payment agreements.

And then there are a number of other initiatives that have to do with cross-listing and finance, export credit agencies, energy alliances. The point to be taken away is that the system is changing in response to a failure, rather than a response to a vision. So these are four themes that if you're sitting in the BRICS you worry about. You think about. You're involved in.

Do they matter from a systemic perspective? And the answer is yes. They matter because this global economy we're living in can ill afford to lose any more growth entrants. Whether you call it the New Normal that Penn coined in 2009 or the Secular Stagnation that Larry Summers coined or even what Christine Legarde coined just over two weeks ago, the New Mediocre. There is a sense that we are challenged in terms of the growth models all over the world. And therefore to see a group of countries that used to be a locomotive of growth, not only slowed down from a cyclical perspective, but also start risking secular and structural engines of growth. That is of concern to the global economy.

And just to give you a sense of how important these countries are, over 20% of market price GDP, over 30% of global GDP at a TPP. They're trading among each other, they account for 17% of all trade and they account for 40% of the world's population. So this is not just about these countries being less able to pull millions of people out of poverty, the systemic implications for the global economies are notable at a time when the global economy cannot afford to lose another engine of growth.

For advanced economies, that of course means fewer markets growth, less investment returns and balance sheets that are less willing to absorb the debt that is issued by the advanced countries. So that is quite a change in the paradigm and in the contribution that the BRICS make to global stability.

If this continues here is what you will see. You will see not just economic disappointments, a little bit what Adam Posen must have felt like when his

Red Sox went from first place to last place in one year. You'll also see increasing political polarization, more geopolitical tensions, and greater source of pressures in a world in which non-state actors have become marginal price setters, okay. And I cannot emphasize again enough the importance of non-state actors.

You'll also see it even harder to achieve cross border policy coordination and even harder to deliver on what the posters at the IMF annual meetings widely said, "Which is global challenges, global solutions". And if all this happens then the world that I live in, the world of financial markets would start being a bigger problem because if all this happens it will be very difficult to validate artificially high financial prices. And if artificially high financial prices start converting back to the sluggish fundamentals they will overshoot. That's what financial markets do and if they overshoot then they drag down the fundamentals.

So this is consequential. Thankfully we're not there yet. And thankfully and importantly, there's nothing preordained about this outcome. I would argue that the challenges when viewed from the BRICS perspective, the challenges of the global economy are much less about engineering, about coming up with the right solution and much more about political wealth. Political wealth, information asymmetry, and sometimes severe coordination problems, both internal and external. Now that is actually good news because if the solutions are there that's more than winning half the fight.

So what does it require? Well you've heard it in this room over and over again. First it would require advanced economies to replace over-reliance on Central Banks, over-reliance on Central Banks. With a more holistic policy approach and economists agree on the three element of a more holistic policy approach. They may disagree on the weights of each, but they agree that these three elements are part of the solution.

The first is restoring more powerful growth entrance, which requires paying attention to things that we haven't paid attention to for quite a long time; infrastructure and investment, the functioning of the labor market, corporate tax reform, immigration. There's all sorts of things that we've identified as a community that we haven't paid enough attention to because we fell in love with the wrong growth model. We fell in love with the model that finance, leverage, and debt entitlement can do it for us.

So the first element is to go back to pro-growth models and understand that that involves a certain focus on element. That's the first thing that people agree to.

Second, people have converged more readily. Not completely, but more readily that we have a problem of aggregate demand. Where there's the will to spend there's no wallet and where there's a wallet to spend there's no will. And the question is how do you reconcile this in order to overcome the problems of inadequate demand?

And third, people have now recalled the biggest lesson of the last decade of Latin America and the biggest lesson of the last decade of Latin America is to allow a debt overhang to stay for too long. Because what a debt overhang does, it discourages new investments.

So the first thing that it requires on the advanced country side is a political will to pursue what I think I can argue is quite a big support for the three elements of the engineering solution. On the emerging side it requires resisting the temptation to go back and rather to continue to go forward. In each of the countries I cited there is knowledge of what going forward means. It just requires the political will that was evident 10 years ago.

And finally at the core of the system, it means coming together from the advanced and emerging worlds and empowering and enabling the IMF to play a role that the G's used to play at one time. There is no replacement for the IMF and it is best suited to play that role if reformed well.

Let me conclude with two summary points and then a hopeful observation, an observation of hope. One is the delay in the advanced world of recognizing that what we faced coming out of the global financial crisis was not just a cyclical setback. But it was a structural and secular setback. It has taken us too many years to make the mindset transition. And for good reason, in the advanced world we normally live in cyclical space, right. So to face something that is secular and structural in nature, it is normal, behavioral scientists will tell you, to go back and assume it's cyclical. You redefine it as cyclical. And we lost critical time there. But now I think there's an understanding that it's not just cyclical, but it's also structural and secular. But that delay and the unbalanced policy response that emerged means that it is very difficult for the rest of the world to navigate the world in which we live in, especially given what has happened to global liquidity.

Because of that, and that's the second point, first that having felt let down by the global system the emerging world now risks failing themselves and this need not be sure because if you look at these individual countries there's still a significant amount of agility and resilience in them. Not as much as 2007-2008, but enough to deal with this.

So what's the hope? The hope is if the politicians step up to their economic responsibilities they and I suspect most of us, will be surprised by how turbocharged the response is going to be. Because as much as people would like to focus on what isn't happening there are two things here that are happening and they can turbocharge a recovery in a very meaningful way and help on the major issues of growth, inequality, unemployment, and financial stability.

The first issue is that there is a ton of cash on the balance sheets of corporations. And to the extent that that cash is deployed it's mostly deployed for things that are not pro-growth; dividend payments, share buy backs, and defensive merger and acquisitions. If the paradigm changes and if the excessive risk taking that's happening in the financial markets is accompanied by some more risk taking on the economic side, where there's hardly any risk taking place in terms of long term investment, that money deployed to investment in plant equipment and people will make a huge difference. And there is a ton of it on the sideline.

The second turbocharger is what's happening on productivity and particularly in two sectors; energy and technology. If you look at this from a company and sector perspective you cannot be but incredibly excited about not just what's taking place, but the potential. At some point these innovations are going to go from being company and sector specific to being macro-specific. And they will turbocharge whatever improvement comes from getting a better policy response and a more holistic one.

Thank you very much and I understand that Adam's going to come up for a Q&A.

Adam S. Posen: Mohamed, that was fantastic. Thank you so much.

Let me just try to get things started. You have what we call in German a [inaudible 00:37:25] concept, one might even go as far as to say a [inaudible 00:37:29], a world view. And I don't want to niggle about small pieces, but I do want to try to get you to flush out a couple of the specifics if you would.

I guess, particularly as an Asset Manager, as well as a Policy Guru, what is it you think that is keeping this money on the non-financial corporate balance sheets? Somebody listening to you might have thought that you were implying it was dead overhang. But we know that at least in the US corporate sector, the balance sheets of corporations in terms of debt is very sound. There's very little corporate debt or some cheaply issued bonds. So that's not it. What do you think is doing that and what role does financial regulation or over regulation or under regulation play in that? Or is that just a sideshow? Or is it the real economy? So what do you thinks going on there?

Mohamed El-Erian: So go back to sort of the drivers of the demand for money. Coming out of the financial crisis it was all precautionary demand. Companies were shut out of markets. There was a sudden stop, literally a sudden stop in capital markets and almost a sudden stop in the payments and settlement system, which is horrific. I cannot tell you what a sudden stop in the payments and settlement system can do other than global depression for a very long time. Because it's very hard to reset the payments and settlement system.

So companies realized that their precautionary demands shot up and as a result keeping cash on the balance sheet was rewarded hugely by shareholders, by management, by boards, et cetera. So typical precautionary demand. In the last few years it's been very hard to justify the precautionary demand. Why? Because they've completely revamped the other elements of the balance sheets. They've taken advantage of low interest rates and incredible risk appetite in financial markets to refinance the debt.

So what has held them back is that they do not see the expected return on investments to be that high. And there are a number of reasons for that. One is the uncertainty. Two is that we live in a world where increasingly investments are becoming a winner take all investment. So if you make the wrong decision and you commit to five or six years and they happen to be in the wrong place, that's very, very costly.

And third, people want the optionality of being able to act when they see opportunities. Now of course, the rest of the world says, "Well if you're going to keep this cash then give it to me". The shareholders say, "Give it to me", right. You are in this sector, you're not in investment management. You're not in cash management, give it to me.

Now ironically as all this is happening when the cost of keeping the cash on your balance sheet is very high because you don't get paid anything at all. So we have one sector of the economy operating with huge risk aversion. Over here on the finance side we have another sector operating with huge risk appetite. And that's a really interesting distinction, right, which is that the financial markets are willing to operate up here and the corporate sector is operating down here. So the fundamentals are down here, finance is up here. Now one explanation is, of course, is that Central Banks can only get to the fundamentals through the asset markets and therefore they're boosting up the asset markets to provoke the wealth effect and/or spirits, et cetera. That is certainly one explanation.

The other explanation is that this world lives in the very short term context. It believes that it can change decisions. Unlike this world where you commit to building a factory, a plant, or hiring somebody, this world thinks that you can change your mind. So if the Central Banks tell me two things; one is that we live in a world in which they will come and support asset prices, not as an end in itself, but to support the global economy. And two is they're confident about the macro-potential measures. So they'll be able to clean up the mess and stop it from growing systemically, then I will lever every single risk factor. And that is what has happened.

Now every once in a while, this part of the world discovers that it has mis-priced liquidity. That is what happened in the taper tantrum. That is what happened two weeks ago when something very small makes consensus change its mind. And at that point you start seeing not just price falls, but we should be worried about the functioning of markets, right. And that is what's really important and that's why Central Banks tend to come back in very quickly to reassure us, "No, no, everything is fine, don't worry. We're going to be able to keep this until the fundamentals validate the artificially elevated financial crisis."

So in responsive behavior, it is two different parts of the world, but also two different perceptions about whether you can undo a mistake. The corporate sector does not have the ability to undo a mistake. The financial sector thinks it has the ability to undo it, right. But I'm not sure that it actually does have it at the end of the day.

Adam S. Posen: Thanks. I started off with a sort of US first world question, but one of the great contributions of your lecture was, as you said in your title, this is a BRICS perspective. So if I could, let me, I'll do two quick questions in a row and then turn it over to the audience.

Your first point you were talking about the effects of unconventional monetary policy in the tourist dollars or tourist cash from the first world or I shouldn't use the first world, from the rich world. But to a lot of economists, including some in this building, the particular perversity of the last several years has been the opposite. It's been the capital running uphill. It's been the fact that there's so much money leaving Asia and other emerging markets coming to the West. And you didn't frame that as any part of your top four points. Is that a misapprehension on our part? Is that not really an issue?

Mohamed El-Erian: So I focused on financial capital that is incredibly volatile. A lot of the capital that's coming from Asia et cetera, is much more stable capital. Part of it is investment of reserves that are no longer reserves, but have become wealth. And there's a fundamental difference in terms of how you think of a country's wealth if you are a sovereign wealth fund, okay, you are investing for future generations. Therefore you can underwrite volatility risks much more than a traditional investor.

So there's fundamentally different characteristics between the money that's coming out of Asia, including corporate investment in the West. And the money going into the emerging world, which is more of the hot money variety, okay, than the other one going out. Now if you're on the receiving end of this you're losing permanent capital and regaining short term capital. That's not a great deal, right. But no one yet has found a way to manage the inflows and outflows. And everything has been tried. I mean that's the irony is that everything has been tried and we talk about Chili, we talk about Columbia, we talk about very well run economies, they are yet to find the right tool to deal with this issue. Why? Because the magnitude is so much.

When a crossover investor allocates 1% of their assets, that may seem small in the crossover investor side, but for a lot of emerging markets that's a lot of money coming in, right. And that's because the initial conditions are so different.

Adam S. Posen: Right. The final thing from me. Your third of your big overarching points was about the idea that there's no north star or lighthouse anymore coming out of the core. And I was wondering whether we should think about that as a genuinely intellectual loss that something's have been dis-proven or whether it's just a political fact that people don't want a slightly edited version of the Washington consensus in a G-20 world even if the Washington consensus has a lot of virtues.

And I'm looking at my colleague, the Honorable Arvind Subramanian, who's about to go save India, or rather help the new Prime Minister save India. And he's obviously not going to be going in and telling them, "Here's John William's checklist, do the following." But he is in terms you spoke about telling them, "Don't fall back on old ways. Stay with the model that's worked in the recent past."

So how do we resolve this? Is it that we've got some things wrong? Or is it just the US and us economists who are centered in the US have to be more humble? Or is that the BRICS should have learned the lesson post taper tantrum, that the Mexico's did better than the Brazil's and the Malaysians did better than the Thailand's, and those that are adhered closer to the Washington consensus actually did do better?

Mohamed El-Erian: Economics, Adam shed a tremendous amount of light on this. The first thing is that not by choice, but by necessity, by political necessity the response in the advance economies hasn't been a first best, second best response. This is the third or fourth best response. We are using partial instruments to deal with a problem. Not because there was in a sense of what the right tools are, but the political system doesn't allow us to do that.

Now when you end up in the world of second, third, and fourth best you have to worry about the cost and risks of what you're doing. When someone from the outside looks at this and add to that coordination failures, then go to game theory. What does game theory tell you? Which is that the Prisoner's Dilemma outcome isn't very likely? Prisoner's Dilemma outcome, which is us getting together makes us both better off, but we can't get together so we pursue what makes ourselves better off and the overall outcome is significantly worse than it would have been otherwise.

That is very rational behavior because we are unable to coordinate, there isn't enough trust in the system, there isn't enough understanding of each other's point of view. And that's what the political system is stuck in. So we have a less than optimal policy approach compounded by coordination failure, which results in outcomes that are less efficient.

So Arvind goes to India.

Adam S. Posen: Thank God.

Mohamed El-Erian: Okay. And he's asked can we trust the global system to deliver the public goods that we have been brought up to know it's in the interest of the system? And the answer he will give is, "I'm not sure that we can trust it quite as much as we used to be able to." The minute he says that, then immediately the reaction is, "Well how can I replicate some of this?" And we started getting the fragmentation occurring at the different levels of the global economy. And that is the risk, that if we continue in this world order or world disorder as someone called it, but if we continue, is that not only do we not achieve what we are capable of achieving, but in addition we start fragmenting the systems and make the challenge even more difficult. And whenever someone says, "We have plenty of time," I remind them of the following.

Look at the amount of long term unemployed. The longer the long term are unemployed, the more difficult it is for them to get a job. Look at youth unemployment. At that age if you're unemployed for a long time you go from unemployed to unemployable. Look at what's happening to income and wealth in equality. It's no longer just a social and moral issue but it's now actually a headwind to economic growth and it's impacting the most important quality of all, which is the quality of opportunity.

So when you look at actually the sort of structural weaknesses that are being imbedded in the system you start getting worried about this world that we're living in. And I think that economists have a huge role to play in explaining what the consequences are of continuing to operate in a world in which we don't get the first best policy approach and in addition, we get coordination failures that result in this Prisoner's dilemmas.

Adam S. Posen: Great. Marina did you want to ask the first question? Jessica will bring the microphone. In general, there's a standing microphone in back or if you're near the front we'll bring you a wandering mic. When I recognize you please identify yourself unless you're Marina. And try to pretend it's a question, not a comment.

Marina Whitman: Mohamed, a few years ago we were talking about the pace of globalization and whether you were for it or against it. Everybody agreed that it was a rather rapid development. Now I have a sense, although people don't always use the term, that there is a lot of deglobalization going on. You used fragmentation, in every sphere, in information, in finance, in immigration. You just name it, in trade, although somewhat less.

And my question is how can the BRICS or how can any country really, it's just the richer countries have more cushions, make adjustments, coherent adjustments to a world in which things seem to be changing at such an incredibly rapid rate?

Mohamed El-Erian: That's a wonderful question. I'm going to give you sort of two perspectives of what's happening on globalization, a distinct level. At the state level we're having deglobalization, if you like, on the economic side. And on the financial side financial globalization's continuing. And in fact one of the issues is that we're having this two speed, in fact, multi-tract globalization where economic globalization and financial globalization have decoupled. And that's a real issue, okay. For those who worry about financial instability that's because finance serves the real economy. So when there's a decoupling like this, as occurred in this country in the run up to the global financial crisis, when we somehow believed that finance was the next state of capitalism and it stopped serving the real economy, you end up with problems.

At the non-state level globalization is increasing. The empowerment of the individual is incredible, absolutely incredible. And therefore what you're really trying to solve is first, get more consistency at the state level and secondly, embrace what's happening at the non-state level to reduce the risks associated with that. And there's huge risks associated with that, okay. And to increase the benefits.

So if you're an emerging economy you have to operate at these multiple levels. I think they'll tell you who was shut out from the first discussion, we're not part of that first discussion and therefore we're responding by creating our own realities.

I remember and I'm not supposed to mention this, but there's another think tank on this.

Adam S. Posen: You can mention it as long as you say they got it wrong.

Mohamed El-Erian: No, no, but I wasn't here for the Spring meetings, but I was watching it on the Internet. And there was this amazing scene of a Central banker from a developing country, a very respected Central banker saying, "You've got to pay attention to what we're saying." And the response was, "Okay, what we're doing isn't the global good because it can reduce global growth." And I don't think that those discussions are happening enough, right.

The other thing that isn't happening enough is understanding the power of enabling the individuals, right. We have to play major catch up on regulations, major catch up on regulations. I can give you silly examples from Uber and the Taxi Service, but they're incredibly insightful in terms of what they say about the empowerment of the individual and you empower both of the modern supply side. So then commerce will come and say, "Well efficiency gains are huge." But guess what, they are competing with the regulative side right. And the regulative side rightly says, "Hey wait a minute, okay, let's get the place better harmonized."

So I think there's a lot to be done for BRICS if they think in that space. But I can tell you that the temptation to go back to the old way of doing things is—look at Brazil, Brazil is a perfect example of going back rather than forging forward.

Marina Whitman: And that was just validated I gathered by the elections.

Adam S. Posen: Yes, I think we're all going to be trying, including here at the Peterson Institute, trying to piece out what yesterday's election in Brazil, the full implications are going to be.

Mohamed El-Erian: But it tells you, I have to act quickly, it tells you that the social element is really important. That the fact that we can pride ourselves that inequality between countries has come down, inequality within countries has gone up almost everywhere in the world, okay. And that is an issue that goes back to the growth model and how there's a need for a more inclusive growth model, all right. So what you're getting is a social reaction to not just low growth, but growth that favors the rich.

Adam S. Posen: We're doing a lot of work on that specific topic here and some of us would push back at that because you're not seeing a lot of radical left parties win large majorities in a lot of countries. That doesn't mean it's not a problem, but it means it's not as-

Mohamed El-Erian: But aren't you seeing the fringe parties come up, look at what's happening in Germany, what's happening in France, what's happening in the UK.

Adam S. Posen: We'll see what happens, see how far it goes. Anyway, I have Arvind was supposed to go to the mic and then I've got these two gentlemen side by—Jessica, these two gentleman side-by-side there at those tables. And then I'll go back to the back mic.

Arvind Subramanian: First of all thanks Mohamed for an absolutely wonderful lecture, beautifully framed and lots of lovely insights.

Can I challenge you on a couple of things, yeah? I mean to me a little bit of the irony of your talk is that it was from a BRICS perspective, but the dominant mood and sentiment you conveyed was very much the West perspective.

You could make the case that over the last 15-20 years and that something that survived even through the crisis, that the real story of the day is longer economic convergence that the rest is catching up with the West, even after the crisis, et cetera, et cetera. And part of the reason it gets obscure is because we live here and we see the West slowing down. But if you look at the numbers, the number of countries and people in countries who are catching up with the West and at the pace at which they're catching is unprecedented. So I say this is the Golden Age for the developing world, including the BRICS. And I think part of it is also obscured by the fact that China is slowing down, but that slowing down was always to be expected. I mean, to think that China would grow at 10% for the 4-1/2 decades was an outrageous assumption that we had.

So in that sense, I'm not yet willing to share your kind of pessimism, at least based on the numbers. And then, of course, if you look at beyond BRICS world, the next Vietnam's, the Cambodia's, the Africa's, for the next 20 years they're just going to grow gangbusters, just because they're so poor. And what I call, I call this they cracked the technology of early convergence. From 5% of the frontier to 15%, now you do some basic things, you'll get there. So I mean, I would like you to react to that about the gloom.

The second point about your nice images about the plumbing and the things coming out. I mean, in some ways wasn't 45-46-47, the aberration; you had a major crisis, you had one dominant power, you could afford to rewrite the [inaudible 00:58:49]. So the counterpart of the Williamson that you only get big change in a crisis is true at the global level as well. So it would be very surprising to get radical change, new rules, global leadership at the global level when the system is chugging along without any major catastrophes. So it's not surprising to me at all that you're getting incremental plumbing rather than that. So your comments on that.

Mohamed El-Erian: Okay, on the first issue, which is a really important one and both your comments are very insightful, how convergence occurs is really important. We lived through a period where you were getting convergence but the whole construct was going up, right. Now it's much easier to get convergence when the whole construct is going up, okay.

Now since the global financial crisis we've been continuing to get convergence with this been stuck basically and you can call it second stagnation or call it whatever you want. And this bit continuing to do but is doing less well. And the question I have to you is, do you still get convergence when the whole construct starts moving down? I don't know. But I can tell you that it's less likely than to get convergence when it's going up. So I think that you can't simply extrapolate from the past because the whole construct is being challenged. This is challenged, this is challenged, right, and the risk is that the construct starts moving down on that.

So that's a question back to you is can we get convergence under these circumstances? And honestly, I'd rather not answer that question. I'd rather go back to that world where I'm pretty sure you can get convergence, okay.

On your second issue, the system chugging along, okay. Those of us who bought in very early into this notion that the global financial crisis was not a cyclical setback but was a very strong statement about secular and structural issues will tell you that the system hasn't been chugging along at all, okay. There's damage being created in the system that makes it even more difficult to solve it.

Go to Europe; just go to Europe, right. I mean, the unemployment issues facing Europe right now are huge, right. I worry about the lost generation of European youth; I really do. So it's not chugging along, all right. It may be chugging along if you're sitting in the United States, but Europe is looking at flat growth with this significant balance of risk on the downside. It's also not chugging along if you look at the geopolitical tensions in the system. We as economists tend to wait for tipping points in their politics. We are one or two rounds of sanctions and counter sanctions away from the geopolitics over the Ukraine tipping Europe into recession, regardless of what the economy looks like, right.

So I would ask you the question, is chugging along good enough when your initial conditions are there? I think the fundamental issue is the quest for better growth models. And it's not clear to me that we are making as much progress as you would hope for. But I know that we will continue that discussion between the two of us later on.

Adam S. Posen: Very good. So these two gentlemen, if I can get those two questions for Mohamed?

Andrey Sitov: Hello my name is Andrey Sitov, a Russian reporter here in DC. Thank you to the-

Adam S. Posen: For which?

Andrey Sitov: For ITAR-TASS, thank you to the Peterson Institute for this event and thank you so for a really unusual perspective that you presented. Again, unusual is somewhat—I found a lot of echoes in your presentation to what I was hearing last Friday from our President Putin because he basically said, "We want integration and we want cooperation, we want coordination, but if you force us to then we'll look out for our own interests." We'll do the Prisoner Dilemma.

So, my question is in this sense, and you just referred to it a little bit, how much sense do you think your sanctions have had at this point? And how sustainable can they be, how long can they last? Thank you.

Adam S. Posen: Great, thank you. And next Helmut.

Helmut: Helmut [inaudible 01:03:12], George Mason University. I'd like to thank you for a brilliant lecture and I want to just bring up three questions.

One, you didn't mention economic nationalism as a cause of the divergence between emerging and incumbent economies. Two, you talked a little bit about the secular stagnation theme, but it would seem that the secular stagnation theme and the coordination failure are very difficult to reconcile with each other. So if there is secular stagnation and that's the issue then it would make coordination failure more unattainable.

Third, when you talked about the cohesion or the leadership in what you called the construct world, one perspective on this is that that world was also very parochial and it was very top down and the institutional mechanisms to conduct that kind of top down policy-making would be much, much relevant in the kind of world you're describing where this is the normal shift between trade among non-first world countries. So I wonder if you could address those three issues? Thank you.

Adam S. Posen: Thank you. After Mohamed's response we'll go to the two gentlemen in back.

Mohamed El-Erian: So let me start with the question from our Russian colleague. Mr. Putin's speech was different.

Adam S. Posen: You didn't take your shirt off when you delivered yours, so you know.

Mohamed El-Erian: Okay the current state of play in Ukraine is lose-lose-lose and Mr. Putin has the ability to change that. It's lose for Ukraine because what's happening there is undermining the country's economic development, it's increasing it's unfunded gap, it's making a debt restructure more likely. It's simply complicating the economic control of the Ukraine.

It is lose for Russia because Russia puts the West in a situation where the West has no choice but to impose sanctions. And it was one thing when they were Level I and Level II sanctions, i.e. targeting individuals and targeting companies, but when they become Level III sanctions targeting sectors and when they get close to energy and they get close to finance, okay, that can create a massive headache for Russia. And let's not also forget what's happening on the energy side and you need to only look at what's happening to the exchange rate of the ruble to get a notion of the difficulties that Russia are facing. So lose for Ukraine, lose for Russia.

It's also a loss for the West because, as I said earlier, we are one or two rounds of sanctions and counter sanctions away from tipping the West into recession through destruction of their energy supply. So here's a situation where rational actors will come together and try to get out of a lose-lose situation, lose-lose-lose. And a lot of that has to do with Mr. Putin.

Let's not forget that this is the first time in a very long time that we've had an annexation of a region, okay, and they are a system of international law, right. And Eastern Ukraine continues to be an issue. And I think that if we continue on this course then it's going to be lose-lose-lose and I do sympathize with the view that it really is about the way Russia has been treating the Ukraine. Now, I understand why that there's a desire and I understand why the popularity ratings are so high. But that's why I put it under trying to reclaim a past that is less relevant for today, if not harmful for today.

The interactions between coordination failure and secular stagnation, this is the multiple equilibria, the vicious cycle because coordination problems increase the chance of secular stagnation. Because we live in a very interconnected world. The minute you get stuck in secular stagnation, your coordination problems become even bigger on that. And you have to get to some tipping point, right, in order for that multiple equilibria to break. And what we know about these multiple equilibria is that left to their own devices they will overshoot.

You put it very nicely when you said the top down world. We used to live in a top down world. We used to live in a world in which nation states had the ability to regulate the economy in a much better way or regulate is a strong word, influence, inform, and sometimes impose certain outcomes on the economy. And we used to live in a world in which nation states collaborated with each other in a much more meaningful world. So this is to me the top down world. That top down world is being challenged by realignments internally and externally and across borders. Internally it's the fact that the political system isn't keeping up with what's needed to be done on the policy side. And again, ask the question, how can the most basic function of economic governance approving an annual budget elude our Congress for four years?

Okay, that gives you a notion of how political polarization has impacted economic governance. It's being challenged as I said, across because you're getting your realignment, so you're not getting anymore the collaboration among different nation states. And the nation states themselves are being challenged by the empowerment and the enabling of the individual.

So this is really a very interesting secular and structural change and that's why I keep on saying that the hardest thing is for us to escape this cyclical mindset. We've lived in it for such a long time. It's a little bit like we as adults live in a cyclical space. It was very different when we were teenagers, when we were living in a secular and things were changing very quickly and it was very different when we go beyond a certain age. But we tend to operate in a world that's basically dominated and we have to force ourselves to think differently, think structurally, and secularly.

And I know why it's so hard. I mean, Behavioral Science gives you lots of reasons why it takes a very long time to make that trip.

Adam S. Posen: Terrific. We're going to run out of time, so the two gentlemen at the back, I'm sorry it's all been gentlemen asking questions.

Mil Arcega: Mr. El-Erian, thank you so much for that wonderful speech.

My name is Mil Arcega at Voice of America. I'm not going to try and challenge your plumbing analogy, since I'm not an economist. But as a master plumber I would like to get your thoughts on what's causing this tremendous volatility this month in the markets? Whether or not it's going to continue? And what is the US Central Bank likely to do about it, if anything?

Adam S. Posen: Oh boy, financial gossip, yes. Next person please.

Jack Goldstone: Thank you, Jack Goldstone from George Mason University and Woodrow Wilson Center. You're a global finance guy, Mohamed and what you've said is optimistic because you say there are problems in the plumbing but if we have the political will there are things that global leaders can do to use the resources we have to get us out of this trouble. But as a global politics guy I'm terrified of that because what I know about political leaders is that when faced with a world of uncertainty, political risk, the breakdown of the type of public goods you described, their instinct is to use whatever they think worked in the past to preserve their political power.

So what I see in Russia and China is a doubling down on authoritarian control, not opening up an embracive greater market mechanisms. In the Brazilian election, I see a doubling down on the type of populism and micromanagement that took away Brazil's momentum toward convergence. And in both America and Europe I see a totally irrational fear of debt, preventing us from doing the easy thing, of using cheap money to invest in education, to invest in infrastructure. Instead that lost generation you referred to in Europe is being-

Adam S. Posen: Can we get this to a question please?

Jack Goldstone: Where is your optimism? Have you met people in Davos who assure you that a change in political leaders' actions is just around the corner? I'd like to hear more of what's behind the optimism you have.

Adam S. Posen: You might have even met them here at the Peterson Institute, I don't know.

Mohamed El-Erian: It's obvious you don't know me well enough because I refuse to go to Davos. I have never been to Davos. But let me start first with the volatility issue because it builds on the other thing. It's funny when the return of volatility occurs. We have been so used to living in a world of repressed volatility that it sounds like the end of the world, right. But in fact, okay, it was a return to more normal volatility in the system.

Why did it occur? Go back again, if you haven't gathered this, I really believe that simple construct really provide insights. You have valuations up here. You have brought the fundamentals down here. And in the middle you have the willingness and the ability of Central Banks to maintain that construct. So what happened in the few weeks leading up to the major market shake up?

First we got indication that fundamentals were not doing this, but doing this. A focus and contraction in German industrial output, a major revision in Germany's growth rate, this late in the year that provides a growth rate from 1.8 to 1.2 in October, right. So that's a major slowdown in an economy. And then of course, the IMF and the OECD and the World Bank all revised down their growth protection. So the first thing that happened is this thing came down here.

The second thing is that the market valuations got disturbed by the fact that volatility has returned to the Foreign Exchange Market. Why has volatility returned to the Foreign Exchange Market? Because we're going from a world of multi-speed Central banking to multi-track Central banking. In the old days, everybody was doing the same thing, just different magnitudes. Now we have two Central Banks that are lifting their foot off the accelerator; the Bank of England and the Fed. And we have two other Central Banks that are putting their foot more on the accelerator; the ECB and the Bank of Japan.

What is the one market that will adapt to that? It's the Foreign Exchange Market. So suddenly you've got volatility from the Foreign Exchange Market and the big secret of the Equity Market is that most equity managers do not hedge the currency risk. So suddenly this volatility is thoughts coming in here through the currency effect. So this was threatened, this was threatened.

Then the middle part was the willingness of Central Banks to be market's best friends. And what indication did we get in that week is that the ECB was more hesitant about going full QE than what the market had anticipated.

So put these things together and the next thing you get is a major adjustment because all three elements and it took Central bankers to calm things down again. In terms of what Central Bank will do, Adam will better speak to this than I will, but I do not expect this week that there will be much change in what the Fed has signaled. So the Fed will exit QE-3 on target, on planned. So this will be the last month of 15 billion large scale asset purchases. The Fed will not hint meaningfully at a QE-4. And the Fed will continue relying on foreign policy guidance.

In terms of why am I hopeful? I made a mistake back in 2009. When we came up with the notion with my colleagues at PIMCO, when we came up with the notion of the new normal. That hey, look, this is more than cyclical. We didn't provide an alternative. So we got called first, "Stupid" was the first word that was described and then "Fatalistic". What I'm trying to hint at is there's nothing fatalistic about this outcome. This outcome can be changed and I would argue one step further, solutions are there if only they can be implemented.

And I think it was a correct criticism, which is, if you tell us what the problem is, okay, what about what can be done about it? And as I said, there is a significant degree of, at least how I read it, Adam may read it differently--of agreement that these factors are important economists tend to differ on the weight.

So will the political system respond? I'm not as completely pessimistic as you are about the political system and maybe because I have an 11-year-old daughter that I care about a great deal. But I am looking for that Sputnik moment. Those of you that remember, actually very few of you will remember, but in the late 50's when the US woke up to the news that the Soviet Union had launched Sputnik. And that was a fundamental paradigm shift in the way that the US thought about the space project and the amount of common objective and unity. And I think if people look at what's happened to unemployment. If people look at what's happened to inequality. If people recognize that you cannot be a witch house in a deteriorating neighborhood. Would you buy a witch house in a deteriorating neighborhood? You wouldn't right. That people realize that the Sputnik economic moment is possible. I think that there's a function to the rest of us to explain the consequences of chugging along, okay. Because chugging along implies making the problems even more difficult to solve.

Adam S. Posen: Mohamed, thank you. I mean, as one ideally hopes for in this building, thoughtful, realistic analysis and articulation of a problem, relevant, aspirational, not fatalistic, but not dreaming policy proposals. Something in the best tradition of the work we try to do here and in the best tradition of the Whitman lecture, which we're grateful to Marina and Bob for making possible. And thanks to you for coming back on this side of the street. You're always welcome here.