portfolio construction forum

The messy politics of economic divergence

Mohamed El-Erian | Allianz | 17 March 2015

The world is increasingly characterised by divergence – in economic performance, monetary policy, and thus in financial markets. Global divergence has already contributed to stockmarket volatility, unprecedented declines in advanced economies' government bond yields, and outsize currency movements. And, the trend is not abating, placing increasing pressure on already-strained political systems.

The world's systemically important economies can be placed into four categories.

The first group includes countries like India and the US, where economic recovery is broadening, enabling them to overcome financial imbalances. The second group is exemplified by China, which is achieving a soft landing onto a growth path that, while lower than in recent years, remains adequate to support continued progress toward high-income status and financial stability.

The third group includes economies – such as Brazil, several eurozone countries, and Japan – that are not growing fast enough, and face downside risks. And, finally, the fourth group consists of economic and financial wildcards like Greece and Russia – countries that could succeed in restoring growth and financial stability, but could just as easily implode, sending shock waves across Europe and beyond.

This divergence is as much a political phenomenon as it is an economic and financial one. Overcoming it – and ensuring steady, financially stable global growth – will require responsive national policymaking and multilateral coordination. Unfortunately, today's rather messy national and international political environments have so far precluded such an approach.

Nonetheless, experimental monetary policies in advanced economies – such as the large-scale asset purchases initiated this month by the European Central Bank – have slowed the vicious circle of subpar economic performance and muddled politics. But it is far from clear that this will continue, especially given the US Federal Reserve's gradual exit from such policies, which puts the US on a different path from most of the other advanced economies.

Moreover, market forces have gained an ever-larger role in reconciling global economic divergence, leading to dramatic shifts in exchange rates. The list of such currency movements – which so far has included the euro's 25% fall against the dollar, a record low for the Mexican peso, and disorderly depreciations of the Brazilian real and other emerging-economy currencies – is getting longer by the day. Even healthy economies like South Korea

are keen to weaken their currencies, leaving the US alone in its willingness to tolerate significant currency appreciation.

On their own, currency markets will not bring about the growth-enhancing global economic rebalancing that is needed. Better policies at the national, regional, and global levels are also essential - and that requires better politics.

Too many political leaders around the world remain unable - or unwilling - to fulfill their economic-governance responsibilities. This is particularly regrettable, given that there is a broad consensus regarding the technical components of the required policy response: structural reforms to revamp growth engines, efforts to rebalance aggregate demand, and the elimination of debt overhangs. (The eurozone must also work to complete the essential underpinnings of its historic integration project.) What is missing is implementation.

But governments seem unlikely to overcome their dysfunction anytime soon. In the US, Congress and the executive branch are locked in a stalemate. Europe's political systems are being shaken by the rise of populist parties, many of which are winning support with an anti-European platform. In the emerging world, Brazil's government has faced multiple corruption scandals. And Russia's leadership remains committed to its disruptive regional adventures, regardless of their devastating impact on its economy.

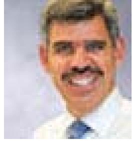
In most, if not all, of these cases, we see examples of a broader phenomenon that might be called governing by inertia - a "can't, won't, and shouldn't" mentality, to paraphrase the economist Mark Blyth, that blocks effective policymaking.

As policy inertia prolongs sluggish growth and impairs job creation, it becomes even more difficult to abandon. Given how hard it is for governments to initiate a shift to a new policymaking mode (that is, to disrupt themselves), pressure will build from the outside. In a democracy, this tends to occur through the fragmentation of traditional parties and the emergence of non-traditional parties - some offering genuine alternatives, and others relying on fear and prejudice.

The global economy is at a critical juncture. Most economists agree on what is needed to avoid another round of lost growth opportunities, inadequate employment, financial instability, and worsening inequality.

Central banks and markets cannot achieve an orderly global rebalancing on their own. As difficult as it may be, politicians need to pursue comprehensive policy responses. The longer they delay, the less effective their efforts will be. As bad politics block economic opportunity, public trust in governments will continue to erode - with serious potential consequences for political systems, and the economies they administer, worldwide.

© PortfolioConstruction Forum 2015



Mohamed A. El-Erian, Chief Economic Adviser at Allianz and a member of its International Executive Committee, is Chairman of President Barack Obama's Global Development Council. He previously served as CEO and co-Chief Investment Officer of PIMCO. He was named one of Foreign Policy's Top 100 Global Thinkers in 2009, 2010, 2011, and 2012. His book When Markets Collide was the Financial Times/Goldman Sachs Book of the Year and was named a best book of 2008 by The Economist.

© PortfolioConstruction Forum 2015