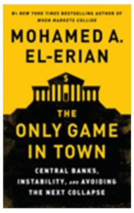

El-Erian M. A. The Only Game in Town

It's important to establish a better working relationship between global economics and global finance. Central banks are engaged in a series of unprecedented policy initiatives using experimental measures and taking enormous risks. Governments and politicians need to be more constructively engaged in the endeavor with central banks. The stakes are extremely high. The current configuration of the global economy and the financial system is getting harder to maintain: the financial system continues to deliver one anomaly after the other and is less than fully rehabilitated. For a very long time, central banks operated in obfuscating mystique. The world changed and they seek to influence a broader set of behaviors and expectations, enjoying much greater independence. They were assuming greater power, responsibilities and prominence that require credibility, political autonomy and accountability. The central banking has worked notably hard and have bought time but the effectiveness of its action is waning. The world is now more depending on the central banks with the narrowest set of instruments at their disposal, they found themselves having to do a lot more than they expected. When prolonged, this experimentation artificially impacts on pricing of the financial assets, leads to excessive risk taking and to misallocation of resources

By the mid-2000s, central banks acquired power, influence and reputation, but the special economic and financial era was outpacing the institution's ability to analytically understand it through conventional economic approach and they lost control of complicatedly leveraged bubblish economies. Banks were involved on a whole range of new activities, assuming risks that they only partially understood. The golden age of central banking ended up by 2007. Finance-dependent economies had gone too far in trusting and enabling banks, in regulating them with a "light touch" and "self-regulation". Misaligned incentives brought to excessive risks. The central banks were considered accomplices in allowing irresponsible finance. Central banking then shifted from a laissez-faire mode to a highly interventionist "whatever it takes" mode. The unprecedented deployment of liquidity and the bold innovative interventions saved the world and bought time for the politicians to get their act together. Disappointing economic outcomes heightened concerns about inequality, along with the surge of financial markets that sharply decoupled from real economy.

The unconventional action of central banks had a bigger impact on financial markets (asset prices) than on real economy (investments), and created risks of financial bubbles that entail a truly unusually uncertain outlook. After many years after the big eruption of the global financial crisis, ten key issues sadden advanced economies:

- repeatedly inadequate and unbalanced economic expansion, reflecting cyclical/secular/structural headwinds, highlights the extent to which many advanced economies still lack proper growth model. Advanced economies wrongly believed that the sharp downturn in 2008-09 would be followed by an elastic-bond-like rebound. New circumstances created difficulties of escaping a liquidity trap and the low growth, lagging structural reforms, mismatch in aggregate demand, persistent debt overhang, Europe's incomplete integration, absence of comprehensive policy action;
- unemployment remains too high in too many advanced countries, and it is getting more deeply embedded in the structure of these economies and, therefore, will become that much harder to solve;
- fueled by an unusual combination of cyclical, secular and structural factors, the worsening of income and wealth inequality has been so pronounced within countries that it now also undermines opportunities. Inequality trifecta (income, wealth, opportunity) hollow out of the middle class, technological structural factor favor higher-skill individuals and the rise of the "winner takes it all", cyclical redistribution policies have been absent; inequalities are accentuated by unconventional policies pursued by central banks ;
- the loss of institutional credibility is part of a more generalized erosion of trust in politicians and in the "system" as a whole. Central banks put their hard-earned brand in play by failing to convince the public at large of the reasons of bailing out irresponsible banks and by taking on massive policy responsibilities by necessity and by visible inability of political system to respond;
- national policies dysfunctions are still a headwind to overcoming economic malaise and restoring genuine and durable financial stability. Political parties find very hard to deal with secular and structural transformations and to agree on policies to move the country forward, especially in Europe. Voters' dissatisfaction has been widespread;
- as national dysfunctions undermine global policy coordination, traditional core/periphery relations fail and geopolitical tensions escalate. Global policies are an uncoordinated game in which the players lack incentive alignments, mutual trust, accountability and enforcement mechanism;

- with systemic risks migrating from banks to nonbanks, and morphing in the process, regulators are again challenged to get ahead of future problems. The impact of information failure and market imperfections is accentuated by behavioral patterns that result in recurrent errors. The Minsky financial instability hypothesis is relevant now. These shifts have been turbocharged by the low interest rates and the search of yield. Peer-to-peer interactions and crowdfunding lower the barriers to entry. These are also areas where regulation is lagging;
- when the market paradigm changes, as inevitably will, the desire to reposition portfolios will far exceed what the system can accommodate in an orderly fashion;
- yet none of these uncertainties and fluidities seemed to disturb financial markets that, operating with an unusually low volatility, went from one record to another. As such, the contrasting gap between financial risk taking (high) and economic risk taking (low) has never been so wide. Herd behaviors can take over markets built on breeding instability by itself (Minsky). This is underpinned by unconventional momentary policies of central banks, tolerating excessive risk taking, an unintended consequence of being the only policy game in town;
- all of this adds up to a considerable headwinds for the better-managed part of national, regional and global system. The post-2008 world has been characterized by too much risk taking in financial markets but insufficient economic investment. It has become important to be quite open-minded about what lies ahead, taking a multidisciplinary approach to specifying what is needed to navigate well an inherently "unusual uncertain" outlook, conscious of the global interlinkages.
- A reduced-form approach to the ten major challenges implies four key outputs:
- to reject financial engineering as a growth strategy and return to the basic building blocks of economic prosperity. A host of structural reforms is needed and overcome the current excessive short-termism, to revamp education system, to strengthen infrastructures, to remove antigrowth fiscal distortions, to improve labor competitiveness and flexibility. It is a mindset change that cannot be achieved without reforming economic institutions (to breack down vested interest, power of bureaucracy, to modernize operational approach, etc.) and to adapt to long-term technological change;
- to resolve the mismatch between the will to spend and the wallet. Fiscal policy has a key role to help alleviate income and wealth inequalities;
- to deal with excessive and persistent indebtedness through high economic growth, by taxing creditors and by subsidizing debtors, through unilateral default and the orderly debt and debt service reduction;
- to get the regional and global architecture right. The Europe plays a "cooperative game" in an uncooperative fashion; the global system needs more coordination to solve the problems of a hyperconnected world.

There is a real chance that the central banks will go from being part of the solution to being part of the problem: their destiny and their future are no longer in their hands, they can only continue to buy time for other policy entities.

An unusual consensus exists among economists on the components of a durable solution, but politicians don't have a great track record of pursuing comprehensive solutions and find harder to coordinate and cooperate regionally and globally: there is political polarization, gridlock, geopolitical tensions, inequalities, etc.. Old habits, existing structures and vested interest frustrate required change. The malaise was fuelling political extremism, the emergence of non-traditional parties and a resurgence of antiestablishment forces. Even under condition of perfect information, you can end up with silly outcomes because of decision-making challenges and constraints. This risk increase significantly in the contest of unusual fluidity and high uncertainty. The complexity can end up being paralyzing. We are looking at a distribution of unusually uncertain outcomes that is shifting from the shape of a normal bell-shaped curve to a bimodal one, less common and more anxiety-creating. The new normal framework encourage us to think beyond conventional characterizations and historical relationships, the advanced world faces longer-term secular and structural issue. Global economy is approaching a three-way junction. The road that the economy is currently travelling will effectively come to an end soon and there is not a enough information today to predict the outcome with sufficient confidence. The growing difficulties that face both national economy and global system depend on five trends that must to be reconciled:

- multi-speed growth (America steadily improve, Cina declines in their growth rate, Europa and Japan stagnate, other countries are volatile, like Russia, Greece, Brasil, Turkey);
- multi-tracking central bank policies create new risks of exchange's instability;
- growing price anomalies;
- non-economic headwinds (nontraditional and antiestablishment parties, geopolitical fluidity like non-state actors and new tensions between nations);
- the impact of certain disruptive innovations (a new supply paradigm for oil, technological revolutions that empowers individuals, deploys big data and artificial intelligence, disruptions on financial service industry).

The bimodal distributions are not easy to navigate well. Their potential outcomes run contrary to the paradigm that consent us to understand most of the things that happen in our lives and require important behavior and strategy modifications, an approach more deliberate, holistic and cognitively open, a nonlinear thinking that can locate more potential innovations. The longer central banks remain the only game in town, the greater the consequent risk of their effectiveness and operational autonomy.