

Navigating the New Normal in Industrial Countries

MOHAMED A. EL-ERIAN

INTRODUCTION

It is a great pleasure for me to appear in front of you today to deliver the 2010 Per Jacobsson Foundation Lecture. At the outset, please allow me to express my deep appreciation to the Board of Directors of the Foundation. Thank you very much for this great honor, for allowing me to reconnect with friends and acquaintances here in Washington, D.C., and for deepening a personal tradition that started for me in 1982 when I attended my first Per Jacobsson Lecture.

As someone who has had the privilege to learn and operate in many different cultures and countries, I feel particularly honored to be invited by a Foundation whose purpose is “to foster and stimulate discussion of international monetary problems, to support basic research in this field, and to disseminate the results of these activities.” At the same time, however, I must admit to you that my delight comes with a certain degree of anxiety.

It is intimidating to follow the outstanding people who delivered past lectures and who truly meet the Foundation’s description of “persons of the highest international qualification and eminent experience in the world of international finance and monetary cooperation.” Indeed, I have had the honor over the years to interact with many who have spoken on this special occasion. Having also worked directly with some of them—including Abdelatif Al-Hamad, Michel Camdessus, Andrew Crockett, Jacques de Larosière, Stan Fischer, Alan Greenspan, Guillermo Ortiz, Raghuraj Rajan, and Larry Summers—I can tell you with a high degree of confidence that I am a negative outlier: the left tail of the distribution if you like! (And you will hear me talk a lot today about distributions and their tails.)

Given this reality, what could I possibly contribute to such a prestigious gathering?

My hope is to share with you an analysis of the global economy based on a rather eclectic approach that combines academic and policy dimensions with the daily realities of working at an investment management firm that is deeply involved in global financial markets. My presentation will be based on three (hopefully familiar) contextual hypotheses:

- First, the international monetary system suffered a “sudden stop” two years ago¹—a cardiac arrest if you like—the adverse impact of which is still being felt today by millions, if not billions, of people around the world.
- Second, the causes of the crisis were many years in the making and included balance sheet excesses, risk management failures at virtually every level of society, antiquated infrastructures, and outmoded governance and incentive systems in both the public and private sectors.
- Third, the dynamics coming out of the crisis management phase—particularly the combination of deleveraging, reregulation, debt overhangs, and structural challenges in key industrial countries—are interacting with an accelerating secular realignment of the global economy to create what U.S. Federal Reserve Chairman Ben Bernanke correctly called an “unusually uncertain outlook.”²

In this context, my presentation will ask a simple, yet critical, question about the disappointing effectiveness of postcrisis responses by both the private and public sectors in industrial countries: Why have outcomes consistently fallen short of expectations, and what are the implications?

In responding, I will refer to three specific examples which shed light on the ongoing dynamics complicating both policy and company responses.

¹The concept of “sudden stop” was used by Guillermo Calvo to analyze the dynamics of emerging market crises (e.g., Guillermo A. Calvo, “Explaining Sudden Stops, Growth Collapse, and BOP Crisis: The Case of Distortionary Output Taxes,” *IMF Staff Papers*, Vol. 50 [special issue on the Third Annual IMF Research Conference, 2003], available at www.imf.org/External/Pubs/FT/staffp/2002/00-00/arc.htm; Guillermo A. Calvo, Alejandro Izquierdo, and Luis-Fernando Mejía, “On the Empirics of Sudden Stops: The Relevance of Balance-Sheet Effects,” Working Paper no. 10520, National Bureau of Economic Research, Cambridge, Massachusetts [2004], available at www.nber.org/papers/w10520). It is another illustration of the extent to which emerging market tools can shed light on the recent experience of industrial countries—something that we will come back to later.

²Ben S. Bernanke, “Semiannual Monetary Policy Report to the Congress,” Testimony before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, D.C., July 21, 2010, available at www.federalreserve.gov/newsevents/testimony/bernanke20100721a.htm.

They are consequential for more than just what is being considered when it comes to appropriate reactions; they also matter for the *how* and *why*.

They speak to challenges that were inadvertently misdiagnosed while others were placed in the wrong context or subjected to excessive operational restrictions. They also shed light on the view that the world has been ill served by the understandable, yet regrettable, temptation of using short-term mean reversion as shorthand for thinking about economic and financial dislocations.

The result is simple yet disturbing. While industrial countries did well in the crisis management phase (think in terms of “winning the war”), they have not done as well in the postcrisis phase (and, thus, are not succeeding in “securing the peace”). Consequently, too many industrial countries find themselves in a rather unsettling situation in which expectations involve an unusually broad range of potential outcomes and equally unusually high risks.³ Increasingly, comforting images of normally distributed (bell curve) expectations—characterized by a dominant mean and thin tails—have given way to much fatter distributions with much fatter tails.

I will argue that this change is insufficiently recognized, even though it is a direct outcome of the three generally accepted hypotheses just cited. Indeed, an unusual aggregation problem persists today: Multiple visible structural changes on the ground are not being sufficiently aggregated into an acknowledgment of the ongoing paradigm shift and in the formulation of appropriate responses—particularly, though not exclusively, in industrial countries.

Recognition is the first part of meaningful course correction—thus the objective of this lecture. And there is much at stake for the global economy.

The longer the recognition problems persist, the greater the risk of continued “active inertia” and disappointing outcomes. The possibility of policy mistakes and business accidents will increase further, it will become harder for industrial country governments to convince their citizenry (as well as decision makers in emerging economies) to participate fully in the formulation and implementation of the required solutions, and multilat-

³For example, Richard Clarida, “The Mean of the New Normal Is an Observation Rarely Realized: Focus Also on the Tails,” *Global Perspectives*, PIMCO, July 2010, available at www.pimco.com/Pages/TheMeanoftheNewNormalIsanObservationRarelyRealizedFocusAlsoontheTails.aspx; and Richard Clarida and Mohamed A. El-Erian, “Uncertainty Changing Investment Landscape,” *Financial Times*, August 2, 2010, available at www.ft.com/cms/s/0/3ff03d10-9e53-11df-a5a4-00144feab49a.html.

eral institutions will not be able to fill the growing void at the core of the international system.

THE ANATOMY OF A GLOBAL FINANCIAL CRISIS

The Domestic Angle

Much has been written—and much more will be written—about the global financial crisis. Undoubtedly, there were many contributors. For a summary explanation, we can think in terms of multiyear balance sheet excesses and payments imbalances coinciding with the overconsumption and overproduction of “innovative” financial products which were only partially understood by consumers and too lightly regulated and supervised by prudential agencies.

As we now know, these innovative financial instruments were potent in lowering barriers to entry to many markets, including important segments of the U.S. housing market. As a result, too many households purchased homes that they could not afford, using exotic mortgages they did not fully understand, and too many small companies took on debt they could not sustain. The situation was greatly aggravated by other lapses in risk management and misaligned incentives in both the private and public sectors.

Prior to the crisis, key industrial countries had embarked upon a multiyear, serial contamination of balance sheets. At PIMCO, we called it the great age of debt and credit entitlements, when massive leverage factories operated unhindered, and often outside the direct purview of regulators and even company CEOs (and thus came to be known as the “shadow banking system,” a term coined by my PIMCO colleague Paul McCulley).⁴

The initial phases of massive leverage involved the balance sheets of households and housing-related institutions. Soon, the balance sheets of banks were also contaminated. Consequently, the pinnacle of the crisis—in September–October 2008—disrupted the functioning of the international payments and settlements system.

Cascading market failures aggravated disruptive attempts at a massive and simultaneous deleveraging. The result was a sudden stop and a related, highly correlated collapse in economic activity around the world.

⁴Paul McCulley, “Teton Reflections,” *Global Central Bank Focus*, PIMCO, August/September 2007, available at <http://singapore.pimco.com/LeftNav/Featured+Market+Commentary/FF/2007/GCBF+August+-+September+2007.htm>.

Governments and central banks had no choice but to step in with their own balance sheets to offset the massive deleveraging elsewhere. They did so in a bold and impressive manner, and they succeeded in avoiding a global depression.

Yet like most things in life, this came with costs (collateral damage) and risks (including unintended consequences). A new balance sheet was contaminated—that of the public sector. And, once again, too many were subsequently surprised when yet more unthinkable and improbable became realities.

The Multilateral Angle

Management of the 2008–09 crisis involved an unprecedented degree of effective cross-border coordination. It started here in Washington, D.C., at the October 2008 deliberations of the Gs and of the International Monetary and Financial Committee, with the United Kingdom taking the lead. It reached its climax in April 2009 at the G-20 summit in London.

It was global coordination at its best.⁵ Lecturing gave way to consultation and true collaboration. The commonality of analysis, focus, and purpose was obvious to the markets, as was the alignment of narratives and interests. The design and implementation of measures were well coordinated. And throughout this period, stubbornly hard-wired (and outmoded) concepts of global representation seemingly gave way to a greater acceptance of modern-day realities.

The Mix

The initial combination of effective national and global responses was highly successful in providing a floor for economies around the world. National authorities acted boldly to address cascading failures and did so in a globally orchestrated fashion. A multiyear economic depression was averted, as was the tremendous suffering that would have been inflicted on billions around the world.

Many emerging economies rebounded very quickly, in part because they had generally entered the crisis with much better initial conditions (including stronger international reserve cushions, greater policy flexibility, and smaller exposure to structured finance). In the process, they

⁵Some have argued that the actions were “correlated” rather than “coordinated.”

demonstrated the type of economic and financial resilience that would have been unthinkable just a few years earlier.

With the depression tail clipped, industrial country financial markets also found their footing. The sharp recovery in wealth (associated with the equity markets rebound) amplified the impact of government/central bank stimulus and the inventory cycle.⁶ Monthly job losses turned into accelerating gains, leading some to declare that the recovery had taken hold.

Unfortunately, such declarations proved premature, especially for the United States and Europe. They also highlighted insufficient recognition of the potent mix of economic, political, and social forces in play. Soon, the pace of job creation slowed, talk of a “recovery summer” faded, GDP projections were repeatedly revised downward, and the risk of a double dip and/or deflation rose.

POSTCRISIS REALITIES

Crisis management is hard, very hard. Leaders must act urgently, and with only partial information. Policy imagination and boldness are needed to overcome malfunctioning transmission mechanisms. There is often little time to create the broad social consensus that is required for strong support of the legitimacy of the policy response, let alone time to make the midcourse corrections which are inevitably required.

In the postcrisis phase, societies must also deal with the unintended consequences of the crisis management period. Inevitably, policy responses are second-guessed. Fairness issues feature more prominently. And the initial policy convergence formed in the midst of the crisis gives way to fragmentation and excessive political brinksmanship. Indeed, governments are often replaced by an electorate that is seeking greater accountability for the crisis.

Much of this has come as a surprise to industrial country societies. Indeed, the whole transformation of unthinkables/improbables into facts on the ground has been unsettling.

Ironically, little of this would constitute news for emerging economies that have faced several financial crises of their own. Yet it has come as a surprise to too many in industrial countries. Indeed, there has been

⁶A good discussion of these dynamics is available in Alan Greenspan, “The Crisis,” *Brookings Papers on Economic Activity* (Spring 2010): 201–46, available at www.brookings.edu/-/media/files/programs/es/bpea/2010_spring_bpea_papers/spring2010_greenspan.pdf.

a distinct resistance among many policymakers to apply “emerging markets lessons” to some of the challenges their countries are facing—despite the important insights that such an approach can, and has, provided.

The recent global financial crisis has also left an important balance sheet legacy. In particular, many industrial countries did not have sufficiently sound initial conditions to accommodate the massive use of public sector balance sheets.

Related concerns about debt and deficits have added industrial country sovereign risk to an already substantial list of systemic concerns—a list that includes (still) overly leveraged balance sheets elsewhere (albeit not to the same extent as before), unacceptably high and persistent unemployment, regulatory uncertainty, and political complications (namely, a situation in which the economically desirable is not politically feasible, and the politically feasible is not economically desirable).

Fragilities are also evident at the global level. As countries’ circumstances evolve differently postcrisis, the delegation of national authority upward to multilateral institutions and groups has become difficult once again, especially as strong and credible global governance mechanisms are still lacking.

Sustaining a high degree of global coordination (or, if you are less charitable, maintaining a high level of “correlated actions”) beyond the immediacy of a crisis is inherently hard—a reality that adds to the complexity of postcrisis periods. Indeed, the narratives at this weekend’s Annual Meetings—particularly on “currency wars” and IMF Board representation—are a vivid reminder.

Sadly, a once-promising global response has now been replaced by inadequately coordinated national economic policies and growing frictions among countries. Moreover, with an oversimplification of the debates (e.g., “austerity now” versus “growth now”), obsession with corner solutions has tended to obfuscate the critical policy nuances in play.

It is not surprising that the impressive degree of global coordination highlighted by the April 2009 G-20 meeting did not last long. It only took a few months for that moment of extraordinary collaboration to give way to solely domestic agendas.⁷ Indeed, and ironically, it is precisely the success of globally coordinated policies which has allowed

⁷Witness the disagreements at the July 2010 G-10 meeting and growing worries about “currency wars.”

countries the luxury of returning so quickly to the pursuit of overly narrow national agendas. In the process, the world has lost both consensus and common analysis.

THE SITUATION TODAY

In the course of the second and third quarters of 2010, it became clear to many that both policymakers and markets had wrongly extrapolated a cyclical bounce in industrial countries, erroneously concluding that the apparent recovery had developed secular and structural roots. Today, policymakers in industrial countries—and especially in the United Kingdom and United States, where a large bet was made on finance—find themselves facing an important set of challenges on the “bumpy journey to a new normal.”

We coined the term “new normal” at PIMCO in early 2009 in the context of cautioning against the prevailing (and dominant) market and policy view that postcrisis industrial economies would revert to their most recent means.⁸ Instead, our research suggested that economic (as opposed to financial) normalization would be much more complex and uncertain—thus the two-part analogy of an *uneven journey* and a *new destination*.

Our use of the term was an attempt to move the discussion beyond the notion that the crisis was a mere flesh wound, easily healed with time. Instead, the crisis cut to the bone. It was the inevitable result of an extraordinary, multiyear period which was anything but normal.

Also importantly, the new-normal concept was not an attempt to capture what *should happen*. Instead, the concept spoke to what was *likely to happen* given the prevailing configuration of national and global factors—some of which were inherited, and others that were the consequences of the choices being made. Put another way, the new normal postulated the world that would evolve absent a significant change in policy and business approaches.

⁸For example, see Mohamed A. El-Erian, “Why the World Should Worry about U.S. Unemployment,” *Financial Times*, July 2, 2009, and “Driving without a Spare,” *Secular Outlook*, PIMCO, May 2010, available at www.pimco.com/Pages/Secular%20Outlook%20May%202010%20El-Erian.aspx; and William H. Gross, “Alphabet Soup,” *Investment Outlook*, PIMCO, July 2010, available at www.pimco.com/Pages/InvestmentOutlookGrossAlphabetSoupJuly.aspx. It emerged later that the term had been used a year earlier in a similar context by Rich Miller—see Rich Miller and Matthew Benjamin, “Post-Subprime Economy Means Subpar Growth as New Normal in U.S.,” *Bloomberg News*, May 18, 2008, available at www.bloomberg.com/apps/news?pid=newsarchive&sid=aVZRne8kZBGI.

It is a world of muted growth in industrial countries and stubbornly high unemployment—one where the private sector continues to deleverage, public finances become more of a concern, and reregulation replaces deregulation. And all this takes place in the context of an accelerated migration of growth and wealth dynamics from industrial to emerging economies.

Little did we know that, after almost a year of acute skepticism from markets and policy circles, the new-normal concept would catch on so widely. (And, in doing so, it now means many different things to many different people!)

Researchers—particularly Carmen Reinhart and Ken Rogoff—have produced admirable and comprehensive empirical work that supports the view of a protracted and complex recovery process.⁹ Others, like Warren Buffett, have found elegantly simple yet powerful ways to convey this reality. Two weeks ago he noted that the United States “had a huge, huge wound. . . . It takes time for wounds to heal, regardless of how good the care is.”¹⁰

The new-normal challenges faced by industrial countries are the outcome of two interrelated phenomena: first, a multiyear process of massively going structurally out of balance, as illustrated by excessive consumption in industrial countries, leverage-fueled asset bubbles, inadequate risk management and incentive structures, and disruptive accelerators in the form of ill-understood financial innovations; and second, the aftermath of large balance sheet destruction, part of which remains obfuscated even today by accounting issues. Their interactions were accentuated by ongoing global realignments.

The symptoms of these challenges include muted economic growth in industrial countries, persistently high unemployment which is increasingly structural in nature, continuous private sector deleveraging, large public sector deficits and debt, regulatory uncertainty, and a much greater

⁹Carmen M. Reinhart and Vincent R. Reinhart, “After the Fall,” Working Paper no. 16334, National Bureau of Economic Research, Cambridge, Massachusetts (2010), available at www.nber.org/papers/w16334, and forthcoming in *Macroeconomic Challenges: The Decade Ahead*, 2010 Economic Policy Symposium, Jackson Hole, Wyoming, August 26–28 (Kansas City: Federal Reserve Bank of Kansas City); and Carmen M. Reinhart and Kenneth S. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (Princeton, New Jersey: Princeton University Press, 2010).

¹⁰Warren Buffett, CNBC interview, September 22, 2010, at the “10,000 Small Businesses” event, LaGuardia Community College, New York. In this interview, Buffett also noted that “the biggest thing you have going for the American economy, actually, is the regenerative capacity of American capitalism, and that doesn’t happen overnight.”

influence of politics on economics. They also show up in the accelerated migration of growth and wealth dynamics to the emerging world.

The resulting dynamics are both unusual and unsettling for industrial societies.¹¹ As such, they also affect the way in which society thinks about the future. Indeed, we are increasingly coming across some noteworthy changes both in the pattern of expectation formation and in behavior.

When it comes to expectation formation, the predominance of regular-shaped (bell) distributions is giving way to flatter distributions with much fatter tails. These flatter and fatter distributions are a reflection of the “unusually uncertain outlook” that is part of a paradigm shift. In some cases, they are even inverted. (As an example, witness the inflationary expectations chart included in a recent Bank of England *Inflation Report*.)¹²

We are also witnessing interesting changes in expectations about the well-being of children and grandchildren. It is no longer unusual to come across surveys in industrial countries that speak to concerns that future generations may struggle to attain the standards of living of the current generations. Meanwhile, the opposite trend is increasingly evident in systemically important emerging economies. There, a growing number of people now believe that their children and grandchildren will have better lives than themselves.

Behavior is also changing, with companies and households in industrial countries embarking on a greater degree of “self-insurance”—again a phenomenon that is familiar to emerging economies but much less so to rich societies where the pooling of insurance dominates. For example, witness the unusual amount of cash that U.S. companies are hoarding on their balance sheets, and note the extent to which U.S. households are derisking their portfolios by continuously selling equities to go into cash and bonds.

All this is happening in a society in which cash has usually burnt holes in the pockets of companies and individuals. It is also taking place in the context of almost confiscatory interest rates and massive attempts by public sector agencies to entice the private sector into taking more risk.

The possibility of a world of persistently low nominal returns, including through unusually low interest rates, has its own complications. Think of the range of promises that have been made on the assumption of higher

¹¹Think again of Chairman Bernanke’s characterization of an “unusually uncertain outlook.” See also Mark Carney, “Restoring Faith in the International Monetary System,” Remarks by the Governor of the Bank of Canada at the Spruce Meadows Changing Fortunes Round Table, Calgary, Alberta, September 10, 2010, available at www.bis.org/review/r100916a.pdf.

¹²Bank of England, *Inflation Report—August 2010* (London, 2010), available at www.bankofengland.co.uk/publications/inflationreport/irlatest.htm. As shown in the report’s charts, larger weights are placed on both the under and the over, as opposed to the outcome’s being at or close to target.

nominal interest rates and return. These are particularly visible in the pension and insurance industry. And while most are supersecular in nature, their impact could start to be priced in much earlier.¹³

We will come back to the implications of all this—and they are important. In the meantime, it is imperative to better understand why this situation has occurred. To this end, it is worth thinking about three previous unthinkables and/or improbables for industrial countries: the importance of debt overhangs, the degree of structural change, and the extent to which financial normalization can complicate (and not just facilitate) economic normalization.

These three factors shed tremendous light on the challenges that industrial countries face. They also explain why policy has been so frustratingly ineffective. And they illustrate the growing tension between economics and politics. Indeed, think of them as pointing to blind spots in policies and markets that can and should be addressed, especially as their adverse consequences can be with us for several years.

Balance Sheets Matter a Great Deal

“It’s the level, stupid, it’s not the growth rates. It’s the levels that matter here.”

This highly insightful remark was made in August 2009 by Mervyn King, the Governor of the Bank of England. Not enough people took it to heart.

Industrial countries in general confront serious balance sheet challenges. With prospects for growth sluggish, it is far from assured that some of these countries will be able to grow their way out of their problems. In the process, they will discover the disruptive nature of “debt overhangs.”

While the parallels are only partial, Latin America’s experience in the 1980s—and the related literature on debt overhangs—may shed important light on some aspects of the challenges faced by industrial countries today.¹⁴

¹³A current example is New Jersey, where the governor is trying to accelerate restructuring decisions on pension payouts.

¹⁴For example, see discussions in Paul Krugman, “Market-Based Debt-Reduction Schemes,” Working Paper no. 2587, National Bureau of Economic Research, Cambridge, Massachusetts (1988), available at www.nber.org/papers/w2587.pdf, and Jacob A. Frenkel, Michael P. Dooley, and Peter Wickham, eds., *Analytical Issues in Debt* (Washington, D.C.: IMF, 1989), as well as Jeffrey Sachs, “The Debt Overhang of Developing Countries,” and other papers in Guillermo A. Calvo, Ronald Findlay, Pentti Kouri, and Jorge Braga de Macedo, eds., *Debt, Stabilization and Development: Essays in Memory of Carlos Diaz-Alejandro* (Oxford: Basil Blackwell, 1989).

Indeed, it may prove as insightful as the much more widely used Japanese comparison.

Yes, some Latin American countries (such as Chile and Colombia) were able to grow and did not succumb to debt restructurings in the 1980s. But most were not as fortunate. The major differentiator for them was whether restructurings were undertaken in orderly or disruptive fashions. In the process, a decade's worth of growth was sacrificed.

The dynamics of debt overhangs are particularly important to understanding the continued dislocations in peripheral Europe.

The European Central Bank (ECB) has been supporting, both directly and indirectly, the government debt issued by peripheral European countries; the European Union and the IMF are providing budgetary assistance, and have indicated their willingness and ability to do more; and several peripheral European governments have embarked on strong and courageous adjustment programs. Yet market measures of risk spreads remain high, including at dangerous levels for some (e.g., Greece and Ireland).

The point is that *despite* all that the official sector has done, new investors are not coming in. Meanwhile, existing investors are taking advantage of the umbrella provided by the public sector to find the exit. In the process, the trio of investment, growth, and employment generators is being undermined.

Under these conditions, some peripheral European economies will find it hard to limit the decline in GDP and the related rise in unemployment and sociopolitical pressures. Meanwhile, concerns will mount about the contamination of the ECB's balance sheet, the risk of contagion will grow, and the revolving nature of IMF resources will be exposed to considerable risk.

Structural Challenges Require Structural Responses

Evidence of structural change is all around us. For example, witness the unusually sluggish functioning of the U.S. labor markets, the change in company and household behavior referenced earlier, and the extent to which companies are resisting policy measures aimed at pushing them to hire more people and invest more aggressively. Is it really that surprising that growth assumptions that have underpinned many policy actions in industrial countries have (repeatedly) proven too optimistic?

Such structural change should not really be that startling if you think about it. Remember, we are coming off the great age of leverage, debt, and credit entitlement. In the process, we are leaving behind a paradigm in which some countries—particularly the United Kingdom and

United States—inadvertently bet (heavily and erroneously) on “finance” as a natural step in the secular maturation of economies climbing up the value-added curve: from agriculture, to industry, to services and, finally, to finance.¹⁵

This unusual period enabled many activities to flourish which are inherently unsustainable. In addition to buying homes they could not afford, people borrowed and drew heavily on their savings on the notion that house prices only go up. Firms invested in sectors that were on a sugar high of activity, but only because of artificial credit availability. And leveraged creditors (including private equity) funded companies that could remain in business only by using ever-growing leverage and other creative financial engineering.

These developments, and their structural implications, were insufficiently understood. Consequently, cyclical considerations have dominated the mind-set and determined the actions of too many governments. As a result, outcomes have consistently fallen short of expectations, including most critically on the employment front.¹⁶

We should worry most about jobs (and, more broadly, the functioning of labor markets) when we look to the future of industrial countries and the global economy.¹⁷ Persistently high unemployment is becoming more structural in nature, thereby eroding the skills of the labor force and putting pressure on inadequate social safety nets and already-strained government budgets. Meanwhile, labor mobility is being undermined by continual problems in the housing sector.

The impact of all this reaches well beyond the unemployed. It also makes those with jobs more cautious, aggravating the problem of deficient aggregate demand.¹⁸

Rather than question the limited effectiveness of the cyclical approaches, the response by too many has been just to advocate doing more of the same. This pattern, while regrettable, should not come as a great surprise. Behavioral economics details the reasons why people and institutions fall hostage to active inertia. It has to do with inappropriate fram-

¹⁵The fact that many used the term “finance” rather than “financial services” speaks loudly to the extent to which the sector grew beyond what could be sustained by the real economy.

¹⁶Mohamed A. El-Erian, “A New Normal,” *Secular Outlook*, PIMCO, May 2009, available at www.pimco.com/Pages/Secular%20Outlook%20May%202009%20El-Erian.aspx.

¹⁷Mohamed A. El-Erian, “Why the World Should Worry about U.S. Unemployment.”

¹⁸Mohamed A. El-Erian, “The Real Tragedy of Persistent Unemployment,” *Wall Street Journal*, July 8, 2010, available at <http://online.wsj.com/article/SB10001424052748704111704575354792743173672.html>.

ing, outmoded internal commitments, and an overly restrictive comfort zone.¹⁹ Indeed, the biggest risk faced by societies undergoing paradigm shifts is not the inability to recognize the change. Instead, it is recognizing the change yet reacting with the familiar rather than the effective.

Unsurprisingly, industrial countries find themselves having to address unresolved and serious challenges.²⁰ In the process, the international payments imbalances of years past have returned, further complicating an already fragile global configuration—one that increasingly faces mounting protectionist risks.

Failures to recognize structural challenges are not limited to the national level. As emerging countries continue to grow robustly, the composition of the global economy is shifting (whether you use activity or wealth measures). It is an ongoing evolution that must be better understood. This can happen only if greater open-mindedness should dominate policy circles and markets, in both industrial and developing economies.²¹

Financial Normalization Far Outpaces Economic Normalization and, Critically, Does Not Spill Over to Help Main Street Quickly Enough

The challenges faced by Main Streets in industrial countries, including the feeling of insecurity brought on by unemployment and excess indebtedness, contrast with the seemingly remarkable recovery on Wall Street—a recovery that took too many policymakers by surprise and aggravated an already complicated sociopolitical situation.

Note that word “seemingly.” Indeed, while some policymakers were taken aback by the speed and magnitude of the recovery, as well as the banks’ return to bad old habits, these developments were predictable given the policy measures put in place. After all, overcoming bank losses

¹⁹For example, see Daniel Kahneman and Amos Tversky, eds., *Choices, Values, and Frames* (Cambridge: Cambridge University Press, 2000), and Daniel Kahneman, “Maps of Bounded Rationality: A Perspective on Intuitive Judgment and Choice,” Nobel Prize Lecture, Stockholm, Sweden, December 2002, available at http://nobelprize.org/nobel_prizes/economics/laureates/2002/kahneman-lecture.html.

²⁰Including high unemployment in the United States, recurrent sovereign debt issues in Euro-land, and Japan’s inability—despite explicit efforts—to counter a currency appreciation that is compounding two decades of muted growth and deflation.

²¹As an example, think of the current brinkmanship by China and the United States on bilateral exchange rate issues: Mohamed A. El-Erian, “IMF Meetings Should Target Double-Dip Risk,” *Bloomberg*, September 15, 2010, available at www.bloomberg.com/news/2010-09-15/imf-meetings-should-target-double-dip-risk-mohamed-a-el-erian.html.

was a target of a policy approach aimed at recapitalizing the banking system, including through the use of higher retained earnings.

Consider the yield curve, the most potent generator of significant, low-risk earnings for banks. The engineering of a very steep curve turned deposit-taking institutions into large profit generators.

For two years now, banks have been paying very low short-dated interest rates on deposits and using the proceeds to roll down a steep Treasury yield curve. This powerful profits engine magnified the impact of all the guarantees that were put in place to help banks raise additional funds and monetize liquid investments.

In the absence of a durable windfall taxation of the artificial surge in earnings, banks passed on part of their revenues in the form of compensation and bonuses.²² Understandably, this reignited anger toward institutions that were deemed by many politicians and citizens to be responsible for the global financial crisis. It highlighted, once again, an outcome that is unacceptable in democratic society: the privatization of massive gains and the socialization of enormous losses. And it also fueled the more general perception that governments were antibusiness.

Meanwhile, the spillover of Wall Street's normalization to the real economy remains limited. Traditional transmission mechanisms are proving less potent, due primarily to balance sheet issues but also to the continued derisking and slimming down of the banking system.

Not much is likely to change on this count in the years ahead. Regulatory reform will evolve from design to implementation. In the process, the speed limit on Wall Street will be lowered and enforcement will be strengthened. The scale and scope of financial intermediation will also be affected by the decline in the de facto subsidization of banks as guaranteed debt matures (a definite) and the yield curve flattens (a possibility).

In Sum

The three cases illustrate influences evident elsewhere when the postcrisis reactions of institutions in industrial countries, whether they are in the public or private sector, are assessed: We have had too many instances of inadequate responses to debt overhangs and structural change, and there is still too little understanding of the functioning of the financial services sector.

²²Even the United Kingdom, which imposed a seemingly draconian bonus tax, was not able to change compensation behavior of banks in a meaningful way. Banks viewed the tax as a one-off and chose to compensate their employees for the tax rather than change the compensation process.

The longer this situation persists, the greater the difficulties that industrial countries will experience in reducing joblessness, sustaining high growth, strengthening safety nets, and overcoming sovereign risk concerns. In turn, this will accentuate big divides that are already evident—not just between Main Street and Wall Street, but also between small companies and large companies, between poor and rich households, and between current and future generations.

It is also important to remember that this is not just a national concern. The global dimensions are also consequential and should not be underestimated.

Today's system of open trade and globalized finance faces significant challenges. We have already witnessed erosion in the promarket, open economy anchor for the global economy; bilateral payments agreements have surged; and currency tensions are evident.

While you cannot replace something with nothing, the world still faces the risk of further erosion in a hitherto-unifying framework, together with a move to a more-fragmented one. In such a world, regionalism goes from being a means (namely, a stepping stone to multilateralism) to an end in itself (a partial replacement).

It does not help that all of this comes at a time when the global economy needs extra adaptability and agility. As noted earlier, it is seeking to accommodate a gradual multiyear migration of growth and wealth dynamics from industrial to emerging countries, and doing so in the context of a distinct lack of common analysis among countries and continued resistance by those who wish to hold on to historical entitlements rather than acknowledge and embrace modern-day realities.²³

LOOKING FORWARD

The analysis suggests that the global economy is again at a critical juncture.

Having averted a crisis-induced depression, industrial countries are now losing the recovery momentum. If they are not careful, they risk slipping into a lost decade of low growth, high unemployment, and welfare destruction. In addition to its direct adverse effects on global growth and trade, such a slippage would complicate the challenge that key emerging economies face internally in managing their development breakout phase.

²³The ongoing disagreement about seats on the IMF's Executive Board is just one example of this.

To minimize these risks, industrial country societies must go beyond thinking of *what* to do; they must also consider the *how* and *why*. Absent such a shift, active inertia will continue to dominate, instrument innovation will become even more elusive, and the private sector will continue to respond through higher self-insurance and greater deleveraging.

Income distribution issues (and other compositional aspects) will also require more urgent attention—within current generations, as well as between current and future generations. And the political system will find it even more difficult to coalesce around a holistic response, aggravating polarization and prompting additional piecemeal and reactive policy measures.

The onus is on national governments to minimize these risks. They can, and they should.

Industrial countries face the hardest challenges, requiring bold steps by policymakers, companies, and households.²⁴ Systemically important emerging economies are also part of the solution to what ails the global economy. Structural reforms are key to sustaining higher consumption by an emerging middle class that, in several cases, saves a remarkably high fraction of its income to offset deficiencies elsewhere.

Yes, most of the heavy lifting must be done at the national level. Having said that, multilateral institutions can (and should) play a much more important role. This aspect is the focus of the final part of this lecture.

Those interested in a better global outlook should look to credible and well-functioning institutions to play a greater role in informing and influencing the design and implementation of globally consistent and reinforcing national policies.

My thinking in this regard is educated by the 15 years I spent here in Washington at the IMF and the time I have closely followed the institution since then.

The average quality of the staff is remarkable. The institution is capable of producing path-breaking analytical insights—and not just in regular publications (such as the *World Economic Outlook* and the *Global Financial Stability Report*), but also through single-topic research (such as the recent analysis of the influence of debt and deficits on interest rate formation in industrial countries).

The IMF is still the best place for centralizing country experiences, exchanging best practices, and providing a safe forum for policy exchanges.

²⁴See Mohamed A. El-Erian, “Time to Go beyond Another Stimulus,” *Washington Post*, August 27, 2010.

The institution's virtually universal membership gives it unmatched access to countries, including under members' Article IV obligations (which translate into periodic—usually annual—checkups by IMF staff, management, and the Board).

Simply put, the IMF is uniquely placed to be the trusted advisor.²⁵ It is also among those best placed to put together the pieces of the new normal and derive action plans that can be discussed, implemented, and monitored. Yet the institution continues to fall short in sufficiently facilitating the required level of international coordination of policies and in hard-wiring a meaningful peer review process that is viewed as credible, fair, and effective.

Some progress has been made in recent years to address the long-standing deficiencies. Witness the retooling of staff to ensure that the traditional focus on economic issues is supplemented by a better understanding of financial markets; attempts to enhance, albeit at the margin, emerging economies' voice and representation; the large increase in the Fund's financial resources; and efforts to improve governance and develop a more robust internal income model.

This progress is important. Yet unfortunately, the IMF is still not where we need it to be to fill the growing vacuum at the center of the international system. The longer this gap persists, the greater the risks for the global economy.

Then there is the even more complex issue—the nature of the IMF's political mandate. This issue will likely involve discussion on the G-20, whether in its present form or reformed, and it will require a degree of trust and interaction between the two that is not yet visible to outsiders.

CONCLUDING REMARKS

Two years ago, policymakers from around the world gathered here in Washington, D.C., and recognized that the world was on the verge of an economic meltdown. Together they initiated an impressive set of measures, showing a commonality of purpose, narratives, interests, and actions. The private sector also responded as companies and households took steps to navigate the sudden stop in global financial flows. The war against a global depression was won.

²⁵Mohamed A. El-Erian, *When Markets Collide: Investment Strategies for the Age of Global Economic Change* (New York: McGraw-Hill, 2008).

History books will report with admiration on the crisis management phase. Unfortunately, they will be a lot less generous when it comes to the postcrisis period.

Having won the war, industrial country societies are failing to secure the peace. Indeed, absent some important midcourse corrections, industrial countries confront the prospects of low growth; high unemployment that is increasingly structural in nature; welfare losses, including a growing number of citizens falling through the large gaps created by overly stretched safety nets; and a rising risk of protectionism.

This dichotomy between winning the war and securing the peace is an important one. It points to shortfalls in diagnosis, inappropriate operational constraints, and the fact that structural and balance sheet imbalances that were years in the making cannot be overcome immediately. It is about what is likely to happen, rather than what should happen, and it speaks to the urgent need for a more common analysis and recognition of the unpleasant yet inevitable political trade-offs that have to be made in the policy world of second and third best.

It also reflects an excessive intellectual reliance on shortcuts, including short-term mean reversion. An important part of the disappointing postcrisis outcomes is due to the high degree of active inertia that dominates industrial countries, including difficulties in shifting from a cyclical mind-set to one that also acknowledges issues pertaining to national and global paradigm shifts and debt overhangs.

It is increasingly urgent for industrial societies to move beyond cyclical responses by also taking a longer, more secular view. Multilateral institutions can and should play a more important role in helping to navigate this critical transition. But to translate the possible into the probable, these institutions must step up their efforts to deal with long-standing, well-known problems—and do so by going well beyond the current measured pace.

In closing, we should not forget the insight of the philosopher Lawrence Peter Berra. Mr. Berra, a legendary baseball player and manager—and better known by his nickname “Yogi Berra”—once said, “The future ain’t what it used to be.”²⁶ Let us all hope that the global economy responds to this reality with the required degree of courage, imagination, purpose, and steadfastness that it displayed in dealing with the global financial crisis.

Thank you for your attention, and for the wonderful opportunity to be with you today.

²⁶“Yogi” Berra, *The Yogi Book: “I Didn’t Really Say Everything I Said”* (New York: Workman, 2010).

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Questions and Answers

Following the formal presentation, Dr. El-Erian took questions from the audience.

ANDREW CROCKETT: Thank you very much, Mohamed, for such a wide-ranging and insightful lecture.

I will ask you to stay at the podium. We have a few minutes for questions, and let me ask those in the audience who would like to put a question to please raise your hands.

QUESTIONER: *I think most of us, if not all of us, agree with you on your new-normal definition. The question that poses itself is, How long do you foresee this new normal, knowing that this last economic problem we had is the worst since the Great Depression, and by extension, one would expect that the recovery period would be atypical compared to typical recessions that we have had since?*

MOHAMED EL-ERIAN: First, let me tell you how glad I am to hear that everybody now recognizes the new-normal concept. It was not so a year ago, when it was a rather lonely situation for my colleagues and me at PIMCO.

To answer your questions, allow me to go back to the probabilities. So we attach—and remember there is nothing deeply scientific about this—a 55 percent probability to the persistence of the new-normal scenario. It is over 50 percent, yet it is not a dominant probability, pointing to questions about the intertemporal stability of the new normal.

It is important to understand the dynamics underpinning the distribution of expected outcomes I mentioned in my lecture, a distribution that is flatter and has fatter tails.

So the first important thing is to recognize what we are dealing with, which, to quote Chairman Bernanke's brilliant phrase, is an "unusually uncertain outlook"; and in itself, it is not necessarily stable. Indeed, we have lots of active discussions at PIMCO as to how stable this base scenario is over time.

My guess is that you are probably looking at three to five years, unless policymakers become more structural in their thinking. And it will be a vulnerable period that is exposed to policy mistakes and market accidents. If you get either, or both, the base case could tip.

Remember, there are two distinct tails. So you can tip either way, and the probability of tipping into a worse scenario is higher, unfortunately, than that of tipping into a better scenario.

These probabilities are a function of the policy response.

QUESTIONER: *Thank you very much for a most extraordinary and most enjoyable lecture. A couple of points. With regard to the new normal, to what extent do you feel that some of the other underlying fundamental developments could actually increase the likelihood of that coming to pass? I have in mind in particular the demographic changes—aging of the population in the advanced economies has been happening and will accelerate. To what extent do you think that will have the adverse consequences you mention?*

The second point relates to the self-insurance you mentioned of the private sector, but also self-insurance on the part of some emerging market economies in terms of reserves. To what extent do you think that leads to a self-fulfilling prophecy, that self-insurance in the private sector, not undertaking investment, that that in turn means that the growth rate is lower, and that sets in train a vicious cycle? Thank you.

MOHAMED EL-ERIAN: Two excellent points, thank you.

First, a matter of definitions. When I was at the IMF, “short term” meant the next twelve months, “medium term” meant one to five years, and “long term” meant beyond five years.

Where I now work, “short term” means the next few weeks and months, “medium term” means the next three years at most, and beyond that, good luck, as there is little visibility.

That is important because today there are, in our definition, important supersecular issues. One of these supersecular issues is the set of promises that have been made on the basis of high historical nominal returns and interest rates and that may now be difficult to deliver.

Another supersecular issue comes from the demographics that you cited—and they are absolutely critical.

The key question for markets is, At what point do the supersecular issues start being priced in a secular context? And we have seen in Japan what can happen when supersecular issues start getting priced in.

Other potential supersecular issues on the negative side include the failure to address climate change properly. On the positive side, there are a number of significant scientific advances that could be the equivalent of a favorable productivity shock that is significant.

As an illustration of this latter point, imagine that we were having this lecture in 1989, and imagine that I stood up and said: “I can predict with confidence that the second-largest economy in the world—Japan—will be taken out of the global economy for ten years when it comes to being an engine of growth. How do we feel about the level of global growth?”

I suspect most of us—and certainly I—would have said, “Uh-oh. This is bad news for global growth. After all, you are talking about the second-largest economy in the world.”

Of course, the 1990s were a period of high and high-quality growth for the global economy. Why? Because we had two massive positive productivity shocks—the Wall coming down in Berlin and the notable entry into the global economy of China and India.

So the supersecular issues that you cite are critical, absolutely critical. On balance, they tend to tip on the need to do more now, because they are net headwinds rather than tailwinds.

To your second issue—absolutely. It is important to listen to what the private sector’s revealed preference is telling you. And today, it is pointing to an unusually high level of self-insurance in industrial countries.

I always remind people to look at revealed preferences of individuals and companies. And what that tells you today is that the private sector feels it needs to self-insure more.

Everybody knows that, beyond a certain point, self-insurance can become very inefficient. Also, from a policy perspective, it results in all the paradoxes that we know about—the paradox of thrift, the liquidity trap, neo-Ricardian equivalence, etc.

Bottom line, if this rather unusual phenomenon is not well understood, it is going to make the path dependency of the new normal scenario higher and therefore make the base case a less stable place to be, linking back to the previous question.

QUESTIONER: *Given that unemployment is high and sticky, and economic growth is low, and at the same time, the private sector is selling equities and has a very high degree of liquidity preference, how should one try to explain the fairly good rise in stock markets around the globe?*

MOHAMED EL-ERIAN: Thank you. On your first issue, it is interesting that conventional models of investment activity, of mortgage refinancing, and of employment levels all yield numbers that are much higher than what is actually happening today. So even with the low growth, historical models would have told you that employment should be larger than it is today, investment should be greater than it is today, and mortgage refinancings at these low interest rates should be higher than they are.

In turn, this suggests that there are two elements in play. There is the usual cyclical mapping and, in addition, there are structural influences.

Turning to your question on markets—and it is a really interesting question—it really depends which market you are talking about. The ten-year U.S. Treasury bond today signals little excitement about future growth. Yet credit spreads and the equity markets point to a lot more optimism.

Why this difference? I suspect it's because the markets are not pricing in the economic outlook as much as they are pricing reactions to future policy measures and, in particular, additional quantitative easing by the United States and elsewhere in the industrial world.

If you look at what has happened over the last ten days, we have had a remarkable rally in everything. It doesn't matter what you owned over the last ten days—except for the dollar, and I'll come back to that. Whether it's government bonds, commodities, equities, you looked really good and you looked really smart. Everything went up in price!

Why? Because the markets have been pricing in a second round of quantitative easing (QE2), or the deeper engagement of the final balance sheet in the system in industrial countries—that of central banks.

So what the market is pricing in is the impact of a big player, with a printing press, coming in to buy assets. That is what is being priced in, in various markets.

The question is, How long will that last? This depends on whether QE2 will be effective in pushing up asset prices and, critically, also helping the real economy. That's going to be the test for the markets.

Now, there is always the risk of collateral damage and unintended consequences. Chairman Bernanke's Jackson Hole speech is very clear about this when it qualifies policy actions in terms of three words: benefits, costs, and risks.

Benefits are things that go well. Think of costs as the collateral damage. And there is the risk of unintended consequences.

And part of the unintended consequences of what is going on today is to make things much more difficult for policymakers around the world. Think of the impact of QE2 expectations on currency instability and the prices of commodities (which are inputs for production).

So markets right now are moving ahead of an expected QE2, and the question is, How sustainable is that? To answer that, you have to make a balanced judgment on the benefits, costs, and risks of the unconventional policy approach.

QUESTIONER: To what extent does your vision of the new normal extend to the emerging markets? Are we going to see a new normal for China, India, and Latin America, or are they going to decouple from the world economy as we see it now, or are they going to be affected in the same way?

MOHAMED EL-ERIAN: Two answers to your question.

First, we are already seeing the new normal in developing economies, and it is a much better new normal there, where we are witnessing a historical developmental breakout phase.

The development economists among you will confirm the nonlinearity of the phenomenon—very little seems to happen; then a critical mass is attained and, suddenly, things move very rapidly. We are seeing that in a number of countries. It is truly impressive in terms of how many millions of people are being taken out of poverty as the growth engines intensify and financial resilience increases in the developing world.

How about the question of deleveraging in the industrial world and the dynamics of decoupling and recoupling between industrial and developing countries? If you go back to 2006 and 2007, everybody seemed to believe in decoupling. In 2008, people said, “Uh-oh, the world is not decoupled after all, it is recoupled.”

The reality is that we need to think of different degrees of re-/decoupling depending on the economic and financial situation. Specifically, think of a saucer-shaped curve.

Emerging economies are relatively decoupled from industrial countries in the new normal. To the extent that the new normal is stable, it will accelerate the global migration of growth and wealth dynamics from the industrial to the developing world. That is what we are seeing today.

If you go to Brazil—and I was there three weeks ago—there is a completely different mood than here in the United States. Those of you who come from Egypt, India, Indonesia, and, of course, China, will report the same thing.

It does not mean that they are not worried about the United States. They are, as the United States is still the largest and most powerful economy in the world and the supplier of a range of global public goods. But there is confidence that so far, it is okay, because the new normal, ironically, is an enabler of gradual decoupling.

Now, things change if we tip either way from the base case. If we tip into a double-dip scenario, developing countries will discover that the decoupling is not as strong as they currently think.

If we tip into the much better scenario, then the recoupling comes in, because the developing world will be turbocharged by the higher activity in the industrial world. And then developing countries will have to manage their success even better.

So when you think of the re-/de-coupling dynamics, put up a saucer-shaped curve, and just see where you are in terms of the industrial countries. This will shed light on how much decoupling or recoupling you get for the developing world.

ANDREW CROCKETT: Thank you. Let me invite you to join me in thanking Mohamed for a very entertaining and insightful lecture.

And as I said at the beginning, I hope you'll join us upstairs for some light refreshments, to enjoy each other's company and perhaps put some additional questions to Mohamed. Thank you.



PIMCO/Tim Rue

MOHAMED A. EL-ERIAN

Mohamed A. El-Erian is Chief Executive Officer and co-Chief Investment Officer of PIMCO, a global investment management firm with \$1.1 trillion in assets under management as of June 2010. Prior to rejoining PIMCO at the end of 2007, he was President and Chief Executive Officer of Harvard Management Company (from February 2006), the entity managing Harvard's endowment and other related assets. He was also a faculty member of the Harvard Business School.

Dr. El-Erian earned a B.A./M.A. in economics from Cambridge University and master's and doctorate degrees in economics from Oxford University. He spent 15 years at the International Monetary Fund before moving to the private sector, where he served as Managing Director at Salomon Smith Barney/Citigroup in London before first joining PIMCO in 1999.

Dr. El-Erian has served on a number of boards and committees, including the Emerging Markets Traders Association, the IMF's Committee of Eminent Persons, and the International Center for Research on Women. He was also a member of the U.S. Treasury Borrowing Advisory Committee. He is currently a board member of the National Bureau of Economic Research and the Peterson Institute for International Economics. He chairs Microsoft's Investment Advisory Committee.

Dr. El-Erian has written widely on global economic and financial issues, including being a frequent contributor to the *Financial Times*. He was ranked sixteenth among *Foreign Policy's* Top 100 Global Thinkers in 2009. His *New York Times* and *Wall Street Journal* bestseller—*When Markets Collide: Investment Strategies for the Age of Global Economic Change*—was awarded the Financial Times/Goldman Sachs Business Book of the Year award for 2008 and named one of *The Economist's* best books of the year and one of the best business books of all time by *The Independent*.

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