

Viewpoints

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Markets Must Exit the Artificial Comfort Zone Created by “Green Shoots”

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Some don't like to hear it, but Britain has been at the forefront of national and international economic policy discussions. As such, investors are well advised to pay close attention to the tone and content of the policy debate in the U.K. – especially when signals out of London are contrasting with the more sanguine views you hear in the U.S.

Historians of the financial crisis will point to Britain's role in helping the world avoid an even greater destruction of employment and welfare. They will note the catalytic role that British policymakers played in October of last year, in the midst of the worst of the global financial crisis. As policymakers gathered in Washington for the annual meetings of the IMF, bold British announcements quickly became the blueprint for policy responses by other G7 nations. As a result, Britain played a key role in stopping the sharp erosion in trust that was pulling the rug from underneath any and all global economic interactions.

Britain's influence was again visible in April when its leadership at the London G20 conference led to clear commitments: countries reiterated their intention to do whatever it takes to implement correlated, if not coordinated, measures; and the actions extended well beyond the national level, also enhancing the IMF's ability to lend to smaller countries suffering from the financial crisis.

Investors drew comfort from this, helping to fuel what turned out to be a significant multi-month rally in global equity markets, therefore minimizing the risk of a once-in-a-century global depression.

How about today? The tone of policymakers in Britain is notably less reassuring than elsewhere. And the gap in rhetoric between Britain and the U.S. is particularly notable, and counter-intuitive. After all, both entered the crisis with similar conditions: high leverage, overdependence on the financial sector, vulnerable housing markets, and heavily-indebted consumers.

In contrast to the U.S. that has emphasized "green shoots," British pronouncements are more cautious, measured and nuanced. Prime Minister Brown has warned against a possible relapse in global economic activity while Bank of England Governor King has poured cold water on those getting excited about the uptick in growth rates. He recently remarked: "It's levels, stupid. It is not growth rates. It is levels that matter here."

Unsurprisingly, domestic policy activism remains intense in the U.K., while it is waning in the U.S. Most recently, the Bank of England expanded by £50bn its purchases of

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market securities (essentially gilts), with Governor King wanting to do even more. In contrast to the Bank, the U.S. Federal Reserve has been signaling a leveling off.

Meanwhile, on the international policy front, the preparation for the September G20 conference in Pittsburgh has attracted surprisingly little attention, let alone excitement. With the intensity of the crisis having subsided in the last few months, the pressure on global policy coordination appears to have receded. Yet complacency would be ill-advised given the significant challenges still out there.

What should we make of all this? Some see it as a consequence of different domestic political cycles: British elections must be held within a year and the Government may be tempted to paint a worrisome picture to remind the electorate of the risk of changing generals in the midst of a war. Contrast that to the U.S. where, having been elected on a reform platform, the Obama administration is eager to minimize the risk of its strategic goals being sidelined by the crisis it inherited.

Others are quick to note the experience of Chancellor Lamont who, in 1991, was precipitate in detecting "green shoots." No British policymaker is keen to repeat that mistake. I suspect that British policymakers are also more sensitive because their economy is structurally more vulnerable. Compared to the U.S., they face the challenge of navigating greater exposure to external shocks, higher dependency on capital inflows, and an inability to exploit the "exorbitant privilege" of providing the world's reserve currency.

The question for investors is whether British policymakers are overly worried? Until recently, the markets' response was a loud "yes." In the past week, however, they have started to recognize that policymakers may have a point. There is a realization that neither Britain nor the U.S. can rely as yet on sustainable sources of private demand to assume the hand-off from massive monetary/fiscal stimulus and short-dated inventory rebuilding.

While we should hope that British policymakers are excessive worriers, we should plan on them being realistic. The time has come for markets to exit the artificial comfort zone created by "green shoots" – real or perceived.

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