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Europe's Adjustment to a New Normal

By Mohamed El-Erian
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Last year's financial crisis originated in the United States, and it is the U.S. that is most impacted by the crisis, the effects of which will play out over a number of years. Yet, the U.S. is far from alone in having to adjust. Virtually every other country in the world, including in Europe, has already felt some dislocation from the crisis. And there is more to come. With the role of the U.S. at the center of the global economy now having been weakened, countries must navigate the accelerated re-alignment of the global system.

Much has already been made, and rightly so, of the important role the U.S. economy played in driving global growth for most of the past decade. Much has also been made of the extent to which this phenomenon was unsustainable as it was powered by consumers' over-reliance on debt to finance excessive spending. As such, there will be no early return to high consumer-driven growth in the U.S. in the next few years. Instead, the global economy is now fully embarked on an accelerated transition from one major engine to multiple engines of growth.

The question is not whether this change will happen over the next few years. It will. Indeed, it is part of the New Normal that will emerge from the crisis. The pending questions relate to the timing and intensity of the process.

The emerging engines of growth are not of sufficient scale and readiness to fully compensate for the weaker U.S. engine. As such, while the New Normal involves more diverse and sustainable global growth over time, the corresponding level of global economic activity will be less than that delivered before the crisis by the U.S.-centered uni-polar system.

Many European companies have already recognized the west-to-east shift in the external sources of demand for their products. For some, this involves redirecting and re-sizing their activities for a world in which buoyant U.S. consumers are only gradually replaced by the expanding middle class in such countries as China and India. For others, it is about recognizing that funds from the east will be larger drivers of asset purchases and tourist revenues.

European governments are also adjusting to this shift, which, in some cases, erodes long-standing entitlements associated with the world of yesterday. Nowhere is this more evident than in the move from the G-7 to the G-20 when it comes to global policy coordination; and in the IMF where efforts, albeit still too timid, are underway to shift some voting power away from an over-represented European block and to under-represented emerging economies.

All these changes are real and permanent. Yet they are only part of the challenges facing Europe in navigating the multi-faceted re-alignment of the global economy that has been turbo-charged by last year's financial crisis. Indeed, the changes in the globe's growth drivers may well turn out to involve relatively easy adaptations when compared to those necessitated by what is implied by other transformations in the role of the U.S. in the global economy.

On the eve of the crisis, and by virtue of its position at the core of the global economic system, the U.S. supplied at least three other important "public goods" to the rest of the world. First, its currency, the U.S. dollar, performed the role of the global reserve currency; second, its large and liquid financial sector was material in the cross-border mobilization and allocation of loanable funds; and third, its government debt constituted the true risk-less* (or real "AAA") credit rating that served as a benchmark for pricing securities around the world.

The global standings of all three of these public goods have been impacted by the crisis, and in ways that will only become fully evident over time. Given the multi-year shock to each of the global public goods supplied by the U.S., one can predict with a high degree of conviction and foundation that the global system will not normalize to what it looked like in 2007. Yet predicting what will transpire exactly is more difficult.

System engineers will be familiar with the core/periphery dynamics that are now in play. In most complex systems, highly reliable circuit breakers are designed to protect the core from the shock-prone periphery. These circuit breakers become less effective in protecting the core from itself. As such, a crisis that hits the core – as was the case for the global economy last year when the U.S. stumbled – will tend to have important, long-lasting and, in some cases, unpredictable systemic effects.

At the most fundamental level, there are no readily available alternatives to fully replace the U.S. in the provision of global public goods. Consider Europe for an illustration. The euro constitutes an important international currency but it does not as yet have the characteristics to substitute for the dollar as the global reserve currency; and European governments are not keen on such a replacement. Europe's financial markets are developed but they are still too fragmented and narrow to substitute for the U.S. on the global stage. Finally, the credit standings of strong European countries, such as Germany and France, are subjected to periodic concerns on account of what is happening elsewhere in the European Union.

Given these considerations, the post-crisis global system is not one in which its core is immediately rejuvenated; instead, it involves countries having to navigate the inherent uncertainties associated with a weakened core. Governments would be well advised to factor this explicitly in their formulation of national and regional policies, investors would be well advised to insist on higher expected returns to commit their funds in such a world, and the community of nations should be more energized and focused on

collectively influencing potential outcomes rather than have them determined by the unpredictability and potential disruptions of a weakened global system at its very core.

* All investments contain risk and may lose value.

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Dr. El-Erian is CEO and co-CIO of PIMCO and is based in the Newport Beach office. He re-joined PIMCO at the end of 2007 after serving for two years as president and CEO of Harvard Management Company, the entity that manages Harvard's endowment and related accounts. Dr. El-Erian also served as a member of the faculty of Harvard Business School. He first joined PIMCO in 1999 and was a senior member of PIMCO's portfolio management and investment strategy group. Before coming to PIMCO, Dr. El-Erian was a managing director at Salomon Smith Barney/Citigroup in London and before that, he spent 15 years at the International Monetary Fund in Washington, D.C. Dr. El-Erian has published widely on international economic and finance topics. His book, "When Markets Collide," was a New York Times and Wall Street Journal bestseller, won the Financial Times/Goldman Sachs 2008 Business Book of the Year and was named a book of the year by The Economist. Dr. El-Erian has served on several boards and committees, including the U.S. Treasury Borrowing Advisory Committee, the International Center for Research on Women, and the IMF's Committee of Eminent Persons. He is currently a board member of the NBER and the Peterson Institute for International Economics. He holds a master's degree and doctorate in economics from Oxford University and received his undergraduate degree from Cambridge University.

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