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PERSPECTIVES

Our Post-GFC World Economy

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Our post-GFC world economy[1]

Mark Thirlwell

After the crisis: How much has changed?

Back in February 2009, I wrote a paper called *All Change or plus ça change?* as an early look at the implications of the Global Financial Crisis (GFC) for the world economy.[2] This is intended in part as a follow-up to that earlier effort, a check on how the judgments made back then have fared since. At the same time, it also seeks to take a slightly broader look at the state of our post-crisis world economy.

In that earlier paper, I began by noting that there were two temptations to deal with when looking at a major shock. The first was to over-interpret and assume that everything would now change; the second was to under-interpret and assume that nothing would change. At the time, the temptation was to over-interpret. The world economy in 2009 was in a parlous state: in the end, global output would contract by 0.6 per cent that year, its worst result in the post-war period, while international trade volumes would slump by an alarming 11 per cent.[3] Both outcomes, incidentally, were significantly worse than official forecasts at the time: for example, in January 2009 the IMF still thought that the world economy would (just) manage to grow, with a forecast of 0.5 per cent real GDP growth, while trade volumes were expected to contract by less than 3 per cent.[4]

[1] This *Perspectives* summarises a series of short talks and presentations delivered during the second half of this year, but in particular is based around the presentation 'Our post-GFC world' delivered on 29 July 2010 in Canberra, as part of the Lowy Institute's *Food for thought* series.
[2] Mark Thirlwell, *All change or plus ça change? The global financial crisis and four key drivers of the world economy.* Lowy Institute Perspectives. Sydney, Lowy Institute for International Policy, February, 2009.
[3] Both estimates from International Monetary Fund (IMF), *Global economic prospects and policy challenges.* Washington DC, International Monetary Fund, October, 2010. The GDP number is for world GDP aggregated using purchasing power parity (PPP) rates, which give a relatively higher weight to faster-growing emerging markets. Measured at US$ exchange rates, world GDP fell by two per cent in 2009.
[4] International Monetary Fund (IMF), *World Economic Outlook update: Global economic slump challenges policies.* Washington DC, International Monetary Fund, January, 2009.

Initially, the crisis also seemed to be displaying some worrying parallels with the economic catastrophe that was the 1930s.[5] Work by Barry Eichengreen and Kevin O'Rourke comparing the two periods found that although the fall in world industrial production during the current crisis was much shallower than that experienced during the Great Depression, nevertheless, output still fell by a worrying 13 per cent peak-to-trough; that world trade volumes fell by 20 per cent peak-to-trough in the GFC in what was the sharpest and deepest fall since the Great Depression; and that world equity markets fell 50 per cent peak-to-trough, delivering an even sharper bout of wealth destruction than applied at a comparable stage in the Great Depression.[6] The big difference between then and now was the policy response, with modern governments avoiding the worst mistakes of the past and resorting to large-scale fiscal and monetary easing to ensure that the eventual outcome was limited to a Great *Recession*, rather than a Great Depression 2.0.

Even after this policy intervention had served to stabilise the immediate situation, aftershocks from the crisis continued to hit the world economy, with Dubai's debt problems in late 2009 serving as an early warning indicator for sovereign debt crises to come, particularly around the periphery of the eurozone in Greece, Ireland and elsewhere.

Bearing all this in mind, the case for 'all change' seems to be a powerful one. Certainly, during the course of 2009, a lot of old ways of thinking about the world were discredited:

- The so-called *Great Moderation* was vanquished by the extreme volatility associated with the onset of crisis, replaced by a new fascination with so-called Black Swans and fat-tailed (non-normal) probability distributions;[7]

- Simple versions of the *decoupling thesis* – the proposition that developing country growth could carry on largely unaffected by a downturn in the US – were comprehensively discredited by a synchronised crash in global trade and industrial production in the final quarter of 2008 and the first quarter of 2009 that saw economic activity stall even in emerging market powerhouses like China;

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[5] The original column was Barry Eichengreen and Kevin H O'Rourke, *A tale of two depressions.* VoxEU.org, 6 April, 2009. The latest update is Barry Eichengreen and Kevin H O'Rourke, *What do the new data tell us? (4th update).* VoxEU.org, 8 March, 2010.

[6] Eichengreen and O'Rourke, *What do the new data tell us? (4th update).*

[7] On the Great Moderation see Ben S. Bernanke. *The Great Moderation. Remarks by Governor Ben S. Bernanke at the meetings of the Eastern Economic Association.* 20 February 2004. On Black Swans and non-normality, see Nassim Taleb, *The Black Swan: The impact of the highly improbable.* London, Allen Lane, 2007.

- According to the Maestro himself, Alan Greenspan, the crisis triggered the collapse of the whole intellectual edifice supporting the *modern risk management paradigm*;[8]

- The *international status of the US dollar and, later, the euro* have both been called into question at various times during the crisis. With the United States initially the epicentre of events, the future role of the greenback was an early subject of discussion, as observers wondered whether it would sustain its status as the world's reserve currency.[9] Later, the intensification of the crisis on Europe's periphery saw the prospects of the US dollar's main contemporary challenger also thrown into doubt;[10]

- The *G7* group of advanced economies, once seen as the effective steering committee of the world economy, was judged as no longer fit for the purpose and replaced by a new grouping.

At the same time, the world seemed to be in the process of adopting some new models, and of discovering new value in old models that had been thought to have lost their relevance. We saw:

- A dramatic return to *Keynesian-style economic solutions* as governments opted for fiscal pump-priming with a vengeance, both in the developed and in the developing world;

- A big comeback for the *IMF*, which only a short time before the crisis had appeared to be on the verge of irrelevancy;[11]

- The elevation of the *G-20* to be the new 'premier forum for international cooperation;'[12] and

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[8] Alan Greenspan, *Testimony to the Committee of Government Oversight and Reform.* Washington DC, US Congress, 23 October, 2009.

[9] Proposals by PBOC governor Zhou Xiaochuan in early 2009 received a great deal of attention in this regard. See Zhou Xiaochuan, *Reform the International Monetary System. An essay by Dr Zhou Xiaochuan, Governor of the People's Bank of China* 23 March, 2009.

[10] On the euro's putative challenge to the US dollar, see for example Jeffrey Frankel, *The euro could surpass the dollar within ten years.* VoxEU.org, 18 March, 2008. See also Jeffrey Frankel and Menzie Chinn, Will the euro eventually surpass the dollar as leading international reserve currency?, in *G7 current account imbalances: Sustainability and adjustment*, ed. Richard Clarida. Chicago and London, University of Chicago, 2007.

[11] Compare for example The Economist, The IMF downsizes: It's mostly firing. *The Economist*, 7 February 2008 with The Economist, The IMF assessed: A good war. *The Economist*, 17 September 2009.

- A (modest) new appreciation of the worth of the *WTO* as the guarantor of an open international trading system: as the crisis intensified, the relative importance of the benefits provided by locking in *existing* levels of openness as opposed to generating *additional* liberalisation shifted.

So, 'all change' then?

Not quite. Fast-forward a little, and many judgments about the nature of change in the world made during the early part of the GFC turned out to need at least some modification.

- The decoupling thesis has since made a comeback, albeit in a significantly modified form that emphasises potential or structural (as opposed to cyclical) growth.[13] Indeed, growth in the developing world has proved so resilient that even the 'G' in GFC is now up for justified questioning: maybe it was really only a US and European crisis, after all?

- For much of the developed world, the Return of Keynes has started to look rather more like a Keynesian Moment, as large debt burdens and a political backlash have pushed many governments towards early (perhaps in some cases premature) fiscal consolidation;

- Despite the increased value of the WTO, there has still been no real progress towards concluding the Doha Round (if ever there was a time for the confidence-building gesture of completing the Round, it was during the worst of the crisis);

- The G-20 has become mired in infighting over competing allegations regarding the economic impact of China's exchange-rate policy and the shift to renewed quantitative easing (QE2) in the United States.[14]

- The US dollar has so far held on to its status as the global currency of choice: when the world panicked, investors fled to US government paper. Moreover, it was the US

[12] This was the decision announced in the communiqué at the end of the Pittsburgh Summit in September 2009.
[13] For more on decoupling, see Mark Thirlwell, *The rise, fall and rise again of decoupling.* International Economy Comments #3. Sydney, Lowy Institute for International Policy, 5 November, 2010.
[14] For a flavour of some of the current pessimism regarding the G-20, see for example Ernesto Zedillo, *The G20: Captive in the prison of mercantilism.* VoxEU.org, 18 November, 2010.

Federal Reserve that had to help bail out the international banking system through a series of currency swaps, acting as the global lender of last resort for US dollars.[15]

So, it's not 'all change' after all.

Revisiting *All change or plus ça change . . .*

One way to try to gauge the balance between 'all change' and 'plus ça change' is to return to the framework set out in that earlier paper. Then, I noted that before the onset of the crisis, I had been telling four interlinked stories about the nature of the world economy:

1. Story #1 was *The Great Convergence*. According to this view, the defining feature of the contemporary world economy was the onset of sustained, rapid catch-up growth in the big emerging markets, including the billion-people-plus economies of China and India. An important corollary of this story was the relative shift of economic, and ultimately geo-political, weight towards emerging Asia.[16]

2. *A Resource-constrained world.* Story #2 followed on from story #1 and was about what happened when the Great Convergence ran into resource constraints. Here the theme was a large, sustained shift in relative prices in favour of resources, together with a significantly enhanced policy focus on issues of resource security and environmental sustainability.[17]

3. *Second thoughts on globalisation.* This third story was about how the globalisation-friendly international policy environment that had dominated the world economy since the 1980s was coming under increased challenge – in part as a consequence of the adjustment pressures created by the Great Convergence and the associated fears raised by a resource-constrained world.[18]

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[15] See for example Maurice Obstfeld, *Lenders of last resort in a globalized world: Keynote speech for the conference 'Financial system and monetary policy implementation', held by the Institute for Monetary and Economic Studies, Bank of Japan, Tokyo on 27-28 May 2009.* Monetary and Economic Studies, Bank of Japan, November, 2009.

[16] For a summary of the argument, see Mark Thirlwell, *The Great Convergence.* International Economy Comments #4. Sydney, Lowy Institute for International Policy, 9 November, 2010.

[17] See for example Alan Dupont and Mark Thirlwell, A new era of food insecurity? *Survival* 51 (3) 2009.

[18] Mark Thirlwell, *Second thoughts on globalisation: Can the developed world cope with the rise of China and India?* Lowy Institute Paper 18. Sydney, Lowy Institute for International Policy, 2007.

4. *The Return of the state.* All three of the preceding stories implied an increasing role for government in the world economy, suggesting that the long swing towards privatisation and deregulation that got underway in the 1980s and intensified during the 1990s had at best stalled, and in some important ways had started to move into reverse.

So, as of February 2009, how did I think that my four stories would fare in the post-crisis world? I was actually pretty confident that all four would remain relevant:

1. My judgment was that, despite some important risks, the most likely outcome was that 'the GFC will represent only a temporary disruption to the *Great Convergence*, and that as the crisis is put behind us, catch-up growth will resume in Emerging Asia.'

2. When it came to a *Resource-constrained world*, I had to concede that the sharp fall in commodity prices that followed the crisis made the story of a *Resource-constrained world* look less appealing. Even so, I still reckoned that, based on my assumption that emerging markets would return to something similar to their pre-crisis growth performance, resource and environmental constraints would remain significant. Indeed, I worried that the former might even be exacerbated to the extent that capacity-expanding investment was now more likely to be postponed.

3. With respect to *Second thoughts on globalisation*, I argued that if the side-effects from globalisation's <u>successes</u> had been enough to prompt some backtracking, then a dramatic <u>failure</u> like the GFC was only likely to reinforce that process.

4. Finally, when it came to the *Return of the State*, the argument seemed to me to have become even more compelling, as governments across the developed world were finding themselves pushed into an unprecedented degree of intervention in their economies. My view was that the financial crisis had served to accelerate the swing in the pendulum back towards a greater (economic) role for government.

Almost two years on, how do those four judgments stack up?

The view from late 2010

From the vantage point of late 2010, all four stories remain quite compelling ways to think about the world economy, albeit in some cases subject to some interesting new qualifications.

1. With respect to the persistence of the *Great Convergence*, the evidence to date has turned out to be even stronger than I thought would be the case back in early 2009. Then, activity in much of the developing world had crashed in the final quarter of the 2008, the first quarter of 2009 was not looking much better, and everyone was – justifiably – writing obituaries for the decoupling thesis. But by the end of 2009, it was already clear that the pre-GFC gap in growth performance between developed and developing economies was still in place. While advanced economies as a group shrank by a bit more than 3 per cent that year, emerging and developing economies still managed to grow by about 2½ per cent. This year, the IMF thinks that advanced economies will grow by less than 3 per cent, contrasted with growth in developing and emerging economies of more than 7 per cent.[19]

2. Signs of the persistence of a *Resource-constrained world* have also been relatively easy to find. For a start, the rapid rebound in emerging-market growth has provided support for commodity prices, which as a result have been much more resilient in the face of depressed developed economy demand than might have been expected based on past behaviour. Moreover, problems with fires and drought in Russia earlier this year prompted the imposition of an export ban that contributed to a sharp upward spike in wheat prices. Together with climate-related crop shortfalls in the Ukraine, Canada, and Kazakhstan this contributed to fears of a renewed global food crisis. Finally, problems over the export of rare earth elements from China have helped keep the strategic aspects of resource security to front of mind.[20]

3. When it comes to *Second thoughts on globalisation*, the backlash against international economic integration has so far been rather less potent than I feared. As two major monitoring exercises confirm, there has been no major retreat to trade or investment protectionism, and on average, countries have held the line well when it

[19] Forecasts from International Monetary Fund (IMF), *World Economic Outlook: Recovery, risk and rebalancing*. World Economic and Financial Surveys. Washington DC, International Monetary Fund, October, 2010.
[20] I discussed the rare earths example in a series of posts on *The Interpreter*, the Lowy Institute's blog.

comes to sustaining open markets.[21] That said, however, the second of those two reports still finds that over 430 protectionist measures have been taken by G-20 countries since the November 2008 G-20 summit at which participants had all pledged to refrain from protectionism. Add in measures likely to be protectionist, and the total breaches the 500 threshold.[22] Combine that backsliding with recent tensions over 'currency wars' and competitive devaluations, and it's more than reasonable to conclude that protectionist impulses remain an important risk. More generally, the significantly increased use of, and perhaps even more importantly, the widespread approval for, capital controls, does fit comfortably into the *Second thoughts* narrative. Similarly, the continued general lack of enthusiasm for any meaningful progress with the Doha Round also indicates a loss of appetite for further liberalisation.

4. Finally, the *Return of the state* has obviously worked extremely well as a prediction, but now needs to be qualified by the fact that in many developed economies the state is now heavily indebted and increasingly preoccupied by the need to restore financial sustainability and fend off fiscal crises. Moreover, national leaders across much of the rich world now face angry, disenchanted and in many cases unemployed voters. Governments in these economies proved to be quite successful in doing enough to stave off the financial crisis, but the political and economic costs of, for example, bailing out the banking sector, means that saving the economy may well have come at the price of not only major increases in public debt, but also of losing the voting public.[23] The unpleasant prospect of sustained austerity and possibly high long-term unemployment are going to constrain governments' freedom of manoeuvre.

In summary, then, I reckon that the same four stories that did a good job of capturing important features of the world economy before the GFC will continue to do a good job after it.

While this is in some ways a reassuring judgment, however, it's also an incomplete one. In particular, the selection of my four stories reflects a particular view of the world economy – one that sees much of the action taking place in the developing world. That is of course a

[21] For the official view, see WTO and UNCTAD OECD, *Reports on G20 trade and investment measures (Mid-May to Mid-October 2010).* 4 November, 2010. For an independent view, see Simon J Evenett, ed., *Tensions contained . . . for now: The 8th GTA report.*2010.
[22] Simon J Evenett, *The state of protectionism on the eve of the Seoul G20 summit.* VoxEU.org, 8 November, 2010
[23] This fear of saving the economy but losing the public is attributed to US Treasury Secretary Tim Geithner in John Cassidy, The economy: Why they failed. *The New York Review of Books*, 9 December 2010.

product of Australia's particular place in the world economy, which is one that is increasingly tied into the economic cycle of emerging Asia in general and China in particular. Nevertheless, it's still only a partial view, and one which does not capture enough of the post-crisis environment.

What about the developed world? Living with the 'new normal'

More specifically, it doesn't do enough to recognise the major shift that's occurred in much of the developed world in the aftermath of the crisis – the arrival of an economic environment that's been described as the 'new normal.'[24]

This new normal is usually envisaged as a rather grim place, a world of slower growth and higher unemployment, of more debt and less wealth. In this, it is a by-product of the particular nature of the GFC.[25] Studies of past crises have highlighted the following three crucial points about the nature of the subsequent recovery:[26]

- Recoveries following recessions that have been associated with financial crises tend to be slower and shallower than the average recovery;

- Recoveries from synchronised recessions tend to be weaker than recoveries from other kinds of recessions; and

- Historically, major financial crises have often been followed by sovereign debt crises.

Since both of the first two features characterised the recent crisis for much of the developed world, history would suggest that these economies should expect a period of sub-par growth, a forecast which to date has been playing out with depressing accuracy. Meanwhile, recent events in Greece and now Ireland suggest that the third prediction is similarly on point.

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[24] Mohamed A. El-Erian, *A new normal.* Secular Outlook, PIMCO, May, 2009. See also Mohamed A. El-Erian, *Navigating the new normal in industrial countries.* Per Jacobsson Foundation Lecture. Washington DC, International Monetary Fun, 10 October, 2010.
[25] I make this argument in Mark Thirlwell, *'New normal' or just the same old nasty?* International Economy Comments #2. Sydney, Lowy Institute for International Policy, 4 November, 2010.
[26] International Monetary Fund (IMF), From recession to recovery: How soon and how strong?, in *World Economic Outlook: Crisis and recovery.* Washington DC, International Monetary Fund, 2009. Carmen M Reinhart and Vincent R Reinhart, *Diminished expectations, double dips and external shocks: The decade after the fall.* VoxEU.org, 13 September, 2010. Carmen M Reinhart and Kenneth S Rogoff, *This time is different: Eight centuries of financial folly.* Princeton, Princeton University Press, 2009.

Our divided world economy

Bringing together my four original stories about the world economy with this fifth story – the new normal – helps highlight a particularly striking feature of the post-GFC environment: The emergence of a divided (almost schizophrenic) world economy.

By this I mean that we now have an international economy which can be divided roughly into two parts. On one side, we have the crisis-hit developed world, currently undergoing a painful process of balance-sheet adjustment and deleveraging, where the key risks for policymakers come in the form of debt and deflation. On the other side of the dividing line, we have a developing world which continues to reap the benefits of catch-up growth, and where policymakers are typically more worried about overheating, asset bubbles, and inflation.[27]

Elements of this divided world economy were captured by the pre-crisis theory of decoupling, although the events of late 2008 and early 2009 were compelling evidence that in fact the cyclical performance of the two groups remains very much coupled. Rather, the big gap is between trend (or potential) growth performance, which has not only decoupled but is showing signs of diverging, simultaneously increasing in the emerging economies while falling in the developed world.[28] The result is a new geography of economic growth, comprising a slow-growing developed world and a fast-growing developing one.

What's more, differences in performance between the two parts of this divided world are not confined to growth. There's also a big gap opening up in fiscal and debt performance. Both groups saw their fiscal positions swing into deficit during the crisis, but emerging economies' budgets did so from a generally better starting position. So while the overall fiscal deficit of the first group is projected to be around 8 per cent of GDP this year (including deficits of more than 11 per cent of GDP in the US and more than 10 per cent in the UK), in emerging economies it is forecast to be just over 4 per cent (although it is worth noting that India is expected to run a deficit of almost 10 per cent of GDP).[29]

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[27] In reality, the divide between developed and developing is of course an imperfect and incomplete one. As already noted, Australia, for example, is very much tied into the economic future of the 'developing' half of this divide. Similarly, economic performance across the developing world is quite varied.

[28] Thirlwell, *The rise, fall and rise again of decoupling.*

[29] Estimates and projections are from International Monetary Fund (IMF), *Fiscal Monitor: Fiscal exit: From Strategy to implementation.* World Economic and Financial Surveys. Washington DC, International Monetary Fund, November, 2010.

The discrepancy when it comes to debt burdens is even starker. The crisis saw the stock of advanced country public debt increase by about 17 per cent of GDP, rising from 73 per cent in 2007 to an estimated 90 per cent this year (including 93 per cent of GDP in the US, 77 per cent in the UK, and 226 per cent in Japan – but only 22 per cent in Australia), and on track to reach about 108 per cent by 2015. For the subset of G7 economies, debt-to-GDP ratios are now rising to levels exceeding those reached during the Second World War. In contrast, for developing economies, the average increase in the debt burden is forecast to be less than 2 per cent of GDP, with debt reaching about 37 per cent of GDP this year, and forecast to *decline* to about 34 per cent by 2015.

One notable consequence of these trends is something I have described as the great sovereign risk shift.[30] Traditionally, country risk has been associated with developing, not developed economies. Indeed, the last developed economy defaults occurred in the aftermath of the Second World War. But that distinction in creditworthiness between developed and developing is now blurring. In the year through to October 2010, developing country ratings upgrades have exceeded downgrades by a ratio of 7:1.[31] In contrast, no advanced economy has been upgraded since 2007, and developed country sovereigns have experienced at least 25 *downgrades* since early 2008.[32]

Managing the policy divide

It should come as no great surprise that big differences in economic conditions have been reflected in significant differences in economic policies, policy prescriptions and priorities. The period of policy consensus that we enjoyed in the immediate aftermath of the crisis has now disappeared, leaving countries divided on what to do next. To take just one example, think about inflation in China and the United States:

- Policymakers in Beijing are worried about rising prices, and in mid-November raised reserve requirements for Chinese banks for the fifth time this year in an attempt to

[30] Mark Thirlwell, *The great sovereign risk shift.* International Economy Comments #1. Sydney, Lowy Institute for International Policy, 3 November, 2010.
[31] Cited in World Bank Development Prospects Group, *Weekly global economic brief.* Washington DC, World Bank, 4 November, 2010.
[32] International Monetary Fund (IMF), *Global Financial Stability Report: Sovereigns, funding and systemic liquidity.* World Economic and Financial Surveys. Washington DC, International Monetary Fund, October, 2010.

control credit following the news that Chinese consumer price inflation in October had jumped to 4.4 per cent – well above the official target of 3 per cent;[33]

- Meanwhile, in the United States, core inflation in October was just 0.6 per cent – the lowest reading since records began. Observers were left worrying that US core inflation figures were following a similar path to that shown by Japan 15 years ago, indicating a growing risk of deflation.[34] For its part, Fed has embarked on a second round of quantitative easing.

An important complicating factor here is that while in this sense the world economy is now a *divided* one, in other ways, it is of course more *inter-connected* than ever before, with large trade and financial spillovers between economies. This particular combination is creating frictions or fault lines between the various parts of the world economy, where competing policy objectives – and perspectives – are rubbing up against each other in an increasingly uncomfortable manner.[35] Again, there are some obvious examples here:

- Take the case of exchange rate policy and the debate over global imbalances. For a policymaker in Washington worried about high US unemployment, the pressing issue is inadequate demand and its global (mal-)distribution – so China's quasi-pegged RMB and its large external surpluses take on the appearance of unacceptable mercantilism;

- Alternatively, from the point of view of a range of developing economies currently grappling with the challenges posed by large-scale capital inflows, the US Fed's decision to resume quantitative easing looks like a potentially destabilising act that will only contribute to a further wave of unwanted hot money pouring into their economies.[36]

[33] Justine Lau and Geoff Dyer, China makes moves to curb inflation. *Financial Times*, 19 November 2010.
[34] Floyd Norris, After the Fed's action, watching inflation's trajectory. *The New York Times*, 19 November 2010.
[35] On the fault lines analogy, see Raghuram G Rajan, *Fault lines: How hidden fractures still threaten the world economy.* Princeton, Princeton University Press, 2010.
[36] Although note that given the respective economic trajectories of the divided world, continued portfolio re-allocation towards emerging economies looks like a sensible adjustment. For more on the capital flows challenge facing emerging economies, see Mark Thirlwell, *Here we go again . . .?* International Economy Comments #6. Sydney, Lowy Institute for International Policy, 18 November, 2010.

In theory, of course, these conflicting policy objectives should be open to reconciliation in the form of a comprehensive package of measures targeted at the modern economic holy grail of global rebalancing.[37] Unfortunately, reality is proving to be a large and uncomfortable distance from theory . . .

This troublesome gap arises because another important consequence of our divided world economy is that it both increases the need for international cooperation and simultaneously makes it harder to deliver. In the world of the *Great Convergence*, the old rich countries' club of the G7 no longer cuts it as even a putative steering committee for the world economy. But there is no sign that new powers' club – the BRICs summit – has any more credibility than the G7, and indeed in reality still has much less. As a result, we have found ourselves with the G-20, which seeks to stitch together the old powers and the new, as well as adding in a little something extra.[38] Making the G-20 work is perhaps *the* pressing challenge for managing a divided world economy – but it's going to be very difficult now that we have got past the 'hang together or hang separately' phase that prevailed at the start of the GFC.

The GFC as an accelerant

So how does all this fit into the question about 'all change' or 'plus ça change'? Well, I think one useful interpretation is to think of the GFC acting as an *accelerant* on some pre-existing trends.

To take the most obvious example, the geographic shift in wealth and power that is a consequence of the *Great Convergence* has been magnified and accelerated by the differential impact of the crisis on developed and developing economies that has created our divided world economy, and by the boost to prestige and credibility given by Beijing's successful policy response.[39]

A similar accelerant-like effect is apparent with the Return of the state, with what might have been a fairly gradual process of re-regulation instead given a big and hasty push by the exigencies of the crisis.

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[37] For an interesting look at the benefits from collaboration, and the downsides associated with a non-cooperative solution, see International Monetary Fund (IMF), *G-20 Mutual Assessment Process - Alternative policy scenarios. A report by the IMF Staff for the G-20 Toronto Summit, Toronto 26-27 June.* International Monetary Fund, June, 2010.

[38] Including Australia.

[39] Geoff Dyer, The dragon stirs. *Financial Times*, 25 September 2009. William H. Overholt, China in the global financial crisis: Rising influence, rising challenges. *The Washington Quarterly* 33 (1) 2010.

Elsewhere, the role of crisis as accelerant is perhaps less obvious, but still present. For example, it seems reasonable to argue that the GFC has exposed some of the underlying strains in the euro area. Remember, right from the beginning, many economists were sceptical about the economic merits of the euro, arguing that the region did not meet the criteria of an optimum currency area (OCA).[40] While several initial studies concluded that the eurozone was not an OCA, there was some hope that the act of monetary unification would encourage a degree of economic convergence among participating economies. But in practice, not only did the eurozone not encourage economic convergence among the relevant economies; it seems to have contributed to quite significant *divergence*, to the extent that countries on the eurozone periphery with overheating economies and inflating asset bubbles found themselves importing inappropriate monetary policy settings that tended to exacerbate the underlying imbalances.[41]

It's also possible to find the roots of the current sovereign debt problems facing many developed economies in the pre-GFC world. So, for example, economists at the BIS have argued that the GFC has served to bring an already simmering fiscal problem to the boiling point. They note that for many developed economies, the path of pre-crisis future revenues was *already* insufficient to finance promised expenditures.[42] The crisis-driven surge in debt took place against a back drop of a long-term erosion of the fiscal position in many economies: from the 1970s to 2007, the collective average public debt ratio in the advanced economies had risen from 40 per cent to 76 per cent of GDP.[43] The risk preoccupying many policymakers now is that newly-swollen debt burdens will dent growth rates in the developed world at the same time as pushing up risk premia, leaving countries vulnerable to weak fiscal credibility and the danger of self-fulfilling debt crises.[44] That said, however, it is important to remember that not all of the current increase in debt can be traced back to public sector profligacy. For example, before the crisis, the ratio of government debt to GDP across much of the eurozone was enjoying a period of decline. Unfortunately, over the same period, the private sector – households and financial institutions – saw their debt soar; indeed, outside Greece, eurozone governments were more disciplined than their private sectors in

[40] The classic reference is Robert A Mundell, A theory of optimum currency areas. *American Economic Review* 51 (4) 1961. The criteria include the degree of labour and capital mobility, the degree of factor price flexibility (of wages and prices), the presence of fiscal transfers to aid with risk sharing; and exposure to common shocks.
[41] See for example Gilles Saint-Paul, *Is the euro a failure?* , VoxEU.org, 5 May, 2010.
[42] Stephen G Cecchetti, M S Mohanty and Fabrizio Zampolli, *The future of public debt: prospects and implications.* BIS Working Papers No 300, Bank for International Settlements, 2010
[43] Bank for International Settlements, *80th Annual Report.* Basel, Bank for International Settlements, 2010
[44] Cecchetti, Mohanty and Zampolli, *The future of public debt: prospects and implications.*

constraining their debt accumulation. For many of these economies, the public debt surge after 2007 was the result of bailing out their profligate private sectors.[45]

Conclusion: six, no seven, stories and a final cautionary note

In this paper I've reviewed four pre-GFC 'stories' about the world economy approach – the *Great Convergence*, the *Resource-constrained world*, *Second thoughts on globalisation* and *The Return of the State* – and argued that all four continue to be useful guides to our international economic environment even in the aftermath of the GFC. Indeed, in several cases it's quite plausible to conclude that the crisis has made them even more relevant.

I've also supplemented these four stories with a fifth, borrowed story (the *'new normal'*) and then proposed that taken together, these five stories suggest a sixth – the story of *Our Divided World Economy*, which highlights the gap in economic performance between much of the developed and developing worlds, and the resulting policy tensions this generates.

(There is, in fact, another important story to tell about the world economy. That story is called *The Return of Geo-economics*, and in many ways it's a product of the original four stories.[46] But I won't try your patience any further by recounting it here.)

The six stories described here tell us some important things about our international economic outlook, and it seems likely that they will continue to do so for some time yet. That said, it is worth finishing on a note of caution. Supposedly the one big lesson to come out of the financial crisis was our inability to predict the future – as noted earlier, in these post-crisis times, we are all supposed to be living in that world of black swans and fat tails. Yet despite all this, we in fact remain remarkably confident about what we think the economic future will hold.[47] Guess what? We're probably going to be wrong.

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[45] Paul De Grauwe, *Fighting the wrong enemy.* VoxEU.org, 19 May, 2010

[46] For more detail see Mark Thirlwell, *The return of geo-economics: Globalisation and national security.* Lowy Institute Perspectives. Sydney, Lowy Institute for International Policy, September, 2010.

[47] This is the theme of Mark Thirlwell, *Our consensus future: The lay of the land in 2025.* Lowy Institute Perspectives. Sydney, Lowy Institute for International Policy, September, 2010

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