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All Change or Plus Ça Change...? The Global Financial Crisis and Four Key Drivers of the World Economy

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All change or plus ça change . . .?
The global financial crisis and four key drivers of the world economy

Mark Thirlwell

'Plus ça change, plus c'est la même chose'

- Jean-Baptiste Alphonse Karr, *Les Guêpes*, January 1849

'When the facts change, I change my mind. What do you do, sir?'

- John Maynard Keynes, replying to a criticism during the Great Depression of having changed his position on monetary policy, as quoted in *Lost Prophets: An Insider's History of the Modern Economists (1994)* by Alfred L. Malabre, p. 220

All change or no change?

If 2008 was the year of the financial crisis, 2009 is set to be the year of the real economy fallout. According to the latest IMF projections, world economic growth (measured in purchasing power parity terms) is forecast to slow to 0.5% this year, down from 3.4% in 2008 and 5.2% in 2007. This would be the lowest rate of global growth since the Second World War. World trade volumes of goods and services are forecast to contract by 2.8%. Commodity prices have crashed. Unemployment is on the rise, and governments have started to topple. After seventeen consecutive years of uninterrupted economic growth, Australians are facing recession. The world is changing. But by how much?

The search is now on for narratives to explain what the crisis means for the world economy. An important complication for such efforts is that there are two common but opposite temptations that arise when analysing the consequences of a major shock. The first is the temptation to under-interpret events: to assume that once the crisis has passed, the world will return to how it was, back to business as usual. The second is the temptation to over-

interpret: the risk of being so caught up in the drama and colour of the present that the assumption becomes that *everything* will now change. During the early part of the global financial crisis, the first temptation was the greater risk. Clearly, that is no longer the case.

Après Lehman, le déluge

Indeed, it's now common to hear the assertion that the world economy changed on 15 September 2008. Certainly, there can be no doubt that the bankruptcy of Lehman Brothers heralded a sharp intensification of the global financial crisis – now so ubiquitous it has its own acronym, the GFC.[1] This in turn has called forth an unprecedented policy response, including the effective nationalisation of large parts of several OECD economies' financial systems and a massive splurge of public sector money. It's also glaringly apparent that the financial carnage is going take a heavy toll on global economic activity in the near future. But has the crisis produced a fundamental change in the *long-term* trajectory of the international economy? Are the changing facts of the global economy – plummeting growth, soaring risk aversion, collapsing commodity prices, vanishing business and consumer confidence, and a massive expansion in the role of government in the economy – so significant that we also have to change our minds about the fundamental ways in which the world will now work?

Until the second half of 2008, the future path of the global economy seemed reasonably clear. We were living in an economic environment characterised by a continuing process of economic catch-up by several major emerging markets, led by China, and as a result, one also characterised by an ongoing shift in the geographic distribution of economic weight (back) towards Asia. A whole series of forecasts, projections and scenarios, beginning with the now famous BRICs projections of Goldman Sachs, predicted a great overtaking of developed by developing economies in the economic league tables (albeit in terms of absolute GDP rather than per capita terms).

The transformations that this convergence process entailed were visibly reshaping the world economy around us. For example, an expanding developing country middle class was exciting the attention of both marketing departments and political scientists. Rapid

[1] Back in 2007 I suggested renaming what was then known as the subprime crisis to the TLA crisis, given the large number of three-letter acronyms (CDO, ABS, MBS, CDS) involved. So it's somehow fitting that the crisis has now produced its very own TLA in the form of the GFC. Mark Thirlwell, *Crunched: Lessons from the 2007 TLA crisis*. Lowy Institute Perspective. Sydney, Lowy Institute for International Policy, November 2007.

industrialisation and urbanisation had contributed to a surge in commodity prices, as well as to growing concerns about resource security and environmental constraints. By July 2008, oil prices had climbed to more than US$147/barrel, and forecasts of US$200/barrel were widely viewed as credible. A run-up in food prices in 2007 and 2008 had seen rice prices exceed US$1000/tonne and sparked fears of a new Malthusian age.[2]

The shifting balance of economic power that was underway was also reflected in a changing pattern of global trade and – especially – financial flows. Thus in the last couple of years the developed world's economies, including Australia, had found themselves struggling to adapt to an international financial environment where Sovereign Wealth Funds (SWFs) and other State-directed investment flows originating from emerging markets were playing an increasingly important role in cross-border capital movements. There were growing fears that financial protectionism would be the rich world's eventual response, with cases such as the extremely negative reaction to the CNOOC bid for Unocal seen as early warning signals. Similarly, in Australia, there was rising public concern about Chinese sovereign investment in the resource sector.[3]

How much of this international economic environment will survive the global financial crisis? One way to approach this question is to look at some of the key drivers of the world economy in the years before the crisis, and then think about to what extent the crisis has either offset, destroyed or reinforced those trends.

How the world worked

Before the intensification of the global financial crisis, it was possible to tell four interlinked stories that captured most of the workings of the world economy as described above.

Story #1 was the story of the *Great Convergence*. This was the tale of rapid, sustained economic growth in the two giant, billion-people plus Asian economies of China and India (and in other major emerging markets), and the resultant gradual narrowing of the income per capita gap between the more than one-third of the world's population found within their borders and that share of the global population fortunate enough to be living in the rich,

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[2] Mark Thirlwell, Food and the spectre of Malthus. *Financial Times*, 26 February 2008.
[3] Fergus Hanson, *Australia and the world: public opinion and foreign policy. The Lowy Institute Poll 2008*. Sydney, Lowy Institute for Public Policy, 2008.

developed world.[4] A significant corollary of this story was a shift in the geographic distribution of economic activity in the world economy towards Asia in general, and emerging Asia in particular, and with it, geopolitical influence.

Changes as profound as those implied by the Great Convergence had all sorts of consequences for the international economic environment, including those captured by . . .

Story #2 the r*esource-constrained world economy*. Story #2 was about what happens when the Great Convergence runs up against resource and environmental constraints.[5] One of the most obvious outcomes of this confluence was a major hike in the relative price of resources – a development that became known as the commodity supercycle. The consequences of a resource-constrained world also made themselves felt though an increased economic and political emphasis on environmental sustainability (particularly in the developed world) manifested in growing public concern about climate change and a heavy focus on resource security (particularly in the developing world), a focus which was initially concentrated on energy, but which was extended to include food security during the recent food crisis.[6]

Story #3 was about *second thoughts on globalisation*. The theme of this third story was the way in which the globalisation-friendly international policy environment that had dominated the world economy since at least the late 1980s was coming under challenge, mainly as a result of a re-evaluation of the costs and benefits arising from globalisation that was taking place in the rich world.[7] This re-evaluation was in large part a product of fears about possible competitive and strategic threats posed by the globalisation-powered rise of China and India as manifested in the Great Convergence, and of concerns raised by some of the environmental and resource security implications of a resource-constrained world.

Story #4 was *the return of the state*. All three of the preceding stories implied an increased 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 started to move into reverse. So, for example, one consequence of the Great Convergence

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[4] See for example the discussion of India in Mark Thirlwell, *India: the next economic giant*. Lowy Institute Paper 01. Sydney, Lowy Institute for International Policy, 2004.

[5] It is important to note that the argument here is not necessarily that these constraints are *permanently* binding ones – in some cases technology or policy changes or even just (substantial) new investment may well provide solutions – but that they are important enough to require significant economic adjustments and policy responses.

[6] Mark Thirlwell, *The spectre of Malthus: Lessons from the 2007-2008 food crisis*. Lowy Institute Paper. Sydney, Lowy Institute for International Policy, 2009 (forthcoming).

[7] 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.

was a shift in economic power towards countries that awarded a relatively larger role for the state in their economies than much of the developed world had become used to.[8] This in turn has called forth a policy response from the developed world (seen for example in the demands to regulate the activities of SWFs) that entailed more government intervention. Similarly, the prospect of a resource-constrained world was also prompting increased government intervention in the economy in the form of environmental policies, including those directed at climate change, as well as in the form of controversy over the ownership of supposedly strategic natural resources.[9] The rethink on globalisation also tended to indicate a bigger role for the state, via increased public demand for either new or extended regulation or protection(ism), or for some combination of the two.

Finally, there was, of course, another extremely powerful story to tell about the world economy over recent years. This was the story of the march of financial globalisation and the emergence of global financial capitalism: according to the McKinsey Global Institute, the ratio of global financial assets to annual world output soared from 109% in 1980 to 316% in 2005.[10] As we now know all too well, this last story has ended in tears. The question we want to answer here is, what does the unhappy ending of this final story mean for the other four?

What the GFC hath wrought

Taking the four stories set out above in reverse order, it seems very obvious that one consequence of the global financial crisis has been to make story #4 – the return of the state – even more compelling. Just think of events over the past year or so. The response of governments to the economic disaster now unfolding has been both dramatic and extensive. After having tried a series of partial solutions – from bans on short selling through the bailout of individual institutions and on to the extension of blanket deposit guarantees and widespread financial support – the authorities in the UK and elsewhere found themselves moving towards the partial nationalisation of their financial systems. Even in the United States, normally almost pathologically suspicious of any policy initiative that might sniff of socialism, the extension of state control has been marked, leading to US economist and blogger Brad de Long's quip to the effect that while the Bush administration may have

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[8] Note this is a point about comparisons *across* countries. It would be reasonable to argue that in most of the emerging economies, the role of the state in the economy had declined over *time*.

[9] For a short view on the Australian debate regarding the latter point, see Mark Thirlwell, Sharing the spoils of China's rise means negotiating some tricky investment twists and turns. *The Australian*, 2 July 2008.

[10] See Martin Wolf, Unfettered finance is fast reshaping the global economy. *Financial Times*, 19 June 2007.

entered office as social conservatives, they found themselves leaving it as conservative socialists.

Furthermore, the collapse in economic activity is now calling forth a huge increase in fiscal pump-priming as government demand seeks to substitute for the faltering private sector.

The financial crisis has accelerated significantly the swing in the pendulum back towards a greater role for government. That swing was already underway, but as a result of the crisis it is now happening much faster, and in countries that had hitherto been closely associated with the move to reduce that role. It also seems likely that the size of the change will now be appreciably greater than would otherwise have been the case: while the return of the state may have been on the cards before the GFC, it's hard to believe that the nationalisation of much of the UK banking sector was. As far as arguments go, then, the onset of the financial crisis has turned the case for the return of the state into a slam-dunk.

Much the same can be said about story #3. If the side-effects deriving from globalisation's *successes* – the fear of powerful new trade competitors, the angst over SWFs, environmental strains, and resource security fears – were enough to prompt some second thoughts on globalisation, then it seems hard to believe that the massive *failure* that is the global financial crisis will not produce an even greater emphasis on the downside of globalisation. To put it another way: if a sizeable proportion of the electorate in the rich world were sceptical about globalisation even before the US housing market went belly up and triggered the subprime crisis and all that followed, then the biggest international financial crisis since the 1930s is hardly going to temper that scepticism. The bigger the real economy fallout – that is, the higher unemployment rates go – then the bigger the likely anti-globalisation backlash.

Moreover, it's quite likely that the crisis will create some new converts to those already sceptical about the benefits of the previous global order. For example, East Asia has in many ways been a big winner from the way in which the world economy has been operating (of which more below), but it has also now been the victim of two major financial crises in the space of about a decade and feels, particularly in the case of the current crisis, that it has been a largely innocent bystander.

Story #2, on the other hand, has been called into question by the impact of the crisis. The proposition of a resource-constrained world is intellectually appealing when oil is at US$147/barrel. When that oil price has fallen to closer to US$40/barrel, it becomes a much harder sell. Environmental concerns are also likely to be viewed as much less pressing during

economic hard times: governments, both elected and authoritarian, are likely to be following their populations in worrying more about unemployment than climate change in the near term, a trend apparent in several recent surveys of public opinion, including our own Lowy polling.

But does the financial crisis completely undermine story #2? Granted, it certainly suggests that a fair proportion of the surge in prices during the resource boom *was* due to cyclical factors, a product of an overheating global economy and quite likely of some speculative excess. But that is not the same as saying that this explained all of the price action. If emerging markets return to a similar kind of growth performance once the crisis is passed, then some of the resource constraints that were occupying minds in recent years will once again start to bite. Furthermore, the cuts in investment in capacity and delays to or cancellations of new projects that will be the product of the abrupt reversal of the price signals and evaporation of financing now underway could well end up laying the foundations for another commodity price spike – and renewed resource security fears – in the future, *provided* that global growth is once again re-established at something close to its previous tempo. A similar reasoning applies to environmental constraints.

All of which brings us back to Story #1, the Great Convergence. At first, the implications of the financial crisis for the Great Convergence and the associated transfer in economic power may have seemed both obvious and positive: another slam-dunk. Certainly, many observers, at least initially, seemed to view the GFC as heralding the decline of the West and the rise of the rest. After all, its epicentre was the United States (and the United Kingdom), and much of the worst of the economic fallout has been concentrated around the Atlantic economies. Equally, there can be little doubt that the blow to US prestige and credibility arising from the effective collapse of its financial system and the failure of its regulatory model is substantial, a blow reinforced by the grinding of teeth occasioned in East Asia (and elsewhere) at the marked difference in the kind of economic policies now being followed by Washington as opposed to those it propounded during the 1997-98 crisis. Not to mention the rapidly expanding cost to the rich world in terms of foregone growth and increased government debt. Finally, the decision to turn to the G-20 as the appropriate global body to deal with the crisis as opposed to the increasingly anachronistic G7 is a recognition of the changed economic and geo-political landscape created by the Great Convergence.

All that said, the consequences of the current crisis for the Great Convergence are not quite that clear-cut. For a start, the developing world itself is now suffering extensive collateral damage from the GFC, with growth forecasts for 2009 and 2010 all marked down sharply for China, India, and Emerging Asia overall. Sure, the current forecasts for Emerging Asia still

call for positive economic growth this year in contrast to the outright contraction anticipated for the developed world, but this is of only limited comfort. The GFC has driven a stake through the heart of the decoupling thesis – the proposition that the rest of the world in general, and emerging Asia in particular, would be only lightly affected by a major downturn in the United States.

Another important question that will be asked through 2009 and beyond is the resilience of political systems across the region (and beyond) in the face of a substantial economic downturn. One lesson of the 1997-98 financial crisis is that the feedback effects between economic and political shocks can have important consequences for medium-term growth prospects (Indonesia being an obvious example here).

An even more important question relates to how the crisis is likely to change the nature of the world economy in the longer term, and in particular, how the consequences of stories #4 (the return of the state) and #3 (second thoughts) influence the outcome. One of the key features of the world economy in recent years is that in many ways it has been particularly congenial for many emerging markets. That is, the international economic environment has been very helpful in terms of facilitating the Great Convergence. This is *not* to say that external conditions have been the driving factor behind economic success in a China or an India – clearly domestic policies and the potential for catch-up growth have been at the heart of the story. Nor is to suggest that there haven't been important downsides to the way the world worked, such as volatile international capital flows. Soaring commodity prices had also provided their own challenges. Nevertheless, the external environment considered overall has been a positive for convergence. So if the financial crisis does turn out to trigger a fundamental change in the way the world economy operates, it is not obvious that this will *necessarily* result in an acceleration of the convergence process. It may well do so. But it is also quite easy to tell stories in which the opposite is true: a world economy marked by more protectionism, slower growth, and greater economic nationalism is very unlikely to be one that is going to stimulate rapid convergence (except insofar as we might all fall down together).

Despite these risks, however, the most likely outcome is 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. There is certainly still plenty of scope for rapid economic growth across most of the region's economies. Still, it is not a foregone conclusion.

Conclusion

The global financial crisis is changing the world economy but it won't change everything. In some cases – the shift back to a relatively greater role for government in the world economy and the rethink on how globalisation works – it will actually serve to accelerate or deepen transformations that were *already* underway. In others – such as the challenges afforded by a resource-constrained world – it will offset or mitigate previously existing trends, although this will very probably turn out to be only a temporary reprieve.

The honest answer to the question as to whether 15 September 2008 will end up marking the start of a new economic era in the way that other dates have – 28 June 1914 for the start of the First World War and effectively the end of first global economy, or 9 November 1989 and the fall of the Berlin Wall for the birth of the second global economy – is that we don't know yet. The great economist John Maynard Keynes is reported to have said 'When the facts change, I change my mind. What do you do sir?' Well, at the moment the 'facts' (although in some cases these turned out to have been something closer to assumptions) are changing thick and fast. So we should not be surprised if we end up frequently changing our minds about the future of the world economy over the course of the coming year.

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