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Chapter Author(s): Martin Wolf

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Afterword
How the Financial Crises Have Changed the World

Martin Wolf

The past is a foreign country. Indeed, even the recent past is a foreign country. The crisis that broke upon the world in August 2007 and then caused a widening economic malaise in the high-income countries and turmoil in the eurozone put these economies into a state previously unimagined by the overwhelming majority of well-informed policymakers.

In 2004, in a celebrated speech on what economists then complacently called the "great moderation," no less a man than Ben Bernanke, then still governor of the Federal Reserve, talked not of looming financial crisis and economic malaise, but of enduring economic stability attributable to good monetary policy. Just listen to what he said: "[I]mproved monetary policy has likely made an important contribution not only to the reduced volatility of inflation (which is not particularly controversial) but to the reduced volatility of output as well."[1] Yes, the reduced volatility of output! We now know a great deal more about that.

Today, such complacency seems worse than quaint. The policy establishment failed to understand how the economy worked, largely because it failed to understand financial risk, and it failed to understand financial risk, partly because it failed to understand how the economy worked. Yet the unexpected turmoil has done more than make the orthodox views of even a few years ago look as dead as the dodo. It has changed the world. Here I consider ten ways the world has changed.

Martin Wolf is chief economics commentator of the *Financial Times*, London.

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1. Ben Bernanke, "The Great Moderation," February 20, 2004, http://www.federalreserve.gov/boarddocs/speeches/2004/20040220/default.htm.

1. Economic Transformation

Start with the obvious. By 2012, the world economy had turned out to be very different from what most people imagined it would be six years before. In the important high-income countries, output was far below previous trends and rates of growth far below what had previously been considered their potential. In only two of the six largest high-income economies—the United States and Germany—were levels of activity above their precrisis peaks. Indeed, in Japan, Italy, and the UK, output was still well below those precrisis peaks. The concern that a prolonged malaise—similar to the lengthy sickness that had overcome Japan over the past two decades—had hit the high-income countries was, alas, growing ever more credible. Maybe the outcome would turn out to be even worse than in Japan.

Meanwhile, emerging economies proved highly resilient. They managed to sustain growth, partly by replacing the external demand they had lost with domestic stimulus. Unquestionably, this worked, remarkably so in China. But such actions also left a difficult legacy: low-quality investments, asset price bubbles, and bad debts. These actions may, for these reasons, be unrepeatable, possibly even unsustainable. At the same time, the emerging countries could not return to the export-led growth cum reserve-accumulation strategies followed by many of the most successful, prior to the crisis. The weakness of private demand within high-income countries precluded that. In all, the legacy of the crisis included deep challenges to policymaking pretty much everywhere.

Furthermore, these crises accelerated a transition in economic power and influence that was already under way. Between 2007 and 2011, the gross domestic product of the high-income countries, in aggregate, rose by a mere 1.1 percent, in real terms (at purchasing power parity), according to the International Monetary Fund, with that of the United States rising by 0.8 percent, and that of the eurozone falling by 0.7 percent. Over the same period, the real GDP of the emerging countries grew by 25 percent and those of India and China by 34 and 45 percent, respectively.

Such a speedy transformation in relative economic weight among countries with large economies is surely without precedent. It has become extremely plausible that China's economy will be the biggest in the world, at purchasing power parity, by the middle of the present decade, and the biggest in market prices by the early part of the next decade, at the very latest. The crisis did not create this transformation. That was already well under way. But surely it accelerated it. Recall also that the combination of a huge financial and economic crisis with a transformation in relative economic power happened in the 1930s. The world failed to manage that challenge altogether. Will it manage to do better this time?

2. Fiscal Deterioration

As a result of these unexpected developments, the crisis-hit countries found themselves struggling with far worse fiscal positions than they had previously imagined. Indeed, for the United States and the United Kingdom, the economic and fiscal costs rank almost with those of world wars. Net fiscal debt as a share of GDP is bound at least to double, in both of these cases. The outcome may well turn out to be far worse than that. In this respect, too, they found themselves following the precedent set by Japan.

As the work of Carmen Reinhart and Kenneth Rogoff, both now at Harvard University, has shown, fiscal crises are an inevitable consequence of financial crises, largely because of the impact on government revenue and spending of declining profits, falling economic activity, and rising unemployment. These come on top of direct fiscal costs of bank bailouts.[2] In the case of the current crisis, as was to be predicted, the biggest adverse fiscal effects were felt in the countries that suffered a direct hit from the financial crises, such as the United States, United Kingdom, Ireland, and Spain, rather than in countries that suffered an indirect hit, via trade. Worse still, the longer-term fiscal position of the crisis-hit countries was always likely to be difficult, because of aging. Now the legacy of the crises will curtail any fiscal room for manoeuvre. In this respect, then, the crisis has accelerated a grim future into the unhappy present.

3. Monetary Transformation

Along with the fiscal impact of the crisis has come a monetary upheaval that is even bigger. In today's credit-based system, central banks are supposed to regulate the price of money, while the central bank and government ensure the convertibility of "deposit money" into "government money," at par, by acting as a lender of last resort (in the case of the central bank) and provider of overt or covert insurance of liabilities (in the case of the government). But the supply of money itself is normally a by-product of the private creation of credit. In the postcrisis world, this is no longer true. Central banks have gone far beyond standard operations to support the provision of credit and ensure an adequate supply of money. They have also gone far beyond lowering their official intervention rates to the lowest levels ever seen: in late 2012, the highest intervention rate employed by one of the four large western central banks was the European Central Bank's 3/4 percent. They have enormously expanded their balance sheets, includ-

2. See Carmen M. Reinhart and Kenneth S. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (Princeton, NJ: Princeton University Press, 2009), 231–32.

ing by purchasing vast quantities of government bonds, with controversial long-term effects. Perhaps even more remarkable, such policies were in effect for years, with only modest effects on economic activity. The apparent ineffectiveness of monetary policy may be a more significant feature of the postcrisis world than the extreme nature of the expansionary policies actually adopted. If one wants to understand why monetary policy has proved so ineffective, one must start by appreciating the implosion of the financial system.

4. Financial Upheaval

The most obvious of all the changes is, indeed, the transformed position of the financial system. The crisis established the dependence of the world's most significant financial institutions on government support, along with the troubling existence of institutions that are too big or too interconnected to fail. The response to the crisis confirmed the previously controversial view that the financial system is rather a ward of the state than a part of a free market economy. The crisis itself has demonstrated the fragility of the financial system. As a result of all this, it has inflicted huge damage on the credibility of the global financial system and, above all, of "Anglo-Saxon financial capitalism." One consequence is that the financial system is being forced through substantial and controversial reforms. Another is that a debate about the proper role and structure of the financial industry is inescapable. Yet another is the marked decline in the willingness of emerging economies to integrate into the global financial system. Moreover, the financial system had not yet recovered in 2012. Finally, the prospect of a long period of subdued credit growth makes a prolonged economic slowdown probable.

5. Ruin of Western Prestige

As a result of the crisis, the established high-income countries suffered a huge loss of prestige. These countries, above all, the United States, remained dominant throughout the post–World War II era, even though they counted for an ever smaller share of the world's population. This was partly because they had the largest economies and so dominated global finance and trade. It was also partly because they controlled the global economic institutions. However much the rest of the world might have resented the power and arrogance of the high-income countries, it trusted that, by and large, they knew what they were doing, at least in economic policy. The financial crisis and subsequent malaise have proved this confidence misplaced. Worse, because of the relative success of China's state capitalism, the blow to the prestige of Western financial capitalism even carried with it a related blow to the credibility of Western democracy.

6. Global Economy Upended

Among the most important features of the precrisis global economy—indeed, one of the causes of the crisis—was the huge net flows of capital from emerging economies into supposedly safe assets in high-income countries. Moreover, the governments of emerging countries organized these flows themselves, largely as a direct result of their massive interventions in currency markets and consequent accumulations of foreign currency reserves. These reached over $10 trillion in 2012, quite apart from around $4 trillion in sovereign wealth funds. The presence of these currency reserves helped emerging countries survive the crisis without undue difficulty. Even so, they were almost certainly excessive: aggregate global currency reserves fell by just $472 billion between July 2008 and February 2009, which was only 6.3 percent of the initial stock.

The recycling of current account surpluses and private capital inflows into official capital outflows was also surely one of the causes of the crisis. Indeed, one of the consequences of the global "savings glut," of which these flows were a symptom, was a sharp decline in the real rate of interest on the liabilities of triple-A rate governments in the late 1990s, in the immediate wake of the Asian financial crisis. This shift also triggered the rise in the prices of long-lived real assets, notably of housing and commercial real estate, which also began at that time in a number of high-income countries, notably the United States, the United Kingdom, Spain, and Ireland. The fall in real interest rates also generated a strong demand for notionally safe, but higher-yielding, securities. The highly liberalized and ever-ingenious financial sector was only too happy to create such pseudo-triple-A securities, in vast quantities, via the invention of asset-backed securities and, in particular, collateralized debt obligations, which were supported by apparently ever-rising house prices. This new form of finance supported the ultimately unsustainable asset-price bubbles that encouraged both strong investment in residential and commercial construction and high household consumption. These, in turn, temporarily generated the demand that absorbed the surpluses of desired savings over investment in large parts of the world economy.

The financial crisis brought this apparently benign, but, in fact, entirely unsustainable source of global demand to an end. It cannot be resurrected. The high-income countries have clearly proved themselves unable to use these inflows effectively. Currently, the place of the precrisis financial deficits of the household sector has been taken by fiscal deficits that few believe are sustainable indefinitely either. Thus, what was destabilizing before the crisis is almost certainly unsustainable after it.[3]

3. The role of the global imbalances in the crisis was the theme of Martin Wolf, *Fixing Global Finance* (Baltimore and London: Johns Hopkins University Press, 2008 and 2010), especially

The natural and, it appears, most desirable flow of capital is "downhill," from rich to poor countries, not "uphill," from poor to rich ones. Even so, the fact that the poorer countries fear the impact of capital inflows means that creating a world in which capital flows in an appropriate direction may require large reforms in the global financial and monetary architecture. Yet this is a challenge that must, somehow, be met.

7. Globalization Threatened

The crisis has also endangered globalization. This is true, above all, of the globalization of finance. Taxpayers have bailed out institutions whose business is heavily abroad. Similarly, they have been forced to protect financial businesses from developments elsewhere, including those caused by regulatory incompetence and malfeasance. This is—or should be—politically unacceptable. Broadly, some combination of two possible outcomes seems possible: *less* globalized finance or *more* globalized regulation. This dilemma is particularly marked inside the eurozone, as Adair (Lord) Turner, chairman of the UK's Financial Services Authority, has noted. This is because financial markets are more integrated and national policy autonomy is more limited than elsewhere.[4] Yet the same is also true, to a degree, for the world as a whole, where tension arises between a drive to agree to common regulatory minima and a desire to preserve domestic regulatory autonomy.[5]

The pressure for "deglobalization" may prove not to be limited to finance. The combination of extraordinarily weak growth with widening inequality, high unemployment, financial instability, the so-called "currency wars," and fiscal defaults may end up undermining the political legitimacy of globalization in many other respects as well. Certainly, the crisis has eroded the optimism many once felt about how an integrated global economy would work.

8. Global Governance Challenged

Inevitably, the legacy of the crises includes large-scale institutional changes in many areas of policy and at national, regional, and global levels. The obvious areas for reform are financial regulation, the functioning of

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Chapter 8 of the revised edition. See also Òscar Jordà, Moritz Schularick, and Alan M. Taylor, "Financial Crises, Credit Booms and External Imbalances," National Bureau of Economic Research Working Paper no. 16567, December 2010, www.nber.org, and Alan M. Taylor, "The Great Leveraging," National Bureau of Economic Research Working Paper no. 18290, August 2012, www.nber.org.

4. Adair Turner, "Financial Risk and Regulation: Do We Need More Europe or Less?", April 27, 2012, Financial Services Authority, http://www.fsa.gov.uk/library/communication/speeches/2012/0427-at.shtml.

5. Another example of "deglobalization" is the proposed ring-fencing of domestic retail banking from global investment banking proposed by the UK's Independent Commission on Banking, of which I was a member. This was set up by the incoming Coalition Govern-

the monetary systems, global governance, and global economic institutions. Substantial reforms are under way. But big questions remain unaddressed and unresolved, notably over the global monetary and exchange-rate regimes. One of the main reasons the emerging countries decided to accumulate reserves was their fear of the consequences of becoming net borrowers. That, in turn, was the result of painful experience in waves of previous financial crises, culminating in the Asian crisis. The implication may be that the only countries in a comfortable position when running large current account deficits are ones with reserve currencies they can create at will. But that, in turn, means they must be running policies that generate large financial deficits in the private or fiscal sectors of their countries. That, too, as we have seen, can end in terrible crises. To avoid such crises would require a system of collective insurance. But agreeing on that is probably impossible.

A revealing institutional step, taken early in the crisis, was the shift from the group of seven leading high-income countries as the focus for informal global decision making to the group of twenty—a shift that brought with it an increase in relevance at the price of a reduction in effectiveness. This is just one aspect of the complications created by the need to take account of the views and interests of more players than ever before.

9. Europe Shocked

Whatever happens at the global level, the crises have created an existential challenge for the eurozone and so for the European "project." It seems clear that, without substantial changes in policy and substantial longer-term reforms, the eurozone will lose members or even dissolve altogether. That would mark the first time that the European project had gone backwards, with dire consequences for the prestige and credibility of European integration. Such a breakdown would also reflect—and exacerbate—a breakdown in trust among the peoples and countries of Europe, with devastating consequences for their ability to manage common challenges, sustain a cooperative approach to the problems of Europe, and act effectively in the wider world. Such a reversal would certainly imperil the single market. It might destroy the European Union.

Even if everything is ultimately resolved successfully, Europe is doomed to become inward looking and distracted for many years, with dire consequences for European influence. If everything is not resolved, the collapse of the European model of integration would permanently shatter the credibility of what was, for all its faults, the most promising system of peaceful international integration there has ever been.

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ment under the chairmanship of Sir John Vickers. See Independent Commission on Banking, *Final Report: Recommendations*, September 2011, London, http://bankingcommission.s3.amazonaws.com/wp-content/uploads/2010/07/ICB-Final-Report.pdf, chapter 3.

10. Ideas in Question

Yet perhaps the biggest way in which the successive financial, economic, and European crises have changed the world is intellectual. They have shown that established views of how (and how well) the world's most sophisticated economies and financial systems work were, quite simply, nonsense. The great moderation masked a lack of financial moderation that would ultimately cause great devastation. Indeed, as Hyman Minsky would argue, the financial immoderation caused the delusion of the great moderation. Similarly, it is quite clear that stable inflation does not begin to be a sufficient condition for economic stability.

These brutal facts pose an uncomfortable challenge for economics and an equally uncomfortable challenge for economic policymakers—central bankers, financial regulators, officials of finance ministries, and ministers. In the last resort, ideas matter. Both economists and policymakers need to rethink their understanding of the world in important respects. The precrisis conventional wisdom, so aptly captured in Mr. Bernanke's speech about the contribution of improved monetary policy to the great moderation, stands revealed as complacent, if not incompetent and vainglorious. The world has indeed changed. The result has to be a ferment of new ideas. Yet what we see, instead, is more a clash of old ideas—Keynesians, both established New Keynesians and radical post-Keynesians, against monetarists, and both Keynesians and monetarists against New Classicals and Austrians. The world needs something better from economists. It is not clear that it will get it.

Opportunity and Challenge

The opportunity of securing a more prosperous and integrated global economy remains. But the challenge of achieving it seems far more difficult than prior to the crisis. It looks, indeed, as though we have a choice between deeper global cooperation or less globalization. We cannot continue with countries making up their own minds on exchange rate and monetary policies, or on financial regulation. The spillover effects have turned out to be too damaging.

It is easy to see how far the financial crises have changed the world. It is far more difficult to know what to do about it. The challenges are extraordinarily complex. But somehow we must rise to the challenge. If not us, who? If not now, when?