How the crisis catapulted us into the future

By Martin Wolf
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Did the financial crisis change very much? That was my question as I went to the annual meeting of the World Economic Forum in Davos last week. The answer is: yes. Above all, it has accelerated the arrival of our future. Even for the winners, this is quite a shock.

It is three and a half years since the financial crisis began and a little more than two years since it reached its worst. Bob Diamond, chief executive of Barclays, gave the financial sector's thanks to governments for the rescue. Now the mood is one of wary optimism. According to the International Monetary Fund's World Economic Outlook update, global output grew in 2010 by 5 per cent, at purchasing power parity, and 3.9 per cent, at market exchange rates. This contrasts with declines of 0.6 per cent and 2.1 per cent, respectively, in 2009. The IMF expects growth to slow only slightly to 4.4 per cent at PPP and 3.5 per cent at market exchange rates, in 2011. Optimism continues to reign.

With the crisis fading into memory, how will historians assess its legacy? Journalists do not have the luxury of distance. So here are my guesses. I will start with possible turnrounds.

The crisis was neither the beginning of a depression nor the end of capitalism. But it has caused a tightening of financial regulation, particularly of banks, though this has occurred within the pre-existing intellectual and institutional framework. After three decades of deregulation, movement is in the opposite direction, though not without resistance.

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The crisis has also marked a turnround in private leverage in high-income countries. The ratio of private gross debt to US gross domestic product rose from 123 per cent in 1981 to 293 per cent in 2009. By the third quarter of last year, the ratio had fallen to 263 per cent. The financial sector led the way in both directions: gross financial sector debt rose from 22 per cent of GDP in 1981 to 119 per cent in 2008. It was down to 98 per cent in the third quarter of 2010. Deleveraging will probably continue. Even if it does not, another such period of rising leverage seems inconceivable.

In the short term, at least, the crisis also marked a reversal of the "global imbalances", as the WEO update notes. The IMF expects a partial backtracking, though the scale of the imbalances should not be what it was before the crisis. One salient feature of those imbalances – the accumulation of foreign currency reserves, particularly by China – has not altered: between February 2009 and October 2010, foreign currency reserves rose by $2,004bn, of which China alone accounted for $849bn. This is perilous.

The crisis also revealed the vulnerability of the eurozone to excessive accumulations of private and public sector leverage, caused by floods of surplus savings into bad investments via undercapitalised financial institutions. Managing the deleveraging will be very hard, particularly without internal exchange rate flexibility.

Now let us move to where the crisis has been far more an accelerator.

The most obvious change is fiscal. Every well-informed person knew that ageing would generate a fiscal squeeze in high-income countries as spending rose and growth slowed. The crisis has brought this forward by a decade. According to the IMF, general government net debt of the Group of Seven high-income countries will jump from 52 per cent of GDP in 2007 to 90 per cent in 2015. This does not mean hyperinflation or default. But managing public finances will govern politics for the foreseeable future. It will be a miserable experience.

Just as important is the accelerated shift in the global balance of economic power. If one were to set GDP at 100 in 2005, it was 105 in the US in 2010, 104 in the eurozone and 102 in Japan and the UK. But in Brazil it was 125, in India 147 and in China 169. "Crisis? What crisis?" That must be the response in China and India.

According to the IMF, the share of advanced countries in global GDP at PPP was 63 per cent in 2000. It was 56 per cent in 2007, on the eve of the crisis. It was 53 per cent last year and will fall below 50 per cent in 2013. China and India account for 80 per cent of the rising share in world output forecast for emerging countries between 2000 and 2013, with China alone accounting for 63 per cent. The growth of these giants has been accompanied by pressure on natural resources. That also can only grow.

What the crisis has accelerated even more sharply is a shift in attitude towards the west and the US, in particular. As Kishore Mahbubani, dean of the Lee Kuan Yew School of Public Policy at the National University of Singapore, has noted, Asians no longer respect the west's competence, battered as it has been by military misadventure and then financial mishap. Along with the changing attitudes has come changing responsibility. The shift from the G7 and G8 to the G20, at the peak of the crisis, symbolised that transformation. This would have happened anyway. But it happened far faster, as a direct result of the crisis.

What struck me even more at Davos is the uncertainty that the crisis has both revealed and caused. While the mood is more optimistic, it is also full of doubts. I had a long private discussion of whether the US would avoid the fate of Japan. This is regarded by most people as inconceivable. Yet back in, say, 1993 few expected Japan's lengthy malaise either. How the private sector deleveraging is to occur, without mishap, is far from clear. The chance of renewed economic weakness is large. So is that of financial shocks, perhaps in response to fiscal concerns. Again, the mood about the eurozone is now more optimistic. But how the zone is to exit from its difficulties remains obscure. European leaders have willed the end: survival of the eurozone. Whether and how they can will the means is still unknown.

The fact that the crisis has catapulted the world into its future also creates huge uncertainties. Some of my most interesting discussions were over whether China has clear plans for the global economic and political systems. A well-connected Chinese scholar assured me the answer is no. Yet, provided China is able to sustain its rapid growth, this colossus will have to develop its own ideas quite soon. It has earned its greatness. Now, after the crisis, it is, willy-nilly, having responsibility thrust upon it.

The crisis has not proved a great turning point, so far. But we cannot conclude that it is of small significance. It has brought some transformation, much acceleration of previous trends and, above all, great uncertainty. That uncertainty was present all along. But now we know.

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