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The Crisis and the Future of the World Economy[1]

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The recovery from the current crisis is unlikely to be quick, strong and complete, particularly in the developed world. Why not? Because the crisis is complicated by several structural problems in the world economy. These include an unsustainable growth model, financial excess, and a global power shift. Let me briefly discuss each of these three problems.

For the past several decades the world economy was sustained by the peculiar combination of US household consumption and savings in the rest of the world, particularly in Asia. This created a virtuous circle of goods and money, but has also built up an ever-growing global imbalances. The crisis and its aftermath have made it clear that the US cannot continue to consume by borrowing more, and Asians cannot continue to grow by investing and exporting ever more. The growth model has become unsustainable. However, the adjustment will not come easily; it will require changes of macro-economic policy, industrial structure, and people's life style. In many cases these changes are politically not welcome. Also, when the economy is recovering from crisis, suppression of consumption and exports can be extremely controversial. Yet, the world

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will need a period of slower growth, for failure to adjust could trigger an even bigger crisis later.

The role of finance in all economic activities has grown so prominent during the last two decades. Finance, which used to play merely a supporting role for the economy, has become the master of the world. Factors which prompted this development are not difficult to identify. First, abundant liquidity was created by the generally easy monetary policy and the growing global imbalances. Second, through the process of globalization, the world has become a huge single financial market which has tremendously boosted financial activities. Third, dramatic progress in computer technology paved the way for financial engineering and led to the creation of a whole variety of new products and services. Particularly noteworthy was the development of securitization and derivatives which radically altered the nature of financial transactions. And last but not least, the global addiction to greed.

The economy, having gorged on finance, inevitably carried a high risk of excess leverage. The collapse of the sub-prime loan market in early 2007 was the match that lit the tinderbox.

It must also be noted that regulators around the world, particularly in the US and Europe, were not aware of the sea-change that took place in the world of finance. In spite of the fact that there were new markets, new products, and new players, regulators were unprepared. Indeed, they were busy deregulating. Until Lehman Brothers collapsed, regulators were incredibly relaxed, but Lehman’s collapse caught them off guard and spurred them into action. They spent trillions of dollars to protect the financial system.

Everybody agrees there was financial excess, but what should be done? Is it sufficient to establish a new code of conduct, or is it necessary to change the structure of the financial services industry? Nobody would deny that new services and products do help to manage risk and facilitate the market. But the real problem is that those commodities were created and traded not for the genuine purpose of risk management or market facilitation but for the naked purpose of making money. Can we trust people to remain within the boundary of moderation? The crisis of 2008 taught us that markets are not always perfect. The principle of market efficiency is that the market will perform best when everybody is allowed to try to maximize profit. However, we learned that the market sometimes fails to adjust itself and can get carried away. While I strongly believe that the market economy is the best, we need to instill certain additional virtues into the principle of market capitalism. First, economic society is built upon our adherence to written contracts. Yet, we need to bolster it by mutual trust. A contract without trust is a monster, many of which went on a rampage during the crisis. Second, competition is the source of innovation, improvement and development. Yet, we need to maintain a sense of modesty and compassion.

In the early days of market capitalism in North America, Europe and Japan, pioneers of capitalistic businesses spent many soul-searching nights trying to assimilate these virtues with the act of profit-making. They reached their own answers and carried them out. This is what our forefathers actually did; it is not merely ethical preaching.

The shift in power is a popular topic these days. It implies that the center of global power is shifting from the West to Asia, and more specifically, that the US is losing its hegemonic power to China. The phenomenal ascendancy of China has become a global issue. The sense of urgency was heightened by the current crisis because, on the one hand, China skillfully managed its recovery and came out as a stronger and more assertive global player. On the other hand, the credibility of the US financial market was dented by the ever-growing external debt of the US, and concerns have risen about the US dollar’s position as a key currency.

China is growing strongly, and it still has enough power and space to grow. Today, China's national policy objectives are threefold: the first is to make the country bigger and stronger, the second is to secure domestic political and social stability, and the third is to maintain world peace. If China continues to grow at 7% p.a. for another 20 years, even without any appreciation of the RMB, its GDP will surpass that of the US today, and its per capita GDP will reach roughly the level of Korea today.

How long can China continue its rapid growth? There are two major risks. One is demographic aging. The other is the increasing pressure of growth constraints which include water, energy, raw materials, environmental preservation, and competition with other Asian nations such as India, Vietnam, and Indonesia. It would be prudent to predict that China’s growth rate will slow to around 5% p.a. sometime between 2020 and 2030.

I do not consider it meaningful to ask whether China will replace the US as the world's hegemonic power in 50 years time. Such a question simply stirs up too many misguided and irrelevant debates. However, it is clear to me that before China, or indeed any other country, can become the global leader, it must be committed to an ideology with which to lead the world and which is accepted by the world. China does not yet possess the ethos of a global leader.

Nevertheless, it is obvious that the global balance of power is changing and the world is becoming multipolar. This multipolar structure is likely to stay with us for a long time. This means we must live with continuing instability and volatility in currencies, trade and investment. Under such circumstances, it is crucial to enhance coordination among countries and between developing and developed worlds. All countries need to be convinced that national interests are achievable in the long run only within the framework of multilateral cooperation. The world has accomplished many remarkable successes since the end of the Second World War. It is not a time for cynicism; rather, it is a time for realism and optimism.

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