Choongsoo Kim: Returning to sustainable growth – an EME's perspective

Special speech by Mr Choongsoo Kim, Governor of the Bank of Korea, at the G20 High Level Seminar on "Returning to sustainable growth – an EME's perspective", Mexico City, 24 February 2012.

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Fellow governors and finance ministers, and ladies and gentlemen.

It is a great honor and pleasure to speak at this high-level seminar. I am grateful to Secretary Meade, Governor Carstens, and Managing Director Dallara for inviting me to deliver this special address.

The recent global crisis has cast a long shadow on financial and real activities worldwide. The financial disruptions and severe recession following the crisis hit both sides of the Atlantic, and at the same time triggered negative spillovers to EMEs, many of which were mere innocent by-standers. The euro area debt crisis, and its threat to financial stability, was the culmination not only of the structural imbalances within the euro area itself but also of a complex web of real and financial linkages that had not been well understood. The global crisis also revealed a number of shortcomings in our financial system, ranging from inadequate regulatory frameworks for addressing systemic risk to under-regulated cross-border capital flows.

Over the past three years or so, the international community has discussed possible solutions to improve stability and resilience of the global financial system. And notable progress has been achieved on multiple fronts, including formulating a strengthened regulatory framework and laying the foundation for reform of the international monetary system under G-20 leadership. No doubt more challenges remain in our search for durable global financial stability. In this respect, the G-20 must continue to be the locus of international cooperation and policy coordination.

As we enter our fourth year since the crisis, however, I would argue that the time is now ripe for renewed attention to sustainable growth. Financial stability – or more broadly macroeconomic stability – is of course a prerequisite for sustainable growth, but the converse is also true. In other words, the real and financial linkages involve a two-way traffic. And indeed, it is hard to imagine that the highly indebted countries in Europe will be able to successfully put their public finances on sustainable footings if their growths remain stagnant.

From this perspective, global financial resources may have in recent years been directed too much toward the financing of unsustainable fiscal deficits in debt-ridden countries, and too little toward growth. I believe that the redirecting of financial resources more toward growth – more specifically, toward countries with high productivity growth – could yield substantial stability benefits to all in the long run.

Despite some irregular signs of economic recovery in the United States, the most recent economic outlook by the IMF points toward slower economic growth this year in advanced economies, particularly those in Europe. Emerging market economies are also projected to face growth deceleration.

A challenging question at this juncture would therefore be what it would take to lift the global economy out of growth recession and return it onto a path of sustainable growth.

Greater role of EMEs in reviving growth

I believe that active macroeconomic policies played an essential role in containing the global crisis, and saved us from repeating the same mistakes our predecessors made some eighty years ago. But I am suspicious that more macroeconomic stimulus by advanced economies can be a solution to reviving growth going forward. The financial markets are already flooded with liquidity, but in the midst of high uncertainty and financial deleveraging its effects in boosting investment and consumption still fall short. In fact, the available policy space may be quite limited in advanced economies, where interest rates are already near zero and fiscal consolidation is necessary to keep sovereign debt sustainable.

In this respect, I see a greater role for EMEs. They weathered the global crisis relatively well, with few scars in their real or financial sectors. Their public finances are generally stronger than those of advanced economies, and their inflationary pressures are now adequately contained. These features of EMEs grant them substantial policy space for stimulating growth in the short run.

One may argue that EMEs where inflation is well under control should therefore not hesitate to use the policy space available to them to address the downside risks to growth. But the reality is far more complicated than it appears. There is substantial tail risk associated with the euro area debt crisis, which if it materializes could wreak havoc on EMEs. This will make EMEs more cautious in using their available policy space for growth right now. Rather, they might wish to preserve it for a much worse scenario.

It is thus crucial, for reviving growth, to defuse the euro area debt crisis by putting in place credible fiscal plans. I am hopeful that the recent positive developments related to the Greek bailout program will translate into a sharp reduction in the financial uncertainties now facing EMEs.

Reforms for sustainable growth

Let me turn to the issue of how to return to sustainable growth.

Reviving growth following recession and returning to sustainable growth are of course not one and the same. The latter will require comprehensive reforms – in both advanced and emerging countries.

And again I see greater scope here for EMEs, particularly emerging Asia, to lead the way back to sustainable growth. To be specific, EMEs contributed about 40 percent to world GDP growth during the globalization period of 1986–2007, compared to 27 percent for the pre-globalization period of 1973–1985. More recently, emerging Asia alone accounted for 50 percent of world GDP growth during 2006–11. And IMF projections suggest that the growth contribution of emerging Asia will continue at around 50 percent for the next five years. These are not surprising in that EMEs are well positioned to undertake high investment for growth along their catch-up process which is not yet completed.

But this large contribution to global growth masks important risks to EMEs, in leading the return to sustainable growth. Many EMEs rely heavily on external demand for growth, and therefore will face challenges going forward if advanced economies do not grow fast enough. Over a longer horizon, the export-led growth strategies of large EMEs will be unsustainable, given their implications for the global imbalances. This suggests that EMEs need to rebalance their growth, toward a greater share driven by domestic demand.

Another risk facing EMEs is financial vulnerability. Liberalization of their capital accounts has exposed these countries to the vagaries of financial shocks of external origin, while their underdeveloped domestic financial markets offer little scope for hedging. Indeed, financial crises have often interrupted the otherwise steady growth trends of many EMEs.

Advanced countries of course also face significant risks to sustainable growth. Their high and rising public debts undermine not only financial stability but also growth. Evidence suggests that public debt above 85–90 percent of GDP tends to affect growth negatively. High long-term unemployment will lead to permanent losses of productive human capital. More recently, rising unemployment and income inequality have compromised social cohesion in these countries. Last but not least, the euro area has and will remain vulnerable to growing structural imbalances between its core members and its periphery.

Based upon these observations, I would like to touch briefly now on several reform agenda that I believe could help us to return to sustainable growth.

First, fiscal and financial regulatory reforms

There is no question that fiscal reform should be the first priority, and mark the starting point of any reform sequence in debt-ridden advanced economies. But EMEs also need to prepare for approaching fiscal challenges associated with population aging and growing demand for social welfare. As to financial regulatory reforms, they have been extensively discussed and formulated into the Basel III policy framework. And for this reason, I will not discuss them further here.

Second, more and better financial integration by EMEs

We all know that trade integration has enabled many EMEs to grow rapidly and accelerate their catch-up processes. I believe that financial integration can do the same for EMEs, by improving resource allocation within and across countries and offering greater liquidity and risk hedging. The diverse development stages and demographics of EMEs offer very fertile ground for efficiency gains from financial integration. These gains can of course be reaped only if the attendant systemic risk is adequately controlled. But the strengthened Basel III framework will render financial integration by EMEs more opportune going forward.

Third, structural reforms to promote domestic demand

Promotion of domestic demand helps to diversify the sources of growth, and thereby yields stability gains for EMEs. Empirical evidence indicates that economic growth in EMEs is not related to the size of the trade surplus, or even to the volume of exports, but rather to the output of industrial products. And as long as domestic demand is sufficient to accommodate it, EMEs can attain sustainable growth by expanding their industrial economic activities.

While the list of possible reforms to achieve this is long, I would like to highlight here the effects of domestic financial development and social safety nets. A recent study finds that their underdeveloped financial systems could be a cause of the high savings rates in Asian EMEs. With limited access to financial markets or opportunities for diversification, firms tend to retain their earnings for future investment and households to increase their precautionary saving. These tendencies dampen private consumption. Incentives for precautionary saving will be even stronger, I should add, if the social safety net remains relatively weak.

Finally, strengthening the global financial safety nets (GFSNs)

The large literature on economic development suggests that the quality and volume of financial intermediation matters a great deal for long-run growth. Existing studies also show that leveraged risk-taking enhances growth. It does of course also bring about undesirable side effects, such as recurring financial crisis, but a review of the evidence indicates that the growth-enhancing effects dominate.

In the context of EMEs, financial intermediation for growth has involved significant amounts of cross-border transactions. And as a result, one of the most pressing issues facing them is how to guard against the contingent risks of negative spillovers from advanced economies. Improved oversight of capital inflows and macro-prudential regulations will help to address the danger of global liquidity surges, and the attendant risk of asset price bubbles.

But emerging economies will still remain vulnerable to sudden reversals or disruptions of global liquidity. Enhanced protection against such global liquidity disruption would facilitate their promotion of financial integration as a new source of growth. The existence of well-functioning global financial safety nets would also help to reduce EMEs' temptations to pile up large volumes of foreign reserves for self-insurance, and thereby mitigate the problem of the global imbalances.

Concluding remarks

Let me conclude.

The G-20 was pivotal in coordinating the macroeconomic policies adopted to address the global crisis, and it has since made great contributions to framing the reform agenda for financial stability and to formulating effective policy solutions as well.

Despite this great success, however, the G-20 now faces an even greater challenge – that of finding solutions to lead our return to sustainable growth. This is particularly challenging given our lack of sufficient knowledge to serve as a guide. Country experiences of sustainable growth are too diverse to draw universally applicable and time-invariant lessons. And the theoretical underpinnings of sustainable growth seem too abstract to offer practical guidance for reforms.

I am confident, however, that collective wisdom and creative thinking will ultimately emerge. I hope that the G-20 agenda under Mexico's Chairmanship will be a turning point in our search for solutions to achieving sustainable growth and global prosperity in the years ahead.

Thank you for your attention.