

Choongsoo Kim: Challenges to the further advance of the Asian economy following the global financial crisis

Dinner speech by Mr Choongsoo Kim, Governor of the Bank of Korea, at the 12th International Convention of the East Asian Economic Association (EAEA), Seoul, 2 October 2010.

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It is a great pleasure and privilege to stand before you all today, to deliver this dinner speech to such renowned economists gathered for this 12th international convention held by the East Asian Economic Association, a leader in studies of the East Asian economy for the last 20 years. I should like to express my deep thanks to all members of this eminent academic circle, including your esteemed chairman, Jang-Hee Yoo, for so graciously inviting me to share this occasion with you.

As all of you here know well, a shift of wealth in the world economy is already underway. The shift is from Western to emerging economies, particularly in Asia, and it will accelerate in the future. According to a study by Professor Angus Maddison, in real PPP terms Chinese GDP is projected to surpass that of the US by 2015, and the sum of Chinese and Indian GDP will be double US GDP by 2030.¹ From this observation, we can easily infer how fast the Asian economy should grow relative to the rest of the world economy in the future. This is not such a surprise if we recall that, for eighteen of the past twenty centuries, Asia has produced over half of world output.² And given this, it is to be taken for granted that Asian, and particularly East Asian, economies, have contributed so greatly to the world economy's recovery from the global financial crisis. In this regard, I think discussion of the role that our dynamic East Asian economies have played in overcoming the crisis is both timely and useful.

The impact of the global financial crisis on the Asian economy

In retrospect, the global financial crisis aggravated by the collapse of Lehman Brothers came as an incredible shock to the world economy. This will be recorded as the worst crisis since the Great Depression of the 1930s. And we can gain a vivid picture of just how greatly world economic integration has progressed over the years from the speed at which this financial crisis, sparked in the US, spread around the world, as well as from the huge scale of the consequent shock.

In particular, even though Asian economies including that of Korea were not at the epicenter of the financial crisis, in its immediate aftermath they still suffered shocks very similar to those at the time of the Asian financial crisis of 1997–98. Basically, the factor behind this was their vulnerability to external shock due to their export-driven growth strategies, rapid economic liberalization and market opening.

As several researches by the Fed of the US and the Asian Development Bank (ADB) have pointed out, the financial crisis in advanced countries was transmitted to Asian economies through the trade channel even more than through the financial channel.³ In the initial phase

¹ Angus Maddison, *Chinese Economic Performance in the Long Run*, second edition, revised and updated 960–2030 AD, The Development Centre, OECD 2007.

² "Asia accounted for over half of world output for 18 of the past 20 centuries." *The Economist*, February 27, 2010, p. 72.

³ For example, the welcome address by Ben Bernanke on "Asia and the Global Financial Crisis" at the Asia Economic Policy Conference on October 2009 and the ADB's Asian Development Outlook Update on September 2009.

of the crisis, the foreign exchange and financial markets in every country in Asia suffered severe turmoil. However, they began to regain stability comparatively quickly. Although this recovery was in part ascribable to the bold and active policy response of countries around the world, and to their close international policy cooperation, as seen for example in the use of bilateral currency swaps, it is also a fact that the Asian financial sector was in comparatively strong shape thanks to its structural adjustments following the Asian financial crisis, and this is considered to have played a considerable part as well. On the other hand, every country in Asia also suffered very large real sector shocks by way of the trade channel. From the beginning of the fourth quarter of 2008, most Asian countries shifted into states in which economic activity was extremely subdued, in line with the sharp drops in their exports as import demand in advanced countries shrank sharply due to the rapid slowdown of economic activity.

Subsequently, however, Asian economies staged much faster recoveries than advanced countries and came to serve as the locomotives of the world economic recovery. During 2009, economic growth in major advanced countries, namely G7 countries, averaged a negative 3.4%, whereas that of the Asian economies reached a positive 3.6%. In this year of 2010, growth rates in Asia are expected to climb to 7.5%, and the forecast is that they will account for 40% of world economic growth this year.⁴

Strengths and weaknesses of the Asian economy revealed by the crisis

The backdrop to this swift recovery staged by the Asian economies lies in a number of strong attributes that they possess.

Firstly, Asian economies have great dynamism. Since the beginning of the 21st century, they have continued their dynamic economic growth, rising to become central forces in the world economy. Basically, this comes from the epoch-making expansions in the extent of their market opening and liberalization. These policies have spurred freer movement and better allocation of resources, which is giving Asian economies improved opportunities for higher economic growth due to greater competitiveness. What is more, the Asian economy including China possesses a vast market, that is not yet saturated. This means that, as Asian economies' incomes increase in the future, rapid growth of their domestic consumption markets is possible. For example, the increase in exports to China caused by its policy of expanding domestic demand has also served as a source of regional growth momentum. In addition, the Asian economy holds abundant potential in terms of supply. There is plenty of capacity for a continual supply, on a large scale, of well-educated, disciplined and low cost human resources, in addition to Asian countries' own considerable capital resources accumulated in the course of rapid economic growth until now. The Asian economies, being still in their comparatively youthful stages of growth, generally differ much from the majority of advanced economies that have already matured. Over and above this, taken together Asian economies possess mutually complementary economic structures, as they are at various different stages of development. East Asian intraregional trade has grown rapidly since the turn-of-the-century, with the formation of a vertically integrated division of labor centering on parts and components. The weight of intraregional trade among non-Japan East Asian countries has risen steeply, from 31.7% in 1990 to 42.0% in 2008.

Meanwhile, however, this recent financial crisis has also served to throw light on certain weaknesses of the Asian economies.

⁴ The Asian economies here are the same as the category used in Box 1 of the IMF's World Economic Outlook (WEO) Update on July 2010. The growth rates and growth contributions are from the WEO (April 2010) and the WEO Update (July 2010).

The external dependency of Asian economies is very high, first of all, because of their pursuits of export-led growth strategies. This has meant that they have weak foundations for domestic driven growth, due to the relatively small sizes of their domestic markets. And, as we have seen during the global crisis, they are thus extremely vulnerable to the impacts of an external shock. Looking at the degrees of export dependency (exports/nominal GDP) of various major countries in 2008, we see those of the USA and the UK standing at 0.3 to 0.7 times the worldwide average, whereas that of Korea was 1.7 times the world average, that of China 1.2 times, and that of the major five ASEAN members combined 2.0 times the world average. Domestic economic activities in countries with high export dependency of course react very strongly to external demand shocks. Empirical analysis shows the USA, the UK and the euro zone exhibiting GDP elasticities of 0.3–0.4% to a 1% increase in external demand (world GDP minus its own GDP), in comparison to which Korea's is for example about 1.0%.⁵ Asian economies consequently tend to show high degrees of economic volatility. Asian economies are in addition at risk of possible financial and foreign exchange market unrest owing to large in- and outflows of global funds. This risk accompanies their pursuit of economic development on the principle of increased market opening and liberalization policies. While causing domestic liquidity to swell, excessive inflows of global funds may at the same time generate steep rises in the prices of assets such as shares, bonds and real estate. In the event of what is termed a sudden stop, i.e. the halting of global fund inflows and their abrupt outflows instead, the domestic financial and foreign exchange markets will be thrown into turmoil. During the global financial crisis, despite holding adequate levels of foreign exchange reserves, a number of Asian countries including Korea underwent severe crises, due to increased foreign currency liquidity risk and steeply rising exchange rates caused by these sudden fund outflows. Apart from this, it must be said that the structures of many Asian economies are characterized by fragility, as they are still stuck in the early stages of development. Compared to the advanced countries, productivity here is low and the service sector lacking in competitiveness, while the environmental problems arising from our long period of rapid growth until now impose constraints on our abilities to continue growing at reasonable levels in the future.

Challenges to the further advance of the Asian economy

Transition to a sustainable growth framework

The Asian economies must move a further step forward if they are to remedy these weaknesses. And as a first step, it is extremely important to shift to a well-balanced economic structure by expanding domestic demand. Toward this objective, consumption capacity needs to be enlarged by reducing the incentive for precautionary savings, through financial system improvement and the building of denser social safety nets. And a recent ADB report in fact appraises the foundation for such a shift toward a demand-led economy as having to some extent already been formed in Asia, through the growth of the middle class.⁶ Provided that Asian economies can make the transition in this way toward an economic structure that is better balanced, it will give them greater capacity to counter external shocks, while lowering the volatility of their economic activities. It can also be anticipated to help in easing the problem of global imbalances.

⁵ The estimates of elasticity refer to Table B11 in Dees et al., "Exploring the International Linkages of the Euro Area: a Global VAR Analysis", November 2004.

⁶ "The rise of Asia's middle class", the chapter on Key Indicators for Asia and the Pacific 2010, ADB, August 2010.

Securing the qualitative improvement of growth potential

We are now reaching the limits of extensive growth relying upon increased inputs of production factors, and should instead be pursuing intensive growth, that seeks to boost productivity by heightening the efficiency with which these production factors are combined. To this purpose, in tandem with developing such aspects of the economic infrastructure as the financial system and the regulatory framework, it is essential to upgrade the caliber of our human capital, to improve the quality of our facilities investment, and to expand our R&D investment. In conjunction with this, it is also desirable to develop those service industries having the greatest scope for enhancement of productivity and high growth.

It is likewise very important to build up fresh growth momentum. The water and air pollution and destruction of the green environment as a result of rapid growth over a number of years are now among the principal factors holding future Asian economic growth back. Green growth, that sets in motion a virtuous circle of environmental protection and economic growth by showing that green and growth can go hand in hand, can now come to the fore as a new growth engine.

Strengthening of regional economic integration and policy cooperation

Last but by no means least, the recent global financial crisis has also underlined both the necessity and the effectiveness of strengthening our regional economic integration and policy cooperation.

Looking ahead, to promote the consistent growth and structural intensification of Asian trade, I believe efforts must be stepped up for greater integration of the regional market. In the long-term, it is desirable to replace the present patchwork of regional FTAs by a single region-wide FTA similar to NAFTA.

Meanwhile, in view of the recent global financial crisis, there is a growing need for regional financial cooperation if we are to avoid repeat crises in the future. As one link in this chain, the drive for regional financial cooperation was furthered in March of this year, when the bilateral foreign currency swap agreements under the Chiang Mai Initiative were re-organized within the multilateral cooperative framework of the Chiang Mai Initiative Multilateralisation (CMIM). Korea, in a similar vein, has officially put forward construction of a "Global Financial Safety Net" as one item on the agenda of the G-20 Summit meetings. The various strands for construction of such a global financial safety net are already in place, in the form of the IMF lending system and regional financial safety nets such as the CMIM, and what is needed now is to link these strands more fully to form a coherent and systematic network. And provided that such a network can indeed be constructed, it is anticipated to contribute greatly to nipping putative financial crises in the bud, while containing the post-facto spread of those that do break out, as the arrangements will complement individual countries' self insurance efforts in the form of their foreign exchange reserve accumulations. In order to make active use of individual Asian countries' funds, for example such foreign exchange holdings, we are also pressing ahead under the Asian Bond Market Initiative led by the ASEAN +3 to nurture a regional bond market. This has already given rise to some tangible results, such as the recent agreement to set up a regional Credit Guarantee Investment Facility. Over and above all this, Asian countries also need to take very active part in the building of the new international financial order now underway in the wake of the global financial crisis.

Closing words

In concluding my address, I would like to emphasize three very important economic implications. Firstly, the global economic crisis cannot be easily surmounted without the contribution of Asia, especially the East Asian economy. In other words, the East Asian economy is becoming more responsible for world economic development, as the weight of

the East Asian economy in the world economy increases. Meanwhile, even though it is not fair to totally attribute the global imbalances to the East Asian economy, it is a fact that the global rebalancing and global financial stability may not be achieved without the active cooperation of the East Asian Economies with the rest of the world. Secondly, the advanced countries have some responsibility for collaborating with the emerging economies in establishing the global financial safety net. This net is not for saving countries in particular regions, but for protecting countries from falling victim to economic crises due to interconnectedness of the economies, even despite their maintenance of sound economies. It is worthwhile protecting benign by-standers. If countries pursuing economic development based on the principles of economic liberalization and market opening remain highly vulnerable to external shocks, the future effect will be harmful: in choosing their development strategies, many of the world's developing countries will choose to not pursue free trade. We should therefore take notice of the very important forward-looking policy implications of this. Lastly, the most important lesson of this global crisis is perhaps that policy effects are maximized in the case of close policy cooperation among all countries. Awareness of this comes from the facts both that policy cooperation can reduce the uncertainties surrounding markets, and that, in an environment of more open international economies, the effects of a single country's policies on its own can be of only limited effect.

I would like to underline one more time, in closing, what I believe have been the two most important determinants of our success in overcoming the current global economic crisis – the role of the East Asian economies, and the cooperation between advanced and developing countries. I look forward to both continuing to increase in the years ahead. I hope that the wide range of papers to be presented here over these two days, and the lively debates that ensue, will provide very fertile soil for a further strong advance of our Asian economies in the years ahead.

Thank you very much for your attention.