Choongsoo Kim: Asia's role in reviving global growth and financial stability

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Good evening, ladies and gentlemen.

It is a privilege and a pleasure for me to speak here this evening. I am extremely grateful to Chairman SaKong for inviting me.

As we have just enjoyed some splendid food, to boost our health and energy, I hope that my address now may serve as substantial food for thought for everyone in this room. I may risk ruining your appetites for dessert and coffee, but being a central bank governor, as you know, it is my job to take away the punch bowl when the party gets going.

I would like to first briefly review recent economic and financial developments in the global economy, before addressing the challenges and opportunities faced by Asia in repositioning itself in the new global financial scene.

I. Where do we stand?

After four years of financial turbulence and economic uncertainty, the global economy is still in trouble, despite some signs of recovery from the fallout of the global financial crisis. The global economic outlook is improving only slowly, and the pace of recovery is uneven across regions. The US economy appears to have turned the corner, with improved risk appetite and real activities, while Asia is leading world economic growth, albeit at a level below its potential so far.

The euro area, on the other hand, has yet to escape the specter of its twin crises and stagnant growth. Given its sheer economic size and dominant share in global banking, the euro area has been the major source of risk to global growth and financial stability over the past two years or so. The recent large-scale liquidity operation by the ECB, the so-called LTRO, has helped to calm the financial markets and stabilize sovereign debt dynamics, at least temporarily. The LTRO's purpose, as I understand it, is to buy precious time for the conduct of necessary fiscal reforms and bank restructuring.

Unfortunately, the positive effects of the LTRO seem to have been waning recently. The sovereign spreads of the highly-indebted countries are on the rise again, while the abundant liquidity is being hoarded by banks amid little signs of any increase in lending. I hope that the time bought by the ECB through the LTRO is used wisely, to put an end to the fiscal crises and the resultant financial instability.

A natural question at this juncture would be how to consolidate the financial gains achieved so far, and what to do to pull the world economy out of its current troubles. I think revisiting the dynamics of the global financial crisis, and the ensuing fiscal crises in advanced market economies – or AMEs in short – could offer us clues to help answer these questions.

II. Reversing the direction of real-financial and cross-border linkages

Let me be more specific.

Some eighty years of macroeconomic research and policy lessons guided us to the deployment of extraordinary monetary and fiscal stimulus measures in response to the global financial crisis, and these policies did pay off by enabling us to avoid another Great Depression. Success was short-lived, however, as the world economy instead fell into the Great Recession. Adverse feedbacks through real-financial linkages triggered fiscal crises in AMEs, particularly in the euro area, which pose threats to global financial stability even today.

Despite their own sound fundamentals, meanwhile, emerging market economies – or EMEs in short – have become the hostages of cross-border linkages, both real and financial, as they have faced weak and highly uncertain external demand, sharp reversals in capital flows, and heightened foreign exchange market pressures. As you may have noticed here, and as I should highlight now, there have thus been two types of linkages at the heart of the post-crisis economic and financial developments – real-financial linkages, and cross-border linkages. And the implication is thus that a global solution is necessary if we hope to return to a sustainable path of growth and financial stability.

We live now in an interconnected world. And in an interconnected world, stagnant growth and fiscal crisis occurring in one region is no longer an isolated problem of that region alone. Rather, it is a global problem, that has far-reaching implications for other regions and, ultimately, the world economy as a whole.

I believe that our search for a global solution to the problems we now face should begin with a focus on reversing the directions of these two types of linkages – so that in place of negative spillovers we instead see positive feedbacks. And in fact, powerful real-financial and cross-border linkages are a basis for positive feedbacks just as much as they are a vehicle of negative spillovers. I also believe that the role of EMEs – and particularly of emerging Asia – is of crucial importance in this regard.

Over the next several years at least, AMEs will find themselves constrained by limited policy space for dealing with macroeconomic challenges. It would not be unreasonable to predict that, to put their public finances in order, AMEs will need to undergo periods of fiscal consolidation. Monetary policy is also unlikely to offer more stimulus, since policy interest rates remain near zero while major central banks' balance sheets are already over-stretched. New financial regulations are being implemented, with stronger standards applied to liquidity and capital requirements. And while all of these developments are certainly conducive to financial stability, they are less conducive to growth – at least in the short run. Without growth, however, financial stability gains will likely prove elusive.

EMEs are in contrast doing better than AMEs in many respects, although their economic growths and financial stability have been adversely affected by developments in AMEs. Economic growth is yet to reclaim its pre-crisis level, due in part to weak external demand, but it does nonetheless remain modest. Inflation is well under control by now. And EMEs have in addition ample policy space, on both the fiscal and the monetary fronts, for use should adverse shocks occur. EMEs have been cautious in their macroeconomic management, however, in consideration of the significant tail risks stemming from the euro area fiscal crisis, financial deleveraging, the high and very volatile price of oil, and other factors.

Now given this broad picture, if you agree on its accuracy, I would like to suggest the possibility of EMEs playing a role in reviving world economic growth, and solidifying financial stability. I believe EMEs' dynamic growth can also be a source of growth for AMEs, that is relatively free from the vagaries of the Keynesian multiplier. And the higher and more sustainable growth in AMEs would then help AMEs to address their fiscal and financial challenges at lower costs than otherwise.

To put this view in perspective, let me point out some numbers. In 2011, EMEs accounted for 53 percent of world GDP, and 70 percent of world economic growth. According to a recent study by the Bank of Korea, a one percent increase in EMEs' GDP will boost AMEs' growth by 0.3 percentage point. The corresponding number for the contribution of AMEs to EMEs' growth is 0.4 percentage point. This same study also shows that structural reforms can enhance growth in both groups of countries. Therefore, stronger autonomous growth by EMEs – driven by domestic demand – combined with structural reforms in both AMEs and EMEs, would clearly help maximize positive feedbacks that benefit all.

III. Challenges and opportunities for Asia

That said, the next question to ask is who should take the first step, to initiate the propagation of such positive feedbacks for growth. And I would argue that Asia – particularly emerging Asia – is well positioned for this job. Asia is large in economic size, represents the most vibrant economic region in the world, enjoys high rates of savings, and has strong trade linkages with AMEs. It is also the region with the greatest potential to grow through expansions in domestic demand. Asia, in short, has tremendous potential to lead world economic growth going forward.

But having great potential is only a necessary condition for Asia to become a source of positive feedbacks for growth. To realize this potential to the fullest extent, Asia needs to do much more on the financial front. Asia is a region in which negative financial and real spillovers from AMEs are the rule rather than exceptions. Asia has been subject to volatile capital flows driven by global liquidity cycles. From the second quarter of 2008 to the first quarter of 2009, for example, foreign claims of euro area and UK banks on Asian economies fell by around 37 percent and 21 percent, respectively (IMF, REO April 2012).

Asia's international trade and finance is invoiced and settled in dollars predominantly, and this results in currency and maturity mismatches. Risk management, however, except through the holding of large amounts of foreign reserves, remains relatively poor. Finally, domestic financial markets in Asia are less developed, with only limited capacity to create high quality safe assets. And as a result the high level of savings in Asia has been invested in foreign assets produced by AMEs. These financial weaknesses and imbalances render Asia very vulnerable to global liquidity disruptions and market uncertainty. And it is more likely now than ever that the global financial market will continue to face significant tail risks, until the euro area finds its way out of the fiscal crisis.

Given this, Asia needs to be better prepared to deal with financial shocks of external origin. This would be Asia's biggest challenge should it endeavor to lead the world economy along a sustainable path of growth and financial stability. The challenges facing Asia are also opportunities for Asia, however. My view is that the next decade or so will prove to be a critical window of opportunity for Asia, to upgrade its financial system so as to make it a new source of growth and strengthened financial stability.

Before concluding, let me briefly discuss what Asia should do to live up to such a vision. First, Asia should push ahead with more financial liberalization and greater integration into the global markets. If we agree that the new global financial regulations will make cross-border capital flows less volatile, we should expect Asia to be able to reap the benefits of financial integration at lower risk. Financial integration will bring new knowledge into our domestic financial markets and policy circles. Financial liberalization is also consistent with the changes in development strategy in Asia toward greater dependence on domestic demand than on exports.

Second, Asia should upgrade its domestic prudential regulations with newly developed macro-prudential frameworks that can address FX risk in particular. Macro-prudential policies should be employed rather than capital controls, which could prove highly distortionary and run counter to financial integration. And in this regard, Korea's recently implemented macro-prudential policies would be good reference for many Asian countries.

Third, Asia should implement structural reforms – which can enhance its growth potential in the face of population aging, increase its labor productivity, and help to stimulate its domestic demand. Pension reform, for example, could help to reduce the unduly large precautionary savings in countries where income uncertainty is high. Increased labor market flexibility can meanwhile contribute to job creation, and facilitate necessary economic adjustments.

IV. Concluding remarks

Now let me conclude.

We have already seen how the powerful real-financial linkages have led to output collapses in AMEs following the global financial crisis, and how they have driven the sovereign debt dynamics in the euro area to their critical limits. We have also seen how cross-border linkages – both real and financial – have transmitted adverse shocks originating in AMEs to the shores of EMEs in matters of months if not days.

But the directions of these linkages can be reversed, I believe – so that they facilitate not negative spillovers but positive feedbacks. Exploiting the reversal of linkage effects should I think be the first step toward finding a global solution to the current economic and financial troubles that we all face. I also believe that Asia should be the region taking this first step, in light of its potential for doing so.

In the next decade or so, Asia will face greater challenges, but also greater opportunities, as it repositions itself in the new global financial scene. The primary task that remains is to seize this opportunity with courage.

Thank you.