Choongsoo Kim: Challenges and policy responses to the euro crisis

Opening remarks by Mr Choongsoo Kim, Governor of the Bank of Korea, at the SEACEN-BIS Executive Seminar, Busan, 24 September 2012.

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Distinguished Deputy Governors, delegates of SEACEN member central banks! Ladies and gentlemen!

I would like to welcome you once again for coming to Busan to attend the SEACEN-BIS Executive Seminar.

In particular, my special thanks go to Mr. Francesco Papadia (Director General of Market Operations and Adviser to the Executive Board, ECB), Professor Takahashi ITO of Tokyo University and Chief Economist Changyong Rhee of the ADB for taking time out of your busy schedules to attend the SEACEN-BIS Executive Seminar as Speakers. Let me also express my appreciation to lead discussants and session chairs. Taking this opportunity, I would also like to express my gratitude to Dr. Eli Remolona and his staffs from the BIS Representative Office for Asia and the Pacific and the SEACEN Center for your efforts and hard work to organize this seminar.

We are holding the seminar today on Challenges and Policy Responses to the Euro Crisis under the theme of Dealing with Financial Contagion with leading experts in each field. I hope particularly that this seminar will be a good chance to further elucidate the causes and the prognosis for the euro crisis and its effects on EMEs, and share our experiences and wisdom on the future policy challenges.

The most notable characteristic of the recent global crisis is that the shocks from a certain sector have spread rapidly and been amplified to the global real sector through the high level of global financial inter-connectedness that has been built up over the past few years. That said, it seems to me that the cross-border adverse spillovers and excessive global liquidity and the resulting capital flow management difficulties, deemed to be at the root of the crisis, have, to a large extent, failed to be resolved when we look at the international coordination efforts so far to deal with the crisis and what they have involved.

Therefore I believe there is a good case for us to conduct a critical review at this point as to whether the active policy implementation efforts made by major advanced nations including the US in coping with the crisis have been effective to some extent but have so far fallen short in terms of the global spillover effects of the crisis, and, furthermore, whether the various policy tools used during the crisis have worked as they should.

As various views and assessments concerning this are expected at today's seminar, I would like to make several points about a future global economic recovery from slightly different perspective and the practical part the EMEs can play in this.

I would like to begin my speech by arguing that the global economy has already entered into a state of multiple equilibria, where bad and good equilibrium coexist. My working hypothesis is that an equilibrium that eurozone area economies attempts to achieve is likely to be a local, not a global equilibrium. Furthermore, it can be a bad equilibrium in that it may incur negative spillover effects on the EMEs. Such equilibria tend to remain unstable and we expect that knife-edge equilibrium cannot be sustainable. I believe a global equilibrium can only be attained with the concerted policy efforts by advanced and emerging market economies.

Let me be a little more specific about my argument.

The eurozone sovereign debt crisis poses a threat to a global economic recovery and financial stability, and the upshot may be that it is hard to rule out the possibility of it affecting the EMEs unstable due to excessive provision of capital and thus making the capital market of EMEs highly volatile. The chances are also slim that the sovereign debt problems of major economies including European countries can be resolved smoothly without achieving global economic growth.

I believe therefore that it is high time for us to concern ourselves with how best to revive the global economy, while consolidating the achievements of the financial reforms implemented by the policy authorities of individual countries in the wake of the global financial crisis from a medium and long- term perspective.

Of course, since the tasks and challenges that we should deal with in order to escape from the current crisis and get back to a sustainable growth track are multifaceted and highly interconnected, the solution should not be limited to a single country or a certain region but be sought at the global level.

In this context, I think the key here is to maximize the positive knock-on effects of growth running between EMEs and advanced nations. And I am convinced that EMEs will play a bigger role in this process going forward.

Specific figures also bear this out as well. EMEs accounted for 54% of the growth of the global economy from 2000 to 2005 and their growth contribution rose to 72% from 2006 to 2011. In addition, while EMEs contributed just 37% of the global GDP in 1999, their share went up to 49% in 2011, hard on the heels of the advanced nations. The IMF recently estimated in its global economic outlook that while the contribution of EMEs to the global economic growth is expected to remain about 70% for the next five years as in the late 2000s, their share in the global GDP is forecast to continue to increase to 54% in 2016.

For more specific details, you may refer to the results of the study conducted by the Bank of Korea recently in order to examine to what extent EMEs could drive the economic growth of advanced nations. According to the study, there are similar positive growth repercussions between EMEs and advanced economies, when controlling conventional macro and institutional factors. To put it another way, a 1% increase of per capita GDP of advanced nations will lead to a 0.4%p per capita GDP growth in EMEs, and a 1% increase in per capita GDP in EMEs will be translated into 0.3%p per capita GDP growth in advanced economies.

Given that the positive knock-on effects of growth between emerging and advanced economies are higher than a certain level, one country's structural reform could have a positive impact on other countries' growth through such knock-on effects. If advanced and emerging economies carry out the structural reforms and expand market openness at the same time, the world economy will grow faster and more robustly.

As we can learn from Asian countries' experience in overcoming the late 1990s Asian financial crisis very fast on the back of major advanced nations' robust economic growth, if EMEs can sustain their relatively high growth rates as at present, this will be greatly helpful to advanced nations in breaking free from the current dilemma of reducing sovereign debt or achieving economic growth.

To catapult the world economy onto a sustainable growth trajectory, what would be the most desirable policies to be taken by major advanced and emerging economies? I cannot explain this in great detail, but I think that roughly five requirements should be met in order for the global economic recovery.[1]

First, major advanced economies should establish a credible medium-term fiscal consolidation plan and put it into practice to put their sovereign finances on an even keel.

[1] Excerpt from Governor Choongsoo Kim's speech on "Out of the Great Recession: An EME's Perspective" as part of the Distinguished Lecture held by IMFS (Institute for Monetary and Financial Stability) of Goethe University. (April 16, 2012)

Second, the negative spillover effects through financial channels should be minimized. To this end, eurozone member states should build a strong firewall ensuring financial stability, while providing sufficient public funds to banks that they can be recpaitalized to fend off contagion effects.

Third, trade and financial protectionism should be completely rejected.

Fourth, even though implementation of a new international financial regulatory framework is desirable for global financial stability, we need more thorough analyses and studies on whether there is a possibility that the framework could undermine the incentives for appropriate risk sharing needed for productive investment.

Last but not least, global financial safety nets should also be strengthened.

This poses the question, what kind of role should central banks play in seeking such global solutions?

I think that above all central banks need to remain faithful to their original mandate. They should contribute to economic growth by maintaining price stability and financial stability and establishing an effective macroprudential policy framework to manage systemic risks.

In particular, major advanced nations' central banks need to bear in mind that their monetary policies could have negative spillover effects on emerging market countries. I think even from advanced nations' standpoint, the benefits from precluding the possibility of adverse effects would far outweigh the ex-post costs caused by conducting monetary policies in consideration of their own conditions alone.

Let me conclude.

As I am sure you are all too well aware, it has been four years since the global financial crisis broke out in September 2008. There is an urgent need for policy responses commensurate with the changing conditions in line with the most severe global financial crisis since the Great Depression in the 1930s.

As I mentioned earlier, to overcome the challenges facing us, we need above all to consider the measures at the global level. To that end, close cooperation in the global community is required, bearing in mind the growing role of EMEs.

The world economy nowadays seems to be waiting for a sage like the philosopher Aristotle who claimed that the whole is greater than the sum of its parts. That is because, in this increasingly multipolarized environment, global leadership which can envision "the whole" future of the human being is becoming more important than ever before so as to address transnational issues, including global policy cooperation and coordination for global financial regulation and global sustainable growth.

In the face of the unprecedented Great Depression in the 1930s, our august predecessors in office were bold enough to change their conventional wisdom and recast the academic framework of the macroeconomy from a new perspective. For our part, we also similarly need to further push back and advance the horizon of a new explanatory paradigm that will stand for the next twenty or thirty years, through the historic impetus of the outbreak and resolution of this global financial crisis.

Noting that "the ever-changing nature of the challenges calls for vigilance and an on-going willingness to re-examine critically even well-honed convictions" in his speech, former BIS General Manager Sir Andrew Crockett, who passed away in early September, emphasized the importance of overcoming the ever-increasing challenges through "vigilance" and "willingness".[2]

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2 Sir Andrew Crockett's speech on "Central banking under test?": conference on " Monetary stability, financial stability and business cycle", Basel, Switzerland (2003.3.28.)

We need to exercise our wisdom to overcome such challenges through creative responses in the face of the historic challenges. To this end, I think all economic players should stop looking back and start looking forward.

Brief though this seminar is, I hope that it will be useful for us broadening our perceptions of the new intellectual paradigm.

Once again I would like to extend my gratitude to all participants and hope that this seminar will serve as a forum for lively and productive discussions with the active participation of all of you who are attending this seminar on behalf of SEACEN members. Thank you.