Out of the Great Recession: An EME's Perspective

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Guten Abend, ladies and gentlemen.

I am truly honored to speak here today at Goethe University, a prestigious institution that has been home to 19 Nobel laureates. I would like to extend my deepest gratitude to Prof. Siekmann for inviting me, and to Prof. Klump, Prof. Luise Hölscher, Dr. Raettig and Consul General Hahn for their welcoming and congratulatory remarks. I wish also to thank Prof. Gerlach, Deputy Governor of the Central Bank of Ireland, for being with us today.

The 2008 global financial crisis was a true test of our modern financial system's resilience. But unfortunately the system failed this test, triggering severe dislocation of the world economy, both advanced and emerging. And in the early stage at least of the crisis, advanced market economies—or AMEs, as I will call them—contracted rapidly, at paces comparable to during the 1930s Great Depression. The lessons learned from the Great Depression, and from eighty years of macroeconomic research, were however not wasted. Active and concerted policy efforts were deployed by major economies, with extraordinary monetary easing and fiscal stimulus undertaken together with financial bailouts. And thanks to these efforts the world economy was able to avoid another Great Depression, although not the Great Recession.

Major AMEs do appear to be pulling themselves out of the recession at present, but only at paces much slower than seen in the past. It is currently taking them four years or longer to return to their pre-crisis peak GDP levels, whereas in the past it took on average only one or two years. And AMEs' post-crisis recoveries appear even further from complete when viewed against the GDP levels implied by their long-term growth trends. The US economy is well behind its long-term trend growth, despite positive signs of recovery such as falling unemployment and improving consumer sentiment. And Germany seems to be doing only slightly better. Both countries' GDP levels remain far below where they would have been absent the global financial crisis. In this respect, we can see how the real cost of the crisis has been truly enormous.

As we enter the fourth year since the global crisis, I believe it is time that we all think about how to revive growth (and I don't mean just a more rapid recovery here, but truly sustainable long-term growth) while at the same time working to consolidate the gains we have made on

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the financial front thus far. And it is of course undeniable that avoidance of disorderly sovereign defaults is a must for financial stability and economic recovery. But it is at the same time true that sovereign debt sustainability will be at serious risk if the current anemic growth continues. In light of this one may argue, and I agree, that financial resources have until now been directed too much toward the financing of unsustainable fiscal deficits and too little toward productive investment and growth. Financial resources are not unlimited, and for the sake of growth they should flow toward where productivity growth is high.

In what follows, I will expound my views on the multi-faceted challenges faced by the world economy, as it struggles to exit the current crisis and embark on a path of sustainable growth going forward. I will then move on to highlight the importance of finding a global solution for growth, with some supporting preliminary evidence. Finally, I will touch upon central banks' crucial role in our search for this global solution, before I finally conclude.

I. Challenges Ahead for Revival of Growth

Let me begin by discussing the fiscal challenges faced by AMEs, and the implications of these challenges to them for growth.

As we all know, the troubled public finances of many AMEs—particularly those in Europe—are at the heart of the slow and tepid post-crisis recovery. The unsustainable sovereign debt and depleted fiscal space have not only limited the scope for provision of real and financial safety nets via fiscal policy, but also become the major source of financial uncertainty. Fiscal contraction has been forced at a time when stimulus is most needed, and banks have undertaken balance sheet deleveraging at a time when lending to the private sector is critical for investment and consumption. The combined results have been highly contractionary for the economy.

The IMF projects that the average public debt ratio among G7 countries will rise to over 110 percent by 2016, with shrinking but still substantial fiscal deficits in the US and other countries over the projection horizon. Such high levels of public debt should be expected to crowd out productive investment for growth and distort resource allocation. Indeed, several recent studies have found that high public debt at or above 85 percent of GDP begins to affect economic growth negatively.

For many debt-ridden AMEs, therefore, public debt reduction has obvious merits. But such fiscal consolidation may unfortunately bear fruit only after a long spell of painful economic contraction. And it could even defeat its purposes, at least in the short run, and result in a higher, rather than lower, public debt ratio—especially in an economy where the public debt ratio is already high and the fiscal multiplier large. To illustrate this possibility, consider an economy in which the public debt is currently 100 percent of GDP, and the government is considering a one percent of GDP fiscal tightening. A simple, albeit speculative, calculation shows that such fiscal tightening will decrease the debt ratio by one percentage point if the fiscal multiplier is small enough, but push it up one percentage point if for example the fiscal multiplier is 1.5.

Of course, the possibility of a negative or non-Keynesian fiscal multiplier is not totally unreal—some anecdotal evidence of so-called expansionary fiscal consolidation is available. This evidence is difficult to generalize, however, given its limited control for other factors that could have driven the expansions observed, such as expansionary monetary policy, income policy to curb wage increases, or currency depreciation (Perotti, 2011).
If the Keynesian fiscal multiplier is taken as the rule, the case for debt reduction through fiscal tightening could be further challenged by the behavior of the risk premium in government bond yields. To be specific, preliminary evidence suggests aggravation of the prospects for growth to cause this risk premium to rise. The combination of a higher risk premium and lower growth would then worsen the autonomous debt dynamics. Indeed, the interest rate-growth rate differential has widened significantly in many Eurozone countries since the global crisis. Moreover, historical decomposition of the changes in debt ratios—using a simple debt dynamics equation—shows that the worsening of autonomous debt dynamics driven by interest rate-growth rate differentials accounts for debt ratio increases of between 5 to 15 percentage points for Eurozone countries.

In these respects, the latest IMF *World Economic Outlook* for the Eurozone is alarming. Italy and Spain are both projected to register negative growth for this year—at -2.2 and -1.7 percent, respectively. And this outlook and the Keynesian multiplier story might explain why government bond yields in the southern periphery remain elevated despite the significantly improved market liquidity seen in recent months.

If fiscal tightening alone cannot solve the problem, one may turn to the possible role of monetary policy. And despite the arguments to the contrary, I agree that the unconventional and extraordinary monetary policies adopted on both sides of the Atlantic have certainly been pivotal in calming the markets and preventing even worse sovereign debt dynamics—at least up until now. And even more importantly, that monetary policy has bought us time for necessary fiscal adjustment and financial restructuring.

But the welcome role of these policies in crisis management is now rapidly approaching its limit. As Chairman Bernanke has put it, monetary policy is not a panacea, and further monetary easing could do more harm than good when the financial markets are already flooded with cheap liquidity but remain nonetheless timid in their lending to the private sector. Financial repression—a dosage of low nominal interest rates combined with moderate inflation—was the key driver of the post-war debt reduction in AMEs (Reinhart and Sbrancia, 2011). But its relevance for the world of today should be discounted, given the current high cross-border mobility of capital and the relatively short average maturity of the sovereign debt of AMEs, at 5 to 6 years. A final, but not less significant, concern is that the continued availability of cheap money may also offer fertile ground for unhealthy speculation and moral hazard.

Moving on now, how about emerging market economies? What challenges do they face?

Emerging market economies—or EMEs in short—were largely innocent bystanders during the global crisis. And they weathered the crisis relatively well, based upon their strong fundamentals including their sound fiscal positions. They remain vulnerable to real and financial developments in AMEs, however, simply because of their close interconnectedness with AMEs—in both international trade and finance. More than 40 percent of EME exports go to the European and US markets, while 50 to 90 percent of their external funding is intermediated by European banks. Given these linkages, the stagnant growth and financial retrenchment in AMEs have direct implications for EMEs. And the financial deleveraging by Eurozone banks has indeed been a major source of uncertainty in the foreign exchange markets of EMEs in recent years.

Cross-border linkages are at work even on the policy front. The monetary policies of the ECB and the US Federal Reserve have been the key determinants of the level and volatility of global liquidity. EMEs do also of course contribute to the creation and destruction of global liquidity. But their contribution is dwarfed by that of the AMEs. And of particular note, negative financial spillovers have always been unidirectional, from AMEs to EMEs, manifesting themselves in the forms of acute surges of capital inflows followed ultimately by sudden stops. Data suggests the recent monetary easing by the ECB and the Fed to have been highly correlated with the capital flows to and exchange rate volatility in EMEs. Finally, negative spillovers are also felt by EMEs through the financialization of commodities, a nontrivial factor behind the recent hikes in the prices of oil and other commodities.

Before proceeding further, let me summarize my discussion of the key challenges to revival of growth thus far as follows. First, AMEs now face a very difficult dilemma in that, while putting their public finances in order is the first priority for resumption of growth, this is less likely to be achieved unless and until they find additional sources of growth. Further monetary easing could do more harm than good, by offering fertile ground for speculation and moral hazard and also because financial repression is at this time less of an option as a means for debt reduction. Second, while EMEs are generally better positioned to lead world economic growth they remain highly vulnerable to the global liquidity cycle and to stagnant growth in AMEs, given their heavy dependence on external demand and on international financial resources. Faced with weak external demand, they also need to find additional sources of growth from domestic demand.

II. Seeking a Global Solution for Growth

What then would our solution be for growth as a way out of the Great Recession?

To be honest with you, I do not have an absolutely certain answer. But I may offer a speculative solution to the problem of achieving sustainable growth, which I believe has a good chance of achievement if we agree to cooperate toward this end. The solution that I envisage is a global one, in which cross-border real and financial externalities are appropriately internalized.

As I noted earlier, revival of growth would require additional sources of growth—for both AMEs and EMEs. At the national level, therefore, center stage should be given to structural reforms that can enhance growth in productivity. For AMEs, for example, labor market reforms geared toward greater labor market flexibility should be a top priority. EMEs should meanwhile focus on reforms to foster domestic demand-driven growth. One example would be pension reform, which could help to reduce precautionary saving. Financial reforms and integration could also yield better resource allocation and productivity growth.

But national efforts alone are not sufficient, and may take time to yield results. In this highly interconnected world, the economic growth of an individual nation is no longer a purely domestic issue. Rather, it is an international issue, that deserves attention from a general-equilibrium perspective. Indeed, the biggest challenge for the world economy at this juncture is that of avoiding local and unstable solutions, and of instead seeking a solution that is global and sustainable.

I would argue that EMEs can and should play a larger role than ever before in the achievement of a global solution. EMEs are better positioned to lead world economic growth than AMEs, and their economic size is sufficient to this purpose as well. Specifically, they accounted for 54 percent of the growth in world GDP during the 2000-05 period, and over the past five years have accounted for 72 percent. Their share in total world GDP has increased significantly—from 37 percent in 1999 to 49 percent in 2011. And these numbers are expected to become even larger going forward. The latest projections by the IMF indicate EMEs' contribution to global economic growth as likely to remain at about 70% over the next five years, and their share in world GDP to be as high as 54 percent by 2016.

To better illustrate the role that EMEs can play, allow me to briefly discuss the findings of my staff at the Bank of Korea. They have recently estimated growth equations that take into account the real linkages between AMEs and EMEs while controlling for the effects of other macroeconomic and institutional variables. The panel data used covers G20 and OECD member countries and spans the period from 1980 to 2010. The study focuses on long-term growth by using non-overlapping observations of five-year average per capita GDP growth rates. All equations are estimated using GMM, to control for simultaneity bias.

The estimation results indicate spillover effects in long-term growth between the two groups of economies that are broadly symmetrical. Specifically, a one percent increase in AME GDP stimulates EME GDP growth by 0.4 percentage points, while the same increase in EME GDP leads to a similar 0.3 percentage point increase in AME GDP growth. The study also echoes the findings of previous research on the growth-enhancing effects of structural reforms and fiscal prudence among both groups of economies. For AMEs, fiscal prudence, financial reforms and trade openness are on the list of factors serving to enhance growth. For EMEs, meanwhile, in addition to these variables, financial deepening and labor market flexibility also help to promote growth.

These positive growth spillovers and growth effects of structural reforms together suggest that the contributions to growth of any single country's reforms can go well beyond its own national borders. World economic growth can obviously thus be more significantly enhanced if reforms are undertaken simultaneously in both groups of economies, and their trade openness expanded. These findings imply that EMEs' growth can be an effective source of growth for AMEs, as well as AMEs' for EMEs. When Asia was hit by its crisis in the late 1990s, it was the solid growth in AMEs that pulled it out of recession. And EMEs' healthy growth can and should likewise now be a blessing for AMEs faced with the difficult short-run tradeoff between debt reduction and growth promotion.

Theory tells us that the competitive or non-cooperative Nash equilibrium will be suboptimal in the presence of externalities, and also that a social planner, if one exists, can achieve a better outcome. By the same token, the positive growth spillovers between AMEs and EMEs suggest the need for a global jurisdiction, that can internalize such externalities in order to maximize growth. But the reality is very far from one characterized by existence of a global jurisdiction, and better described as one of a non-cooperative equilibrium. This is why I argue for better and more international cooperation, for the sake of growth and financial stability.

Let me elaborate on this point further. I believe that EMEs, and particularly large EMEs, need to shift from external demand-driven growth to more domestic demand-driven growth. This latter type of growth will not only be less prone to drive a buildup of global imbalances but also contribute more to world economic growth, through positive spillovers. Such a shift may however be constrained—at least during the transition period—by the financial vulnerabilities of these countries to external shocks, particularly shocks related to the volatile global liquidity cycle. During their transitions, the current accounts of EMEs may be in deficit for extended periods of time before they return to balance. And given their limited and often uncertain access to the international capital markets, such deficits are a latent but serious risk to EMEs that can materialize abruptly. Even at present, the financial spillovers from AMEs to EMEs pose serious risks to investment and growth for many EMEs, including Korea. Prudent and coordinated management of global liquidity, and enhanced surveillance of capital flows, could in this regard I think have significant growth effects, by removing the constraints on investment and growth now faced by many EMEs.

Having said all of this, I would like now to offer my short "To-do" lists for AMEs and EMEs. These lists are of course incomplete, and not tailored to individual country circumstances. Nevertheless, I think they will be useful to us in organizing our thinking as to what we need to do to lift the world economy out of the Great Recession.

First, I think major AMEs need to put their fiscal houses in order, by putting credible fiscal plans on the table. Where available, fiscal space should be used wisely, to promote growth and financial stability. Even in countries with no fiscal space currently left, space for growth can be created by the undertaking of tax and pension reforms and switching of expenditures toward pro-growth activities. Fiscal devaluation could also be an option for highly indebted Eurozone countries (Cottarelli, 2012).

Second, negative financial spillovers should be minimized, if not prevented altogether. To this end, Eurozone countries need to establish a backstopping framework to ensure financial stability, and devote sufficient public resources to the recapitalization of banks and to ring-fencing them from contagion. In addition, an orderly withdrawal of the current excess liquidity should be pre-planned by major central banks.

Third, trade and financial protectionism must be decisively rejected by all. The analysis by the Bank of Korea clearly shows increased trade to promote growth in both EMEs and AMEs, and that financial deepening is a plus for EMEs. Korea has long been a leader in promoting free trade in goods and services. It has completed FTAs with a total of 45 countries in eight regions including the EU and the US in the 2000s, and is currently in the process of negotiating additional FTAs with 12 countries including Canada and some in the Middle East.

Fourth, more research is needed to ensure that the new international financial regulatory framework does not discourage even adequate risk taking for growth. Some unintended consequences of the new regulations could be quite damaging to growth, as seen from the fact that the higher capital requirements for Eurozone banks have resulted in deleveraging rather than capital replenishment.

Fifth, the global financial safety nets need to be strengthened. Bilateral central bank swap lines can be an effective mechanism in this regard. At the national level, EMEs with liberalized capital accounts may also introduce macro-prudential frameworks. And Korea's experience in this regard would I think perhaps be useful to other EMEs.

III. Role of Central Banks

Now let me briefly touch on the role of the central bank.

There is no doubt that central banks have thus far played a pivotal role in crisis management. Henceforth, by quickly overcoming the on-going crisis, their role needs to be returned to normal. More precisely, central banks can best contribute to growth by securing price and financial stability and developing effective macro-prudential frameworks for systemic risk control. A gradual withdrawal of the unconventional measures deployed for crisis management should be planned in advance, to guide market expectations smoothly. And major central banks should be always mindful of the possibility of negative financial spillovers to EMEs. I believe that, at the margin, the benefits for a global solution of preventing negative spillovers outweigh the costs that might be incurred from a domestic perspective.

In this respect, cooperation among central banks is crucial. In the current setting, the G20 and other international forums could serve as venues for such cooperation. In the long run, central banks may aim higher, to form a more formal institution such as the International Monetary Policy Committee (IMPC) suggested by many renowned scholars. Such an IMPC might serve as an effective mechanism for evaluating the overall effects on global liquidity of individual central banks' monetary policies, and thereby lead toward introduction of a multilateral perspective in policy-making. It can also be a way to make up for the absence of an international lender of last resort.

Ⅳ. Concluding remarks

Let me conclude now with a few short remarks.

The global economy stands at a crossroads at present. We have managed the global crisis relatively well but are yet to leave it behind. The sovereign debt crisis in Europe, a legacy of the global crisis, is threatening economic recovery and financial stability, and even posing the risk of another global crisis. Without growth, however, successful resolution of the sovereign debt crisis seems only remotely possible.

I am hopeful that EMEs can play a greater role in pulling the world economy out of the Great Recession and returning it to a path of sustainable growth. Taking maximum advantage of positive growth spillovers would be the way forward. And this premise, together with the absence of a global jurisdiction for economic policy, is the basis of my argument for international cooperation to achieve a global solution. However, we should always bear in mind that the benefits of positive growth spillovers can only be reaped if negative financial spillovers are at the same time prevented.

Vielen Dank.

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