Out of the Great Recession
An EME’s Perspective

Choongsoo Kim
Governor
Bank of Korea

IMFS, Goethe University
April 16, 2012
Great Recession in Perspective

Global economy contracted at a pace comparable to the Great Depression but reversed its course within a year.

Sources: Eichengreen and O'Rourke (2009); Bloomberg; Global Insight; CPB World Trade Monitor

Note: 1. MSCI world index
2. GDP-weighted average of G7 countries' stock price indexes
Great Recession in Perspective

- Active and concerted policy efforts were pivotal

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**Policy Rates of Central Banks**

- Great Depression
- Great Recession

**World Money Supply**

- Great Depression (1925=100)
- Great Recession (2004=100)
- Great Recession (G7, 2004=100)

**Fiscal Balance of GDP**

- Great Depression (1925=100)
- Great Recession (AEs, 2004)
- Great Recession (EMEs, 2004)
- Great Recession (World, 2004)
- Great Recession (G7, 2004)

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Sources: Eichengreen and O'Rourke (2009); IMF; Bloomberg; Global Insight
Great Recession in Perspective

Current recovery is slower than in the past

Note: 1. Cycles with peaks in 1973 and 1981

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United States

(Peak=100)

(Peak = 100)

Germany

Note: 1. Cycles with peaks in 1979 and 1990

Sources: IMF; Eurostat

Note: 1. Cycle with peak in 1992

United Kingdom

France

3
US economy is falling behind long-term trend
Great Recession in Perspective

Germany is doing only slightly better

Recovery from Recession of Early 1980s (Germany)

Recovery from Great Recession (Germany)

Note: 1. Average GDP growth rate between 1970-2007 (=2.5%) Sources: IMF; Eurostat

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Challenges Ahead for Revival of Growth
AMEs’ public debt projected to rise further despite shrinking deficits

Note: Simple averages
Sources: IMF WEO and country reports of Greece, Ireland and Portugal
Debt Overhang

AMEs’ public debt ratio at or above critical threshold for debt overhang

**Gov't Debt to GDP Ratio**

- **U.S.**: 98.5 in 2010, 112 in 2013 (P)
- **U.K.**: 75.1 in 2010, 90.3 in 2013 (P)
- **France**: 82.4 in 2010, 93.1 in 2013 (P)
- **Germany**: 83.2 in 2010, 279.8 in 2013 (P)
- **Japan**: 246.8 in 2013 (P)

Growth-hampering threshold: 85%

Source: IMF Fiscal Monitor (Jan. 2012)

**Fiscal Balance to GDP Ratio**

- **U.S.**: -10.5 in 2010, -9.4 in 2013 (P)
- **U.K.**: -9.9 in 2010, -6.4 in 2013 (P)
- **France**: -7.1 in 2010, -6.5 in 2013 (P)
- **Germany**: -4.4 in 2010, -4.3 in 2013 (P)
- **Japan**: -9.3 in 2010, -8.8 in 2013 (P)

Source: IMF Fiscal Monitor (Jan. 2012)
Fiscal Consolidation

Fiscal tightening may not bring about the intended results

Impact on Debt Ratio of 1% of GDP
Discretionary Fiscal Tightening (1st yr)

Sovereign Bond Yield Spreads and Projected GDP Growth

Source: Cottarelli (2012)
Generally higher during post-crisis period in most AMEs and among GIIPS in particular

Source: BOK staff calculation
\[ \Delta d_{t+1} = (r_t - g_t)d_t - p_{b_t+1} + sfa_{t+1} \]

\( d = D/GDP \) = public debt ratio (% of GDP), \( r \) = real effective interest rate on debt, \( g \) = real GDP growth, \( pb \): % of GDP (minus if deficit), \( sfa \): % of GDP

Source: BOK staff calculation
Alarming Growth Prospects for AMEs

Disappointing growth in US and mild recession in the Eurozone

Sources: IMF WEO (Sep. 2011 and Jan. 2012)
Government bond spreads have fallen but still remain elevated

Source: Bloomberg

Government Bond Spreads of Euro-periphery
(Two-year yield spread over German bunds, basis points)
Limited Policy Space on Monetary Front

Unconventional monetary easing in AMEs

- **Fed:** $2.4 trillion in total through QE 1 and QE2
- **ECB:** LTRO €1.1 trillion through 1\(^{st}\) and 2\(^{nd}\) LTRO

**US Fed Balance Sheet**

**ECB Balance Sheet**

Sources: Fed; ECB
Sources of Negative Financial Spillovers

- AMEs’ deleveraging
- AMEs’ extraordinary monetary easing
- Financialization of commodities
EU and US are major trading partners of EMEs
The brunt of EMEs’ external funding is intermediated through European banks

European Banks’ Share in EMEs’ External Funding
(As of Sep. 2011)

Source: BIS Banking Statistics
AMEs’ monetary easing causes instabilities in EMEs

QEs and Portfolio Investment into Korea and Brazil

Korea

Brazil

Portfolio inflow (RHS)
Exchange Rates
Stock (Kospi)

Portfolio inflow (RHS)
Exchange Rates
Stock (Bovespa)

Note: Shades indicate the periods during which the Fed's QEs or the ECB's LTRO was implemented.
Sources: Bloomberg; the Bank of Korea; Banco Central do Brasil
Spillover: Policy Linkages

Financialization of commodities

QEs\(^1\) and Oil prices

Note: 1. Shades indicate the periods during which the Fed's QEs or the ECB's LTRO was implemented.
2. Bloomberg US dollar index
3. WTI
Source: Bloomberg
Ⅱ Seeking a Global Solution for Growth
Greater Role of EMEs Expected

EMEs’ contribution to world GDP growth amounts to 70%

EMEs’ Contribution to World Economic Growth

<table>
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<tr>
<th>Period</th>
<th>(Asia EME)</th>
<th>EMEs</th>
<th>AEs</th>
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<tr>
<td>2000~2005</td>
<td>53.6% (32.0%)</td>
<td>46.4%</td>
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<td>2006~2011</td>
<td>71.9% (50.4%)</td>
<td>28.1%</td>
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<td>2012~2016</td>
<td>69.0% (50.2%)</td>
<td>31.0%</td>
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Note: Figures in the parenthesis are for Asian EMEs
Source: IMF WEO
Greater Role of EMEs Expected

EMEs share in the world GDP has risen to 50% by 2011 and expected to reach 54% by 2016.

Share of EMEs in the World GDP

1999
- 36.8% EMEs
- 63.2% AEs

2011
- 49.0% EMEs
- 51.0% AEs

2016
- 53.8% EMEs
- 46.2% AEs

Source: IMF WEO
Positive Growth Spillovers

Growth spillover effect of 1% per capita GDP increase

Note: Figures are the result of growth regressions using 5 yr. non-overlapping averages of the variables
Source: BOK staff’s estimation
### Determinants of L-R Growth: AMEs

**Dependent variable = per capita GDP growth rate**

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**Note:**
1. Financial reform index (0~21) developed by Abiad et al. (2010)
2. Employment protection legislation index (1~6) developed by OECD and Botero et al. (2004)
3. Sum of export and import to GDP ratio
4. Unemployment benefit to GDP ratio
5. Domestic credit to GDP ratio
* Other control variables (not reported) include log per capita GDP at t-1, gross fixed capital formation to GDP ratio, working age population to total population ratio, tertiary education completion ratio (Barro and Lee 2010), and log CPI. All the variables are 5-year non-overlapping averages for the period of 1980~2010. The system GMM is used for the estimation.

**Source:** BOK staff's analysis
## Determinants of L-R Growth: EMEs

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Source: BOK staff’s analysis
Growing out of Great Recession: To-do List

- Address fiscal problems through reforms and wise use of fiscal space if available

- Minimize negative financial spillovers by putting in place backstopping framework for financial stability with sufficient public resources

- Trade and financial protectionism should be rejected decisively by all
Free Trade Agreements of Korea

- Entered into force: 45 countries in 8 regions
- Underway: 12 countries in 7 regions
- On the agenda: 16 countries in 10 regions

Source: http://ftahub.go.kr
Growing out of Great Recession: To-do List

- More research about unintended consequences of new financial regulatory framework
- Strengthen global financial safety nets and macro-prudential framework
Macro-prudential Framework for FX Risk of Korea

Introducing cap on FX derivative positions (since Oct. 2010), strengthened (July. 2011)

- 50% → 40% for domestic banks, 250% → 200% for foreign bank branches

Restoring tax on foreigner’s bond investment (Jan. 2011)

- Reintroducing withholding taxes—14% and 20%—on interest income and transfer gain, respectively

Macro-prudential Stability Levy (since Aug. 2011)

- Levied on non-deposit FX liabilities of banks
Role of Central Banks
Central Bank’s Role for Growth

- Major central banks’ policy should return to normal for price and financial stability
- Prevent negative financial spillovers and pre-plan orderly withdrawal of excess liquidity
- G20 can be a useful forum at hand for discussing monetary coordination
- Multilateral perspective in policy making through a global institution (e.g., IMPC)
Concluding Remarks

- World economy at a crossroad
- Need a global solution for sustainable growth
- Take advantage of positive growth spillovers while minimizing negative financial spillovers
- International cooperation is key
Vielen Dank