

Global Policy Challenges in the Post-Crisis Period

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The global financial crisis of 2008–09 has cast a long and wide shadow over the world economy. Financial disruptions in advanced economies, triggered by the bursting of housing bubbles, spilled over quickly into the real economy. They then crossed borders to impact emerging market economies, many of which were innocent bystanders. During the concerted policy responses to deal with the crisis, official interest rates in many countries were cut to near zero, while large-scale fiscal stimulus measures were deployed.

Another Great Depression was avoided thanks to these policy responses, but the global financial crisis has yet to give way again to normality. The economic recoveries in Europe and the United States are still faltering, with growth anemic and unemployment high even three years since the crisis erupted. Monetary policy has been overstretched on both sides of the Atlantic, with unconventional measures that have proven less effective than many anticipated. The fiscal legacy of the crisis is particularly challenging. The sovereign debts of major advanced economies have soared to over 100 percent of GDP, with little prospect of their fiscal deficits falling for years to come. Fiscal crisis engulfed the southern periphery of the euro area in 2010, and is now threatening the core. U.S. public debt meanwhile lost its triple-A rating in the course of a political clash over the debt ceiling. Unless addressed quickly and decisively, the sovereign debt crisis in advanced countries could mark the beginning of a new global banking crisis.

In the wake of these economic and financial developments over the past three years, the challenges now facing global policy are both enormous and unprecedented. Bank and household balance sheets are severely impaired, with losses in the trillions of dollars being incurred. Under these circumstances, monetary policy has proven no panacea, with its transmission channels broken or dysfunctional. Despite the super accommodative stances maintained since the outbreak of the crisis, liquidity and credit have not flown to where they are most needed. Fiscal policy meanwhile did play an important role in the early stage of crisis management but no longer appears able to. Governments in advanced

economies are heavily debt-ridden now, with little or no fiscal space to support economic recovery or recapitalization of their banks. Last but not least, millions of workers remain either unemployed or underemployed. If it continues for long, high unemployment will destroy human capital and significantly undermine future growth potential.

In this light, the key global policy challenges at the current juncture can be summarized as follows:

Deleveraging without Hampering Growth

The global financial crisis and more recent sovereign debt crisis clearly indicate that, for long-run sustainability, the excessive leverage of governments, financial institutions, and households need to be reduced sooner rather than later. The aggregate indebtedness of advanced countries, as measured by the gross financial liabilities of governments, households, and nonfinancial corporations combined, doubled between 1980 and 2010—from 165 percent to 320 percent of GDP. In contrast, the corresponding number for emerging market economies barely changed and stood at 110 percent of GDP in 2010. A recent study shows that public debt at or above 85 percent of GDP tends to affect economic growth negatively, and similar thresholds seem to also apply to the private debt owed by households and nonfinancial corporations (Cecchetti et al. 2011). Deleveraging is thus an urgent task, not only for short-run financial stability but also for long-run growth and sustainability in many countries. Further delay will only make the problem worse.

However, deleveraging through fiscal austerity would in all likelihood be contractionary—and even more so if undertaken by many nations simultaneously. If deleveraging leads to stagnated growth or recession for an extended period of time, it is less likely to produce the intended outcomes. In fact, the possibility cannot be ruled out of a premature fiscal tightening or withdrawal of fiscal stimulus triggering a vicious spiral of rising public debt and stagnating growth. It was just two decades ago that Japan faced this same challenge, and failed to avoid such a spiral.

One global policy challenge would thus be how to deleverage in an orderly fashion without hampering either short-run recovery or long-run growth. In theory, one solution would be to put in place a credible fiscal plan that could anchor market expectations for long-run debt sustainability. Such a plan would then create extra fiscal space that could be used to facilitate economic recovery in the short run. The bulk of the increase in public debt since the global financial crisis has in fact been due to the collapse of government revenues amid severe recession, rather than to discretionary fiscal stimulus or the fiscal cost

of banking sector bailouts (International Monetary Fund 2010). In this respect, supporting a short-run recovery might help facilitate deleveraging at a lower cost.

This is much easier said than done, however. There is in reality great uncertainty about what constitutes a credible fiscal plan—in terms of its pace and the level of debt reduction it aims for. It is even more difficult to calculate an optimal path of debt reduction within a class of credible plans. Guidance on these issues would seem to require more research.

Regulatory Reforms: Striking the Right Balance

There is no question about the need for strengthening of prudential regulations with a greater focus on systemic risk and a multilateral perspective. This is one of the key lessons of the global financial crisis. However, it is also critically important to avoid shifting the pendulum too much. Leveraged risk-taking is a crucial feature of financial intermediation. And of course, as demonstrated by the global financial crisis, too much leverage threatens financial stability. But too little leverage and risk-taking will undermine market efficiency and, ultimately, real investment and growth in the long run.

The recent international policy discussions on regulatory reforms are almost entirely geared toward reducing systemic risk, based on the belief that stronger regulations can help prevent financial crises and growth destruction. This belief certainly has some truth, as countries affected by financial crisis often register discernible declines in long-run growth. But overregulation would also risk negatively affecting long-run growth, by discouraging even productive leveraged risk-taking.

The large literature on economic development suggests that the quality and volume of financial intermediation matters a great deal for long-run growth. Existing studies also show financial deregulation to be a double-edged sword—enhancing growth by encouraging leveraged risk-taking on the one hand, but also killing growth through the recurrence of financial crisis that it gives rise to on the other. The data do, however, indicate that the growth-enhancing effect dominates (Ranciere et al. 2008). Such evidence, if taken literally, suggests that financial overregulation could on average hamper long-run growth, despite its positive role in preventing financial crisis.

In this respect, our global policy challenges are to better understand the conflicts between the financial regulatory roles of securing financial stability and of fostering economic growth, and to contemplate optimal financial regulation that balances the trade-offs between these two objectives. As the current international discussions on regulatory reform are taking place in a global

setting, the implications for growth of such reform will also likely be global—affecting long-run growth in both advanced and emerging economies.

Highly indebted advanced economies may be tempted to resort to some form of financial repression to facilitate deleveraging, as they did during the first three decades or so after World War II (Reinhart and Rogoff 2009). Although financial openness may reduce the scope for deleveraging by way of financial repression, stronger regulatory controls on liquidity and risk-based capital of banks under the Basel III framework may increase the demand for sovereign debt and discourage investment carrying higher risk weighting, including cross-border investment in emerging and developing economies. The growth effect of overregulation would thus likely be felt globally.

Strengthening the Global Financial Safety Net

Global liquidity is created and destroyed through very complex interactions among many players, including official and private-sector lenders and borrowers. If we focus on the international dimension of the global liquidity cycle, the existing evidence suggests the cycle would be driven more by the actions of or market developments in advanced rather than emerging economies. While most emerging market crises over the past two decades or so were considered home-grown crises, the underlying vulnerabilities were, with few exceptions, related to surges in north-to-south capital flows originating in advanced countries and reaching the shores of emerging economies.

Whenever financial crises erupted in emerging economies in years past, the basic policy advice always concerned what emerging economies should do, with little discussion of what advanced economies could or should do to stabilize the global liquidity cycle. And while international policy discussions since the global financial crisis have addressed a variety of policy issues related to global liquidity, their focus still lies on north-to-north capital flows.

At present, and in the future as well, one of the most pressing issues for emerging economies will be how to guard themselves against the contingent risk of foreign exchange liquidity shortage and negative spillovers from advanced economies. Improved oversight of capital inflows and macroprudential regulations will help address the danger of global liquidity surges and the attendant risk of asset price bubbles. But emerging economies will still be vulnerable to sudden reversals or disruptions of global liquidity.

Global liquidity disruption has always been a unidirectional process: It starts from advanced economies and spills over into emerging economies. But its real consequences are of course not unidirectional. Retrenched growth and depreciated exchange rates in emerging economies ultimately feed back

into lower economic growth for advanced economies. There are thus good reasons to argue that major central banks should bear greater responsibility for strengthening the global financial safety net. And in this regard, the currency swap arrangements that the U.S. Federal Reserve offered to several emerging economies during the global financial crisis proved highly effective in calming the markets and stabilizing exchange rates. The existence of a well-functioning safety net would also help reduce emerging economies' temptation to hoard more and more foreign reserves, and thereby mitigate the problem of the global imbalances.

With greater responsibility, of course, might also come higher risk. For example, liquidity-providing central banks might have to bear balance sheet or policy risks if offering currency swap arrangements to emerging economies. However, the costs of such risk-taking would be far smaller than those of inaction—that is, the costs of adverse feedback effects from emerging economies.

Strengthening the global financial safety net may, it is said, also nurture moral hazard. But there are reasons to believe otherwise. First, financial crises have proven very costly to countries, not only economically but also politically. And the high cost of a financial crisis is by itself an effective deterrent to debtor moral hazard. Second, the safety net aims at addressing liquidity disruptions of a global nature, and not idiosyncratic or home-grown liquidity crises. Third, from the perspective of emerging economies, foreign reserves holdings and access to the safety net are close substitutes and thus essentially offer the same insurance benefit and moral hazard risk. So if, for example, access to a given central bank swap amount reduces an emerging economy's foreign reserves by the same amount, the total risk of debtor moral hazard will remain unchanged.

Finally, any remaining concerns about moral hazard could be addressed by an appropriate mechanism design. For example, some constructive ambiguity could be introduced as to central bank swap line availability. It should be emphasized in this regard, however, that too much *ex ante* ambiguity might be time inconsistent if the recipient country is systemically important. To be specific, access to swap lines could be conditional on a set of *ex ante* qualification standards. Such *ex ante* qualification would make decisions on access by the liquidity-providing central banks more predictable, while minimizing the risk of moral hazard on the side of the liquidity recipients. In short, constructive ambiguity works better the better it is structured.

Korea's Policy Reforms since the Crisis

Despite having strong macroeconomic fundamentals, Korea was severely hit by the global financial crisis during its early stage. Once Lehman Brothers

collapsed, Korean banks found themselves facing significant funding difficulties in the international capital markets. The rollover rate on short-term foreign currency debt fell sharply, and so did the nation's foreign reserves in the first several months after the Lehman bankruptcy, while the Korean won depreciated more than 20 percent before settling at a new equilibrium.

In retrospect, Korea's financial vulnerability had been masked by its ample foreign reserves and good macroeconomic performance. Prior to the global financial crisis, Korea's economic growth had remained at a solid 4 to 5 percent, and its current account was running only a small deficit after a long period of surpluses. Inflation was rising slightly above target, but this was due mainly to supply-side factors such as oil prices. Foreign reserves exceeded US\$260 billion in the first half of 2008. More importantly, although real estate prices had risen in specific regions within the Seoul metropolitan area, Korea had shown no signs of a major housing bubble prior to the crisis, thanks largely to prudential regulations such as its loan-to-value and debt-to-income ratio requirements. On the financial front, however, short-term foreign debt (on a remaining maturity basis) rose to the high level of 78 percent of foreign reserves as of the end of 2007, and increased further to 97 percent by the end of 2008. In addition, the average loan-to-deposit ratio of domestic banks remained over 125 percent at the time of the global financial crisis, a level among the highest in Asia.

In a nutshell, the global financial crisis has demonstrated that stable macroeconomic conditions and a large reserve buffer are not sufficient to guard against adverse external shocks, particularly if underlying financial vulnerabilities are large. Indeed, the role of Korea's foreign reserves in stabilizing the foreign exchange market was limited due in part to the fear of losing reserves. The exchange rate reversed its course of rapid depreciation only after Korea signed its currency swap agreement with the Fed. Microprudential regulations meanwhile also were not enough to curb the currency and maturity mismatches on bank balance sheets.

Taking lessons from its experiences during the global financial crisis, Korea has since implemented important macroprudential reforms with a focus on managing risk related to foreign exchange liabilities. First, to prevent the buildup of systemic risk arising from banks' excessive exposure to short-term external debt, caps on the foreign exchange forward positions of banks were introduced in October 2010, which are at present set to 40 percent of capital in the previous month for domestic banks and 200 percent for foreign bank branches. Second, to reduce capital flow volatility and increase long-term and stable funding, a macroprudential stability levy (bank levy) was introduced in August 2011. The levy is imposed on nondeposit foreign currency liabilities at rates that vary

depending upon the maturity—from 20 basis points for less than one year to 2 basis points for five years or longer.

In parallel with these reform measures, a major change in the financial sector policy framework was enacted recently, with the revision of the Bank of Korea Act in August 2011 to impose a new mandate on the Bank of Korea (BOK) for financial stability, in addition to price stability. The amendment offers the BOK greater informational access for surveillance and a stronger legal basis for undertaking macroprudential policy and its role as lender of last resort, while at the same time requiring higher policy accountability. Specifically, the BOK can access nonbank financial institutions for information, enforce reserve requirements on bank noncore liabilities, and extend emergency liquidity support to nonfinancial enterprises if necessary. It is also required to submit a semiannual financial stability report to the Korean National Assembly.

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