The Global Financial Crisis: Causes and Policy

Responses

Dr. Il SaKong

Chairman

G20 Summit Korea Coordinating Committee

Office of the President

Republic of Korea

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Good morning. I feel privileged to speak before this distinguished audience. I am thankful to the World Bank and the Ministry of Strategy and Finance for giving me this opportunity.

Although there are signs of green shoots, the global economy is still in the midst of the worst crisis since the Great Depression of the 1930s. Some scholars even
describe the current global financial and economic crisis as “depression-sized” in terms of its severity and magnitude.

What I would like to do here this morning is: first, to draw your attention to the major causes of the crisis; and second, how the global community as a whole has been responding to the crisis. I am of the view that if there were no such globally concerted efforts, the crisis could have been another depression, not just depression-sized.

According to the National Bureau of Economic Research (NBER), the average duration of the post-war recessions in the US is ten months and the two longest recessions lasted 16 months each. By the way, both of these recessions occurred after the two oil crises in the 1970s and the 1980s. The NBER officially declared that the current recession started in December 2007. So in terms of duration, the current recession already broke the previous record.
However, with the globally concerted policy efforts, I am sure that the global economic recovery, although anemic, will begin soon, perhaps in a few months’ time. My discussion on the global policy responses will be primarily based on the G20 which produces more than 85 percent of the global GDP.

Let me now turn to the causes of the current crisis. Indeed, there are many factors blamed for causing the current crisis. Some point to the lack of prudent regulation and supervision. They go as far as to say that the current crisis is caused by “the greatest regulatory failure of modern history.” And still others point to the excessive greed on the part of the financiers and their excessive risk-taking and over-leveraging. Some others point fingers at low interest rates, exceedingly accommodating monetary policy, and the global imbalances as the culprits. Certainly, no one factor should take all the blame. These factors are all
interrelated and they happen to be the causes and consequences of each other. Therefore, it is not easy to single out main causes of the crisis. I am sure that numerous PhD dissertations, articles and books will be written on the subject in the years to come.

That said, let me try to explain how the crisis unfolded, starting from low interest rates and accommodating monetary policy with excessive liquidity. Low interest rates together with excessive liquidity available pushed the financial markets to search for high yields. Since financial yields are inversely related to credit quality, the result was that not only the subprime mortgages but other risky asset markets boomed. Particularly in the absence of a prudent regulatory and supervisory regime in place for the whole financial sector, the shadow banking and off-balance sheet transactions multiplied. Also, with the rapid digitalization and computerization, the new financial instruments have
been introduced at the speed which the regulators and supervisors could not catch up with.

Obviously, however, all these developments could not be sustained without the global imbalances of savings and consumption or the “global savings glut,” supporting the low interest rates regime in the US for so long. Furthermore, with the accelerated globalization, the financial globalization in particular, the crisis started from the US and immediately became a global crisis.

Naturally, the over-leveraging, excessive risk-taking and the US consumers’ spending beyond their means meant to be doomed. So when the subprime mortgages market started to crumble, the negative impact spread quickly throughout the financial markets in the US first, and then, you know the rest of the story of contagion throughout the world to make the crisis the worst since the Great Depression of the 1930s.
At the early stage of the current crisis, that is, when the US government dealt with the Bear Stearns’ problem in March 2008, none of us foresaw the severe global crisis in the making. Many at the time still saw the problem as a national or a specific sectoral one. Consequently, policy responses at the time were mostly based on individual nation’s initiatives.

However, following the Lehman Brothers’ bankruptcy in September 2008, the world began to come to terms with the seriousness of the crisis requiring concerted global responses. Upon recognizing this, leaders of the 20 globally important economies gathered together in Washington DC on November 15, 2008. Undoubtedly, the gathering itself was, in my view, a historical event for the global governance. Until then, under such circumstances, only leaders of the G8, which has been acting as if it were an informal global steering committee, would have gathered.
But this time around, given the global nature of the problem, leaders of the systemically important emerging economies were also invited to the Washington meeting.

On the day of the Washington G20 Summit, the Washington Post described the occasion as marking “historic power shift.” To be more accurate, I would say that it was a delayed recognition on the part of the G8 of the global economic power shift already taken place during the last couple of decades. For this reason, even a maverick economist like Paul Krugman claims, “This is two decades too late. But better late than never.”

In any case, the G20 leaders in Washington DC shared a common view regarding the seriousness of the current crisis and agreed to take concerted policy measures. In fact, this global response would differentiate the current crisis from the Great Depression of the 1930s in terms of its
severity and magnitude. You will remember that the world leaders met in London in 1932 with a purpose similar to that of the G20 leaders’ gathering. However, the meeting in 1932 failed to agree on exchange rate policies. On stark contrast to that, the G20 leaders in Washington last November decided to meet again on April 2 this year to follow up on their agreements and to see if additional measures are needed. As you all know, the third G20 Summit is scheduled to be held in Pittsburgh on September 24-25 this fall.

Now, I would like to bring your attention to the G20 Summit meetings held in Washington DC and London last November and this April respectively and briefly go through with you what the leaders have achieved so far.

First of all, the leaders in Washington DC formed a consensus to have broader concerted policy responses.
They agreed to use fiscal measures to stimulate aggregate demand rapidly although they did not come up with specific guidelines. Secondly, the leaders also decided to resist protectionism not to repeat the same mistake the world made in the 1930s. More specifically, they agreed to have “standstill” on protectionist measures regarding trade and investment at least for one year.

At this juncture, critics may point to the fact that by March this year, 17 out of 20 countries took 47 protectionist measures in one form or the other. They would say, “What is the big deal about the standstill agreement which doesn’t do any good?” My response to them would be that, as the WTO analyzes, none of those measures seriously distort global trade as yet. It is my view that the leaders with their public commitments would give a second thought before they take any serious protectionist measure.
The leaders in London this year brought the WTO in the G20 Summit process for monitoring and publicly reporting protectionist measures taken for “naming and shaming.” In addition, the leaders in London recommitted to the standstill and even the rollback of the protectionist measures taken since the Washington meeting. By the way, it was President Lee Myung-bak who successfully advocated both the standstill and the rollback ideas.

Another critical achievement of the two G20 Summits is the special attention paid to emerging and developing economies which suffer the most in times of crises. The leaders’ decision to enhance international financial institutions’ resources with additional 1.1 trillion dollars in London would primarily benefit developing and emerging economies. The rest of the world would also benefit as well once these resources are spent to become an additional global stimulus.
Let me now take a brief moment for a few words on the role Korea played in the process of preparing the London Summit.

First of all, Korea made strenuous efforts in cooperation with the UK, the chair country for the London Summit, to have the G20 leaders agree to produce deliverables and implementable measures. Towards this end, Korea played a key role in bringing the IMF and the WTO into the G20 Summit for the provision of their expertise and analytical support.

Secondly, Korea tried its best to bridge the gap between the industrialized countries and emerging and developing economies and to support the causes of these economies. Undoubtedly, we Koreans still have a vivid memory of absolute poverty and developmental pains. Also, Korea which succeeded as a country primarily through
international trade knows the value of free trade better than anyone. This is well reflected on President Lee Myung-bak’s trade policy initiatives at the two Summits.

Now, I would like to turn to the prospect of the forthcoming G20 Summit. With the globally concerted policy measures taken by major global financial and economic players, the recovery of the global economy seems to be imminent. However, considering the fragility of the recovery, it would be premature to put the “exit strategies” outright on the agenda for the Pittsburgh G20 Summit in September. If done, it would most likely end up giving the wrong signal to the market, pouring cold water on the green shoots of recovery. Therefore, I would rather like to see the exit strategies fully discussed at the fourth G20 Summit, assuming the leaders will have decided to meet again sometime next spring. In fact, for this very reason, the world may need another G20 Summit meeting after the
Pittsburgh Summit.

At this point, I would like to re-emphasize that the G20 leaders should be mindful of premature exit policies of the 1930s in the US and the 1990s in Japan and the dire consequences. Considering the “depression-sized” current crisis, the G20 leaders might want to take the risk of unwinding their countercyclical policies rather late than too soon. I agree with Martin Wolf to say that “the world needs aggressive monetary and fiscal policies far longer than many believe.” Of course, there is the danger of a “malign stagflation” once the global stimulus is withdrawn too late. However, considering the pace of repairing private sector balance sheets going all over the world, the likelihood of stagflation does not seem to be higher than the danger of reverting to recession once exit strategies are implemented too early.
Clearly, in the Pittsburgh Summit on September 24-25, the leaders need to have a close follow-up on their London agreements to make sure they are being properly implemented. You will remember the cheer the global community, the financial community in particular, gave to the outcome of the London G20 Summit. I believe it was because the Summit came up with not just rhetoric but deliverables. However, to make the G20 Summit effective and relevant, the deliverables need to be delivered in due course. I would like to again emphasize that in the process of the follow-ups, special attention must be given to the causes of developing and emerging economies.

The leaders also spent a substantial portion of their time at both Summits in discussing the reform of the international financial system to help prevent the recurrence of similar crises in the future. In doing so, the G20 leaders, instead of overhauling the existing international financial
architecture, the leaders decided to improve on the existing international financial institutions (IFIs). In other words, instead of aiming for a Bretton Woods II by creating new supranational financial institutions, they agreed to strengthen the Bretton Woods institutions and the Financial Stability Forum. To enhance these institutions’ political legitimacy and operational effectiveness, the G20 leaders were particularly mindful of emerging economies’ increased representation and enhanced voices.

In my view, their approach is perhaps not ideal but realistic and practical considering the current complex global decision making process. However, at the forthcoming future G20 Summits, bolder reform measures regarding their governance and mandates should be introduced to make these institutions more legitimate and effective.
For example, with regard to the IMF governance, in addition to the agreement on the expedited quota adjustment made in London, the representation in the Executive Board needs to be further readjusted. Currently, 8 out of 24 Board seats are held by Europe, which is disproportionately larger than their current economic weights. To make the IMF better reflective of the global economic reality, readjustment seems to be the order of the day. That way, the IMF can become more legitimate and effective.

Also, as was agreed in London, the enhanced IMF surveillance in cooperation with the newly established Financial Stability Board should be applied even-handedly to both industrialized countries and the rest of the IMF members.

At the same time, it is important to have the IMF’s increased role of overseeing the international capital markets and their
transactions. These issues should be fully taken on board in the Pittsburgh Summit.

Although the global imbalance is considered to be one of the major fundamental causes of the current crisis, this issue was not fully debated in the two previous Summits. However, at the Pittsburgh Summit the leaders should earnestly tackle the issue for its early resolution.

In addition, as unemployment may steadily increase for some time to come, the G20 leaders at the Pittsburgh Summit should recommit themselves to resisting protectionist pressures.

Even with these efforts at both the global community and national level, there still may be a gap in the provision of public goods for sustained global financial stability and economic prosperity. Taking this into account, the global
community should encourage rather than discourage the regional level cooperation to fill the gap. In this light, the recent expansion of the Chiang Mai Initiative and other regional arrangements should be welcomed, provided their mode of operation remains consistent with that of the existing multilateral organizations.

Another critical issue which should be put on the agenda of the Pittsburgh Summit, in my view, is how to strengthen the global governance by making the G8 and the G20 complementing each other. Although some say “The G7 is obsolete,” and some others say, “The G20 will sound the death knell of the G7,” I do not think the G20 Summit should intend to replace the G8 Summit. Instead, there should be a serious political endeavor by the G20 leaders to find ways to cooperate and coordinate for maximum synergy between the two processes. The G8 can be seen as a caucus in the G20. I personally think that with an appropriate
division of work and cooperative mechanism, they can be mutually reinforcing toward better global governance.

The real challenge is though how to work out the appropriate division of work and cooperative mechanism. No doubt that it will be a politically complex and sometimes painful process to find the best possible way. Even then, the G8 leaders together with the rest of the G20 members should make conscientious efforts toward this goal. I was glad to see the recent G8 finance ministers’ meeting in Italy already seem to engage their discussion toward cooperation with the G20. I hope that the G8 leaders in L’Aquila in July will make sure the momentum going.

Before concluding, let me say that the current economic and financial crisis proves yet again that the world is ever more interdependent and in a deeper integration stage where not only neighbors’ but problems of a far distant
country can soon become my own and that of the world. In light of this, in addition to appropriate policy measures and institutional reforms at the national level, the G8 and the G20 together on behalf of the whole global community should be responsible for appropriately managing and strengthening global governance for sustained global stability and prosperity.

Once again, I thank you for inviting me to be part of this conference.

Thank you.