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Welcoming Remarks

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Good morning, distinguished scholars and policymakers.

I bid you all a very warm welcome to Seoul and to this conference. It is indeed a pleasure and privilege for the Bank of Korea to host the conference on "Asia: Challenges of Stability and Growth," jointly with the International Monetary Fund (IMF) and IMF Economic Review. I hope the gorgeous weather this autumn morning will prove auspicious for the success of these proceedings.

At this time we find ourselves at a watershed as the global economy moves into a new phase. Global economic growth still remains sluggish as it has been over the past few years. But its underlying dynamics are changing: notably, key emerging market economies (EMEs) in Asia and elsewhere, which served as the world's growth engine, have slowed recently.

With the accumulated imbalances built up during rapid growth, however, Asian EMEs now face a range of risks, including concerns over volatile capital flows and the slowing of their growth pace. The risks were partly materialised through financial market turbulence upon the Fed's hint of a potential reduction of its asset purchases this May-June. Even though the FOMC's latest decision to hold off the tapering of quantitative easing (QE) may provide some short-term relief to financial markets in Asian EMEs, I believe that it will not change fundamentally the volatile external conditions confronting us. At this juncture, we should calmly take stock of the current situation at this conference and assess the challenges ahead of us, so that we can help lay the foundation for stability and growth in Asia.

With this backdrop in mind, my remarks today will cover two main issues:

- First, I would like to briefly run through recent developments in the global economy since the 2000s in three phases. In doing so, I will put forward some thoughts about the main features of Asian EMEs and financial markets.

- Second, I would like to share with you a bird's eye view on what the main risks to Asia are in achieving stable and balanced growth, and what policy challenges Asian policymakers may face in tackling them.

Recent Developments in the Global Economy and Asia

It will be useful to divide the period since the turn-of-the-century into three phases in discussing where Asian EMEs are at, and how they got here in the context of global economic developments.

(Pre-global Financial Crisis: Global Imbalances and Underlying Imbalances in Asia)

In the first phase, Asian EMEs marked brisk growth from 2000 onwards. The counterpoint to this was the accumulation of global imbalances, with advanced economies generally running current account deficits, and emerging economies running current account surpluses. Low real interest rates in advanced economies discouraged saving, leading to the widening of the negative saving-investment gap. For their part, many Asian EMEs built up foreign reserves, partly from precautionary motives following the Asian crisis, in response to massive capital

inflows. These reserves were then invested in safe assets in advanced economies. In this regard, global imbalances can be seen as a result of local optimisation by each country instead of global optimisation (Kim 2013). This period, often dubbed the Great Moderation, was thus characterised by the substantial worsening of the global imbalances.

Behind these global imbalances, Asian EMEs typically have suffered from three underlying imbalances: (1) an imbalance between internal and external demand, (2) an imbalance between the real and financial sectors, and (3) an imbalance between high trade integration and low financial integration.

These three typical imbalances give rise to at least three major characteristics of the Asian financial markets. First, regional savings tend to be invested in advanced economies, coinciding with the insufficient amount of such safe assets in Asia (Yoshino 2012). Second, a significant part of the funds flowing into the Asian financial markets come from advanced economies, whereas intra-regional flows make up only one fifth of the total.

The third feature is that, while Asian government bond markets are developing rapidly, there is much room for improvement in corporate bond markets. It follows that firms have little alternative but to rely on bank loans. To make matters worse, bank loans typically have short maturities, and this is even more the case in EMEs (G30, 2013).[1] Thus it is hard for firms to meet their financing needs for long-term investment.

(Post-global Financial Crisis: Deleveraging in AEs and Releveraging in Asian EMEs)

The epicentre of the global financial crisis was in the advanced economies, but the crisis hit not just these economies alone but also innocent bystanders such as Asian EMEs owing to strengthened global linkages and accumulated global imbalances. In response to the crisis, major central banks took unprecedented policy actions, such as keeping policy rates extremely low for a prolonged period, undertaking large-scale asset purchases, and providing long-term liquidity to banks. These bold actions clearly helped prevent this crisis from becoming another Great Depression. And, to be fair, Asian EMEs greatly benefited from the positive spillovers from these bold measures.

But the global recovery process was quite uneven. The pace of recovery of advanced economies turned out to be very slow amid continued deleveraging in the private sector. On the other hand, Asian EMEs played a leading role as a global growth engine on the back of China's rapid growth and relatively favourable economic fundamentals.

In line with this uneven recovery, the responses of advanced economies and Asian EMEs have been startlingly different. Those countries at the epicentre of the crisis, such as the U.S., saw substantial private sector deleveraging. In addition, resolute financial regulatory reform helped financial institutions repair their balance sheets. By contrast, Asian EMEs experienced a re-expansion of domestic credit, building up financial instability. Under these circumstances, however, policymakers in the region might fail to carry out structural reforms

[1] Even though there are no statistics for Asian EMEs, the average maturity of bank loans in EMEs is only about 2.8 years, much shorter than the 4.2 years in advanced economies.

to address the growing imbalances (IMF 2013a; OECD 2013a). Therefore, a prolonged period of low interest rates in advanced economies entailed unexpected consequences for Asian EMEs because some part of the increased global liquidity flowed into the region and threatened their financial stability (ADB 2013, IMF 2013b).

(Current Status of the Global Economy and Financial Markets)

Let me briefly talk about the current global landscape. The growth momentum in Asia, which led global economic growth over the past decade including the recovery from the Great Recession, is decelerating, whereas advanced economies are showing some signs of the strengthening of growth prospects (OECD 2013b, IMF 2013c). On the other hand, global financial markets remain vulnerable. For example, the Fed's remarks on tapering in May-June triggered an episode of financial turbulences in both advanced and emerging market economies.

Rising Risks Ahead and Policy Challenges

Now let me turn to the risks faced by Asian EMEs and related policy challenges.

(Volatile Capital Flows)

Recently, many Asian EMEs have experienced sharp capital outflows. As was the case with rapid capital inflows until this spring, this reversal represents the confluence of pull and push factors, and clearly underlines the volatile nature of capital flows (Bluedorn et al., 2013). Nor is it a new departure for Asian EMEs, which have already experienced several episodes of capital surges and sudden stops since the global financial crisis broke out. The recent turbulence is just another revelation of the region's underlying vulnerabilities and financial imbalances.

EMEs might very well plead that the recent financial market turbulence is not of their doing. But given their financial market fragilities we noted earlier, the lack of their efforts to enhance financial resilience is in stark contrast to the bold financial reforms, such as exchange rate liberalisation, following the 1997-1998 Asian crisis.

While we cannot fully eliminate the volatility of capital flows in today's closely intertwined global financial system, we can at least alleviate it through various policy actions. Today I would like to focus on two issues: (i) financial deepening through the integration of regional financial markets over the medium term and (2) macroprudential policy in the short term.

First, it is essential to enhance financial depth through the integration of regional financial markets. Deep financial markets can channel savings and investments within the region, avoiding the adverse effects of volatile capital flows. Integrated financial markets can help share risks among countries through building up intra-regional financial infrastructure; and reduce reliance on safe assets of advanced economies, conducive to global rebalancing. Financial integration, however, could work as a channel of contagion and amplification. Therefore, strengthening the financial safety net and using macroprudential measures in a coordinated manner will help maximise net benefits from financial integration by containing the risks of contagion.

Let me turn to short-term corrective measures to tackle volatile capital flows; namely macroprudential policy. As we now know, monetary policy alone is not effective in countering volatile capital flows. Macroprudential policy, having the advantage at addressing vulnerabilities in specific sectors, can complement monetary policy. From the perspective of Asian EMEs, macroprudential policy can be a second-best option, when global equilibrium cannot be achieved due to the lack of sufficient global policy coordination.

In this regard, Korea has utilised several macroprudential policy tools—alongside conventional macroeconomic instruments—to address the systemic risks stemming from capital flow volatility. Specifically, these measures have aimed at reducing the excessive FX risks on our banks' balance sheets. A recent study, albeit preliminary, suggests that they have been effective in lengthening the maturity of external borrowings and in improving the soundness of banking sector. We should not forget, though, that ill-devised regulations could hold back financial development, and that regulations hastily adopted at a time of crisis (e.g., capital controls) could aggravate the very problem that they are trying to solve.

(Lacklustre Growth)

The other biggest risk is lacklustre growth in Asia amid slowing internal and external demands and falling commodity prices. Although we do not know yet whether such a slow-down is temporary or structural, the implications are not confined to the region in this closely interconnected global economy.

A fundamental cause of the weakening of growth momentum in Asia seems to lie in a lack of proper structural reforms for productivity enhancement, rebalancing between internal and external demands, and inclusive growth (OECD 2013a). Indeed, some have raised concerns that a string of success against small crises since the global financial crisis made us complacent and less aggressive in pursuing structural reforms (IMF 2013a). Potentially, a prolonged period of stable economic and financial conditions may heighten complacency in Asia. Indeed, some Asian EMEs might not properly use the borrowed time and monetary/fiscal spaces under the favourable economic environment in boosting growth potential (Caruana 2013; and Lagarde 2013).

Another cause can be weakened financial intermediation. Although the abundant global liquidity helped mitigate the liquidity constraints facing firms and prevent a sharp credit crunch in Asian EMEs, liquidity failed to flow into sectors with high growth potential. The weakening of financial intermediation is due largely to rising counterparty risk and the shrinking supply of safe assets available as collateral since the global financial crisis.

In response to the weakening growth momentum, I believe that, while policymakers should work on short-term challenges, long-term policy challenges are equally important. First, Asia should press ahead with a broad range of structural reforms to boost labour productivity, increase the share of domestic demand, and pursue inclusive growth for sustainable and balanced growth. In particular, to reduce the reliance on external demand from advanced economies, Asia should modify the current paradigm of manufacturing/export-oriented growth and facilitate the development of the less-developed service sector. Second, Asian policymakers should enhance funding for long-term investment. To regain Asia's growth

momentum and job creation, long-term investments in infrastructure, R&D, education, and health are all vital. These can be supported by the expanded intermediation of long-term financing through regional financial systems.

The third and last item on the agenda today is credit policy. Despite ample liquidity provided by central banks around the world, this liquidity often failed to flow into the real sector where it was needed. And, indeed, this has been pointed out as the main factor hampering growth in many countries. In such a situation, credit policy may effectively facilitate funding for small-and-medium-sized enterprises with great potential to boost vigorous economic growth. I believe that the usefulness of credit policy is even larger in the case of non-key currency countries with limited scope for QE and other such non-conventional measures. In line with this, the Bank of Korea has recently revamped its credit policy tools in a bid to help businesses realise their growth potential and recover their capacity for job creation.

Nevertheless, the goal of credit policy lies in addressing market failures in liquidity provisions, not in replacing market functioning through excessive intervention. To reinforce credit policy's effectiveness, proper incentives, monitoring, and fine-tuning are all crucial. Also, careful consideration should be given to ensuring its transparency, simplicity, and harmony with monetary policy.

Concluding Remarks

My starting point today was the recent developments in the global economy, and I explored several policy measures for stability and growth in Asia. The need for such a multi-pronged effort implies that there is no silver bullet in today's highly uncertain economic environment. Therefore, policymakers throughout the region should make use of a comprehensive set of policy tools, taking a holistic approach. Also, it is essential in the short term for policymakers to take proactive actions against emerging financial instability in the bud, but it is perhaps more important for them to calmly maintain a long-term perspective regarding structural reforms.

After the outbreak of the global financial crisis, advanced and emerging market economies alike made a concerted effort to rescue the global economy from a looming second Great Depression. Given the increasingly intertwined financial and economic linkages, though, the results of policy choices by major economies can have a negative impact on emerging market economies, which could eventually boomerang and end up with two-side spillovers. In this regard, individual countries should also factor in the possible spillovers to other countries in carrying out their policies. I believe a positive-sum global equilibrium can only be attained through the concerted policy efforts of both advanced and emerging market economies.

My final point today is that since the eruption of the global financial crisis, central banks have adopted a series of experimental policy tools, which are creative-but-not-proven in nature. In the course of this, policymakers and scholars have learned a lot from each other. I believe this conference will certainly offer you such opportunities. I very much look forward to productive and insightful discussions as to how to help the Asian economy hold a stable growth path, thereby contributing to a worldwide economic recovery.

Thank you for your kind attention.

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