Keynote Address

The Global Financial Crisis: Causes and Policy Responses

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

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" because of its severity and magnitude.

This morning I would like to draw your attention to the major causes of the crisis and how the global community as a whole has been responding to it. I am of the view that if there were no such globally concerted efforts, the crisis could have become another depression, not just a depression-sized recession.

According to the National Bureau of Economic Research (NBER), the average duration of postwar recessions in the United States was 10 months, and the two longest recessions lasted 16 months each. 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 it has already broken the previous record for duration.

However, with the globally concerted policy efforts that have been undertaken, I am sure that a global economic recovery, although anemic, will begin soon, perhaps in a few months. My discussion of the global policy responses is based primarily on the G-20, which produces more than 85 percent of global gross domestic product.

Let me now turn to the causes of the current crisis. Indeed, many factors are blamed. Some observers point to the lack of prudent regulation and supervision. These critics go so far as to say that the current crisis was caused by "the greatest regulatory failure of modern history." Still others point to excessive greed, excessive risk

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taking, and overleveraging on the part of financiers. Others single out low interest rates, overly accommodating monetary policy, and global imbalances. Certainly, no one factor deserves all the blame. These factors are all interrelated, and they are both the causes and the consequences of each other. Therefore, it is difficult to single out the main causes of the crisis. I am sure that numerous 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 pushed the financial markets to search for high yields. Since financial yields are inversely related to the quality of credit, the result was a boom not only in subprime mortgages but also in other risky assets. Particularly in the absence of a prudent regulatory and supervisory regime for the whole financial sector, shadow banking and off-balance-sheet transactions multiplied. Also, with rapid digitalization and computerization, new financial instruments were introduced so quickly that the regulators and supervisors could not keep up with developments.

Obviously, these developments could not be sustained without the existence of global imbalances of savings and consumption or the "global savings glut," which supported the low interest rate regime in the United States for so long. Furthermore, with accelerated globalization—financial globalization in particular—the crisis started in the United States and immediately became a global crisis.

Naturally, the overleveraging, excessive risk taking, and excessive spending of U.S. consumers were doomed. When the subprime mortgage market started to crumble, the negative impact spread quickly throughout U.S. financial markets. You know the rest of the story: the contagion spread throughout the world, making the crisis the worst since the Great Depression of the 1930s.

At the early stage of the current crisis—that is, when the U.S. government dealt with the Bear Stearns problem in March 2008—none of us foresaw the severe global crisis in the making. Many saw the problem as specific to one nation or one sector. Consequently, policy responses at the time were based mostly on initiatives in individual nations.

However, following the bankruptcy of Lehman Brothers in September 2008, the world had to come to terms with the seriousness of the crisis and to recognize that combating it required concerted global responses. Leaders of the 20 globally important economies gathered together in Washington, DC, on November 15, 2008. In my view, the gathering itself was a historic event for global governance. Until then, under such circumstances, only leaders of the G-8, which has been acting as if it were an informal global steering committee, would have gathered. 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 G-20 summit, the *Washington Post* described the occasion as marking a "historic power shift." To be more accurate, I would say that it was a delayed recognition on the part of the G-8 of the shift in global economic power that had been taking place during the last couple of decades. For the same reason, Paul Krugman claims, "This is two decades too late. But better late than never."

In any case, the G-20 leaders in Washington, DC, shared a common view regarding the seriousness of the current crisis and agreed to take concerted policy measures. This global response would differentiate the current crisis from the Great Depression of the 1930s. You will remember that the world leaders met in London in 1933 with a purpose similar to that of the gathering of G-20 leaders. However, the meeting in 1933 failed to agree on exchange rate policies. In stark contrast to that, the G-20 leaders in Washington last November decided to meet again on April 2, 2009, to follow up on their agreements and to see if additional measures were needed. As you all know, the third G-20 summit is scheduled to be held in Pittsburgh on September 24–25, 2009.

Now, I would like to bring your attention to the G-20 summit meetings held in Washington, DC, and London in November 2008 and April 2009, respectively, and outline briefly 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 issue specific guidelines. Second, they also decided to resist protectionism and to avoid repeating the same mistake the world made in the 1930s. More specifically, they agreed to have a "standstill" agreement on protectionist measures regarding trade and investment for at least one year.

At this juncture, critics may point to the fact that by March 2009, 17 out of 20 countries had taken 47 protectionist measures in one form or another. They would say, "What is the big deal about a standstill agreement that does not do any good?" My response would be that none of those measures has seriously distorted global trade yet. It is my view that given their public commitments, the leaders would pause before taking any serious protectionist measure.

The leaders in London this year committed to monitoring and publicly reporting protectionist measures for the purpose of "naming and shaming" effects. In addition, the leaders in London recommitted to the standstill agreement 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 G-20 summits is that special attention was paid to emerging and developing economies, which suffer the most in times of crisis. The leaders' decision in London to enhance international financial institutions' resources with an additional $1.1 trillion would benefit primarily developing and emerging economies. The rest of the world would also benefit, as these resources would become an additional global stimulus as they are spent.

Let me now take a brief moment to say a few words on the role the Republic of Korea played in the process of preparing the London summit. First, Korea made strenuous efforts in cooperation with the United Kingdom, the chair country for the London summit, to have the G-20 leaders agree to produce deliverables and implementable measures. Toward this end, Korea played a key role in bringing the International Monetary Fund (IMF) and the World Trade Organization (WTO) into the G-20 summit to take advantage of their expertise and analytical support.

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

Now, I would like to turn to the prospect of the forthcoming G-20 summit. With the globally concerted policy measures taken by major global financial and economic players, the recovery of the global economy appears imminent. However, considering the fragility of the recovery, it would be premature to put the "exit strategies" outright on the agenda for the Pittsburgh G-20 summit in September 2009. Doing so would most likely give the wrong signal to the market, pouring cold water on the green shoots of recovery. Therefore, I would rather see the exit strategies fully discussed at the fourth G-20 summit, assuming that the leaders will decide to meet again sometime next spring. In fact, for this very reason, the world may need another G-20 summit meeting after the Pittsburgh summit.

At this point, I would like to reemphasize that the G-20 leaders should be mindful of the dire consequences of premature exit policies taken during the 1930s in the United States and the 1990s in Japan. Considering the "depression-sized" current crisis, the G-20 leaders might want to take the risk of unwinding their countercyclical policies later rather than sooner. I agree with Martin Wolf, who says, "The world needs aggressive monetary and fiscal policies far longer than many believe." Of course, there is the danger of "malign stagflation" if the global stimulus is withdrawn too late. However, considering the pace at which private sector balance sheets are being repaired all over the world, the likelihood of stagflation does not seem to be higher than the danger of reverting to recession if exit strategies are implemented too early.

Clearly, at the Pittsburgh summit on September 24–25, 2009, the leaders will have to follow up on their London agreements by making sure that they are being implemented properly. You will remember the cheer the global community—the financial community in particular—gave to the outcome of the G-20 summit in London. I believe that this was because the summit came up with not just rhetoric but also deliverables. However, to make the G-20 summit effective and relevant, the deliverables need to be delivered in due course. I would like to emphasize again that in the process of following up, special attention must be given to 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 prevent the recurrence of similar crises in the future. In doing so, the G-20 leaders, instead of overhauling the existing international financial architecture, decided to improve on the existing international financial institutions. 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 the political legitimacy and operational effectiveness of these institutions, the G-20 leaders were particularly mindful of emerging economies' increased representation and enhanced voices.

In my view, their approach is not ideal, but it is realistic and practical, considering the complex global decision-making process. However, at the forthcoming and future G-20 summits, bolder reforms regarding the governance and mandates of these institutions should be introduced to make them more legitimate and effective.

For example, with regard to governance of the IMF, in addition to the agreement on the expedited quota adjustment made in London, representation on the executive board needs to be adjusted further. Currently, eight out of 24 board seats are held by European countries, which is disproportionately larger than their current economic weights. To make the IMF more reflective of the global economic reality, readjustment seems to be the order of the day. Doing so would make the IMF more legitimate and effective.

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

At the same time, it is important to increase the role of the IMF in overseeing the international capital markets and their transactions. These issues should be addressed fully 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 G-20 leaders at the Pittsburgh summit should recommit themselves to resisting protectionist pressures.

Even with these efforts at both the global and national levels, 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 regional 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 that should be put on the agenda of the Pittsburgh summit, in my view, is how to strengthen global governance by making the G-8 and the G-20 complement one another. Although some say, “The G-8 is obsolete,” and others say, “The G-20 will sound the death knell of the G-8,” I do not think that the G-20 summit should intend to replace the G-8 summit. Instead, there should be a serious political endeavor by the G-20 leaders to find ways to cooperate and coordinate for maximum synergy between the two processes. I personally think that with an appropriate division of work and mechanism of cooperation, they can be mutually reinforcing of better global governance.

The real challenge is how to work out the appropriate division of work and cooperation. No doubt this will be a politically complex and sometimes painful process. Even then, the G-8 leaders together with the rest of the G-20 members should make conscientious efforts to attain this goal. I was glad to see that the recent meetings of G-8 finance ministers in Italy discussed cooperation with the G-20. I hope that the meeting of the G-8 leaders in L’Aquila in July will keep 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 more integrated; the problems not only of neighbors but also of a far distant country can quickly become one's own and those of the world. In light of this, in addition to appropriate policy measures and institutional reforms at the national level, the G-8 and the G-20 together on behalf of the whole global community should be responsible for appropriately managing and strengthening global governance with the aim of achieving sustained global stability and prosperity.

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