

The Current Global Economic Slowdown and Asia

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It is always a great pleasure to be here in Korea, but I think this is the first time here that I will have addressed an audience primarily of students. There have of course been students that I have met and talked with, but this is the first student audience, so I am anxious to get through my talk so that I can hear questions to find out what students are thinking about the current global financial crisis.

We are meeting at a time when there is frenzied anxiety throughout the world about the state of the world economy. I certainly do not recall anything like this during my lifetime, but more than that, I have read a fair amount of economic history - I once had to go through all the economics press about international economic relations during the Great Depression - and certainly, there was nothing in the newspapers in that time that gave anything like the same sense of communicated panic and fear that we have in this recession.

I would like to start out with the background and origins of our current difficulty and then present briefly the two different factors that are feeding into it that are making it so very complicated to figure out. Then on that basis, I would like to talk about what we think might happen and finally, the role of Korea and the rest of Asia in the international economy.

[Background]

Let me start by pointing out something that is very important and not fully appreciated.. The international economy has been very successful over the past 60 years. There has never been a time like it in world economic history. This has been a time of economic success for the entire world, not just for a few countries. Korea has been more successful than most, but even countries in Africa that we think of as doing poorly have living standards that are somewhat higher and education standards that are considerably higher than they had 50 years ago. They are still very poor, certainly by our standards, but they are better off than they were and there's no record of a time in human history when the entire world has made this kind of progress. For the six years before this crisis, it was estimated that the world GDP grew at a rate of over five percent per year. You cannot find a time like that in history at all comparable. So, do not forget that we have a system that worked very well.

One of the things we learned in this sixty-year period of rapid growth is how very important the international economy is. Countries that are open and integrate with the rest of the world have had much more satisfactory and more stable growth than the countries that have not done so. It is not true that problems are avoided by isolation from the rest of the world. There are different problems, which by and large, are worse.

International trade over the past 60 years grew at about twice the growth rate of world GDP. It has been a major engine of growth, a mechanism whereby developing countries that were intent on economic growth could achieve much more for the same effort. By opening up to the international economy, they could get competition which they could not get in small, closed economies and also get needed technical change. Having a crisis is not good, but it is not the worst thing in this world. I know a very easy way not to have a crisis. Just become like Myanmar. You will have stagnation, but you will not have a crisis; things will just be very bad all the time. So I want to stress before I start that while we have a crisis, it is not the worst thing that could have happened to the world. One of the other things I want to leave with you is that it is very important as we go forward that when we make policy decisions affecting the world economy, we make them now not only for what they do in the short run, but we make sure that they will not interfere with getting back to that healthy growth trajectory that we had.

The second thing I want to say by way of the preliminary is that if I leave you with the impression that I understand what is going on, I will have misled you. This is a very complicated situation and nobody understands exactly what is going on. There will certainly be academic researchers for at least 10 years, looking back at what has happened and what led into this situation, discovering more and more about it. One of the problems policy makers have is that they cannot wait until the researchers are done, they have to act on what we know now. In some circumstances, that is a real problem.

[Current Global Economic Crisis]

Balance Sheet Recession

For a long time, there have been two basic theories of recession. One of those is very well-known, the Keynesian theory of aggregate demand, which argues that recession is because aggregate demand is inadequate; to get the economy out of trouble the policy prescription is to have more aggregate demand. This can be done with some combination of easier monetary and fiscal policy. Easier money helps lower the interest

rate which stimulates investment, and at the same time, if you cut taxes or increase government expenditures, that creates even more demand.

There is another view complementary to the Keynesian theory of aggregate demand, but which was largely forgotten because it has not been experienced in the post-war period and that is what economists refer to as a balance sheet recession. Once asset prices start falling in a balance sheet recession, the owners of those assets have their balance sheets impaired. When someone does not pay his or her bank loan, the bank finds that it has to write off its non-performing loan. It then has its equity slightly impaired, so now it has to sell some assets so that it can replenish its equity, but somebody has to buy them. From an increased supply of assets, the price of assets falls. The fall in price means that other people have their balance sheets impaired, so they have to sell some assets as well, which makes the price of assets go down again, and you get a vicious circle on the asset side. In the current recession, we can see much more of that component than we have in past recessions. With an aggregate demand recession, although you do not know from past behavior what will happen exactly this time, you can get an estimate. With the balance sheet effects we are much more in the dark, as we have no easy way to go back and look at what happened. This current global financial crisis is in a very big part a balance sheet recession.

Housing Market

What happened in the housing market was simple. Housing prices began to go up and there was a very low interest rate. With very low interest rates, housing became attractive, because mortgages were cheap, so there was more demand for housing. Housing construction increased, but housing prices also increased and as this happened, people began buying houses not because they wanted to live in them, but because they thought they were a good investment. As more people bought for speculation, the price of housing went up some more and for awhile there was a bubble, a situation where there were self-reinforcing increases. In the summer of 2006 in the United States, a little bit before that in the United Kingdom, much before that in Australia, later than that in Spain and in many other countries, there has been that same experience because of low world interest rates.

When the bubble finally burst, housing prices began to fall. When that happened, some people found that the amount they borrowed to buy the house was greater than the value of the house itself. They thought that there was no point in trying to pay the mortgage

and walked away. People put the keys in an envelope – in the United States, they call it “jingle mail” - and mailed them back to the bank. Banks do not want to be landlords, so they tried to quickly and naturally sell the houses that people were not paying for anymore. Consequently, housing supply increased, and at the same time when housing prices were no longer going up, the demand for housing fell because there was no more speculative demand. As a result, the housing prices fell some more. When the prices of houses fell even more, so many people found their houses under water as the mortgage was worth more than the value of their houses and we got a vicious circle in housing of this asset variety. So, there was a real side to it too. The number of new housing starts decreased, which led to less demand for building materials and fewer workers in the construction industry. Accordingly, there were massive layoffs and that cut both incomes and aggregate demand. Both the demand for housing itself and the construction workers who no longer had jobs were part of aggregate demand, so we ended up with a recession where we have a balance sheet effects in the banks. Both factors were at work in this recession to a much greater extent than they have than in any recession that I can think of, certainly since the 1930s.

Flow of Credit

One of the lessons from everywhere that I think every economist agrees on is that you cannot have a healthy functioning economy without an adequate flow of credit. If you cannot get credit circulating, you are in major trouble. What happened with the flow of credit was that the banks had taken a different stance toward mortgages than they had earlier on. In the bubble, banks took many mortgages as before, but instead of holding those mortgages, they originated them and then sold packages of slices of mortgage. What do I mean by a slice? For example, you take 20 mortgages and you sell the first three years’ payments at a low interest rate to someone who is fairly risk averse. Then you take the next three years of payments and you sell the rights to those to someone else at slightly higher interest rate. When you sell the mortgages in packages of three years, nobody knows who owns the mortgage and even if you knew, you would have to get all the owners to agree to the restructuring terms, which basically cannot be done or quickly enough in the current situation. Furthermore, there is no way of finding how who owns which mortgage and who owes what to whom.

When people began being unable or unwilling to pay the mortgages, the banks did not know the value of the risky assets they had in their books. One of the many things that happened is they got a little bit ahead of themselves. They thought that they had gotten

rid of more of the mortgage risk than they had. In fact, some of the banks' CEOs did not know that they had residual liabilities. However, when the residual liability was recognized, everyone became very suspicious of everyone else, because nobody knew how much bad paper was in anybody's portfolio. This resulted in the unwillingness of banks to lend to other banks, because they did not know if that bank would still be solvent the next day. We had a credit freeze when that happened, and it became very serious after the fall of Lehman Brothers. It started to some extent before that, but Lehman Brothers was the icing on the cake. Thus, in the fall of 2008, we had a very bad credit freeze from which I hope we will recover pretty soon.

With everything that has happened in the mortgage market, we of course had some very big failures. The first one is Bear Stearns, but then we had Freddie Mac and Fannie Mae, they of course held guarantees of a lot of mortgages and ran out of money. Then we had AIG, Lehman Brothers, and a number more of big, respected financial companies that ended up with non-performing loans so their equity was wiped out. In some cases, for example, Citigroup and Bank of America, the solution has been to put money in to keep those banks going; in others, it has been to let them be sold to another bank, to force a merger, etc. Sorting out the banking situation is essential to get the flow of credit going and sorting out the housing situation is essential to prevent the banking situation from getting worse.

[Global Imbalances]

Low interest rates are not important right now in the intermediate term, but they are very important for longer term growth. There are three things to worry about: turning the recession around, the recovery, and getting back to longer term growth. The low interest rates accompanying global imbalances encouraged financial people to look for what they refer to as a search for yield. When interest rates are very low, you are looking for something that yields a higher return. When bankers and others are looking for higher returns, they must be willing to take on more risky ventures. One of the things that happened when interest rates became low was that in addition to mortgages, banks and others began lending more to more risky things. There was a big, so-called "carry trade." A carry trade is when I borrow, for example, some Japanese yen and I promise to pay my two percent. Then I go and buy New Zealand dollars, which yield seven percent and I invest them in a seven percent New Zealand bond. I get the interest

on that bond, I pay the two percent to the Japanese and I keep the five percent in my pocket; it's a good deal. However, I have big problems when the New Zealand dollar devalues.

Why were interest rates low? Again, if I told you I know for sure, I would not be telling the truth. However, I think everybody agrees that at least part of all the explanation lies in the fact that we had global imbalances. There were some countries that were spending far more than their incomes and therefore running deficits in their trading and current account and other countries running large surpluses. First, you had huge surpluses on the part of the Chinese and from oil exporters. Those surpluses had to be invested somewhere and the United States was the destination of choice. If that investment was to be absorbed and be used in the United States, interest rates had to be very low. Some people claimed that there were more savings than could be usefully absorbed in the world economy. Another way of saying it would be that there was not sufficient consumption in China and too much in the United States. Either way, we had the global imbalances, which in turn led to low interest rates. This intensified the housing booms in many countries, which then set the stage for the bubble, which happened and then burst. The immediate causes of what happened had to do with the financial sector and the housing market in 2006-2007, but before that was the basic problem of low interest rates.

However, before you say that it is all the fault of the United States because it ran large current account deficits, let me point out something very sad. If the United States had not been willing to run current account deficits and had taken sufficient measures so that the current account deficit was cut even in half, there would have been a highly restrictive monetary and fiscal policy. With a highly restrictive monetary and fiscal policy, the United States would have had much slower growth and it would probably gone into a recession. If that had happened, the rest of the world would have had to grow much more slowly, so we would not have had the five years of good growth leading up to 2006. The problem was one of imbalances. Somewhere, some were saving too much and others were consuming too much. What was needed was not to cut world consumption, but to get consumption more balanced between those who were saving more and those who were not. That problem, once we get out of the current mess, is going to recur again unless action is taken and it is something important for the longer run.

But, I now need to go back to the crisis and discuss where we get to from here. All kinds of things intensified the housing bubble and made it worse at times people did not even recognize. In the late 1990s, Congress passed a law requiring that all banks make a certain percentage of their mortgages to very low income households. In many cases, these were households that probably should not have been taking out a mortgage, but the banks were perfectly willing to put 10 or 15 percent of their money into these low income loans, in part because Congress wanted Fannie Mae and Freddie Mac to guarantee them and in part because they needed to do what they could not do with the rest of their mortgage business. That is partly the reason why Fannie Mae and Freddie Mac failed, because they had too many non-performing loans coming in. It was not only that the foolish bankers were making bad loans; bankers had to do it partly because they were required by Congress. If anybody says that it was wholly too much deregulation after 2000, at least in the United States, he or she is wrong, because there was no such deregulation after 2000. However, it did have something to do with a little more regulation before 2000. The simple story that deregulation led to the crisis has very little to do with the truth and simply does not fit the facts.

Consumers also began drawing home equity loans and using them for other purposes, which drove up United States' consumption and housing, all of which contributed to the crisis that came. The crisis started in the sub-prime part of the markets, but once the prices of the low-income housing began falling, other parts of the housing market began to be affected. Once that happened, the fall in housing prices became much more general. Even then, when people began getting laid off from their jobs and becoming unemployed, there were of course some people who basically expected to pay their mortgages and expected to continue to work, but could not do so. However, there was another group and this has to be remembered because it makes social policy very hard. There were a lot of people who borrowed a 105 percent of what the new house cost. They borrowed it because they could and thought housing prices were going up. They intended to keep the house a year or two, then sell it and make money, pay off the bank and walk away. A lot of houses that have been foreclosed have never been lived in. People did not buy all of them to live in, but bought some of them for pure speculation. If there had not been as much speculation, it would make policy toward bringing the housing sector under control far easier than it is now. One thing you can be pretty sure of is the recession will not hit the bottom until prices in the housing market more or less stabilize, because until that happens, the non-performing loan situation is going to get worse no matter what you do in advance. To get rid of that, all mortgages would have to

be guaranteed, which simply cannot be done and we have to worry about this issue as we go forward.

In the United States, the worst thing that came about quickly was the Lehman collapse. Partly because people did not expect it and partly because nobody foresaw that the government would let it go. Then the question was who else would they let go? Who else is going to go under, who will be the next one that will fail? That question has died down a little in recent months, but it is not gone. There are still some issues there as to how solid are the banks that are important in the recovery. However, when Lehman Brothers failed, credit froze almost absolutely. I know that Korea has lost orders on exports and one of the reasons is that one of the parts of the credit market that froze up fast is trade credit. Almost no international trade happens without trade credit financing, which finances from the time the exporter ships until payment is received from the importer.

In the fall there was also a very steep and sharp plunge in consumer spending. People were scared. They did not know what would happen, so they stopped spending not only because they had to, since they did not have any money, but also because they wanted to hang on to what they had until they knew for sure what the situation was. We then had a period from September to probably some time in February when things went down very rapidly. I stress once again that this was not only in the United States; the biggest housing bust was probably Spain. The low interest rates had the same effect in many parts of the world.

[Future Prospects]

So, what do we do, where are we now, and where are we going? The first question is when is the bottom and what is going to happen? We need action both in the balance sheet repair and aggregate demand. You can increase aggregate demand all you want, but as long as balance sheets are impaired and inter-bank lending does not resume, the problem will not be solved. There are perfectly good businesses in the United States where they have laid off their workers, because even though they had a hard line of credit, the bank withdrew it. Therefore, they could not get working capital and could not buy materials, so the workers have nothing to work with. As soon as they can get working capital, they can work again unless the orders dry up. It is not a matter of lack of demand, but a lack of credit. There are other businesses whose orders have dried up

and they of course too have a problem, but it is a different problem. Since both are happening simultaneously, it is very hard to sort out the cause of the problem. The first question then, is whether enough has been done to reverse the downward pressure or at least stop it and that is a judgment call.

On the financial front, restoring the flow of credit is the objective. There have been measures taken; we have to remove the bad paper from the banks, we have to restore their equity, we have to make sure there is not more bad paper coming forward. For this issue, what happens in the housing market is critical and that is interesting because just in the past month, things have begun looking a little bit better. There are a few housing markets in the United States where housing prices have actually started turning up. There are others where at least it looks as if the bottom is there. On top of that, the evidence seems to suggest that there is a normal replacement demand plus new household formation. The estimate is that you need about two and a half million new housing units per year in the United States to meet that demand, meaning approximately 1.8 million of those houses that are sitting there right now will be used and there is some evidence that that should very quickly lead to a turnaround in housing. Moreover, the rate of decrease in housing prices does seem to have slowed down. Hence, on the housing front, there is some hope that things may go forward. There is some optimism that perhaps by the summer, the housing market will at least bottom out. If that happens, that stops the problem of uncertainty as to what is in the banks' portfolios.

Secondly, the United States has a huge stimulus starting to feed in and if that is not enough, the government will do more. One of the reasons for the very big drop in economic activity in the fall was that people were scared about the future. They were worried that they might not have enough money. Once we get rid of some of that uncertainty and once it looks as if the bottom is there, it is likely that some people will start buying the things they put off buying. As that happens, that will help bring about the bottom or the upturn too. So, if people hear news about the housing market, they will probably spill over into other markets.

The interesting thing is that the stock market has risen about 20 percent since the 1st of March. When the stock market prices increase, firms have more equity including banks. As they have more equity, they have a better basis on which to borrow, which means they can lend more, which means that the bad news can start unraveling and the good news can start coming in. If the stock market continues at its present level and it rises

even further, that will give more latitude up for some American and European companies to be able to get back to filling their orders, have working capital, and get things moving again. On several fronts right now, then, there is at least some glimmer of hope that if the bottom is not here yet, it may be fairly close. Meanwhile, the Treasury in the United States says it is conducting stress tests on the banks to see how solid they are. They said they would announce the results of those tests by the end of April. If they credibly announce that these banks are solid, that again could be some restoration of confidence in the system and all these things could feed into a gradual improvement over the next few months. I think there is a reasonable basis for hope, that we could see the start of the turnaround fairly quickly. On that argument, you will probably see the bottom some time in the summer of 2009, which is not that far off, and economists I know whom I respect greatly, who are quite convinced that will happen. I know economists who are equally convinced it will be 2010 before we get the turnaround. I think I end up not convinced that it will turn around this summer, but on the optimistic side; we will be more likely to have that than not.

However, the next question is, once we get to the bottom, how quickly will things turn up? To use the words that are now being used all over the place, the recession could be V-shaped – you go down very fast and you come up very fast – or it could be L-shaped. The argument for the L-shape is the banking situation and the balance-sheet repair situation. The government stimulus that is in the works in the United States surely by the beginning of 2010 will have a major effect on aggregate demand. Maybe not before that, but certainly by then, and meanwhile if everybody sees that coming, it is even more likely that we might sooner get the turnaround. Whether V-shaped or L-shaped, again, it is a judgment call. I tend to think it is more of a V-shape, because the precipitous drop in consumption was not the function of what happened in the real economy. It was expectations and news of the decrease in asset prices. The minute people learn that they are not going to get wiped out, I suspect to see some increase in the flow of consumption. Meanwhile, inventories in a number of places have been worked off and that too will help in terms of the turnaround. I tend to be moderately optimistic over the short term and the medium term.

But there are questions about the longer term. We do not want to do things to get out of the recession that will result in stagnation or slow growth in the international economy over the next two decades. On this score, I am a little less optimistic for several reasons. First off, when large stimulus packages kick in and especially when the recovery starts,

they are going to lead to strong inflationary pressure and to very high debt to GDP ratios for many of the industrial countries, including the United States. The estimate for the United States fiscal deficit for this calendar year is 13 percent of GDP. The United States' debt to GDP right now is 55 to 60 percent. GDP is not going to rise this year, so that says that this year alone we could get a new increase in the debt to GDP ratio of over 70 percent. It is fine if interest rates are low while the recession is going on. However, when the turnaround comes and demand is picking up in the private sector, that could be a real problem and then there will have to be a way of pulling back all of the liquidity that has been poured into this system. Politicians are naturally much more concerned with their unemployed citizens right now and they care much less about what is going to happen three years from now. Over the medium term, restoring fiscal balance is going to be terribly important and if we don't get enough liquidity out of the system, we will revert to the instability of the '60s and '70s in terms of global macro-economic policy and that itself hurts growth. That is reason number one.

A second and equally important reason is that we see protectionist pressures in a number of countries. The G-20 heads of government in November promised that there would be no new protectionist measures for a year. Already in March, 17 of the 20 countries represented by those heads of government had taken 47 protectionist measures, that the World Bank could identify. Some of them are not that major, but others are more so. The Indian government cut off imports of all toys from China, which is protectionist and against WTO rules. Argentina has ceased automatic licensing for a whole variety of consumer goods imports and that is fairly major; the United States has decided to subsidize the auto industry and once the United States did that, everybody else is doing it. I previously mentioned that one of the underpinning factors of good, healthy economic growth is the open, more liberalized international trading system. Yet the trading system is under threat, partly because of the recession and the protectionist measures it brings and partly because of the fact that the Doha Round of multi-lateral tariff reductions was not completed before this crisis. It is very difficult to roll back protection once it is in place and yet more protectionist measures are being implemented. If then other countries retaliate, as it happened in the 1930s, that could all portend very poorly for long term growth, even if we get out of the current mess.

It is not a small issue in the longer term. One of the things that we all need, especially countries like Korea, is to get into a world where protectionist measures are not used to try to offset macro-economic difficulties of the kind we are now having. There is a lot

more work that needs doing on the international trading system. There is a whole variety of important issues surrounding preferential trading arrangements and the discrimination they lead to, capital flows, etc., and these issues have to be addressed. Instead, we are moving in the wrong direction and there could be momentum to it, which is scary.

So in the longer term, I have major concerns. I have concerns about inflation, fiscal balances, the entire trading system, and global imbalances. There is plenty to worry about in the longer term. Obviously, getting ourselves out of this crisis is the first step, but let's not in the process do things that could hurt the longer term. One of those things that I have not focused for a lack of time is financial regulation. Every politician right now says that the whole problem arose from not having enough regulation. Maybe we did and maybe we did not, I do not know. But I know that there is some regulation or regulatory reforms we could have that would make things worse and others that would make them better. I hope there is enough differentiation between those.

[Role of Korea and Asia in the International Economy]

Let me turn to Korea and to Asia. Obviously, Korea has already been hard-hit, especially by the freezing of trade credit. The impact was probably a little greater, because Korea has been supplying intermediate inputs to some other countries and intermediate inputs have been harder hit than the final products, because businesses run down inventories as they adjust. However, that is also hopeful for Korea because once inventories are run down, as business picks up, the orders will go with it, and perhaps even more orders for inventory.

Korea is fortunate in that policy makers have been good in building up considerable reserves, which gives something of a buffer, and of course changes in the exchange rate and keeping that rate flexible has offset some of the impact from the freeze in trade credit. The trade account has turned positive these last two months, which has been very helpful. There is a bit of an issue as to whether there is enough liquidity to cover financing needs this year and having that trade account in surplus is important in having a safety cushion. The outlook for Korea is probably a little bit better than the outlook for a country like the United States. In Korea's case, it looks to me at least, as if it is a much more classical aggregate demand phenomenon and therefore is somewhat more easily handled if the world economy turns around. But, that said, Korea is more likely than

many countries to get hurt if protectionist pressures increase, because Korea is more open and depends more on trade with the rest of the world, and in that sense, has more to lose. Thus, the longer term outlook may not be as good due to the aforementioned reasons.

With that in mind, an important question is why is it that trading countries like Korea have not been more vocal and have not taken more of a leadership role in pushing for conclusion of the Doha Round? Why has Asia not taken more leadership in international forums on these issues of great importance for the economies not only of Korea but for almost all of Asia? The majority of Asia is highly dependent on trade and for growth prospects, needs trade probably even more than the United States and the Europeans do and therefore has a special interest. Yet, I see very little leadership coming out of Asia on these subjects. Asia has become more important in the world economy. Asia is now a major player in the international economic community, so I think Asia's voice should be much more than it is now and there is scope for change in that regard. China has a special responsibility with regard to global imbalances, but I think countries such as Korea have a special responsibility to convey their need to have those imbalances resolved rather than sitting back and waiting for the very large countries to do it. We have already figured out that they are not very good at that and pressures need to come from somewhere else.

I would argue that if there is one thing that Asia needs to change, it needs to move from being a passive recipient of the healthy world economy into a much more responsible partner, taking on much more of a leadership role and being much more adamant as to what Asia's interests are in this system. Now, that said, I know exactly what your reaction is going to be. It is going to be, "Well, we do not have a share of the votes we need at the IMF and the World Bank." You are right, you do not and the share should increase. I think Korea now has the 18th largest number of shares; it ought to be 10th, but it is 18th, Korea has a voice, and it should be heard. Much that goes on in the international institutions and organizations is on the basis of discussion, ideas, and leadership. It is not only the percentage of votes that matters, but the ideas and proposals that come forward, the argumentation at the Board of the IMF are terribly important. Governance is an issue, getting an appropriate share is an issue, but it is not *the* issue of the moment and it certainly is not the only issue, and I would end by making a plea for a stronger emphasis on the part of Asian countries in general, but since I am in Korea, Korea particularly, to play a more active role in discussing and

advocating various kinds of policy options that could make the world a better place in the longer run. The role of Asia is already bigger than Asia thinks it is; Asia is just not taking advantage of it. On that note, let me stop here. Thank you for your attention and I will be happy to listen to Professor Pyo's comments on all this and start learning the truth from an Asian viewpoint. Thank you.

[Prof. Hak-Kil Pyo, Department of Economics, Seoul National University]

I am very thankful for this invitation and also feel very privileged to be a discussant on Dr. Krueger's speech. What is surprising is her global perspective; she introduced two key concepts for us to understand. The first key concept is the balance sheet recession, which is not a typical Keynesian recession and as a consequence, it is much more complicated. Therefore, it may not have an immediate solution as Dr. Krueger already mentioned. In addition, Dr. Krueger also emphasized the need for a true meaningful international coordination, not simply verbal or political gestures. This is a fallacy of composition situation, where one country's protectionism spills over to another country's protectionism. Dr. Krueger finds Asia's solution, as well as Korea's solution, as becoming more of a vocal group in the international arena that speak for themselves and argue for trade liberalization rather than trade protectionism. I think most of her points are very well-received and I think it is important for us to understand her main messages.

I have prepared a few slides to complement what she has said and also to promote an interaction between our talented audience with Dr. Krueger herself. This is one slide that I prepared that I like to always use from her article from 1977. I think in the case of Korea in this financial global crisis, there still remains one big question: why has Korea's KOSPI failed by a very substantial margin and why has Korea's currency deeply depreciated? Most of these charts cover important Asian countries. As you can see, against the dollar in the last one year period, you can see that the Japanese yen has appreciated by 18 percent, whereas on the other hand, Korea's won has depreciated by 35 percent. The Chinese yuan has also appreciated. Between the Japanese yen and the Korean won, there is almost a 50 percent margin of depreciation.

In a discussion over luncheon, Dr. Krueger pointed out the large impact the yen carries, but that the yen itself cannot fully explain the 50 percent marginal divergence. This means that there is a clear-cut imbalance at the pre-crisis currency alignment level, meaning that the yen was terribly undervalued while the South Korean won was terribly

overvalued. As you can see, these are stock market bonds. The Japanese Nikkei went down by 42 percent, Korea's KOSPI by almost 40 percent. This shows that even within Asia, the direction of currency valuation does not always go hand in hand with the stock market movement. In the case of Japan, the stock market decline coincided with currency appreciation instead of depreciation. These are all issues that we have to resolve.

These charts demonstrate why the Korean market can be characterized by sort of a decoupling; we can say that once a foreign financial crisis emerges, as Dr. Krueger correctly pointed out, Korea is more vulnerable as a consequence of the 1997-1998 financial crisis. The dependence of Korea on stock markets and foreign investors has increased. The level of decoupling has characterized the Korean market, so it becomes more vulnerable. You can see that even though macro indicators were reasonably stable up until the third quarter of 2008, there was indeed still a great deal of vulnerability in terms of KOSPI won-dollar rate. This synchronization and level of decoupling show Korea's vulnerability from then up until now. Korea's market has been much more volatile. In contrast to the proposition that Korea has been relatively less affected by the current financial crisis, the empirical data show a great deal of vulnerability.

Dr. Krueger mentioned global imbalances, that of trade and fiscal surplus of China, for example, and a great deal of trade and fiscal deficit of the United States and the rest of the world. As a complement to her remarks, let me point out the imbalance between the real sector and the financial sector, pre-existing before the current financial crisis. According to this chart and as Dr. Krueger explained, between the period of 2003 and 2006, major economic industrial nations have enacted easy expansionary monetary policy and fiscal policy. However, per capita labor productivity is a value-added labor productivity, which means how much value-added was created per person. This shows a very opposite direction; in other words, many nations simply were not producing as much as they should have been producing to be consistent with this expansionary macro-economic balance. I think this imbalance between macro-economic policies and labor productivity was the main cause behind the speculative bubble.

Another chart that I would like to share with you is the database of Japan, the United Kingdom, the United States, Germany, and Korea that I have involved myself with in recent years. For example, look here at the per capita real value-added of five countries' average. This is a financial intermediation industries per capita value added. This blue

line is total manufacturing average. Of course, per capita value added of this financial industry is higher than manufacturing. So it is natural that the financial sector must be paid more, but the gap between these two sectors has been inconsistent and it was diverging. In other words, the financial intermediaries' pay is diverging away from real per capita index. In the case of the United States, the divergence is even larger. In Japan, the divergence is relatively checked and in the United Kingdom I would say it is containable. In Germany, it is relatively stable as well. How about Korea? I think the Korean case is the most interesting one. Why is the real per capita value-added of financial intermediation almost the same as manufacturing? They have been paid much higher. We are having financial industries still full of very highly paid workers without going through real meaningful structural adjustments. That is why we are having financial stress result run by many international credit rating agencies. That is why the Korean financial market is more fragile, more volatile, because even though this is very small evidence, the marginal per capita salary just does not guarantee the per capita real value-added difference. Still, we have a great deal of homework to do and we need a more rapid and significant structural adjustments and restructuring in Korea's financial industries.

[Dr. Anne Krueger's Comments to Professor Hak Kil Pyo's Remarks]

I do not have very many comments. One of the striking things in your graph is the very rapid growth of productivity in the real sector of the economy, non-financial. If you look at all the other countries in this graph, Korea has had the most rapid growth in the real economy of labor productivity, labor value-added, of any of the countries charted. There may have been elements of over and undervaluation on the exchange rate, but one of the interesting things about those charts is that Korea had the bigger exchange rate change and Korea does not have the biggest drop in real GDP. Countries that tried to keep their exchange rate did worse. The exchange rate, as I said in my lecture, did help buffer Korea to some extent.

The vulnerability came from the fact that people are looking at the short term how much new money Korea needs to roll over its existing obligations in 2009. In January, it looked as if Korea had for sure 75 percent of what was needed and that is a low number. But now, it is up to about 100 percent, which is better, but it may yet not be enough. I think that is another reason why there has been more concern about Korea, because of the short-term financing issue. It is why the current account surpluses these last couple

of months are important, because that gives more cushion and it also means there is not that drain and it will give more confidence. Having seen those numbers since I got here, I am much more confident about Korea this year than I was ahead of time, because that source of vulnerability quite clearly contributed to the exchange rate and it is less of a factor now than it was because of the turnaround.

Question1. [KH Lee]

Let me ask my question by comparing the 1997 financial crisis and the current one. First, similarities between the two are that both are pretty much balance sheet recessions as you described and we are in need of the dollar in both times. The previous one originated from Asian countries and the current crisis originated from the United States. Another thing is that the pain was carried by the Asian countries, but this time, the burden is shared equally by all the countries in the world. At that time, we were required to reduce liquidity by tightening up monetary and fiscal policy, and as a result interest rate went up. But this time, the key word is liquidity supply all over the world, so interest rate, instead of going up, is going down. There is obviously asymmetry between what we experienced ten years ago and what we are experiencing right now. We Koreans are using the saying that if I am dating a girl, we call it romance, but if you are dating a girl, we call it a love affair, a double standard. Is the current global financial crisis an international standard or double standard?

[Dr. Anne O. Krueger]

There is a major difference between 1997-1998 and now. That is, in 1997-1998, the countries that were hit were hard hit, but there was a world economy out there that was growing fairly rapidly, so the countries that were hard hit could, with changes in policies, export enough so that raised aggregate demand and helped them get out of the crisis more quickly. Right now, everybody in the world is involved, so there is no similar mechanism that could work on a country by country basis, which makes it tougher for anybody, including the United States, to escape difficulties. Nobody can really rely on the international economy to pick up their goods the way Korea and other afflicted countries could then. That is number one.

Number two, there are a lot of people who are worried about the United States' liquidity right now and where it will go and I share your concerns in that regard. Is it a double standard? I think not. I think that the standard is simply the United States has had both the advantages of being the largest and therefore the key currency and the disadvantages.

The disadvantages have to do with a whole variety of things, including the cost to the United States in some cases of maintaining the system, higher tax rates for some public goods, etc. The benefit has been that the people accept dollars because they know they will be able to exchange that dollar for other goods; they have confidence in it. If the United States does not restore its stability, people are not going to have confidence anymore and that will take care of that fast. The really interesting question is what other international currencies would you rather now hold? The dollar still has the credibility that has been earned. The last thing in this world you should want right now is for the United States to raise interest rates. That would hurt the United States a bit, but it would hurt the rest of the world a lot.

The United States is big and it does have international responsibility just by virtue of its size. The estimate I last heard – and this is five years ago – is that one third of the currency in circulation in the world is being held outside the United States. People want dollars. There is a good side and a bad side. One of the bad sides was that the Chinese and the Koreans when they wanted to build reserves, they wanted dollars. Any day the Chinese want to get rid of those dollars, they can sell them, but the big problem they realize now is that they would take a loss because it would drive down the exchange rate on the dollar. As I said, it is both sides of the coin. The United States has been an anchor in the international economy with benefits to the United States, but also with costs. Both sides have to be taken into account, not just one.

Question 2. Student

I would like to ask a question about the effect of the current crisis on the global imbalance – would it make it better or worse? I think the last G-20 efforts of strengthening the IMF may not be consistent with the reduction of the global imbalance. Also, what about the Keynesian idea of the Clearing Union? I think the United States at the time in 1944, was a trade surplus country, whereas the United States right now is a trade deficit country. I think the United States may be in a position to accept the Clearing Union idea. What are your thoughts on that?

My second question is regarding pulling out liquidity after the huge package for fighting for the recession. I wonder whether the world or United States' economy has any means to pull out liquidity from the economy?

One of the little noticed facts is that starting in about 2006, the United States current account deficit was starting to fall significantly. If you take the oil price increase out of the United States current account deficit, that fall has continued, so there was some effect there already as global imbalances were correcting. With the United States fiscal stimulus now, I see no way that that current account deficit is going to do anything but go up in the short run. But that is good news for the rest of the world, since that is what we want right now, but the real problem is that everything that makes sense now does not make sense in the longer run and vice versa. Everything you need to do for the long run you do right now will make things worse and everything you do for the short run now will make the long run worse, unless you can reverse it. Reversing it is going to be hard and that is going to pull liquidity out of the system and there is going to be no way around it. How do you do that? It's going to be difficult.

Keynes' Clearing Union idea – I guess the best thing to say about that is that it is a non-starter. It is not going to happen, because no one is going to want it. However, if you said to me that we need one world currency and a world central bank, I would surely agree if we could ever get there, but we are not going to get there for a very long time. So any variant of that, we might as well spend our time reading comic books for all the good will do.

Question3. [Student, Int'l Cooperation 1st semester, GSIS-SNU]

It is such an honor to have such a distinguished lecturer here at SNU GSIS. You said that Asia is growing as a significant power in the global economy and Asia should take more leadership role in solving this financial crisis. However, the IMF and the World Bank are founded by Western countries, so even if we try to have our voices heard, would the IMF and the World Bank find ways to accommodate Asian voices to solve the world economy or to have more international cooperation? Would they be willing to have, for instance, a branch in Asia, Asia as a chair, or a solid member of these organizations?

[Dr. Anne O. Krueger]

Leadership is not only a matter of sitting in a chair at the IMF, and by the way, Korea did have an executive director sitting in a chair and speaking at the board. Leadership is also about ideas, a matter of writing and communicating with the global economic policy community. There are publications that are read internationally that have impact; look at the Financial Times' op-ed page. You get people from many parts of the world

writing and you only occasionally get something from Asia. Maybe Asia should have a few more votes, but I do not think that that is the big issue. I think basically Asians have been more than happy to speak of their local concerns on the issue of the moment at the board, which is fine, but not so much to take a stance in terms of the world economy and where that is going. That is where I would like to see a lot more representation. Obviously, votes for Asia should go up; you could triple Asia's vote – which would slightly be overdoing it – but if there is no more on the idea side, no more discussion, and no more leadership role, I do not think the influence of Asia will be much more than what it is today. It is not primarily a matter of votes, it is primarily a matter of leadership and ideas.

Question4. [Jessica Shim, Japanese Area Studies major, GSIS-SNU]

Thank you for your wonderful discourse. My name is Jessica Shim, Japanese Area Studies major. I would like to turn attention to my area of interest, which is Japan. You have mentioned earlier about the unemployment issues, financial deregulation, and housing demand bust. It seems like we have been there before, it is almost like *deja vu*. Is the United States repeating the mistakes of Japan and are there any lessons we can take away from it? Also, if I remember correctly, President Lee mentioned in the recent G-20 meeting the importance of upholding the free trade spirit. Could this be a right step forward for Asia taking a leadership role?

[Dr. Anne O. Krueger]

Quite the contrary, I think that everybody has looked very carefully at Japan and recognizes that Japanese fiscal stimulus during the 1990s was ineffective, largely because they did not address the balance sheet aspects of their problem. They left their non-performing loans in the bank until about 2001 and they did not turn around until they began changing it. So, I think that is not only consistent with what I said, but that is part of how we learned from Japan, so I do not think that is an issue at the moment. I know of nobody who says that right now the United States is repeating the Japanese mistakes on the balance sheet side.

President Lee did talk about free trade and its importance. It was remarkable because he spoke up at all. The Korean voice, the Japanese voice, etc., should be much more heard and they should be heard not only at a G-20 meeting, but ahead of it. If President Lee

has the best idea in the world for solving this current financial crisis and waits until the next G-20 meeting, it is going to get nowhere. These ideas require discussion, understanding, and international consensus and they do not happen in heads of states meetings. It happens long before that and as I said, it is through opinion articles, through academics, and through discussions like this. I think the Asian voices have not been in those discussions at that level as much as I think they should be. I do not think it is only a matter of speaking up, but that is important too and I was delighted to see that he did it. However, I think there could be much more vivid statements of why the free and open trading system is of so much vital interest to so many countries. I think there should be an op-ed piece a week by somebody important from different Asian countries, because there are so many countries that could benefit. There is a silence where there ought to be strong protests about the way the system works.

Question5: [Student from Indonesia, Int'l Development Major, GSIS-SNU]

As you know, when the United States and the EU face a turnaround both would have improved domestic financial regulation. How would the turnaround process and the improved financial regulations affect the global financial and the Asian financial structure?

[Dr. Anne O. Krueger]

Well, first we would have to figure out what the change in financial regulation will be. You may remember the infamous Enron affair, where we in the United States had a company that grew very big very rapidly and it later turned out it was doing all kinds of things wrongly, resulting in a big mess. Very quickly the Congress decided it had to do something, so they passed something called the Sarbanes-Oxley Act. The Sarbanes-Oxley Act wanted to make CEOs more responsible, so CEOs had to go in and inspect all the control systems in their companies. Now, a control system can include such things as making sure that when the company has shipped you the butter that you ordered for your cafeteria, that it sent you the right amount. It makes sure that the kitchens are cleaned after the meals, etc. Any CEO who really did even the best part of what the Act called for would not be doing his job. The estimate is that the cost to the average company of complying, even when the CEO does not personally do it, is around 40 million dollars a year. For a large company, that does not make an awful lot of difference, although it is not a good thing, if it does not do any good. But for small and medium companies, the cost is devastating. The interesting thing is, what Enron did had nothing to do with absence of controls. It had to do with some people acting very

deliberately and illegally and fraud. So here came a piece of legislation that everybody thought was horrible, that did not solve or even address the problem, all with high costs. With financial regulation now, I fear that there is a risk that something similar will happen. Why? Because everyone says the problem is that there is too little regulation. I do not know if too little regulation was the problem or not, but I do not think anyone can really pass a sensible judgment yet. If I could be dictator of the world for a day, one of the things I might do is put in an edict that we will not do anything about financial regulation for three years. Let us stand back and look at what happened, let us learn what we can learn, and then let's go forward. There are some interesting ideas out there and some of them may be very good. But what will happen if we have legislation right now, I fear may not make things better. I started by saying let's not throw out the baby with the bath water; if we do it all wrong and make the regulation too tight, financial regulation might not solve the current problems and might make them worse. On that one, I cannot tell you what will be the Asian financial structure or anybody else's because I do not know what the changes would be and I think really we do not have an idea yet as to how it should go.

Question6: [SH Park, faculty member of the Graduate School of Public Administration]
I have a provocative question regarding your logic. I may not have understood you correctly; if so, please correct me. My understanding of your logic is the following: global imbalances caused low interest rates, which in effect caused the balance sheet recession. I am a little skeptical about that kind of explanation for the following two reasons: first of all, I am not an international economics expert, but we have already had some global imbalances especially between Japan and the United States in the '70s and '80s, yet there was no global low interest rate. Secondly, I am not sure whether low interest rate will cause so-called balance sheet recession. Low interest rate will surely cause aggregate expansion, which would cause inflation, but if you do not consider any risk-enhancing financial innovations from the late 1990s, I am not sure whether we can explain the current global financial crisis with the theory of balance sheet recession. What are your thoughts?

[Dr. Anne O. Krueger]

The United States-Japan imbalance was very much smaller relative to GDPs than the imbalances today. United States was up to about seven percent current account deficit of GDP; that is huge. Japan never got up anywhere near China's current account balance

last year was 10 percent of GDP. It is just a very different order of magnitude. Japan's current account surplus as the percentage of what was going on in the United States was not that big. There were many other countries on both sides of the ledger. In that sense, it is not comparable. There was discussion about Japanese competitiveness in the 1980s, but I do not think it is comparable to the global imbalances in the macro impact.

You say low interest rates may not cause balance sheet impairment, but low interest rates surely induce people to buy houses. Low interest rates surely impact the rate of investment. That is documented in empirical study after empirical study. Low interest rates quite clearly came about in part because there was more money in the system, because of the excessive imports over exports, which came about because of global imbalances. Obviously, the housing boom would have been less and would have started later and prices would not have risen anywhere as nearly as much had interest rates had been somewhat higher throughout. Had that happened, you could not have had the degree of bubble that we did, I figure that is self-evident. Now, how much less would it have been? Quite a bit less. How much is quite a bit, I do not know. I do not know of any economist who says that neither low interest rates nor global imbalances were important. There is disagreement as to how much a few other things came in and what a big percentage global imbalances were. Martin Wolf says that the global imbalances were the ultimate cause. There were a couple of other books recently; everybody that I know and have been meeting has been coming out with global imbalances as a major factor – not the only – but a major factor. Certainly, had there been smaller global imbalances, the recession we are in now would have been less severe.