# Financial Globalization and Macroeconomic Policy Coordination

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Macroeconomic policy coordination is the heart and soul of the G-20's mission. The 2008 global financial crisis highlighted the interdependence of national economies and gave impetus to the creation of the G-20 at the leadership level. Through this forum, the leaders at the September 2009 Pittsburgh Summit established the Mutual Assessment Process (MAP) to ensure the collective consistency of their macroeconomic policies; and they agreed at the November 2010 Seoul Summit to develop a set of indicators to address global imbalances. After much debate, the G-20 finance ministers subsequently agreed in Paris in February 2011 on a two-step process: first, to examine a relatively restricted set of fiscal, financial and external indicators; and then, consider a much more comprehensive set of variables, including structural variables, if the initial indicators point to serious problems.

Although the progress made by the G-20 in promoting macroeconomic policy coordination is commendable, the substance of that progress is becoming problematic. In particular, under the current agreement, there is an increasing risk that the G-20 will drift toward a highly contentious debate on structural reforms at the national level instead of tackling the realities of financial globalization, which is at the core of macroeconomic interdependence these days. While "demand interdependence," affected by structural variables, is an important source of macroeconomic spillovers, "financial interdependence" should receive greater attention in the MAP if it is to lead to effective macroeconomic policy coordination and avoid what is likely to be counter-productive discussions on overhauling deeply ingrained institutional arrangements and practices by G-20 members.

Just as macroeconomics as a discipline is undergoing a wholesale re-examination in the wake of the 2008 global financial crisis, macroeconomic policy coordination by the G-20 should draw lessons from the crisis and focus on the implications of financial globalization. Against the backdrop of a fundamental asymmetry between reserve currency and non-reserve currency countries and uncertainty about the extent of implicit government guarantees for financial institutions, the liberalization of capital flows creates spillover effects that were not evident in the era of capital account control. The G-20 should focus on developing new debt sustainability indicators that cover the private sector as well as the public sector and reflect the realities of financial globalization. In this regard, it must be recalled that countries such as Ireland seemed to do well prior to the crisis, when assessed by traditional debt sustainability measures that focused on the fiscal health of the public sector. At the end of the day, what matters in the eye of the creditor is the ability of the debtor (with uncertainty about the extent of implicit guarantees by national or foreign governments) to pay back in both the short and long run, and new debt sustainability indicators should reflect this basic principle.

## Macroeconomics Before and After the Global Financial Crisis

The G-20's thinking on macroeconomic policy coordination is bound to be affected by the evolution of macroeconomics as an academic discipline. To avoid a repeat of the global financial crisis and promote strong, sustainable and balanced growth through international economic cooperation, it is useful to examine why macroeconomics as a discipline had failed to detect and mitigate the risks

that led to the crisis and how macroeconomists are rewriting their playbook in the wake of the crisis.[1]

In terms of relevant aggregate variables and policy instruments, macroeconomics is comprised of monetary, fiscal, financial and external dimensions. The essential goal of macroeconomic policy is stable inflation and stable output gap, preferably at a low level. The mapping between policy instruments and targets is complex. For example, fiscal, financial, and external policy instruments affect inflation and output gap.

Prior to 2008, however, macroeconomic policy was viewed largely as a monetary issue. The use of discretion in the application of non-monetary policy instruments was discouraged, and it was believed that the adoption of a single monetary policy instrument could achieve both stable inflation and stable output gap. That single monetary policy instrument was the interest rate rule that targeted a low and stable level of core inflation, or consumer price inflation net of volatile food and energy price movements, with little regard for asset prices. As Olivier Blanchard (2011) notes, it was thought that setting the key policy rate affected the term structure of interest rates and asset prices—and hence aggregate demand—in a predictable manner. In the pre-crisis period, mainstream macroeconomists also believed that fiscal policy, susceptible to political abuse and misuse, was basically unnecessary in the short run with the right use of monetary policy. To the extent that they cared about fiscal policy, they focused on maintaining mid- to long-term fiscal sustainability, with a rule of thumb such as keeping the government debt to GDP ratio below 60 percent. As for financial policy, most macroeconomists basically ignored the details of financial intermediation and regulation such as leverage and capital adequacy ratios. Finally, on external policy, macroeconomists thought that a country could either set an inflation target and float, or fix its exchange rate by adopting a hard currency peg or joining a common currency area. Looking back at the pre-crisis consensus, Blanchard (2011) observes that "in a world in which central banks followed inflation targeting, there was no particular reason to worry about the level of the exchange rate or the current account balance. Certainly, attempting to control exchange rates through capital controls was undesirable. And multilateral coordination was not required."

The global financial crisis shattered this consensus and forced macroeconomists to re-examine their beliefs. In the wake of the crisis, it was evident that macroeconomic policy was much more than a monetary issue. The adoption of a single monetary policy instrument, the interest rate rule, could not guarantee stable inflation and stable output gap. In fact, the *appearance* of stable inflation and stable output gap prior to the crisis had concealed deterioration in the balance sheets of households, firms and financial institutions, as measured by such indicators as debt-to-income ratios. The details of financial intermediation and regulation mattered a great deal because of balance sheet effects and counterparty risks. Fiscal policy came back with a vengeance when the interest rate reached the zero lower bound and the public sector had to step in to shore up aggregate demand to make up for the precipitous decline in spending by the private sector. As financial shocks propagated beyond national borders and governments adopted expansionary policies, macroeconomic policy coordination was needed to arrest contagion and overcome the free rider problem. External policy was clearly affected by "financial interdependence" and "demand interdependence."

Greece provides a case in point on macroeconomic interdependence in the age of financial globalization. Greece is a relatively small economy in Europe, but if it defaults, its international debt is large enough to affect the solvency of systemically important financial institutions in other parts of Europe. In other words, Greece's GDP divided by Europe's GDP is not a relevant metric when we try to assess the potential spillover effects of its default; rather, we should look at Greece's international debt at risk relative to the capital base of large European banks, which in turn are connected with other financial institutions around the world. If investors begin to fear that the capital base of these banks may be

wiped out, concern about counterparty risks will lead to rising interest rates and exclusion of weaker financial institutions from the capital market, with enormous macroeconomic consequences. Furthermore, although Greece has benefited from low and stable inflation since joining the euro, it has forfeited its ability to adjust the exchange rate and must take drastic measures to improve its competitive position. Unless Greece is ready to leave the euro (*a la* Argentina's decision to break the dollar peg in 2001), with serious repercussions for the European project, its only option is to make nominal wage cuts and improve productivity. Last but not least, although German taxpayers were indignant about bailing out Greece, they were really bailing out German and other European banks with a large exposure to Greek debt—creating asset fire-sale opportunities and saving the euro along the way.

The Greek saga is not unique to Greece. Emerging market economies without recourse to reserve currency have had to live with the effects of financial globalization, as the increased availability of cheap and mobile capital has not only helped to finance productive investment projects but also raised the risks of unsustainable credit growth and asset price escalation as well as sudden capital flow reversals. Furthermore, international financial crises in Latin America, Asia, Russia and now the North Atlantic region have shown that debt restructuring is likely to be limited as creditors, backed by their governments and international financial institutions, typically minimize their losses and impose adjustment costs on debtor countries. This, in turn, reinforces expectations that governments provide implicit guarantees, creating moral hazard. If *ex post* debt restructuring is not credible, *ex ante* restrictions should be imposed to prevent crisis. For instance, monetary authorities should contain credit growth, looking at not only core inflation but also asset price escalation. Borrowers should be subject to regulations such as debt-to-income ceilings, and lenders should be subject to strengthened capital and liquidity standards and macroprudential regulations. For example, dynamic provisioning adopted by Spain and a few other countries can help contain credit growth and provide a countercyclical buffer. Macroeconomics as a discipline will have to catch up with the realities of financial globalization if it is to provide useful guidelines for policymaking.

## Korea's Experience with Debt Crises

Korea's experience with debt crises shows how the balance between "demand interdependence" and "financial interdependence" shifted over time. Korea faced three major debt crises in 1972, 1980 and 1997 and averted a crisis in 2008 in the early months of the global financial crisis. On each of the first three occasions, the average debt-equity ratio for the Korean corporate sector exceeded 400 percent,[2] and its average interest coverage ratio was barely 100 percent. By contrast, the near-crisis in 2008 took place against the backdrop of low indebtedness and high profitability.

The crisis in the early 1970s primarily had to do with Korean firms' dependence on short-term curb loans from the informal domestic financial sector. Suffering from their crushing debt and a slowdown in exports due to a recession in advanced economies, Korean business leaders at the time went so far as to urge the government to reduce taxes, expand money supply, and have state-owned banks take over the "usurious" curb loans. In the end, the government issued an emergency decree in 1972 that bailed out the debt-plagued corporate sector by placing a three-year moratorium on the repayment of curb loans and converting short-term high-interest loans into long-term loans on concessional terms. The government in effect sacrificed the property rights of underground curb lenders to relieve the debt burden of entrepreneurs it had come to trust as agents to carry out its ambitious economic development plans.

The financial crisis in the early 1980s was a product of the government-orchestrated heavy and chemical industry drive of the 1970s. As such, the crisis had primarily to do with policy-oriented loans provided by state-owned banks, and the government could afford to take a gradual approach. In fact, the

government took a number of industrial rationalization measures— spiced with "special loans" from the Bank of Korea to commercial banks—and waited for the economy to grow out of the problem.

Starting in the 1980s, liberalization and democratization weakened government control while expectations for government protection against large bankruptcies remained strong. Even as various entry restrictions and investment controls were lifted, institutional reforms and credible market signals (such as large-scale corporate failures) designed to replace weakening government control with market-based discipline were not introduced. The *chaebol* expanded their influence in the non-bank financial sector and took advantage of the government's implicit guarantees to make aggressive investments, systematically discounting downside risks. The liberalization of capital markets in the 1990s exacerbated the problem by making Korea vulnerable to sudden capital flow reversals. In fact, portfolio investment and bank lending accounted for more than 90 percent of total foreign investment in the years leading to the 1997 crisis, and their combined subtotal almost quadrupled between the 1990-93 period and the 1994-96 period.

Particularly problematic was the relative size of short-term foreign debt. In 1997, the amount of foreign debt coming due in a year was more than twice Korea's foreign exchange reserves, as Korea abided by the old rule of thumb of keeping foreign exchange reserves to cover three months of imports and neglected to prepare for the possibility of capital flow reversals. In fact, foreign bank lending declined sharply from the average of $19.9 billion in 1994-96 to $2.8 billion in 1997, as foreign creditors refused to roll over existing loans. Spooked by a series of major bankruptcies in Korea since the beginning of 1997 as well as the outbreak of the currency crisis in Southeast Asia, foreign creditors began to express doubts about the asset quality of Korean commercial banks that had provided substantial loans to failed companies. The foreign exchange liquidity problem in Korea was mainly caused by the creditors' run on Korean banks rather than by the speculation of short-term portfolio investors.

The Korean government, however, did not have effective policy tools to respond to foreign creditors' bank run because it could not credibly guarantee the repayment of foreign loans—short of securing credit lines in reserve currency and taking over debt obligations from financial institutions. The government had little choice but to go to the IMF for immediate relief and promptly recognize the latent problem of nonperforming loans. Although the weakening of investment discipline under asymmetric liberalization was the underlying cause of the 1997 crisis, financial globalization thus played an important role in the outbreak of the crisis.

After the 1997 crisis, Korea began to make serious efforts to strengthen prudential regulation and improve the transparency and credibility of market signals. It also began to run a current account surplus to accumulate foreign exchange reserves, having learned that a three-month import cover would not be enough to protect the country from sudden capital flow reversals. The precautionary motive explains much of international reserve accumulation in most non-reserve currency countries,[3] and Korea provides a prime example. In fact, prior to the 1997 crisis, despite its reputation as an export-oriented economy, Korea had consistently run a current account deficit, except for the 1986-89 period.

In 2008, Korea's foreign exchange reserves amounted to 1.3 times its short-term foreign debt, and the Korean corporate sector had an average interest coverage ratio of well over 400 percent, but Korea came close to having another debt crisis. By this time, Korea had become one of the most liquid emerging markets with few restrictions on repatriation, and foreign investors sold more than $30 billion of Korean stocks in 2008 as they feverishly tried to make up for their losses at home and reduce leverage in the wake of the Bear Stearns and Lehman crises. To shield Korea from collateral damage, Korea's foreign exchange reserves had to cover not only its short-term foreign debt but also domestic bonds and stocks owned by foreign investors, who could create turbulence by taking "flight home" at any time. In the end, Korea managed to weather the storm by securing a currency swap arrangement

with the United States in October. Unlike in 1997 when the financial crisis was largely confined to Asia, the U.S. probably found it in its own interest not to have another domino fall given the tumultuous global market conditions at the time.

## Principles for Macroeconomic Policy Coordination

With increasing financial globalization, the nature of international macroeconomic interdependence has shifted in favor of financial, as opposed to real (demand), sources. The G-20's macroeconomic policy coordination should reflect this sea change.

On the whole, the management of "demand interdependence" is straightforward. Countries should adopt macroeconomic policies suited to their aggregate demand conditions, while avoiding what is likely to be counter-productive discussions on overhauling deeply ingrained institutional arrangements and practices in other countries. If they all suffer from deficient demand, they should coordinate policies to overcome the free rider problem. While current account imbalances are important, they tend to take their toll if countries allow them to persist on a significant scale. Persistent and significant surpluses raise the risks of domestic inflation and foreign mis-investment; whereas, deficits may trigger a collapse of confidence in the country's ability to pay back.

By contrast, the management of "financial interdependence" is much more challenging. The G-20 should focus on developing debt sustainability indicators such as debt-to-income ratios that cover the private sector as well as the public sector. The G-20 should also look at the ratio between short-term foreign obligations and foreign exchange reserves, for liquidity matters as much as solvency. As changes in the creditor's perception of the debtor's ability (backed by governments) to pay back can create significant macroeconomic spillovers, these indicators should be developed in conjunction with the G-20's work in financial regulatory reform, taking into account balance sheet effects and counterparty risks.

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## Endnotes

[1] Blanchard (2011). See also background papers and presentations prepared for an IMF conference on *Macro and Growth Policies in the Wake of the Crisis*.

[2] Lim and Hahm (2006).

[3] Aizenman and Lee (2005).