Choongsoo Kim: Time for a new central banking paradigm

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Honorable fellow governors, Excellencies, distinguished guests, ladies and gentlemen,

It is a great pleasure for me to welcome you to the 2010 Bank of Korea International Conference, which is also being held in celebration of our bank's 60th anniversary. I wish to express my profound appreciation to all of you for attending. Let me also take this opportunity to express particular gratitude to our esteemed speakers, presenters and discussants, and to our conference orgaruzers.

The theme that we have selected for this year's conference is *The Changing Role of Central Banks*. This is one of the most critical issues that the recent global financial crisis has led us to consider.

The global financial crisis and changing beliefs

The recent global crisis has shaken many of our beliefs about economics and economic policy. Prior to the crisis, many of us talked about the so-called "Great Moderation," believing that macroeconomic volatility had declined substantially in most advanced economies over the past two decades. The declines in volatility of output and inflation were regarded as a remarkable economic achievement, which we attributed to improvements in macroeconomic, including monetary, policy. Many of us also assumed that risk management at financial institutions had improved greatly.

But now we feel differently. Occurring as it did in such an optimistic environment, the sudden outbreak of the crisis has very seriously challenged our confidence in macroeconomic management and financial regulation. It has motivated us to carefully evaluate what went wrong, and what we must do to avoid any future recurrence of such a destructive calamity.

The crisis has also directed attention to a number of particularly salient issues for central banks, among them new challenges for monetary policy, the central bank's role in financial stability, and management of volatile capital flows. I would like to discuss these issues a bit more now.

Challenges for monetary policy

First of all, bitter controversy over several key components of monetary policy has arisen, out of central banks' dealing with the crisis.

Central banks' monetary policies have of course evolved over the years. In the mid-1970s, a large number of advanced economies adopted monetary targeting, to address the high inflation at that time. As the relationship between the monetary aggregates and inflation subsequently grew less stable, however, monetary targeting was replaced in the 1990s by inflation targeting.

Central bank independence has also been greatly strengthened over the last decade, as an institutional safeguard to facilitate more successful monetary policy by mitigating the time-inconsistency problem. It is, we can see, very natural that search for a new monetary policy paradigm takes place when economic conditions have changed or novel problems have emerged.

One of the most prominent issues in the present debate on monetary policy is the question of the desirability of the current *modus operandi* of inflation targeting, a core element of central bank monetary policy in many countries over the last decade.

One contentious question in this regard is whether the target inflation rate should be adjusted. Olivier Blanchard and some others, for example, have proposed moderated inflation targeting operation, while also insisting on a strengthening of macroprudential regulation by the central bank.[1]

Meanwhile, more radical suggestions, of replacing inflation targeting altogether with a new policy framework, have also been proposed. Professor Carl Walsh, for example, the eminent presenter in the second session of this conference, suggests price level targeting as an alternative to inflation targeting, arguing that under price level targeting inflation expectations can act as an automatic stabilizer.[2]

The crisis has also pushed to the center stage of debate central banks' recent unconventional monetary policy measures, in acting as lenders of last resort or market-makers of last resort. Principal questions in this regard include issues such as when the central bank should implement such measures, how effective they are, and when and how the bank should ultimately withdraw them.

Our debate on all of these important issues at this conference is anticipated to help us very much in developing our monetary policy frameworks further.

Increased demand for a greater central bank role in financial stability

Another salient question posed to central banks by the crisis is that of the need for expanding their role into the area of financial stability – beyond their traditional roles of ensuring price stability and, in some countries, economic growth. There is especially strong demand that the central bank do more to help *prevent* financial instability. This issue has attracted much public attention in Korea, in fact, as adding financial stability to our bank's explicit objectives, in addition to price stability, has been one of the central issues related to the recent bill revising the Bank of Korea Act, which remains pending in our National Assembly.

How to proceed in this regard is unclear, however. In particular, there is controversy about the policy instruments that the central bank can use to ensure financial stability. One critical question here is whether monetary policy, the key policy tool of the central bank, should be used to preemptively tackle developing financial imbalances.

Prior to the global financial crisis, the majority view was that the central bank should not assume responsibility for correcting financial imbalances – whether through its monetary policy or any other tool. Given recent experience, however, the pendulum of opinion is now shifting in favor of preemptive central bank action. This "lean against the wind" view has in fact been long supported by Dr. William White, who is with us here today, and his colleagues at the Bank for International Settlements.[3]

Strong support for the central bank's preemptive monetary policy to address financial imbalances is understandable. The crisis erupted despite low and stable inflation, and it has also shown us just how difficult *ex post* cleaning up after a burst bubble can be. All in all, this crisis has highlighted for us the desirability of *ex ante* prevention of bubbles that could eventually bring us face to face with crisis.

[1] Blanchard *et al*. (2010).

[2] Walsh (2010).

[3] See, for example, Borio and White (2004).

Regarding the central bank's role in preventing financial instability, we should note that before the recent crisis many macroeconomic models, including the conventional models of monetary economics used by central banks, paid insufficient attention to the financial markets.

The crisis has shown us quite clearly, however, how financial intermediaries can play a very significant role in the development of financial imbalances. For proper incorporation of financial stability into the monetary policy framework, therefore, we must reconsider the role that the financial sector plays in our monetary economics.

Another important issue related to the central bank's contribution to preventing financial crises is its role in macroprudential regulation.

The outbreak of the recent crisis has shown financial regulation to have gone seriously wrong in many countries. In particular, while focusing heavily on the soundness of individual financial institutions, attention was not adequately paid to systemic risks.

We accordingly have strong agreement now that our macroprudential, as well as our microprudential, regulation needs strengthening. And central banks are widely said to be the best candidates for this task, given their expertise in assessing macroeconomic conditions and macrofinancial developments.

Management of volatile capital flows

So far I have talked about the new challenges for central banks with a focus mainly on the domestic side. Let me move on now to problems caused from external sources, in particular triggered by sudden capital outflows.

As we have witnessed during the global financial crisis, and again also during the recent European sovereign debt crisis, when an international financial crisis occurs and capital begins to flow toward safe havens, many emerging market economies, the international uses of whose currencies are highly limited, tend to experience severe exchange rate volatility, even though they are not the origins of the crisis.

Foreign capital flows to emerging market economies tend, in fact, to be procyclical. And this is a big problem, as countercyclical macroeconomic policy is not available in many of them.[4]

The typical means that many emerging market economies have, since the late 1990s, adopted for dealing with abrupt foreign capital outflows has been the accumulation of large volumes of foreign exchange reserves, as a form of "self-insurance." Prior to the recent crisis, there was even criticism that the volumes of foreign exchange reserves in emerging market economies, and especially in Asia, were "excessive."

However, the crisis has proven such criticisms of our so-called "excessive" reserve holdings to have been invalid, as reserves were in many cases still not sufficient for ensuring foreign currency liquidity. Some observers have also pointed out the reluctance of many emerging market economies to even use their foreign exchange reserves, despite their large volumes, out of fears that resultant declines in their reserves might be perceived as signalling their growing vulnerabilities.[5]

And so we have problems. We have no clear idea how large a volume of foreign exchange reserves is sufficient for a country. It can be very enormous during a systemic crisis. Meanwhile, as we all know, the accumulation of large levels of foreign exchange reserves also entails substantial economic costs.

[4] Kaminsky *et al.* (2004) and Kim and Chey (2010).

[5] Aizenman (2009).

Yet such problems of needing to "self-insure" can be resolved to a significant extent through inter-central bank cooperation, for example currency swaps among central banks. One good example case was that of South Korea during the recent crisis, when we benefited greatly from currency swaps between the Bank of Korea and the Federal Reserve, the People's Bank of China and the Bank of Japan.

Those swap arrangements had some shortcomings, however, such as their *ad hoc* natures and the high selectivity of the counterparties involved. It is thus worth considering greater broadening and institutionalization of such inter-central bank cooperation, to ultimately help establish a global financial safety net.

In this respect, East Asian countries' inauguration this March of Chiang Mai Initiative Multilateralization, a multilateral currency swap arrangement covering all ASEAN+3 members, is a mark of significant regional progress. I am delighted to note as well the recent agreement, at South Korea's initiative, to discuss global financial safety net improvement during this year's G20 summits In Toronto and here in Seoul.

Establishment of such an international institution is of course by no means easy. For it to be effective, several salient problems need to be resolved, including the "stigma" effect on countries needing assistance, on the one hand, and moral hazard on the other.

Strengthening of macroprudential regulation is also likely to help emerging market economies manage volatile capital flows. Even if individual financial institutions are rational, their behavior can generate negative externalities. Indeed, as I have mentioned, foreign capital flows to emerging market economies tend to be procyclical, heightening the need for countercyclical policy measures through which these countries can cope with such procyclical flows.

Macroprudential regulation can be a significant help in this respect, by changing financial institutions' incentive structures in ways that internalize the negative externalities caused by their own activities. It is, of course, important to prevent the possibility of regulatory arbitrage in response to our strengthening of macroprudential regulations, and for this international cooperation is very much required. All of these issues should of course be discussed in harmony with our efforts to build a better international financial architecture. And at this moment, I think the G20 may provide the ideal forum for effective international cooperation to this end.

Concluding remarks

I have until now briefly discussed some major challenges that central banks face in overcoming the global financial crisis and afterwards. Before closing, I would like to call attention to one final point.

In our efforts to search for a new paradigm for central banking, we will naturally develop new economic models and theories. In this regard, one very important lesson from the recent crisis is that such models and theories must face up to reality. The real world does not always work in the way economists would like it to work. And when we face such a situation, it is the theories that need to be twisted, and not the facts that they are supposed to be helping us understand.

Especially, we should always keep in mind that we live in a globalized environment, in which all of our individual economies are now closely interconnected. We should be aware, in addition, of the increasing influences of emerging market economies in world economic activities.

I believe that this conference will be a valuable opportunity for us to come together and pool our thoughts about what central banks must do to make this world a less risky place. It may of course be difficult for us to obtain all the necessary answers to this big question in a two-day conference. But I am confident that the debate during this conference will give us a big boost in that direction.

Thank you very much. And now let the debate begin.

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