Choongsoo Kim: Recovering from the crisis and the policy initiatives

Keynote speech by Mr Choongsoo Kim, Governor of the Bank of Korea, at the Wharton Global Forum, Seoul, 29 May 2010.

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I. The global financial crash and the course of recovery

(Greetings)

Ladies and gentlemen,

I am indeed delighted that so many distinguished experts from managerial and academic circles at home and abroad together with fellow alumni are gathered here today at this Wharton Global Forum. I count myself privileged to have been asked to deliver this keynote speech.

I intend to speak today about how Korea has confronted the global financial crisis and the policy challenges that lie ahead.

1. The outbreak of the global financial crisis

(Foreign exchange and financial markets)

In the wake of Lehman Brothers' collapse, the Korean foreign exchange and financial markets were thrown into turmoil under the influence of the global credit squeeze.

The Korean won/US dollar exchange rate increased by a large margin and market interest rates in the corporate bond and CP markets and elsewhere rose precipitately. Although the loss in the exchange value of the Korean won was less than that in the earlier foreign currency crisis, it was relatively large in scale compared to that of other Asian currencies.

The foreign exchange and financial market unrest was heightened as foreign portfolio investment funds were hurriedly pulled out. Over the course of 2008 there was an outflow of some 35 trillion won in foreign equity investment funds and the share price index plunged by more than 40%.

Factors making for the fragility of the Korean foreign exchange and financial markets under the impact of external shocks included the sharp rise in short-term foreign debt and the inadequate asset liability management of financial institutions. Total external debt more than doubled after 2006 and the ratio of short-term external debt surged from 46% to 97%. Because of high loan-to-deposit ratios, domestic banks' market risk had increased.

(The real economy)

Domestic business activity shrank rapidly as a mood of unease came on top of the global credit crunch, the consequent worldwide economic recession, and the worsening foreign exchange market. The subdued state of domestic demand in terms of consumption and investment intensified while exports declined abruptly.

In Q4 of 2008, GDP registered deeply negative growth, falling 4.5% quarter on quarter (annualized rate 16.8%). Economic activities shrank on a much larger scale than countries at the epicenters of the financial crisis such as the United States and the Euro-zone.

2. The policy response

(Monetary policy)

Seeking to rein in the sharp plunge in economic activity, the Bank of Korea reduced its policy rate at an unprecedentedly fast pace. From October 2008 to February 2009, it cut its policy rate in a series of six steps, bringing it down by 3.25 percentage points from 5.25% to 2.0%.

Although the scale in the reduction in the policy rate was less than the United States where the economic maelstrom was at its most intense, it was at a similar level to that prevailing in the other advanced countries.

In addition, Korean-won and foreign-currency liquidity was supplied in an active manner to alleviate the credit squeeze and bring stability to the foreign exchange markets. Liquidity of some 28 trillion won, equivalent to 2.6% of nominal GDP, was supplied in order to restore financial market stability.

Liquidity support for the financial markets as a whole was stepped up by means of open market operations including long-term and ad-hoc RP purchases and outright purchases of Treasury bonds. Liquidity supply was also expanded to sectors that were suffering because of the credit crunch by means of subscriptions to the Bank Recapitalization Fund and the Bond Market Stabilization Fund.

A total of USD 26.8 billion in foreign currency liquidity was injected through the use of the foreign currency reserves and the proceeds of currency swaps in the period from October 2008 until February 2009. Notably, the scale of the foreign currency available for use was greatly expanded by currency swaps with the central banks of major countries.

(Fiscal policy)

The government, for its part, operated fiscal policy boldly in order to counter the downturn in activity.

Over the course of 2009, a total of 38.8 trillion won directly or indirectly linked to the financial crisis was additionally injected through the disbursement of fiscal funds and tax reductions. For example, to avoid the contraction of private consumption becoming protracted, car sales tax was temporarily reduced.

The total scale of the stimulation package, amounting to 3.7% of nominal GDP, was larger than that in the USA, the UK and other advanced countries.

3. Current state of the economy

Domestic economic activity recovered swiftly from the second quarter of last year onwards, helped by the easing of the global financial unrest and the pro-active operation of policy.

For 2009, GDP growth came in at a positive rate of 0.2% year on year. Among the OECD member countries, apart from Korea, only two others, Poland and Australia, registered positive growth in 2009.

In Q1 this year, GDP growth chalked up high rates of 1.8% quarter on quarter and 7.8% year on year as exports and domestic demand continued buoyant.

Going forward, too, the Korean economy is expected to maintain its solidly-based recovery trend led by the private sector.

The GDP growth rate is projected to rise to 5.2% this year and 4.8% next year.

Exports are continuing their double-digit increase thanks to the recovery of the world economy, and private consumption, similarly, is maintaining its improving trend, bolstered by the increase in household incomes and suchlike.

Facilities investment seems set to increase substantially owing to the upturn in IT activity, but construction investment remains lackluster owing to subdued construction of buildings for residential use.

Employment conditions are improving along with the recovery of business activity, but the extent of the improvement remains relatively constrained.

The scale of the increase of the number of persons in employment over the year is unlikely to reach its pre-crisis level of 300,000 persons owing to the weakened employment generation capacity of growth and is forecast to stand at around 240,000 persons.

The rise in the CPI is predicted to stay around the 2 and a half percentage level for some time, but to gradually pick up during the latter half of the year owing to the increased demand pressure resulting from the recovery of activity. During 2011, the rates of headline inflation and core inflation will both exceed 3%.

The current account is forecast to sustain its underlying surplus trend but the scale of the surplus will gradually narrow to USD 10.5 billion this year and to USD 5.5 billion next year. The goods account surplus will narrow in scale as import growth outstrips that of exports and the services, income and transfers account will move more deeply into the red owing to sharply increased overseas travel payments.

The future outlook is surrounded by no small degree of uncertainty with the opposing interplay of upside and downside risks.

Upside risks are as follows:

As private sector deleveraging is now in its closing stages including the shift back to an increase in bank lending, global financial conditions return to a normal state at an early stage.

The growth of the world economy expands amid a more rapid than expected improvement in labor market conditions in the US and other major countries.

And, downside risks are:

Global financial market unrest recurs in response to the fiscal problems within the Euro-zone and China’s tightening of liquidity management.

The world economic recovery stalls out amid a sharp run-up in international commodity prices including that of oil.

The recovery in business activity is constrained owing to increased failures of domestic SMEs.

II. Future policy challenges

Going forward, economic policy needs to secure and enlarge a stable basis for counteracting the possible outbreak of a crisis on the domestic front, complementing the efforts to avoid the recurrence of a global financial crisis at an international level.

1. Strengthening of international policy cooperation

Toward this end, strengthening international policy cooperation constitutes the priority task.

The world economy has been recovering more rapidly than expected owing to the fact that international policy cooperation has been swiftly brought to bear against the global financial crisis.

A great contribution to this has come from the soothing of market uncertainties by the delivery of a consistent message of recovery from the crisis by every country around the world and, in addition, from the forestalling of the leakage of the effects of independent policy implementation in open economies.

In future, every country around the world needs to strengthen the basis for global financial stability still further through international cooperation.

Under the aegis of the BIS, discussions on proposals for policy cooperation are now underway with the aim of reducing gaps in financial regulations among countries and the tendency of financial institutions to indulge in risk-taking behavior. Standards for financial soundness including those relating to capital, leveraging and liquidity are being tightened with a major focus on systemically important financial institutions.

Korea proposed placing the construction of a global financial safety net on the official agenda at the last G20 global summit meeting.

In regard to individual countries, the financial safety net now consists of the IMF lending system (FCL), bilateral currency swaps and the expansion of the foreign exchange holdings. However, in actual fact, it is difficult for these arrangements to function in the envisaged manner because of problematic points such as the stigma effect and the expansion of global financial market imbalances.

For the construction of an effective global financial safety net, it is considered appropriate to discuss these at the G20 level in view of the necessity of fine tuning conflicts of interest between the advanced countries and the newly emerging market countries with respect to international capital movements. The presentation of specific proposals is eagerly awaited at the forthcoming Seoul summit in November.

At the same time, Korea is pushing energetically for financial cooperation and the avoidance of a renewed crisis among Asian regional countries through the Chiang Mai Initiative Multi-lateralization (CMIM).

On March 24 this year, the existing bilateral CMI was expanded and enhanced into the multilateral CMIM, putting in place a financial stability facility able to supply swift funding support. The arrangements for short-term foreign currency liquidity support by way of “mutual currency swaps between central banks” has been converted into a method of “uniform contract multilateral swaps”.

The total pot available has been expanded from USD 78 billion to USD 120 billion, of which Korea has been allocated USD 19.2 billion with a corresponding withdrawal facility.

2. Heightening macro prudential stability

Heightening macro prudential stability constitutes the second policy challenge.

In the aftermath of the global financial crisis the importance of macro-prudential policy has been greatly elevated.

It has been a fundamental experience that the macro prudential risk to the future financial system has been overlooked, including that from the expansion of credit and a run up in real estate prices under price stability. Owing to the development of financial derivatives products, the mutual linkages between financial institutions had grown closer and this made tackling risk generation and its expansion to the financial system as a whole solely by micro prudential regulation and supervision a difficult proposition.

Recently the USA, the UK, and other jurisdictions have witnessed lively discussion on the re-organization of the macro prudential policy framework.

While there has been an emphasis on multi-lateral cooperation on financial policy including the government, the central bank and the supervisory agency, the importance of the central bank’s financial stability role has also been emphasized.

The rationale is this: the central bank maintains close linkages with financial market participants and is also well placed to pick up on financial system strains at an early stage. Additionally, it traditionally carries out the role of the lender of the last resort role at times of financial crisis.

Even though the central bank strives for financial stability, this is not seen as conflicting with price stability.

Considering that financial system unrest generally means that the transmission channels of monetary policy are not working as they should, financial stability is a precondition for a price stability.

The central bank's expansion of liquidity supply in order to contain the crisis is also consistent with price stability in that deflation and disinflation may be generated at times of financial crisis.

On the other hand, financial crises are mainly provoked by excessive liquidity supply, and so the central bank needs to expand its liquidity adjustment tool-kit to carry out its financial stability function efficiently.

In consideration of discussions on the organizational structure in major countries, Korea needs to establish a macro prudential policy framework with a view to heightening its financial crisis response capacity.

3. Strengthening the economic fabric

The third challenge is to strengthen the economic fabric so as to minimize the impact on the real economy of external shocks such as the eruption of a financial crisis.

Growth potential should be enhanced by cultivating industries offering new growth momentum while the structural adjustment of existing firms should be driven forward without delay or error.

(Drive for corporate restructuring)

The thoroughgoing corporate structural adjustment undertaken following the 1997 Asian foreign currency crisis has contributed greatly to Korea's swift recovery from the global financial crisis.

Firms' financial structures were greatly improved, helped by the turnaround, exit or sale of distressed firms and the tightening of accounting standards to heighten management transparency. Corporate debt ratios in manufacturing were slashed from 396% at year-end 1997 to 98% at year-end 2007 and there was a rise in the equity capital ratio from 20% to 51% over the same period.

Meanwhile, firms' further structural adjustment has been delayed in the course of the response to the global financial crisis.

Instead of the number of firms in default shrinking, there was a big increase in the number of firms with an interest coverage ratio less than unity owing to the promotion of various emergency support measures including the government's fast track support for SMEs and increased credit guarantee ceilings.

Since the Korean economy has largely shaken off the influence of the global financial crisis, the drive for the restructuring of firms should in future be carried out in a normal manner at their own initiative based on the market mechanism.

Systematic improvement efforts should be redoubled so that the market mechanism can work properly by reducing the barriers to new entry and exit for firms. Government support should be limited to start-ups that have just entered the market so as to block the continued existence of firms that are dependent upon rent-seeking behavior.

(Expanding growth potential)

Given that overcoming the financial crisis ultimately hinges upon the sustaining of growth, it is an essential task for policy to foster industries that offer future growth momentum.

Most advanced countries and our developing country rivals are also pressing ahead with similar types of growth strategies.

Considering Korea's stage of economic development and its changing demographic structure including the ageing of the population, there is little to be gained by continuing to follow a growth strategy relying on the expansion of inputs of capital and labor.

In the early stages of economic development, labor intensive industries take the lion's share because the quantitative expansion of factors of production is quite simple while growth is driven by investment in capital goods for the enlargement of production capacity.

When the economy enters the mature stage, there are limits to the extent to which growth can be generated by the quantitative expansion of capital owing to restrictions on further inputs of labor. Growth is then led by the enhancement of productivity based on technological advances.

For fresh growth momentum, we must look to green technology industries such as renewable energy, industries incorporating leading-edge technologies including broadcasting and communications, and high value-added services including global healthcare.

III. Closing words

Despite the fiscal problems of Southern European countries acting as a source of global financial market turmoil, the global economy now appears to be breaking free from the influence of the financial crisis.

Consequently countries around the world are now seeking exit strategies for the unconventional policy tools that were mobilized in the course of surmounting the crisis. In view of differences in the state of their economies, the timing and sequencing of exit strategies will vary from country to country, but it is vital to maintain a fundamental spirit of policy cooperation as exemplified by information sharing.

In the case of Korea, the foreign currency crisis in late 1997 was overcome by bold corporate restructuring under the fundamental principles of market opening and economic liberalization. Similarly, Korea is held up as the country that has most swiftly recovered from the recent financial crisis.

This Wednesday, the OECD predicted that the Korean economy would grow at a rate of 5.8% for the year as a whole. This puts the country second only to Turkey (6.8%) among its members.

Going forward, it is crucial to encourage principles of economic liberalization, openness and free trade so as to promote world economic prosperity, while trying to ward off a repetition of the global financial crisis.

As the chair country of the G20, advocating principles of liberalization and openness, Korea will do its utmost to ensure that discussions concerning the global financial safety net achieve specific and tangible outcomes.

Drawing my remarks to a close, I hope that at this meeting all of you have been able to gain valuable information about the Korean economy and engage in lively exchanges of views.

Thank you very much for listening so attentively.