Choongsoo Kim: Global and local economic trends and challenges for the Bank of Korea's monetary policy

Speech by Mr Choongsoo Kim, Governor of the Bank of Korea, at the Seoul Financial Forum, Seoul, 17 August 2010.

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I. Greetings

Good Morning,

I am indeed delighted to be here with you this morning to deliver a speech at the "Seoul Financial Forum", which is focused on helping Korea as a premier international financial center in Northeast Asia. Let me take this opportunity to express my deep thanks to all participants in this forum and especially to Chairman Kim Ki Hwan, for this invitation to address you.

I intend to survey with you the current state of the economy at home and abroad and then to talk to you about the monetary policy challenges that lie ahead.

II. Global and local economic trends

The world economy

Let me look first to developments in the world economy, which are one of the more important factors in judging the course of the Korean economy, whose growth is heavily dependent upon trade with the world economy.

In fact the world economy is generally deemed to be maintaining a recovery, even though there are differences from country to country in its pace. Giving the lie to initial worries following the global financial crisis that the economic recession would prove prolonged, countries around the world have found themselves on a relatively rapid recovery track.

This was certainly greatly helped at least until the end of last year by the policy effect stemming from the bold and decisive monetary and fiscal policies put in place. More recently though, there have been stirrings of recovery in the private sector's self-sustaining growth dynamism against the backdrop of an increase in the volume of world trade and improvement in the labor market.

Strikingly the global recovery is being led by the Asian emerging market countries, of which club Korea counts itself a member, with the rapid growth of India and China and the consequent expansion of intra-regional trade.

That said the picture is not without several downside risk factors.

In the US economy, where anticipations of an economic recovery were running high early in the year, labor and housing market related indicators have recently been coming in more subdued than expected and consumer confidence has also deteriorated. Reflecting these conditions the Federal Open Market Committee back-pedalled somewhat from its previous upbeat note in its appraisal of the state of economic activity in its statements of the monetary policy direction this June and August. Specifically, last week, on 10th of August, the FOMC stated that the pace of economic recovery had slowed in recent months, indicating that it would take a little longer for the US to return to the normal state.

Similarly the euro-zone faces a situation in which the sovereign risk problems of certain Southern European countries have not yet been fundamentally resolved. Nevertheless the July 23rd announcement of the results of the stress tests carried out on European banks have greatly allayed concerns about the future of the euro-zone banking system.

For its part, the Chinese economy may well see its pace of growth slow from that of recent months as both leading and coincident indexes of economic activity have declined in line with the blunting of both investment and production growth while real estate prices have receded.

Amid these uncertainties, the global financial markets may prove turbulent in the future and there is the likelihood of the heightened volatility of business activity in the major countries. At the end of the day, nonetheless, the underlying pattern is that of a continuing modest recovery in economic activity in the US, albeit its pace of recovery slowed down a little recently, the euro-zone and other major countries along with the improving tone of the world economy. Principal international organizations such as the IMF and major central banks see little risk of the world economy drifting into a double-dip recession.

The Korean economy

Bolstered by these improvements in world economic conditions the Korean economy is continuing its pronounced upward trend. In the first half of this year the GDP growth rate came in at 7.6% year on year, driven by resilient domestic and external demand.

Exports led the economic upswing with exports for the whole month and daily average exports chalking up their highest-ever monthly figures. Private consumption built up consistently owing to increased wage payments and improved employment conditions while facilities investment expanded greatly in a climate of revived business confidence.

What was particularly noteworthy was the clearly marked improvement from April onwards in labor market conditions, which had largely given rise to the lingering concerns about the private sector's capacity to pull itself up by its own bootstraps.

The number of persons employed in the private sector, i.e. stripping out public-sector employment, expanded by 300 thousand persons year on year in April and this was followed up by a widening of the scale of increase to 650 thousand persons in July. The increase of the total number of employed persons year on year in July turned out to be 470 thousand persons as there was a decrease in public sector employment by about 180 thousand persons.

These strong growth trends of the Korean economy have certainly caught the eye of the rest of the world. Korea grew at a rate of 0.2% last year, standing together with Australia and Poland as the only three of the OECD's member countries to register positive growth. Its first-quarter growth this year (8.1% year on year and 2.1% quarter on quarter) was second only to that of Turkey (10.9% year on year) in the OECD.

Going forward, from the latter half of this year onwards, the robust growth trend is expected to carry on at around the level of the potential GDP, led by the private sector. Actually the rate of GDP growth in the latter half year is forecast to drop from that of the first half, running at around 0.8% quarter on quarter. But concerns over this may be exaggerated as the projected slowdown in the pace of growth is best interpreted as a natural reaction occurring after a swift burst of growth.

Although consumer price inflation is presently holding steady at around 2.6%, upside price pressures are expected to build up going forward. In the course of the continued upswing in business activity, demand-pull upward pressures have been increasing, added to which charges for a number of public utilities have been raised. It should be particularly remarked that the rate of headline inflation is forecast to move above the midpoint of the Bank of Korea's medium-term target from the fourth quarter of this year onwards.

While the current account seems set to remain in the black for some time to come thanks to buoyant exports, the scale of the surplus is forecast to narrow gradually. The main contributing factors here will be the greater scale of the increase in imports than that of exports following the domestic demand's recovery along with the swelling services account deficit resulting, for example, from increased outlays for overseas travel. Straight after the collapse of Lehman Brothers the scale of the rises in both the Korean won's exchange rate volatility and CDS premiums was very much larger than those of other countries. Taking this experience on board, we must count sustaining an underlying current account surplus a vital task for the sake of the stable growth of the Korean economy, which is very much at the mercy of changes in external conditions.

Taking an overall view in the light of the points I have just mentioned, we certainly cannot say that Korean macro-economic variables present an unsatisfactory pattern. But vigilance is also called for as the Korean economy confronts problems that are by no means trifling.

Firstly the public perception of the actual state of economic activity is by no means as flattering as conventional indicators might suggest owing to the deterioration of the terms of trade and the severe downturn in housing market activity. Secondly although overall employment conditions are picking up, youth unemployment is still running at a high level and the improvement in employment conditions for weaker members of society including the self-employed still remains inadequate. It is also very well possible that inflation expectations among the general public will build further as the rate of price increases accelerates.

III. Challenges for BOK's monetary policy

Now I would like to turn to the challenges ahead of monetary policy in confronting the present domestic and international economic environment.

Conducting interest rate policy efficiently

The Bank of Korea has already begun to undertake efforts to normalize the policy stance by phasing out the measures adopted immediately after the global financial crisis.

After keeping its policy Base Rate on hold for 17 straight months, the Bank of Korea raised it by 25 basis points from 2.0% to 2.25% on July 9 this year, taking into consideration the strong possibility of inflation pressure increasing in the latter half of the year with the continuation of the economic upswing. As all of you are aware, the Bank of Korea decided to maintain the Base Rate at 2.25% in August.

Ahead of this, on June 24 this year, it cut down the Aggregate Credit Ceiling for the third quarter this year by 1.5 trillion won. This had been increased in two steps by 3.5 trillion won to 10 trillion won following Lehman Brothers' bankruptcy.

In this way Korea has joined the ranks of those countries around the world that have raised interest rates along with Canada, Australia, Norway and Sweden and so on. In fact the IMF and the OECD had advised a preemptive hike of interest rate for Korea in order to counter upward price pressures.

Although the policy rate has been adjusted upward, the scale of the increase in interest rates was not very large and, as it had to some extent been factored in, it is likely to have only a limited impact on the financial and housing markets and on the household and corporate sectors. What is more, despite the hike in the policy rate, the current monetary policy stance is still deemed highly accommodative, given the situation of the real economy in terms such as the potential growth and inflation rates.

Looking ahead, in carrying out monetary policy, we will take into overall consideration the influences that risk factors at home and abroad exercise on business activity, prices and the financial market situation. We will conduct monetary policy in such a way as to help the economy maintain price stability, while sustaining sound growth under the accommodative policy stance.

Strengthening the economic fabric

Strengthening the economic fabric constitutes the second policy challenge. It is absolutely vital to strengthen the basis for domestic demand so that the Korean economy can attain a well-balanced growth path without being excessively affected by changes in the external environment.

Toward this end, the role of households as consumers and that of small and medium-sized enterprises (SMEs) as the main source of job-creation are very important for balanced economic growth. But the current situation of both households and SMEs is only fragile.

For households there is not enough capacity for spending because of the weight of their accumulated debts and lower saving rates. On the other hand, for SMEs, a large proportion are found wanting in terms of both efficiency and profitability. In particular, over the 30% of SMEs registered an interest coverage ratio of below 100% last year, which means that even their interest payments were not covered by their operating income.

I think that monetary policy has some role to play in strengthening the economic fabric. As the central bank, we have a responsibility not to hit weak sectors such as households and SMEs too hard by raising interest rates. On the other end, we must also be on our guard against households and SMEs having an incentive to delay strengthening their fabric due to excessive dependence on low interest rates environment.

Structural reform, rather than being seen as just a negative concept involving the laying off of workers and the elimination of marginal firms, should be taken as a development concept: by shifting resources to sectors with high productivity it serves to heighten firms' competitiveness and bring a renewed expansion of employment and economic growth.

Global financial reform: themes and prospects

As the last of the policy challenges I will address today, I should like to talk about the global financial reform presently underway.

The current discussion worldwide concerning financial sector reform was precipitated by the latest global financial crisis. In wake of the present financial crisis, a variety of measures for financial reform have been discussed to prevent a future financial crisis and to bolster the stability of the financial system. While the Financial Stability Board (FSB), the Basel Committee on Bank Supervision (BCBS) and other setters of international standards are leading this discussion, major central banks around the world have taken an active part in it.

In contrast to the past, the present debate on financial reform is taking place within a framework of close international cooperation under the aegis of the G20, and also the scope of financial reform is becoming wider and more embracing.

We may say that there are four items on the agenda for financial reform now under discussion.

Firstly the Basel Committee on Bank Supervision is leading the discussion on the strengthening of banks' capital and liquidity regulations. The background to this is the criticism that, as the recent financial crisis unfolded, the existing scheme of capital regulation under Basel II was simply not up to its function as a tool for crisis prevention. Let me give you an example. Even banks with satisfactory capital adequacy ratios under Basel II became distressed. The expansion of excessive leveraging served as a factor in ramping up financial system instability.

Secondly, in addition to strengthening the existing micro prudential regulations, this item on the agenda sets out to construct a framework of macro prudential regulation to deal with systemic risks. Spurred on by the financial crisis, the importance of macro prudential policy has come to be emphasized as the missing pillar within the existing edifice of financial stability. To put it another way, macro prudential policy for the management of overall risk within the financial system is needed because the micro prudential soundness of individual financial institutions alone cannot guarantee the stability of the financial system as a whole.

Among macro prudential regulations, the main focus is directed to those targeting systemically important financial institutions (SIFIs). In line with the question of being “too big to fail” that arises in the case of systemically important financial institutions, this proposal needs to be pursued to avoid financial system stability being put at risk by moral hazard.

Third on the agenda is enlarging the objects of regulation from financial institutions alone. This involves strengthening the regulation of over-the-counter derivatives markets and hedge funds, whose riskiness was highlighted by the latest financial crisis, and also that of credit rating agencies.

The last item on the agenda is to build a global financial safety net (GFSN), which is part of the “Korea Initiative” as it was put forward by Korea.

The financial crisis that erupted in the United States and other advanced countries inflicted serious damage on a number of countries for no-fault of their own as the crisis spread out willy-nilly to engulf the emerging market countries. In particular Asian emerging market countries including Korea whose economic fundamentals were sound could not escape the influence of the crisis, even though they had built up foreign exchange reserves as a buffer against external shocks.

To address this problem, at a meeting of the G20 Finance Ministers and Central Bank Governors in Washington this April, the question of the construction of a GFSN was put forward successfully by Korea for inclusion on the official agenda.

A GFSN should be a tightly-woven multi-layered network of facilities with their respective strengths. The GFSN could have three layers: bilateral, regional and global. An example of the bilateral layer is the swap lines between the central banks. The second layer is built up of regional financial safety nets such as the Chiang Mai Initiative Multilateralisation (CMIM). Lastly, various liquidity provision facilities of the IMF make up the global level layer in the GFSN.

For emerging market countries including Korea, the GFSN will, it is anticipated, contribute to warding off crises preemptively and to reining in subsequent post facto propagation by underpinning the foreign exchange reserves that constitute a form of national self insurance.

Among the items mooted for inclusion on the discussion agenda, strengthening of banks’ capital and liquidity regulations and addressing systemically important financial institutions are expected to be confirmed as final proposals to be put to the G20 Seoul Summit Meeting this November. In particular, agreement was reached to place a substantive framework for BCBS capital and liquidity reform on the agenda at the meeting of Group of Central Bank Governors and Heads of Supervision (GHOS) on July 26 this year. This issue is now being actively pursued with a view to its introduction before the end of year 2012.

IV. Closing remarks

In the wake of the present financial crisis, I must admit to some misgivings as to the usefulness of what we experienced and learned in the past.

For example if the central bank should pursue price stability only, then does it ensure the stability of the economic system as a whole? Again, does the dispersal of risk by means of financial derivatives result in the underestimation of actual risk? Does it, in fact, encourage overly risky investment?

It is in this context that, once the crisis has been overcome, I believe the world economy should pursue a post-crisis economic paradigm rather than returning to the pre-crisis state.

In tackling the global financial crisis, countries around the world have, in contrast to the past, emphasized the attainment of international policy coordination so as to reduce market uncertainties. It had generally been perceived that international policy coordination was theoretically possible in the textbooks, but almost impossible in the real world.

However, at the time of Lehman's collapse and the Greek fiscal crisis, policy coordination efforts among countries around the world were directed to diminishing market uncertainties. Due to these efforts, the global financial unrest was eased significantly.

In this process, which was without past precedent, a new system of international consultation for the G20 was borne and Korea has taken an important role in this new system.

The Bank of Korea, as the central bank of the G20 chair country, will continue to take a leading part in discussions on the reorganization of the international financial order for strong, sustainable and balanced growth and for preventing any future repetition of the global financial crisis.

Thank you very much for listening so attentively.