Choongsoo Kim: The Korean economic outlook and policy initiatives for the course ahead

Speech by Mr Choongsoo Kim, Governor of the Bank of Korea, at a special luncheon of the New York representative office of the Bank of Korea and The Korea Society, New York, 25 August 2010.

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Greetings

Ladies and gentlemen,

I am indeed delighted to be here with you this afternoon to deliver a speech on the topic of the Korean economic outlook and policy initiatives.

Let me take this opportunity to express my deep thanks to all participants in this meeting, especially to Chairman Thomas C. Hubbard, former US Ambassador to the Republic of Korea, for this invitation to address you, and to Terrence J. Checki, Executive Vice President of FRB New York, for his close cooperation with the Bank of Korea.

In addition, my thanks go to H.E. Inkook Park, Ambassador to the UN, and Youngmok Kim, Consul General in New York, and

the very many distinguished experts from Wall Street.

I intend to speak today about how Korea overcame the shock of the global financial crisis and the policy challenges that lie ahead.

I. Economic movements after Lehman's collapse

1. Foreign exchange and financial market

While the Korean foreign exchange and financial markets were thrown into turmoil due to the global credit crunch following the collapse of Lehman Brothers, they have improved markedly since the second quarter of 2009.

- The Korean won/dollar exchange rate, which had risen to 1,530 at the end of February 2009, subsequently fell back to a level of 1,270 at the end of June 2009 as the foreign exchange supply and demand conjuncture improved because of the sustained current account surplus.
- In September 2009, spreads between long-term market interest rates such as corporate bond yields and Treasury bond yields narrowed to their level before Lehman Brothers' collapse amid the waning of credit risk fears.
- Share prices in terms of the KOSPI index continued on an upward trend in keeping with the turn for the better in the economic situation, rising from 1,070 as of the end of November 2008 to 1,690 as of the end of September 2009.

Even amid the overall foreign exchange and financial market stabilization, though, the exchange rate volatility of the Korean currency is still much higher than other countries'.

- Day-to-day volatility in the Korean won/dollar exchange rate was running at 0.92% in the second quarter of 2010, much higher than the 0.56% of UK pound or 0.51% of Japanese yen against the greenback.

2. Real economy

Growth

Real economic activity has maintained its swift recovery trend since the second quarter of last year.

- The rate of GDP growth in the fourth quarter of 2008, just after Lehman Brothers' collapse, tumbled to △4.5% quarter on quarter. However, economic growth swiftly returned into positive territory so that it registered 0.2% year on year for 2009 as a whole.
- A clearly-marked upward trend has been maintained also from the beginning of this year with quarter-on-quarter GDP growth coming in at 2.1% for the first quarter and 1.5% for the second quarter.

Among the OECD member countries, only three countries, Korea, Australia and Poland, chalked up positive growth in 2009.

What is more while it took six quarters for the economy to regain its pre-crisis scale following the Asian foreign currency crisis in 1997, it took only four quarters after this latest crisis.

- This is largely ascribable to the fact that it was possible to take bold monetary and fiscal policy measures to deal with the crisis in contrast to the situation following the foreign currency crisis. Korean financial institutions and firms had put themselves on a sound financial footing following the 1997 meltdown.

Employment

Similarly, labor market conditions, which lag economic activity, have improved greatly since the beginning of the year.

- The number of persons in private sector employment shifted to an increase in the fourth quarter last year, and by the second quarter this year it was higher than its level just before Lehman Brothers' collapse.
  - On the other hand, the main advanced countries have not so far been able to pull out of the downward trend in the number of persons in employment.

Prices

Mirroring the movements of the real economy, consumer price inflation eased from 4.1% in 2008 to 2.8% last year and this year it has continued at a little above 2 ½%.

- Actually the scale of the change in Korean price movements has been rather lower than that of other countries.
  - The rate of increase in US consumer prices fell steeply from 3.8% in 2008 to ∆0.4% in 2009 and that in Chinese prices similarly tumbled from 5.9% to ∆0.7% over the same two-year period.

House prices

House prices in Korea have shifted to an upward trend since the second quarter of last year, after experiencing a mild drop following Lehman Brothers' collapse.

- Due to the tightening of mortgage lending regulations including DTI ratios, however, house prices show a slower pace of increase this year; with the Greater Seoul area turning to a mild decrease.

In contrast to their very steep falls from pre-crisis levels in countries such as the USA and the UK, house prices in Korea have remained relatively unaffected.

- From January 2008 up until the present, house prices fell by 20.8% in the USA and 7.0% in the UK whereas they edged up 5.5% in Korea.

3. Policy responses

Thanks to the active implementation of monetary and fiscal policies, the Korean economy could overcome the financial crisis faster than other major countries.

Monetary policy

In the immediate aftermath of the collapse of Lehman Brothers, the Bank of Korea moved boldly from that October to bring stability to the foreign exchange market and ease the credit squeeze.

- It supplied a total of 26.8 billion US dollars in foreign currency liquidity by making active use of the foreign exchange reserves and a currency swap facility with the US Fed.

  Through open market operations and support for a bank recapitalization fund and so on, it also pumped in Korean won liquidity of 28 trillion won, amounting to the equivalent of around 2.6% of nominal GDP.

- In a further move, between October 2008 and February 2009, it cut its policy rate dramatically from 5.25% to its lowest-ever level of 2%.

From the second quarter of 2009, in line with the stirrings of improvement in finance and the economy, it progressively withdrew the liquidity supplied in the course of tackling the financial crisis.

- During 2009, it collected in full the foreign currency liquidity provided through swaps and loans.
- Similarly last year, it recouped the entire amount of the liquidity pumped in by way of RPs.
- In June this year the Aggregate Credit Ceiling for the financial support of SMEs was reduced by 1.5 trillion won, part of the 3.5 trillion won increase undertaken in response to the crisis.

→ Right now the total scale of the Korean won liquidity supplied and still outstanding amounts to only 6.9 trillion won (0.6% of nominal GDP), being made up of part of the increases in the Aggregate Credit Ceiling (2.0 trillion won), the Bank Recapitalization Fund (3.1 trillion won) and the Bond Market Stabilization Fund (1.8 trillion won).

The Bank of Korea adjusted its policy rate upward from 2% to 2.25% on July 9 this year after keeping it on hold for 17 straight months.

- Consideration was given to the possibility of mounting upward price pressures against the background of business activity's continued increasing trend.
- The scale of this recent rise in the interest rate being moderate and to some degree factored in, it is not considered likely to have any great impact on the financial and housing markets or on the household and corporate sectors.

Fiscal policy

The government implemented active fiscal stimulus measures to ward off an overly-deep recession in the real economy.

- Total additional fiscal spending and tax cuts directly and indirectly related to the financial crisis amounted to 38.8 trillion won in 2009.

→ The fiscal expansion associated with crisis-related discretionary measures amounted to 3.7% of nominal GDP, larger than that in both the U.S. and the U.K., the epicenters of the financial crisis.

Fiscal policy for 2010 is being implemented in such a way as to support the economic recovery and improve fiscal soundness.

- Government expenditures for this year will contract to 261.4 trillion won, 4.2% less than last year's (272.9 trillion won).
  - The ratio of the fiscal deficit to nominal GDP is expected to decrease from last year's 4.1% to 2.4%.
- Nevertheless, in order to increase the economic stimulus effect, the disbursement of the budget has been front-loaded like last year's.

II. Economic outlook

1. Growth

Looking forward, economic activity appears set to continue on its upward track so that GDP growth for the year as a whole is forecast to rise greatly from last year's 0.2% to stand at 5.9%.

- Although the government sector policy effects will weaken, the private sector is expected to lead the economic upturn.
  - The drawing-down of inventories has been almost completed so that we are moving into a phase of intended inventory rebuilding. Facilities investment, likewise, should build up swiftly, bolstered by the buoyant business situation in the IT sector.
  - The situation as regards consumption should improve as wage and salary income increases in an improved labor market.

GDP growth in 2011 is likely to come in at around 4.5%, somewhat lower than this year's.

I would add the caveat, though, that no small degree of uncertainty surrounds the course of growth including the possibility of a slowdown of the recovery in major countries and fiscal problems in European countries.

2. Prices

The rate of consumer price increases this year will move up from 2.7% during the first half to around 3.0% in the latter half-year. Notably, from Q4 onwards, it is forecast to be running above the mid-point of the medium-term inflation target (3%).

- Demand-side pressures are expected to build up in future because of rising business activity at a time when international commodity prices are themselves continuing on an increasing trend.

The rate of increase in the CPI next year is put at 3.4%, much higher than this year's 2.8%.

- Core inflation, which strips out food and energy prices, is similarly expected to accelerate substantially from this year's 1.8% to 3.1% next year.
- There is also a possibility that expected inflation will pick up owing to the acceleration of the rate of price increases.

– Although the rate of increase in consumer prices dropped back below 3% from May last year, expected inflation is still running above the 3% mark.

3. Current account

Turning to the current account, although the underlying surplus will continue, its scale is predicted to narrow gradually owing both to the increased goods imports drawn in by the recovery of domestic demand and to the widening of the services account deficit.

- The current account surplus is forecast to shrink from last year's 42.7 billion dollars to 21.0 billion this year and to around 11.0 billion next year.

→ The ratio of the current account surplus to GDP is expected to drop from 5.1% in 2009 to 2.0% this year and further to 1.0% in 2011.

III. Future policy tasks

1. Monetary policy

Looking ahead, the Bank of Korea will conduct monetary policy in such a way as to help the economy maintain price stability, while sustaining sound growth.

- The outlook is that the improving trend in the USA, China and other major countries will be maintained, even though the pace of the recovery will be slower than expected. In the case of China, the government's targeted 8% growth is likely to be easily reached both this year and next year.
- In Korea there is a need for vigilance against the possibility of the awakening of inflation expectations among the general public along with the acceleration of price increases.
- Lately the housing market has presented a subdued pattern as transactions have been drying up under the combined impact of the regulation of lending and the expanded supply of public housing while housing sale prices have declined, led by those in the Greater Seoul area.

  There are, however, some limits on the possibility of the depressed housing market leading to a sharp fall in house prices.

Despite the hike in the policy rate last month, the current monetary policy stance is still deemed highly accommodative, given the financial and economic situation at home and abroad.

- Since Lehman Brothers' collapse, the real interest rate in the short-term money market has been hovering around zero.

2. Major policy tasks

Enhancing macro-prudential soundness

Spurred on by the financial crisis, a lively debate has sprung up about whether central banks should play an active role not just in maintaining price stability but also financial stability.

- The rationale here is that because central banks maintain close linkages with financial market participants they are in a position to pick up on financial system problems at an early stage while in a financial crisis they carry out the role of lender of last resort.

- Similarly in Korea, the desirability of strengthening the central bank's financial stability function is being advocated in order to heighten the country's capacity to respond to financial crises.
  - The National Assembly is now examining the incorporation of this purpose in a revised draft of the Bank of Korea Act.

In the USA, the UK and elsewhere proposals for a realignment of the macro prudential policy framework to secure financial stability have now been put in place or are under consideration.

- This June, the UK unveiled plans for an overhaul of the financial supervisory system. Its main points included scrapping the Financial Services Authority and endowing the Bank of England with macro-prudential supervisory authority.
- In the case of the USA, under a financial reform bill (entry into effect July 22), the Federal Reserve was entrusted with the authority to establish regulations for the application of heightened standards and safeguards concerning systemically important financial institutions (SIFIs).

In terms of macro-prudential policy instruments, three main target areas have been identified for their application.

1) In order to buffer structural shocks arising from herding risk, contagion effects and so on, we should strengthen the regulation and supervision of the capital and liquidity of systemically important financial institutions.
2) To cushion shocks to the real economy brought about by a sharp expansion or contraction of credit supply in keeping with changes in economic activity, we need the introduction of regulations calling for counter-cyclical loan-loss provisioning.
3) Proposals should be worked out for the appropriate management of cross border capital flows so that excessive capital in- and outflows do not give rise to a heightening of foreign exchange and financial market volatility.

⇒ This June the Bank of Korea, the government and the financial supervisory authority jointly announced plans for easing the volatility of capital in- and outflows; and this step forms part of the drive to heighten macro-prudential soundness.

Construction of a global financial safety net

In order to avoid any repetition of the financial crisis, individual countries around the world will in future emphasize soundness in their operation of the macro economy and the financial system.

Under the global economic system in which we live, there are inevitably limits to what any one single country can do and, in this respect, its efforts need to be underpinned by the construction of a global financial safety net.

- Many countries including Korea maintained sound financial systems and built up their foreign exchange holdings as a buffer against external shock only to experience acute foreign exchange and financial market turmoil right after the financial crisis broke out.

A global financial safety net can be built drawing on existing international resources including a bilateral dimension such as swap lines between central banks, a regional dimension as represented by the Chiang Mai Initiative Multilateralisation, and an international dimension in forms such as the IMF's Flexible Credit Lines.

1) The Bank of Korea sought to engineer foreign exchange and financial market stability by activating currency swap contracts with the US and Japan following the outbreak of the global financial crisis.

2) Last March, under the Chiang Mai Initiative Multilateralisation involving a regional grouping of Asian countries, Korea actively sought to pursue financial cooperation and prevent a renewed crisis.

 – The scale of the fund's total resources was enlarged from USD 78 billion to USD 120 billion, of which Korea contributed 16%, or USD 19.2 billion.

3) In regard to the IMF, studies are now underway on improving its current lending system and supplementing the necessary lending resources so that it may carry out the function of global lender of last resort more effectively.

⇒ It is anticipated that a global financial safety net would contribute to warding off potential crises pre-emptively and restricting the spread of those that do occur by supplementing the foreign exchange reserve holdings of individual countries.

- At the Washington meeting of prime ministers and central bank governors this April, Korea successfully put discussion of a global financial safety net on the formal agenda for the upcoming G20 summit in Seoul.

Consolidating domestic demand

In tandem with efforts to prevent further financial crises we should seek to cushion the shock of those that do occur.

- This requires consolidating domestic demand by strengthening platforms for the growth of SMEs, identifying and fostering industries with fresh growth momentum, and rightsizing household liabilities.

1) Strengthening SMEs growth platforms

- Job creation and an increase in household income can be brought about by fostering SMEs that have high employment generation effects.
- Government support for the fostering of SMEs should put emphasis on new start-ups that have high growth potential rather than on existing marginal or zombie firms.
  - In the course of tackling the global financial crisis, structural adjustment was delayed, so that the proportion of marginal SMEs whose interest servicing ratio is less than 100% stands at more than 30%.

2) Identifying and fostering industries with fresh growth momentum

- By fostering the next-generation growth momentum of NT, BT etc. from a medium and long-term perspective and heightening the competitiveness of service industries, employment can be improved both qualitatively and quantitatively.
- Such high value added industries are vital in order to solve the problem of youth unemployment, which exhibits a high "reservation wage".
  - Although there has been an overall improvement in the labor market in Korea, unemployment among young people stood at 8.3% this July, which was still above its pre-crisis level.

3) Rightsizing household debt

- As household liabilities have been increasing faster than household incomes, the rightsizing of household liabilities, bringing them into an appropriate relationship with income, should be encouraged to avoid the shrinking of households' consumption capacity.
- Care is necessary as household liabilities may increase excessively when interest rates are low.
  - In the advanced countries there has been considerable deleveraging by the household sector as the financial crisis runs its course, but in contrast in Korea the household debt to income ratio rose from 146% in 2007 to 153% at the end of 2009.

Closing words

Korea has won praise as the country that overcame the global financial crisis most successfully.

- GDP growth for this year as a whole will be somewhere very close to 6% and next year it is expected to continue at its potential level.

→ This macro economic performance is considered to owe much to the great dynamism of Korean economic agents, both households and firms, together with the timely and appropriate response of the policy authorities.

While the world economy is not considered to have fully overcome the crisis and there is always the likelihood of ups and downs occurring in economic activity in certain regions, there is judged to be only a slight possibility of a double-dip recession or recurrence of the crisis.

- In this situation the Bank of Korea will conduct monetary policy appropriately in keeping with our particular economic situation.
- At the same time it intends to seek the further strengthening of international policy cooperation such as the construction of a global financial safety net in order to bring about coexistence and prosperity while warding off renewed crises.

As the chair country of the G20 meeting, now preparing for the Seoul summit in November this year, we intend to firmly anchor our vision of "the Korean economy as a model for the world economy".