Choongsoo Kim: Changes in the global financial and economic landscape and challenges facing the Korean economy

Speech by Mr Choongsoo Kim, Governor of the Bank of Korea, to the American Chamber of Commerce in Korea (AMCHAM) General Membership Meeting, Seoul, 16 March 2011.

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(Greetings)

Good afternoon. I would like to thank the American Chamber of Commerce in Korea (AMCHAM) for inviting me to be here with you today.

My remarks today will focus on the changes in the global financial and economic landscape, and I will also offer some thoughts on the challenges now facing the Korean economy.

First of all, however, I would like to offer my deepest condolences to the Japanese people in their suffering after the earthquake, and my hopes that Japan recovers swiftly from the damage caused. It is very much to be hoped that worldwide economic cooperation be directed now toward helping Japan in its hour of need.

Let me begin my remarks now with the ***Changes in Financial and Economic Conditions***.

Policymakers around the world face a whole new set of challenges today, posed by the recent changes in the global financial and economic landscape. This is an evolution that has been ongoing since the global financial crisis broke out.

And these difficulties, which are marked by uncertainty, owe to the fact that nowadays, in this post-crisis era, there can be no return to the world economy of the pre-crisis days, but only a transition to a new paradigm to be explored in international forums like the G20.

Familiar concepts as we know them are now in flux. To cite just one example, the concept of “too interconnected to fail” has arisen in parallel with that of “too big to fail”.

Now, the most prominent feature of the global economic environment today is the fact that a two-speed recovery still continues.

As you are all well aware, what this means is that the growth paths and growth rates of the advanced and the emerging economies are diverging. And this concept, I would say, is one integral part of the new paradigm that has emerged since the crisis.

In this two-speed global recovery, emerging economies now agonize over the instability of their prices, including those of real estate, as they overcame the crisis swiftly and are now enjoying rapid growth. The advanced economies in contrast fret over their own sluggish growth and high rates of unemployment.

The task of analysis imposed on us as policymakers thus becomes all the more complicated, because it is no longer sufficient to consider just the one-way spillovers by which economic policies in advanced economies influence emerging ones. The two-way spillovers, where the influences run in both directions, must be taken into account at the same time.

A good case in point is our analysis of the effects of the US Federal Reserve’s second round of quantitative easing, or QE2, in which we must not simply consider the impact that the Fed’s policy has on emerging economies in addition to its own, but also take into account how this impact on emerging economies feeds back to the US economy in turn.

Another major concern in the global economy these days is the growing problem of global inflation.

At present, most countries other than the United States and Japan are quite concerned about inflation.

And for the emerging economies in particular, prices, including asset prices, have risen greatly as capital inflows to them have expanded.

That being said, in the global financial markets we are presently seeing some indications of capital being pulled from emerging economies over the short-term, as a consequence of the economic recoveries in advanced economies and the emergence of geopolitical risks.

The international prices of oil and other commodities have also surged, with the recent escalation of geopolitical risks in North Africa and other regions, adding further to the impact of the increased demand for them generated by the global economic recovery.

It follows from all of this that the normalization of monetary policy has emerged as a very pressing policy concern for most central banks, which must ensure that the ample liquidity supplied in response to the crisis will not stoke inflation.

The last of my comments on the changes in financial and economic conditions relates to the G20, which has been at the center of the active post-crisis discussions on a new global economic order. The key to construction of such an order is of course to resolve the problem of global imbalances, that lay at the root of the crisis, by producing concerted and coordinated deliverables in relation to the indicative guidelines laid out in the discussions at the G20 meetings.

We must not forget that at the center of any financial crisis lies a crisis of the real sector of the economy, and that correcting the conditions for sound operation of the real sector is thus of paramount importance.

And needless to say, because such deliverables cannot be achieved through the efforts of a few countries alone, we must endeavor to reduce market uncertainties through policy coordination among countries at international forums including the G20.

Now then, what are the ***Challenges Facing the Korean Economy***?

The growth outlook for the Korean economy this year is clouded by the existence of several downside risks, among them the political unrest in the Middle East and North Africa, and resultant rise in international oil prices, and domestically, the damage caused by foot-and-mouth disease.

On the other hand, there are also upside risks, such as the strengthening of the economic recoveries in the US and other major advanced economies. And as the effects of these downside and upside risks are likely to be of similar magnitude, we at the Bank of Korea expect the Korean economy to achieve favorable growth at the originally-forecast level of around 4.5% this year, with balanced contributions from exports and domestic demand.

Employment has exhibited a trend of recovery since 2010, led by the private sector, with the unemployment rate holding steady at the mid-3% level, while a solid trend of surplus has been maintained in the current account, albeit at a declining ratio to GDP. For this year as well, we foresee outcomes similar to those of last year both in employment and in the current account balance.

Given such prospects, I believe price stability to thus now be the greatest challenge facing the Korean economy.

Amid the build-up in demand pressures from our swift recovery from the global crisis and economic upswing, consumer price inflation, after recording 4.1% in January, marked 4.5% in February, exceeding the upper bound of the Bank of Korea’s medium-term inflation target. This is due mainly to three factors. First are the run-ups in oil and other international commodity prices, and the surge in prices of agricultural, livestock and fisheries products owing mostly to the abnormal cold wave experienced this winter and to the outbreak of foot-and-mouth disease. Second is the demand-side pressure, as measured by the positive output gap. And the third factor is the rising inflation expectations. Roughly speaking, the supply-side factors account for half of the price inflation that we are seeing.

In the coming months, consumer price inflation may remain elevated at a high level for some time.

Having said that, I expect inflationary pressures to be concentrated more in the first half of this year than in the second half, and particularly those stemming from supply-side factors like international commodity prices to ease in the second half relative to the first.

Given the very wide range of factors at play in this recent bout of inflation, including the supply-side and the demand-side factors, I think that a multi-pronged response is likewise called for on the policy front.

Particularly in terms of macroeconomic and monetary policies, I believe it vital to block off second-round effects such as wage increases, spurred by cost-push inflation spreading to other sectors via inflation expectations and so forth.

An important task for the Korean economy from a longer-term perspective, meanwhile, lies in securing financial and foreign exchange market stability.

Korea and the other emerging market countries presently experiencing large global capital inflows, in line with their continued strong growth, are necessarily wary of the possibility of heightened financial and foreign exchange market volatility in the event of any future reversal of these capital flows.

And for Korea, reducing exchange rate volatility has become an important policy objective, since the Korean won's volatility towers well above those of other currencies.

The won's intraday volatility vis-à-vis the US dollar was in fact found to be 0.60% for 2010, fourth-highest among the 25 major currencies assessed against the dollar.

In order to address such issues, the Korean government aims to ensure financial and foreign exchange market stability through such measures as regulation of banks' foreign exchange forward positions, re-introduction of withholding taxes on foreigners' domestic bond holdings, and implementation in the latter half of this year of a "Macro-prudential Stability Levy" on non-core foreign currency liabilities. These measures are being employed purely as a matter of macro-prudential policy, and not as capital controls, and they will be legislated and implemented in line with global standards.

(Closing Words)

While Korea was the first among OECD members to overcome the impact of the global financial crisis, it was also the one hit the most severely when the crisis initially erupted, as was seen in the dramatic drop in GDP growth.

Internationally, countries are now striving not only to overcome the global crisis but also to devise and put into place mechanisms to prevent its recurrence. Through the construction of a new financial regulatory framework, dubbed Basel III, we seek to prevent individual financial institutions from becoming insolvent while at the same time keeping systemic risks under control, and to thereby avert future global crises.

In overcoming and preventing global economic crises, the central bank's role as its national economy's lender of last resort is indispensable. In light of this, the Bank of Korea is moving to cooperate actively in the systems of international policy coordination, by strengthening our networks with other central banks.

Domestically, we find ourselves in a situation in which inflationary pressures have become very large, driven by global inflationary trends due to the excessive global liquidity and rapid growth in emerging economies, and by the continued growth of our domestic economy. It is high time now for us to seek ways of establishing a post-crisis paradigm so as to firmly anchor the foundation for price stability in the medium- and long-term, based upon thorough analysis of the currents of economic change both at home and abroad.

Going forward, we must be unremitting in our efforts to restore the robustness of the Korean economy, so that it is not so greatly swayed by domestic or external shocks.

I am firmly convinced that all AMCHAM members gathered here today will also contribute much, in your own individual fields of expertise, as our partners for the stable growth of the Korean economy.

I should like to close by again expressing my gratitude to AMCHAM for giving me this opportunity to address you.