Choongsoo Kim: New role of central bank and regional financial cooperation after the global crisis

Opening address by Mr Choongsoo Kim, Governor of the Bank of Korea, the 47th SEACEN Governors' Conference, High-Level Seminar and the 31st Meeting of the SEACEN Board of Governors, Seoul, 13 February 2012.

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Distinguished governors, ladies and gentlemen,

I would like to express my gratitude to all my fellow central bank governors for taking part in the 47th SEACEN Governors' Conference, High-Level Seminar and the 31st Meeting of the SEACEN Board of Governors.

My special thanks go to 5 distinguished speakers, Mr. Pier Carlo Padoan, Deputy Secretary-General of OECD, Mr. Stephen P. Groff, Vice-President of the ADB, Professor Charles Engel from University of Wisconsin, Mr. Hannoun from BIS and Mr. Chia from IMF who have come from afar to deliver the keynote addresses.

It is a great honor and pleasure for us to be hosting the SEACEN Governors' Conference in Seoul again after 13 years.

Though I stand before you today as the representative of the Bank of Korea, I bid you welcome on behalf of all the Korean people.

In the wake of the global financial crisis, emerging market countries recovered faster than the advanced countries.

However, the increasing uncertainties surrounding the world economy since then still pose a threat to the Asian economies.

At this juncture, we should learn the lessons of the Global Financial Crisis.

This means setting the financial infrastructure right and establishing an effective policy response system in order to ward off further crises by speeding up global economic recovery.

I think now is the time to change the policy stance and also strategies. Global financial resources may have in recent years been directed toward financing of unsustainable financial deficits and debt-ridden countries, and little toward growth and job creation. I believe that redirecting of financial resources more toward growth, and more specifically toward countries with high productivity could yield substantial benefits to all in the long run. This is why I see a greater role for Asia going forward. Asia overcame the global financial crisis well, and has remained resilient to negative spillover from ongoing crisis in Europe. Moreover, many expect Asia to develop even more into an engine of global economic growth.

If we look at the outbreak and spread of the Global Financial Crisis and the policies adopted in response, we can draw many precepts and pointers as to the role of central banks and monetary policy.

The most important lesson from the Global Financial Crisis that we should particularly bear in mind when setting policy options for the avoidance of future crises is that there is a strong linkage between the real and the financial sector and this linkage has to be reflected in setting up a new international financial architecture and monetary policy framework.

The real and financial linkage implies that price stability can hardly be separated from financial stability. And, behind the financial crisis, there lurk the imbalances in the real economy.

Unless we understand the mutual linkages running between the financial and real sectors, we may well not be able to deal with the fundamental problems but end up killing the messenger.[1]

By taking this opportunity today, I would like to talk about several matters relating to the harmonization of monetary and macro-prudential policy, which has emerged as a new issue since the Global Financial Crisis.

I should also like to say a few words about proposals for strengthening financial cooperation in the Asian region, where intra regional trade and financial transactions have been increasing.

Harmonizing Monetary and Macro-prudential Policy

Orthodox monetary policy exercises an influence on both price and financial stability but this does not always run in the same direction.

In this regard, monetary policy hits a road-block in achieving at once price stability and financial stability.

To elaborate, adjustment of the policy rate is something of a blunt instrument and ineffective for achieving financial stability, hence "financial imbalances" are better handled using micro-and macro-prudential instruments, such as capital and liquidity requirements.[2]

Macroprudential policies can contribute to reducing economic costs associated with crisis prevention as it can alleviate policy tradeoff that traditional monetary policy faces.

An appropriate mixture of orthodox monetary policy focused on price stability and macro-prudential policy oriented to the prevention of bubble formation would make it possible to achieve price stability and financial stability at the same time with minimal costs to the economy.

In order to prevent conflict between monetary policy and macro-prudential policy, governance structure should be clarified.[3]

Broadly speaking, there are two types of governance structure here. In one the central bank in charge of monetary policy is also responsible for macro-prudential policy.

In the other a supervisory agency apart from the central bank is fully in charge of macro-prudential policy.

We have recently witnessed a sea change in the governance structures of macro-prudential policy in major financial center countries, where central banks have now become responsible for – or at least involved in – both monetary and macro-prudential policies.

As there is no solution which can be universally applied, however, I believe that governance structures should rather be tailored to individual countries' circumstances.

It should nonetheless be made clear that the central bank needs to play a role in a macro-prudential oversight of systemic risk, and that close dialogue and policy coordination

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1 Speech by Governor Choongsoo Kim at KMFA Academic Conference on "Monetary Policy Reform after the Global Financial Crisis" (June 11, 2011)

2 Lars E.O. Svensson, Central-banking challenges for the Riksbank: Monetary policy, financial-stability policy and asset management , Sveriges Riksbank, Stockholm University, CEPR and NBER, November 17, 2011 (revised December 6, 2011)

3 BIS (2010)., "Macroprudential instruments and frameworks: issues for central banks", A note for a meeting of Governors on Monday 8 March 2010

between the central bank and the supervisory authority, when they are not one and the same, is crucial for financial stability.

Taking into account these changes in the domestic and overseas environment and in order to bolster macro-prudential foundation for the domestic financial system, the Bank of Korea was given responsibility for achieving financial stability through the revision of the Bank of Korea Act in September 2011.

The recent IMF report similarly recommends that it is desirable for the central bank to play an important role in constructing the macro-prudential policy framework for pursuing financial stability.[4]

An individual country's macro-prudential policy should be operated in harmony with its own monetary policy in line with its specific conditions and there cannot be a one-size-fits-all type of macro-prudential framework.

Meanwhile I want to suggest some points to be considered, if macro-prudential policy is to take deep root as a new policy framework for financial stability.

Firstly, as the macro-prudential policy instruments now under discussion internationally have the nature of binding regulations, care must be taken in the drive for their introduction to avoid any undue inhibition of financial industry dynamism.

Likewise, international or regional policy cooperation will have to be stepped up to prevent any emergence of regulatory arbitrage.

Secondly, the macro-prudential policy framework needs to be designed in such a way that the central bank as the lender of last resort plays an active role.

This is because successful conduct of macro-prudential policy requires accurate judgment of the business cycle and a profound understanding of the linkages between the financial market and the real economy.

Thirdly, macro-prudential policy runs the danger of becoming vulnerable to political pressure.

The neutrality and transparency of policy-making must therefore be adequately guaranteed in macro-prudential policy just as in monetary policy.

Lastly, I think we need to bear in mind that potential risks in the financial system may still build up due to both micro- and macro-level incentives.

In this regard, we must try to strike a balance between macro-prudential and micro-prudential policy.

Strengthening Regional Financial Cooperation

At the time of the Global Financial Crisis, what began as a crisis in the U.S. and other advanced countries spread to emerging market countries, making no distinctions and causing several of them willy-nilly to suffer the fate of innocent by-standers.

Notably, Asian emerging market countries were not free from the repercussions of the crisis, even though they enjoyed favorable macroeconomic conditions and had built up their foreign reserves as a buffer against external shocks.

These countries saw their financial markets thrown into turmoil due to huge outflows of foreign capital.

In response to such abrupt swings in international capital flows, discussions are now underway on measures such as increasing foreign reserves, expanding and institutionalizing

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4 IMF Staff Discussion Note, "Institutional Models for Macroprudential Policy", November 1 2011

currency swaps between central banks and establishing global financial safety nets. Moreover, there is a growing consensus of opinion that macro-prudential policies should be put in place to enhance the soundness of financial institutions' behavior and ease the procyclicality of foreign capital flows.

In the aftermath of the global financial crisis, there have been a series of discussions on improving systems, regulatory policies and market structure, and progress has been made in terms of financial regulation such as the adoption of BASEL III.

However, we still have many tasks to deal with.

Notably, due to the growing interconnectedness between countries, capital flows have been acting as a transmission channel for the worldwide spread of what was originally a national or regional crisis.

In this regard, we need a global jurisdiction which can maintain stable global liquidity and monitor cross-border transmission.

It is very encouraging that regional cooperation organizations such as SEACEN, ASEAN+3 and EMEAP have recently stepped up their cooperation in promoting regional financial market development and stability, by drawing up joint response plans, such as the launch of the CMIM, to tackle such financial crises, and by seeking ways to foster regional financial market development and improve macroprudential frameworks.

To my mind, the best way for Asian economies, which are vulnerable to external shocks, to expand their mutual economic interests is to strengthen their collective response by making integration of their real economies, by way for example of FTAs and the setting up of regional financial safety nets.

Meanwhile, the establishment of policies within the Asian region and within individual regional countries should be in line with the reforms underway in the international financial architecture.

Amid the increased possibility of systemic risk, where shocks arising from certain financial institutions or markets spread rapidly due to the heightened financial interconnectedness, financial stability cannot be achieved based solely on policies of individual countries, unless accompanied by international cooperation.

Above all, in order to regulate the financial market, where globalization has progressed the most, we should participate energetically in networking among central banks around the world, thereby strengthening international cooperation in regard to macro-prudential policies.

Closing Remarks

While undergoing the bitter experience of previous financial crises, Asian countries at least profited from them in drawing lessons that, I believe, greatly helped them see off the Global Financial Crisis successfully.

Although we are not at the epicenter of the ongoing global financial crisis and euro area sovereign debt crisis, we should also take them as object lessons.

Above all, I hope that we can look to a brighter future as the dark shadows shrouding the world economy fade this year, blown away by the energy of the black dragon which is believed to rule the dark.

I wish the best of luck throughout this year to all of our SEACEN member economies and our partners around the world.

Thank you very much for listening!