Choongsoo Kim: Monetary and macroprudential policies in the aftermath of the crisis

Opening remarks by Mr Choongsoo Kim, Governor of the Bank of Korea, at the Bank of Korea International Conference 2012 "Monetary and Macroprudential Policies in the Aftermath of the Crisis" co-organized with the IMF, Seoul, 14–15 June 2012.

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Good morning.

Distinguished speakers, participants.

I bid you all a very warm welcome to the 2012 Bank of Korea International Conference. In particular, I would like to express my gratitude to Professors Thomas Sargent, Barry Eichengreen, and Yung Chul Park, Dr. Jonathan Ostry, and all of our speakers and participants for their invaluable contributions to this conference. My special thanks go as well to the IMF, our conference co-host.

I am confident that this conference will provide us with an excellent forum for discussing the valuable precepts drawn from the global financial crisis, and sharing ideas in the face of risks and challenges in the years ahead. Since the outbreak of the global crisis, policy community and academia in the global world have brought their minds to bear on the question of how the crisis arose and proposals for its resolution.

Although I am sure that these efforts need to be continued, especially so amid the sovereign debt crises in the eurozone, it is never too early to start the discussion of what direction of monetary policy should follow in the future.

Crises are the surface manifestation of important underlying imbalances. There is no doubt that financial and real imbalances played major roles in causing the crisis and worsening its severity. We should, however, acknowledge that a big gap between reality and our perception of it sowed the seeds of the crisis. We need, therefore, to reset our understanding of the real economy and the financial system.

In fact, this has been how our predecessors overcome the economic crisis of the 20th century. The Great Depression changed the world as they knew it, and put their knowledge and ideas to the test. But, they were willing and brave enough to revise their views and beliefs to lay the foundation of new framework – "macro" economics.

A crisis is accompanied by severe strains. But, at the same time, it offers an opportunity to broaden our understanding. If we can come up with a new framework that will last for decades or longer, we will be similarly remembered as another generation of economists and central bankers that overcame the previous orthodoxy to turn the crisis into the beginning of a new era.

Taking the opportunity given me here today, I would like to address several critical issues related to future monetary and macro-prudential policy, and to say a few words about strengthening global cooperation to achieve financial stability.

Global financial crisis and monetary policy

The global financial crisis, as we all know, started in the financial sector but has eventually led to fiscal crises in many advanced economies, not to mention a global recession.

In response to the crisis, central banks around the world undertook a wide range of measures. Policy rates were cut swiftly, and non-conventional measures were also deployed including, among others, large-scale term-loans to troubled financial institutions, outright asset purchases, and interventions in credit markets. These measures have helped support financial markets and thereby avoid financial meltdown.

Despite such success on the financial front in the early phase of the crisis management, monetary policy fell short of avoiding deep recessions, which in turn triggered severe strains on the fiscal status of many advanced economies. The ensuing eurozone fiscal crisis is still an on-going event that is preventing the global economy from recovering a sound growth momentum – even four years after the outbreak of the global crisis.

As we have seen in many instances, central bank activism is indeed pivotal in crisis management. But we should also be mindful of potential adverse side effects. Socializing private losses may easily lead to moral hazard while central banks' over-stretched balance sheets could end up constraining the flexibility of future policy operations. Massive increases in official liquidity may have negative spillovers across sectors and national borders. In this light, we should keep in our mind that monetary policy is no panacea. I believe that an in-depth review of post-crisis monetary policy and its outcomes, including both successes and failures, should be a first step toward establishing new thinking on monetary policy.

To be complete, however, our new thinking should go beyond its operational aspect to cover more fundamental dimensions such as the mandates and the governance structure of the monetary policy as broadly defined. I believe that new thinking on such dimensions is essential to our efforts to build a stronger institutional basis for crisis prevention.

Many specific questions arise in this regard. Should the mandate of monetary policy be broadened to include financial stability – particularly in the context of inflation targeting? How should monetary policy be coordinated with macro-prudential policies? Who should bear the responsibility of keeping financial stability if multiple authorities are involved? What institutional structures should be in place to render the monetary authority more accountable?

All these questions have in fact been taking center stage in the post-crisis debate on monetary and macro-prudential policy. And there was notable progress in our search for practical answers.

In retrospect, the monetary policy has been a victim of its own success in that the global crisis was preceded by the period of the Great Moderation. It is evident by now that ensuring financial stability is as important as maintaining stable prices. It is also evident that policymakers – including central banks – failed to detect systemic risks in advance and keep them under appropriate control. Last but not least, the danger of excess leverage and global liquidity expansion has been downplayed in the midst of stable inflation.

In this light, I commend highly the initiative led by the G20 in formulating a new financial regulatory framework that can be an effective complement to monetary policy in achieving price and financial stability simultaneously. Specifically, the Basel III framework requires stronger capital and liquidity buffers than its predecessor, and also includes a set of macro-prudential tools. Regulations on Global-SIFIs should help address possible market distortions arising from the too-big-to-fail hypothesis.

For emerging economies with highly liberalized capital account, it is of utmost importance from a macro-prudential perspective to guard against adverse shocks of external origin and associated volatile and pro-cyclical capital flows. In this regard, Korea has recently implemented macro-prudential tools such as adjustable caps on banks' foreign currency derivative positions and a macro-prudential levy on their foreign currency liabilities. I hope that Korea's policy experience could be a good reference for other emerging countries.

Despite such commendable progress, however, many critical questions are still left unanswered or unsettled with regard to the monetary and macro-prudential policies and the global financial system. I hope this conference will shed new light on these critical issues.

Global cooperation for global financial stability

Now allow me to briefly touch upon the issue of global policy cooperation before closing my address.

I should begin by saying that we must clearly recognize the enormous complexity of today's financial realities and economic circumstances. The real and financial sectors are fast fusing, and ever-growing cross-border activities rule out unilateral actions. As such, no policy framework is likely to be effective without close cooperation among countries. This is indeed one of the key lessons from our policy responses to the global crisis.

In today's highly interconnected world, financial disruptions in one country or region would be no longer a problem of the country or region alone. By the same token, policy measures taken by a country can easily affect other countries. For example, extraordinary monetary easing by major central banks does appear to have helped their home countries contain the fallout from the crisis. But many emerging countries were forced to confront adverse financial spillovers from large and sharp swings in the global liquidity condition.

In short, coordinated global efforts to rein in the excessive global liquidity and cross-border spillovers have fallen short of expectations. And we all know too well that international policy cooperation has always been difficult to achieve. But history is not destiny. Nor does it mean that we should give up. A global solution is needed more than ever to overcome the current crisis, which is a global problem. And for the benefit of all, the global community should be more united than ever in tackling the enormous challenges that lie ahead of us.

Concluding remarks

Ladies and gentlemen,

The world economy is still struggling to find its way out of the Great Recession. It is in need of stronger and wiser policy actions that can address the very complex economic and financial troubles we are facing now. But our understanding of what went wrong and what should be done is still incomplete. This is even more the case if we turn our attention to the future of the global financial system and to the monetary and macro-prudential policy framework.

As I mentioned earlier, I believe that global policy cooperation should be a priority in our search for an exit from the current crisis. I also believe that effective collaboration between policymakers and academia is every bit as crucial as that between policymakers.

We do not sit idle by during the crisis. Nor should we sit idle by, being complacent with the conventional wisdom. We must bridge the gap between reality and our perception of it. It is our duty and indeed our very real privilege to engage in and work through the conundrums we encounter today.

I look forward very much to a new thinking on monetary and macro-prudential policy. And I am confident that this conference will contribute to developing the new thinking that we all need.

Once again, I wish to extend my heartfelt appreciation to all participants, and my hope for your active discussion of new insights and views here during the next two days.

Thank you.