Comments on: "Inflation targeting in Korea: a model of success?" by Soyoung Kim and Yung Chul Park

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Before the 1997-98 financial crisis Korea was a middling inflation economy. The Bank of Korea Act passed during the financial crisis institutionalised inflation targeting and since then Korea has become a much lower inflation economy. Soyoung Kim and Yung Chul Park's paper documents that both the level and the volatility of inflation have come down since inflation targeting was introduced. This is true for both headline and core inflation measures.

How much of Korea's improved inflation performance can be ascribed to the adoption of inflation targeting? This is the question Kim and Park set out to answer.

They first ask whether the drop in inflation volatility is due to luck or a more inflation-resistant economic system. To do this they analyse whether the lower volatility can be traced to a lower variance of the inflation shocks that have hit the country since inflation targeting was adopted or whether inflation propagation diminished. They find that shocks diminished in size and their propagation was weaker after inflation targeting was introduced. But crucially for the inflation targeting debate, the weaker propagation effect was more important than the decline in the size of inflation shocks in explaining the decline in inflation volatility.

The authors also look at the sensitivity of inflation expectations to realised inflation in the pre- and post-inflation targeting periods. They find that inflation expectations were more sensitive to changes in actual inflation in the pre-inflation targeting period. This finding suggests that the Bank of Korea has successfully de-linked inflation expectations from realised inflation, another positive for inflation targeting.

So far, so good. The Bank of Korea's policy of inflation targeting seems to have anchored inflation expectations more firmly than in the previous regime and this may be responsible for the superior performance of the economy in response to inflation shocks. The authors argue that confidence in their tentative findings would be strengthened if they could get inside the Bank of Korea's monetary policy black box and demonstrate that the transmission mechanism was well understood. Obviously, if a link between monetary policy and the favorable inflation outcome cannot be established then the latter cannot necessarily be attributed to the adoption of inflation targeting. It must be true that "the public understood the mechanism of inflation targeting and believed in the resolve of the central bank to sustain price stability".

They estimate a central bank reaction function that indicates that the Bank of Korea places a high importance on price stability. They then attempt to measure the effects and transmission mechanism of monetary policy using impulse response functions. They first attempt to identify monetary policy shocks using a basic model that includes as variables core CPI, industrial production, the central bank's policy interest rate (the call rate) and the monetary base. Their findings are robust enough to enable estimation of an expanded model that includes different interest rates and monetary aggregates to permit an examination of the transmission mechanism. Here things break down. The finding that monetary policy shocks,

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which are modelled as shocks to the call rate, have no impact on long-term interest rates but a pronounced negative impact on business investment is especially anomalous.

In their concluding remarks the authors conjecture that their failure to illuminate the contents of the Bank of Korea's monetary policy black box may be due to the Bank's accommodation of the objective of controlling the exchange rate. It is not surprising that the transmission of monetary policy is not clear when there are two nominal anchors in the system.

This is a controversial point, as the authors note. The Bank of Korea steadfastly insists that it is not in the exchange rate targeting business. It justifies foreign exchange market "smoothing" by the need to control excessive exchange rate volatility, which, if they were to allow it, could unsettle inflation expectations. In a similar way, the Bank keeps a close eye on the property market. It regularly mentions the current account position in its monetary policy statements. My view is that the Bank of Korea sees its inflation targeting mandate as giving it a great deal of flexibility. Kim and Park's results indicate that a downside of this flexibility is an unclear monetary transmission mechanism.

Thus, on the big question posed in their title of whether the implementation of inflation targeting in Korea is a model of success, Kim and Park answer "Yes, but...". Yes, inflation fell and became less variable after inflation targeting was adopted. But no, we cannot be sure it was because of inflation targeting.

There is, I believe, another lesser success that can be attributed to the adoption of inflation targeting, and which strengthens the case for recommending it as a monetary policy rule. I refer to institution building and the strengthening of financial policymaking.

The authors note that prior to the adoption of inflation targeting, the public paid little attention to the Bank of Korea's policy pronouncements and, in fact, public confidence in the Bank was low. Things are very different today. Market players today take very seriously the Bank of Korea's policy pronouncements.

It is even possible to imagine that the institutional developments that have come with inflation targeting have created forces that could ultimately resolve the problem of having two nominal anchors. The change may not be far off considering the recent scale of the Bank of Korea's activities in the foreign exchange market.

From January 2002 through to the first quarter of 2005, the Bank of Korea accumulated over \$100 billion of foreign exchange reserves or about \$3 billion a month on average. Just as this creates problems for Kim and Park's reaction functions, it also creates problems for Bank of Korea officials, who have to explain their actions in the annual monetary policy report they present to the National Assembly. In the last two years, these reports have provoked questions from elected officials about the Bank of Korea's reserve accumulation/sterilisation operations. Losses incurred by the Bank have been a political issue.

Political pressure is the most likely source of a policy change in the direction Kim and Park hint, a liberalised capital account with a much more freely floating won. And there is evidence that such a change is occurring, most recently the Foreign Exchange Liberalization Plan announced on 19 May, 2006. In a one-anchor system it seems reasonable to conjecture that a re-estimation of the reaction functions in Kim and Park's paper would be more successful in identifying the monetary transmission mechanism.

I have two small issues with the paper. First, the Fed and the ECB continually emphasise that keeping inflation low and stable is the best thing they can do to promote economic activity, which is obviously one of the variables of ultimate interest. The authors could usefully have looked at whether the decline in inflation volatility has been accompanied by a decline in the volatility of output, ie has Korea joined in the Great Moderation?

I also believe the paper would benefit from a comparison of the pre- and post-inflation targeting experience in terms of the transmission of monetary policy shocks. Given the inconclusive findings for the inflation targeting period, it would be interesting to know whether in adopting inflation targeting the Bank of Korea has traded a more favourable inflation performance for a less transparent monetary transmission mechanism.

Milton Friedman recently gave an interview[2] where he expressed surprise at how well different countries had been able to keep to their inflation targets. Where central banks understand their primary objective to be avoiding inflation, they are able to do it. He concluded that economists had overestimated how hard it is to maintain low, stable inflation. Kim and Park's econometric results do not enable us to say with confidence that inflation targeting deserves the credit for Korea's improved inflation performance. However, I would argue that the better inflation performance per se and the gains from institution building warrant a less qualified title for their paper.

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2 "Agreeing to disagree: Robert Kuttner speaks with Milton Friedman", *American Prospect Online*, 1 May 2006.