Seong-Tae Lee: Monetary policy in an environment of low inflation

Opening address by Mr Seong-Tae Lee, Governor and Chairman of The Bank of Korea, at The Bank of Korea International Conference 2006, Seoul, 16 June 2006.

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Greetings

Ladies and gentlemen,

I am delighted to be here to express my warm welcome to all of you attending "The Bank of Korea International Conference 2006". I would like to extend particular gratitude to our keynote speaker, Professor **Frederic Mishkin** of Columbia University; to our luncheon speaker, President **Un-Chan Jung** of Seoul National University; to President **William Poole** of the Federal Reserve Bank of St. Louis; and to our other chairpersons, speakers and discussants, for taking time out from their busy schedules to be with us today.

This year's conference, marking the 56th anniversary of the Bank of Korea's establishment, deals with the theme of "Monetary Policy in an Environment of Low Inflation". Many central banks including the Bank of Korea are currently facing difficulties conducting monetary policy in the new environment characterized by low inflation. In this regard, I believe that today's conference is very meaningful and most timely.

Conducting monetary policy under low inflation

As we are all aware, inflation throughout the world has declined since the mid-1990s. This is mainly attributable to the emergence on the global stage of vast low-wage economies such as China and India; to productivity gains made possible by information technology (IT) development; and to intensified competition in both domestic and global markets.

In addition to all of these factors, the increased credibility of central banks is also believed to have contributed to low inflation. Over the years, central banks around the world have been resolute in their pursuit of price stability, while working hard to enhance their capabilities in the conduct of monetary policy. Together with the continuing price stability, this has helped lower the inflation expectations of economic agents.

The case is much the same in Korea. Both consumer price and core inflation rates are running at levels some two percentage points lower than those we saw here prior to the currency crisis. Particularly, the rate of core inflation nowadays is moving substantially below the lower bound of the Bank of Korea's target range.

In the last few months, upward price movements have been observed in several countries. However, rising prices on a scale similar to those of the past are no longer expected to reappear for the time being, as firms continue their efforts to improve productivity with the accelerating integration of the world economy. Although there is concern that the run-up in oil prices may serve as a factor causing price instability, oil has much less effect on inflation now than in the past. This is mainly due to declining oil-dependency in line with improved energy efficiency, to the stabilization of inflation expectations, and so on.

This emergence of global low inflation is of course a welcome phenomenon for central banks, for whom price stability is the top priority. At the same time, however, it imposes upon them a new set of tasks. Above all, if monetary policy is conducted solely with an eye focused on price stability, factors representing threats to the stability of the whole economy could be overlooked.

From early 2001, thanks to an environment of continued price stability, central banks around the world were able to combat economic slowdowns through substantial reductions of their policy rates. The continuance of low interest rate stances over a significant length of time, however, led to over-abundant supplies of liquidity with accompanying side effects including a sharp rise in asset prices. As we saw in the case of the Japanese asset bubble in the late 1980s, low inflation does not always guarantee financial and macroeconomic stability.

How best to deal with such economic imbalances is a common problem that many central banks nowadays face. Particularly for those countries that have selected inflation targeting regimes, this challenge is even more serious.

In the case of Korea, during the protracted period of low interest rates, real estate prices rose sharply with the large increase in household sector borrowings from financial institutions. This now imposes a burden on the Bank of Korea in its conduct of monetary policy.

Another challenge confronting central banks in the current era of low inflation is the possibility of their policy response ability becoming blunted. If nominal interest rates are low, in line with a stabilization of inflation expectations, there is little room for central banks to act against a business recession. In particular, when nominal interest rates fall close to the zero bound due to deflation and other factors, there is likelihood of a loss of monetary policy effectiveness.

Besides this, the response of the real economy to interest rates may change, and the sensitivity to inflationary pressures may lessen in an environment in which prices have remained low and stable over an extended period of time. We need to keep a careful eye on these phenomena.

Closing remarks

Ladies and gentlemen,

I look forward to a thorough and constructive debate on the various challenges facing central banks. I am sure that today's words of wisdom from many eminent professors and senior central bankers assembled here will be of great help to policy-makers at the Bank of Korea and other central banks as well.

In closing, let me once again voice my deep gratitude to all of you taking part here, for sparing your precious time to be with us.

Thank you very much.