

Seong-Tae Lee: Korea's experience in relation to macro-prudential supervision

Luncheon speech by Mr Seong-Tae Lee, Governor and Chairman of The Bank of Korea, at the IMF-FSC/FSS International Conference, Seoul, 7 November 2006.

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Greetings

I am delighted to see eminent figures from central banks and financial supervisory agencies, together with noted scholars from around the world, gathered here at this conference.

Korea's experience of financial crisis and the importance of macro-prudential supervision

Today I would like to tell you about Korea's experience in relation to the theme of this conference, macro-prudential supervision. Over the past ten years, we in Korea have suffered two major episodes of financial instability. Let me brief you on what lessons we have drawn from these difficulties.

When the financial crisis, which took the form of banking and currency crisis, broke out toward the end of 1997, financial intermediation contracted abruptly. The economy was plunged into recession with the collapse of a large number of companies and financial institutions. The underlying causes of the financial crisis included poor risk management of financial institutions, macroeconomic disequilibria, and the lack of a crisis management capacity on the part of the policy authorities.

Renewed financial turmoil broke out in 2003 when credit card companies were hit by huge losses. Stock and bond prices tumbled and investors rushed to pull out of money-market funds that were heavily overweight in bonds issued by credit card companies.

While the 1997 crisis had been brought about by the inability of financial institutions to manage corporate sector risk adequately, the primary reason for the credit card crisis was a failure of their household-sector risk management. The instability was compounded by their herd behaviour in expanding their share of the household credit market.

In fact, these two financial disturbances were overcome within a fairly short space of time thanks to the bold and decisive restructuring of financial institutions and companies, and the supply of liquidity by the central bank to deal with the credit crunch.

The aftershocks of these crises, though, rumbled on for a long time and they still weigh down the dynamism of the Korean economy.

In the course of the crises, the labour market worsened and household credit delinquencies increased. This resulted in a prolonged contraction in consumer spending. Firms became extremely risk averse in their investment behaviour, and this has weakened the growth potential of the economy.

Considering that the objective of macro-prudential surveillance is to support the stable growth of the economy by ensuring the stability of the financial system, I think that Korea's experience over the last ten years underlines just how important macro-prudential surveillance really is.

The importance of a micro-prudential perspective

It goes without saying that the soundness of individual financial institutions, in other words the micro-prudential perspective, plays a key part in ensuring financial stability. Given banks' crucial role in financial intermediation, their soundness, above all, is essential to financial stability.

I think that the example I mentioned earlier of the troubles of Korea's credit card companies shows the vital importance of banks' soundness. Even though most credit card companies faced a serious weakening of their balance sheets, we were able to avoid a severe credit crunch thanks to the fact that banks' profitability and capital adequacy were, by then, much higher than in 1997.

From the brink of failure in 1997, Korean banks had improved their balance sheets and capital adequacy to a favourable level within a few years. This owed much both to the thoroughgoing financial reforms and to the financial supervisory agencies' drive to impose stricter standards of supervision. It

is now well known how we overcame the financial crisis, so let us now leave it behind us and move on to what lies ahead.

Tasks ahead

The soundness of individual Korean financial institutions has made such great strides over the past ten years and there is now a much greater recognition of the importance of macro-prudential surveillance. Having said that, we face new challenges in maintaining financial stability.

In contrast to the real sector, the financial sector is intrinsically unstable. What is more, the progress in information technology, together with the advances in financial liberalisation and globalisation, have brought us increasingly sophisticated financial tools. Financial linkages running between markets and between countries have also deepened greatly. This means that risk factors we have never faced before continue to rise up.

In such circumstances, financial stability is not easily attained. It is, however, absolutely essential for the sustained growth of the economy together with price stability.

As I draw close to the end of my remarks, let me touch on some directions for further development in Korea to heighten the stability of the financial system, which is the common goal of both micro- and macro-prudential surveillance.

Firstly, a broad and diverse range of factors may affect financial markets and institutions. If we are to maintain financial stability, we have to consolidate our efforts to build up a framework of cooperation and an appropriate division of roles between the authorities involved. These include the central bank, the finance ministry and the financial supervisory agencies.

Secondly, information asymmetry is one of the major factors working to increase financial instability so we must strengthen our efforts to heighten the transparency of the accounting and management information of financial institutions.

Lastly, financial market players tend strongly toward herd behaviour, which fosters the accumulation of risk factors and the spread of crises. In order to calm this galloping herd, the policy authorities should provide appropriate information on market conditions, so that players can decide upon the level of risk they wish to accept from a long-term and system-wide perspective.

Concluding remarks

So far, I've briefly dealt with our experience of financial crises and the importance of macro- and micro-prudential surveillance, together with the tasks ahead. I am sure that this conference will provide a great opportunity to build up an effective framework for financial stability.

Thank you for listening so attentively.