

Seong-Tae Lee: Global stagflation threat and monetary policy

Opening address by Mr Seong-Tae Lee, Governor and Chairman of The Bank of Korea, at the 16th Central Banking Seminar, Seoul, 21 October 2008.

* * *

Opening remarks

Ladies and gentlemen,

Let me extend a hearty welcome to all central bankers gathered here from around the world to take part in the Bank of Korea's "Central Banking Seminar". I would like to express my special thanks as well to our keynote speaker, Professor Dr. Hermann Remsperger of the Executive Board of the Deutsche Bundesbank.

This seminar, now in its sixteenth year, is held to promote exchanges of experience and opinion among the staff of central banks of various countries. We hope as well that it will lead to a consensus among us on major monetary policy issues.

At the present time, countries around the world face a very grave situation. Economic slowdown and inflation are occurring simultaneously and the worldwide financial turmoil is worsening.

In this context the theme of this week's seminar, the "Global Stagflation Threat and Monetary Policy" merits deep interest and close attention of all central banks.

Global economy facing triple whammy

After enjoying a long period of prosperity under low inflation, the global economy is now experiencing acute difficulties in the three areas of economic activity, prices and finance.

The global economy is shrinking fast, led downward by the advanced economies, due to the combined shock of persistently high oil prices and the US subprime mortgage meltdown. Emerging economies, too, which had for some time seemingly decoupled from the advanced ones, are now also showing signs of slowdown.

What is more, inflation rates around the world continue to run at high levels due to the knock-on effects of the sharp rises in prices of international commodities including oil and grains.

In the midst of all this, counterparty risks are emerging starkly in the international financial markets and the volatility of price variables such as share prices and exchange rates has grown greatly. A severe credit crunch has thus erupted in response to credit risk reappraisal and the ongoing deleveraging by financial institutions. In consequence, emerging countries now face difficulties in securing foreign currency liquidity, as they are perceived to have relatively higher credit risk.

Central bank policy tasks

Ladies and gentlemen,

When a cost shock occurs, such as a steep rise in oil prices, it is widely acknowledged that the central bank's policy options are constrained. This is because the resulting economic slowdown and inflation go hand-in-hand.

Past experience and the consensus among economists suggest that, when there is a high risk of second-round effects, in other words when a cost shock feeds into overall price increases by way of rising wages, monetary tightening is necessary.

In the situation we face today, however, the financial markets are very unstable and their future direction is unclear. We therefore need to be cautious in coping with price pressures.

This is because the downside risks to growth increase while the upside risks to prices dwindle, as the financial market turmoil has an ever greater impact on the real economy. A forward-looking monetary policy that takes account of medium and long term macroeconomic trends also becomes more difficult at a time like this, as uncertainty mounts concerning economic conditions at home and abroad.

For countries facing foreign currency fund-raising problems, meanwhile, constraints on monetary policy easing may exist even when the downside risk to growth is substantial. Easing of monetary policy could adversely affect their foreign exchange supply and demand conditions.

Even though central banks are confronted with such manifold difficulties, however, they must do their utmost as far as circumstances allow, to prevent the erosion of the foundation for price stability. Only if they act in this way can central banks, whose main purpose is the maintenance of price stability, retain public confidence. And on this basis they can secure the effectiveness of their monetary policy.

Closing remarks

Fellow central bankers,

I am sure that this week's seminar will provide an opportunity for lively discussion on the most desirable ways for central banks to tackle the stagflation threat, particularly when financial markets are in turmoil as they are today.

Drawing my remarks to a close, let me express my wish that this seminar may contribute to stronger cooperation among all of our central banks, by fostering good fellowship among us.

Although I know your days this week will be fully occupied, I hope you will also spare a few moments to savor the beauties of Korean culture and the autumn colors.