It is my great honour to be invited to speak at the “Bank of Korea International Conference 2010”, held this year in conjunction with the 60th anniversary of the Bank of Korea. Let me take this opportunity to congratulate the Bank of Korea on this special occasion. The Bank of Korea can take great pride in its achievements during these six decades. From its establishment in June of 1950, the Bank of Korea has devoted great efforts to provide a stable and conducive macroeconomic environment and to build an effective financial system that has facilitated the growth of the Korean economy and its long-term sustainability.

This recent decade has been the most challenging for policymakers, in particular, for Central Banks. In the late 1990s, the Asian region was confronted with a severe crisis, and about a decade later, the world was confronted with a financial crisis of unprecedented global proportions. While Asia was adversely affected by these crises, there was a rapid return to recovery, both during the Asian financial crisis and during this recent global financial crisis. For the Bank of Korea, the courageous policy responses to some of the very tough challenges presented during these episodes can be judged by the results that have been achieved. There is now a cause for optimism in the present circumstance. Korea is recognised as one of the economies that has been the fastest to recover from the crisis. The exceptional work by the Bank of Korea has been an important element in this unwavering resilience of the Korean economy.

As the nature of globalisation changes and as financial innovation intensifies, the world has become more complex and less predictable. While the trend for greater trade orientation continues, changes in comparative advantage and shifts in the direction of global demand have transformed the trade patterns in the global economy. In addition, the financialisation of savings and the increased diversification of these funds into financial markets have increased the impact of these markets on the real economy as the performance of these markets experience booms and bust. The greater integration of financial markets across borders has also increased the potential for its effects to be rapidly transmitted from one financial system to another market in another part of the world. In this new environment, the greater interdependence arising from the stronger interlinkages between economies and financial systems have thus significantly raised the risk for contagion.

At the same time, new economic growth centres have emerged that are shaping the economic and financial landscape of the world economy. Emerging economies in Latin America, the Middle East and Asia have become important centres in the global economy. These trends have resulted in an increasingly multi-polar world in which the economic power is more dispersed in the global economy. In Asia, the growing significance of domestic demand, the enhanced quality of the workforce and the more developed and resilient financial systems have all contributed to this strong growth performance. While the strong global linkages continue to be an important element in this growth process, this decade has seen the tremendous expansion in intra-regional trade in Asia. Intra-regional trade has increased from 32% of total trade in 1995 to now exceed 50%. This trend has generated mutually reinforcing growth in the region.

While this trend has reduced the extent to which external demand and supply shocks affect the Asian region, the more recent phenomenon of greater international financial integration has left no country insulated from the contagion of external shocks and from financial crisis from other parts of the world. In this new environment of greater international financial
integration, developments in one asset class in a market in a distant country can spread to other asset classes, markets and to other parts of the world. Financial exposure through third markets are also becoming the new norm as liquidation of assets frequently occur in well functioning and high performing markets to meet obligations in other markets that have experienced disruptions or meltdowns. This was evident in the post-Lehman period which saw massive outflows from the Asian region following the deleveraging by the financial sector in several of the advanced economies. The increased connectivity of the world means that systemic risk events will become more widespread and significant compared to previously.

These fundamental changes in the national and international financial environment have prompted the search for solutions that would reduce the prospect of such financial disasters from happening in the future. This search has involved the reassessment of the role that should be assigned to Central Banks. It is important to recognise however, that there is no unique blueprint for the design of the institutional arrangements for a Central Bank and that it needs to be relevant and suited to its own circumstances. Indeed, the roles of Central Banks have varied considerably and have ranged from having a narrow mandate of maintaining price stability to more broader mandates that have included maintaining financial stability, undertaking the supervisory and regulatory function of the financial sector, maintaining orderly financial markets, addressing financial imbalances, leading the financial resolution initiatives in the management of a crisis and finally, driving the development of the financial system. My remarks today will focus on the mandate and role of Central Banks from the perspective of emerging economies, and more specifically, in the context of Asia.

National roles

This recent two decades, have witnessed radical reforms of Central Banks in several parts of the world, generating widespread debate on two specific trends that have emerged. The first relates to the shift in focus to the single mandate of price stability as being the core function of Central Banks. This has been frequently accompanied by the adoption of the inflation targeting framework. The second relates to the establishment of a separate entity to undertake the supervisory function of banks, although more than half of the Central Banks around the world still have the responsibility of the supervisory function. In the aftermath of the recent global financial crisis, the search for the appropriate framework for monetary stability and for the optimal institutional structure for financial sector regulation and supervision continues, perhaps now with greater earnest.

Prior to the recent financial crisis, the predominant view was that Central Banks should pursue “one tool and one target” policy strategy. Based on this view, the best role for the Central Bank in pursuing macroeconomic stability and prosperity was to ensure that inflation remains low. This recent crisis has changed this perception. Maintaining price stability and financial stability is a means to an end. The ultimate goal is surely to achieve sustainable economic growth and prosperity. Maintaining orderly financial markets has also now become an important role for Central Banks given the implications it has on the functioning and performance of the real economy.

For the emerging economies in Asia, ensuring orderly financial markets has always been an important role for the Central Banks in the region. Given the stage of development of the financial markets and its relative size in the international financial system, disorderly conditions that do not self equilibrate generally threaten to undermine the performance of the real economy. This was evident during the Asian financial crisis in 1997 and 1998. Ten years hence, several financial reforms and initiatives have been implemented by the region. These reforms include deregulation and instilling greater market orientation, the development of the domestic financial infrastructure and the supporting legislation, increasing the range of instruments at the disposal of the Central Bank and strengthening the surveillance capabilities of the Central Bank.
These developments have yielded tremendous payoffs to the Asian region. The strengthened resilience that has been achieved has enabled most financial markets in Asia to absorb the destabilising implications of the recent global financial market turmoil. Most importantly, there was no disruption to our financial intermediation process. This has not only allowed the markets to facilitate the transmission of policy but it has also supported the recovery of private sector economic activity.

Equally important has been the role of the Central Bank in addressing the build up of financial imbalances which would not only have an impact on financial stability, but also on macroeconomic stability. While interest rates have been an important tool to address the build up of such financial imbalances, most Central Banks in Asia have placed greater reliance on macroprudential measures. Prudential measures applied since the 1990s have been successful in containing the build up of such financial imbalances, thus reducing the risk to financial stability.

The world going forward is likely to continue to be affected by financial crisis. History has shown that there have been more than a hundred distinct banking crises in these two recent decades. The prospect of surviving such a crisis is not only about building resilience but also having the capacity to manage it. The institutional arrangements for financial stability continue to be a key area of debate. The main issues have tended to centre on the role of the central bank in financial stability, and whether there should be a single or multiple supervisory authorities. Given that the central bank is the lender-of-last-resort, the central bank is invariably in the frontline of the actions to restore stability. While there is no general agreement on the optimal structure for the supervision function, it is recognised that financial systems have become increasingly complex and interconnected. Whether a country adopts an integrated model or a model that is organized along sectoral lines, effective coordination is critical to effectively safeguard financial stability.

As the entity responsible for monetary policy, the Central Bank undertakes surveillance on macroeconomic conditions and in undertaking open money market operations and the management of international reserves, the Central Bank has direct contact with the financial markets. The Central Bank is thus able to gain valuable insights that contribute towards a more informed financial supervision, including in the design and implementation of macroprudential policy measures. The Central Bank is also best positioned to evaluate the tradeoffs should conflicting objectives arise. In such situations, a fragmented institutional arrangement frequently results in delays and compromises in policy responses. In addition, there would also be a lack of clarity of the accountability for the decisions.

Finally, the Central Bank also performs a critical role in crisis containment and management, in particular, to provide liquidity, to prevent disruptions to the functioning of the financial system and to restore stability and confidence to the financial system. To avoid a piecemeal approach by any individual agency in the system and to ensure a comprehensive response to the financial crisis, the institutional arrangements for greater coordination across agencies is essential to allow for prompt action that may include a range of measures such as capital injections, debt guarantees and asset purchases in the effort to contain and manage the crisis.

Regional roles

At the regional level, the role of the Central Banks in East Asia has in this decade, transitioned to a new level of collaboration and cooperation. Following the Asian financial crisis, efforts have focused on five main areas, namely, to enhance the effectiveness of regional economic and financial surveillance, to improve the arrangements for regional crisis management that is reinforced by regional support mechanisms, to develop the regional financial infrastructure including the bond market and the payments and settlement system, to strengthen regional financial stability, and finally, to pursue capacity
building collaboratively, so as to enhance the effectiveness of the Central Banks in the region.

The priority for Asia going forward is to accelerate regional financial integration. To ensure this takes place in an environment of regional stability, strengthening cooperation is also aimed at managing the risks and vulnerabilities of the region. In 2006, the East Asian Central Banks have established a monetary and financial stability committee as a forum to discuss the risks to regional macroeconomic and financial stability. In addition, the ASEAN+3, a subset of this group, has already taken concrete steps to multilateralise the Chiang Mai Initiative into a more advanced and robust framework for the effective pooling and utilisation of liquidity support in the region. While the Asian region is highly diverse, in these key areas of cooperation and collaboration, the Asian region has demonstrated its cohesiveness in coming together to deal with the challenges that the new environment presents to us.

Conclusion

Let me now conclude. The world has changed and will continue to change. To remain effective in the new environment and to have the capacity to respond to the new challenges, Central Banks also need to undertake its own transformation and modernisation. Moreover, in preserving the independence of the Central Bank and to be able to stand our ground in performing our responsibilities, Central Banks need to be standing on solid ground. This requires continuous capability enhancement and capacity building so as to be well positioned to have the ability to rise to the challenges of the new environment. This may involve significant changes to the governance arrangements, the empowering legislation, the skills required, the role of communications, the human capital management and development and the organisational culture. Indeed, capacity building is a further robust area of collaboration in the Asian region.

Going forward, Asia’s participation in the global economic and financial system is set to increase exponentially. As the countries of the region connect with each other and the rest of the world, there is every reason to hope for a better future of sustained stability and enhanced growth prospects for the benefit of the regional and world economy.