Choongsoo Kim: Harmonious operation of macroprudential and monetary policies, and challenges

Speech by Dr Choongsoo Kim, Governor of the Bank of Korea, at the International Seminar on “Macroprudential and monetary policies”, Bank of Korea, Seoul, 8 April 2013.

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Good morning

Let me bid a heartfelt welcome to you all from academia and research institutes attending this seminar. My special thanks go to Professor Charles Goodhart of LSE who will be delivering a lecture and to Professor Dimitrios Tsomocos of Oxford University who will be making a presentation. I would also like to thank all moderators, presenters and discussants.

Since being given a mandate for financial stability under the revised Bank of Korea Act, we at the Bank have been widely involved in lively discussions concerning macroprudential policies in the international community along with other central banks, supervisory bodies and academia, and it has been well to the fore in discharging its macroprudential policy responsibilities by initiating fresh changes, for example, taking an active part in the drawing up of global financial regulations.

The Bank of Korea is one of the few central banks in the world to have set up a Department in charge of macroprudential analysis and policy tool development; this is called as the Macroprudential Analysis Department which is incidentally responsible for organizing this seminar. The Bank of Korea has also, by developing a systemic risk assessment model (SAMP[1)] designed to assess financial stability comprehensively and systematically, generated the momentum that, in a process of consultation with the BIS, the IMF, the BOE and the Fed, can contribute to better understanding about the root causes of the financial instability for both Korea and worldwide academic community. Seeking to heighten the quality of its statutory Financial Stability Report, the Bank of Korea has taken advice from global experts and devoted its unremitting efforts to ensuring that the report gains worldwide recognition and respect.

The theme of this seminar “Macroprudential and Monetary Policies” constitutes a core issue that all central banks should consider, in order to carry out their financial stability responsibilities successfully.

Studies on this issue have already been actively undertaken by central banks, academia and international organizations. In particular, through the construction of macroeconomic models that include the financial sector and macroprudential policy tools, the foundations have been laid for the comprehensive analysis of the effects of monetary and macroprudential policies on macroeconomic and financial stability.

This seminar is therefore an invaluable opportunity to review the research findings so far and to set out future tasks.

In this context, I would like to touch upon the limits of the macroeconomic policy operating framework before the outbreak of the crisis, the efforts to improve it to bring financial stability, the need for carrying out macroprudential policies and how best to achieve harmony in the conduct of monetary and macroprudential policy.

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[1] Systemic Risk Assessment Model for Macroprudential Policy

Limits of macroeconomic policy framework operation before the crisis

As the Great Recession triggered by the financial crisis has been persisting for a long time, each nation's policy responses are more critical than ever before to prevent recurrence of a financial crisis. Although some nations especially emerging market economies have regained the trend growth prior to the financial crisis, advanced economies including Europe are fretting about the possibility of long-term low growth as their economic recovery has been delayed.

For appropriate policy responses, nations around the world have first to recognize that the conventional macroeconomic policy operating framework used before the crisis was of limited effectiveness in properly preventing the recurrence of financial crises and coping with the Great Recession. Prior to the crisis, the policy authorities played down the effects that monetary, fiscal and microprudential policies have on each other and were effectively unable to avoid the outbreak of the financial crisis. In addition, although major economies have implemented bold macroeconomic policies since the crisis including a massive expansion of fiscal spending and interest rate cuts for economic pump priming, fiscal deficits swelled enormously and sovereign credit crisis concentrated above all in Southern Europe erupted.

Therefore, the importance of a new paradigm for new policy operation has been highlighted, and in this sense it is necessary to carry out in-depth studies on the conduct of monetary and macroprudential policies. First, it is urgent to undertake research on how to improve the monetary policy operating framework when central banks implement monetary policies giving attention to financial stability. Since the crisis, active discussions have been underway on introducing macroprudential policy tools as a way to respond to systemic risks. However, studies on their effects and limits are still ongoing and further clarification is needed as to who should carry out such policies and their precise delineation. To work effectively toward stability in real economic activity and the financial sector while avoiding conflict or overlap of their policy effects, we need continuous research concerning ways of operating monetary and macroprudential policies in harmony.

Efforts to improve monetary policy operational framework considering financial stability

Before the financial crisis, there was a prevailing notion that the goal of monetary policy should generally be limited to price stability. This seems attributable mainly to the situation that as nations around the world suffered high inflation during the 1970s, price stability had come to be considered the most important policy goal. It was also thought that monetary policy responses were regarded unnecessary as financial stability could be achieved through microeconomic regulations on financial institutions and financial instability had little impact on the real sector.

However, while the low levels of inflation persisted during Great Moderation before the crisis, financial imbalances accumulated and systemic risks were created. After the outbreak of the crisis, the heightened financial instability had a serious direct impact on the real economy. As a new economic phenomenon that runs in the face of conventional wisdom has emerged, discussions on re-establishing the monetary policy operating framework are underway in a direction that strengthens central banks' financial stability function.

These movements, as Professor Goodhart so ably and succinctly brought into order for us, at the 2010 BIS annual conference, seem to be natural considering that the central banks' role previously underwent a dynamic change from financial stability to fiscal support and price stability in line with the times and economic issues we faced, and the monetary policy operating framework also changed along with it.

With regard to the direction of improvement of the monetary policy operating framework taking account of financial stability, the opinion has been put forward that the effects arising from taking a macroprudential perspective should be considered in making monetary policy decisions, but it has not yet been clearly formalized. People share the view that monetary policy should be conducted preemptively and proactively to resolve financial imbalances by paying attention to credit growth rates and the rate of increase in asset prices as well as inflation to prevent financial instability.

However, I think there should be further discussions on the view of Dr. Adrian of US Fed and Professor Shin of Princeton University that central banks should consider price stability and financial stability at the same time and on the argument of Olivier Blanchard of the IMF and Professor Rogoff of Harvard University that macroprudential policy tools should also be used separately, divorced from the policy rate which is the main monetary policy instrument. It seems that collapse of the financial system can be avoided by actively injecting liquidity through unconventional monetary policies at an early stage of crisis as in the recent global financial crisis. This has many implications for improving the monetary policy operational framework going forward.

Need for the conduct of macroprudential policies

After the experience of the global financial crisis, it seems that a consensus has been already formed that microprudential regulations alone are not sufficient and a policy approach from a macroprudential perspective is needed. Many nations experienced a rapid destabilization of the financial system through contagion effects due to their interconnectedness, even if their own financial institutions were sound before the crisis. They also witnessed a further amplification of the volatility of economic activity when it was passed through the financial sector owing to its procyclicality.

Accordingly, the G20, the FSB, the BCBS and the IMF have been leading discussions on establishing a macroprudential policy framework and developing policy instruments, and a wide variety of findings have emerged from these discussions. Major regulations include Basel III regulations, such as the countercyclical capital buffer, liquidity and G-SIFI regulations. Besides this, countries have pushed ahead with establishing country-specific macroprudential policy frameworks and introducing instruments commensurate with their own particular economic systems.

For the case of Korea in a situation in which global financial interconnectedness has intensified, the expansion of capital flow volatility and household debt accumulation until recently posed potential systemic risks. In response, Korea adopted macroprudential policy instruments. As macroprudential instruments in the foreign exchange sector, Korea established the ceiling on foreign exchange derivatives positions and imposed a Macroprudential Stability Levy to curb the inflow of short-term capital and prevent sudden capital outflows.

Hyun Shin of Princeton University showed that the introduction of macroprudential policy tool targeting non-core liabilities in open economies could increase the maneuvering room for the monetary policy operation by reducing the effects of exchange rate fluctuations on the economic system. And in accordance with his view, the introduction of foreign exchange macroprudential instruments by Korea can be assessed favorably.

As policy tools for household debt, we used the LTV and DTI ratios out of concern over surges in housing prices and household debt delinquencies. The LTV and DTI regulations were effective to a large extent as they cooled down the increases in mortgage lending and blunted the run-up in housing prices. They are also thought to have contributed to preventing household debt delinquencies during the global financial crisis.

Since macroprudential policy measures have been in place for a relatively short period of time compared to other macroeconomic policies, however, their effects need further verification. While Hong Kong, Brazil and Turkey have introduced macroprudential policies or strengthened related regulations in the wake of the global financial crisis, it is too early to decide on their effectiveness.

Macroprudential policies should capture potential systemic risk factors before financial instability gets out of control and turns into a crisis and be applied preemptively. What is most important is to determine the appropriate timing of their application. In addition, since the development of indicators designed to determine the choice and settings of these macroprudential policy tools is still at an early stage and the data on the basis of which they are determined is insufficient, the conduct of policy should be based on more abundant and sophisticated micro data when implementing policies.

Macroprudential policy instruments are normally applied in the form of regulations on financial institutions. As the pursuit of regulatory arbitrage by financial institutions including the use of shadow banking could undermine the policy effects, we need responses to deal with this. It has been assumed so far that macroprudential policy measures will be used mostly during economic expansion. We should be however mindful of asymmetry as well which rather accelerates procyclicality or weakens regulatory effects during economic downturn.

Harmonious operation between monetary and macroprudential policies

As mentioned earlier, countries around the world do not yet have enough experience with implementation of macroprudential policies and systemetic risk indicators measuring the degree of financial uncertainty are still under development. Against this backdrop, it would be difficult to expect satisfying synergy effects from the mutual complementarity of macroprudential and monetary policies. If the effects of the two policies overlap or are in conflict and they are not operated harmoniously, this may give rise to the problem of excessive or offsetting policy effects, as they both work by way of changes in financial institutions' balance sheets.

If macroprudential policy works smoothly toward the targeted objectives at an opportune time, however, it can form a mutually complementary relationship with monetary policy and thus maximize social welfare through price stability and financial stability, as suggested by Stijn Claessens and others of the IMF. This view claims that, as we can see from the experience of the financial crisis, it is possible to respond to the accumulation of financial imbalances, including the build-up of leverage which can be triggered by monetary policy, by using macroprudential policy instruments which reduce the interconnectedness of financial institutions and procyclicality through regulations on financial institutions' balance sheets. Furthermore, if additional macroprudential policies which can contribute to financial stability successfully play a complementary role to monetary policy, this can contribute to enhancing the monetary policy's credibility and transparency.

In order to achieve financial stability through the harmonization of operations between the two policies, it is essential for the various policy authorities to cooperate closely. And there is a global trend toward emphasizing the central bank's role in setting up an institutional framework to ensure seamless cooperation. Policy decisions should be made through this institutional framework based on adequate sharing and analysis of information to avoid overlap and conflict between policy goals.

In the process, the role of the central bank is important particularly since it is in charge of monetary policy and forms the mainstay of macroprudential policy implementation. While carrying out monetary policy so far, central banks have been equipping themselves as systemic regulators to take the lead in implementing macroprudential policies by building up expertise in evaluating overall economic conditions and financial market stability based on their process and analysis of macro and financial data. The US FSOC (Financial Stability Oversight Council), Europe's ESRB (European Systemic Risk Board), the UK FPC (Financial Policy Committee) set up to carry out macroprudential policies since the crisis show that the central bank plays a leading role within the financial stability policy agencies.

Conclusion

Almost five years have now gone by since the global financial crisis and we have faced two major assignments of overcoming the crisis successfully and subsequently preventing a recurrence of the crisis. On the one hand, major advanced countries are implementing quantitative easing to overcome the crisis, and on the other hand international financial bodies such as G20, FSB and BCBS are developing global financial regulatory reform measures and promoting their implementation. Coordinating these measures designed to overcome the crisis and prevent its recurrence is one of the major challenges the international community now faces.

Along with this, international policy cooperation to curb regulatory arbitrage, as well as each individual country's coordinated operation of its macroeconomic policies, is crucial for the sustainable and stable growth of the world economy. There has been of course a constant repetition of financial and economic crises, most prominently the Great Depression of the 1930s, and consequently regulatory measures have been put in place to prevent crisis recurrence, but it is still hard to say for sure that there are no more crises to come. In order to prevent the eruption of a further crisis, we should prepare for a new, unpredictable crisis rather than looking back at the previous ones, and in this respect, we should make sure that the regulatory reforms not just reflect lessons from previous crises but preemptively identify potential factors triggering a crisis and prevent their occurrence.

Organizations carrying out macro-prudential policies need to have the abilities of a prophet to monitor on a constant basis and identify preemptively all the economic and social factors that could possibly give rise to systemic risks. This being the case, the policy authorities must be imbued with a sense of mission to shoulder the great national responsibilities that they bear.

Thank you for listening so attentively and I hope that what we have discussed today will give us a clue how to cope with the challenges we have in front of us.

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