Choongsoo Kim: Rebalancing the macroeconomy for robust growth – challenges and resolutions

Opening speech by Dr Choongsoo Kim, Governor of the Bank of Korea, at the SED Pre-Conference 2013, Seoul, 26 June 2013.

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Distinguished speakers and participants of the conference,

I bid a warm welcome to all those taking part in the 2013 SED Pre-Conference. Let me express at once my deep gratitude to Professors Robert Lucas, Edward Prescott, Nancy Stokey, and Hyun Song Shin, who will be making presentations on the main theme of this conference.

The world economy now appears to be recovering from its worst post-war recession but only very slowly and at a different pace across regions and countries. Uncertainty as to future growth prospects remains still high as the legacy of the global financial crisis has cast a long shadow. Financial systems of major economies have yet to be repaired in full and will have to adapt to new and more complex regulations. Fiscal sustainability risks faced by many advanced economies will fade away only gradually even under a benign scenario, while the macro-financial consequences of an exit from unconventional monetary policies by major central banks are at best poorly understood at the current juncture. Without resolving such uncertainties and challenges, we may find ourselves for considerable time in an uncomfortable zone where economic recovery continues to be fragile and with insufficient traction to reach a sustainable growth path.

I believe each and every financial crisis is intertwined with real sector fragilities. The global financial crisis is well recognized to have had its roots in real imbalances – mostly between advanced and emerging-market economies. The euro zone debt crisis was also preceded by long-lasting large and unsustainable external imbalances within the euro zone. Indeed, the financial crises we have witnessed over the past few decades were the culmination of underlying real and financial imbalances. It follows that there will be no durable gains in growth momentum without the proper rebalancing of the global demand and/or structural reforms to boost productivity.

It is quite obvious that the desired return to a sustainable growth path can be achieved only if the current economic recovery process is strong and durable enough to lift the world economy out of the depths of the global financial crisis. In the light of this recognition and also from the perspective of a policy maker, I would like to touch upon short- to medium-run issues that I believe have a crucial bearing on future growth of the world economy. I hope my focus on shorter-term issues may be found complementary to our invited speakers' presentations. And I am lucky enough to be able to put my views straightforwardly to this gathering of distinguished scholars from around the world that I stand before today.

Specifically, the issues I wish to cover fall broadly into three parts. The first issue that immediately confronts us pertains to the withdrawal of the unconventional monetary stimulus undertaken by major central banks and its financial and macroeconomic implications. The second issue concerns the central bank's expanded role in the aftermath of the crisis and going forward. The final issue I focus on today is related to the tension between the need for international policy coordination and the absence of an effective global jurisdiction for it.

QE and exit strategy

With regard to the first issue, I should say that the extraordinary monetary easing by major central banks was well received by markets, and that it has thus far been beneficial to global financial stability and economic recovery despite some negative spillover effects on emerging market economies in the form of higher volatility in cross-border capital flows and exchange rates. By contrast, an orderly withdrawal of monetary stimulus – particularly after a long period of monetary easing – would likely be a dangerously difficult task for any central bank. Since 2012, we have seen growing signs of financial markets getting ahead of the real economy in both advanced and emerging market economies. We also know that global financial markets have been flooded with liquidity for years and will continue to be so at least for a few more years to come. Last but not least, the fiscal sustainability risks faced by advanced economies may well be compounded by a rise in the global interest rate. In this setting, forward-looking financial markets are likely to respond abruptly, rather than responding incrementally, no matter how transparent and gradual is the exit from the current monetary stimulus. Indeed, over the past month or so, we saw how the U.S. Fed's statements related to exit provoked a tumble in asset prices in advanced and emerging market economies alike.

In short, global financial markets will be faced with Knightian uncertainty going forward, and the possibility of multiple equilibria will likely be higher than ever. Such uncertainty, together with a rise in global interest rates, may well weigh heavily on economic growth. Emerging market economies with open capital markets will be particularly vulnerable to such negative impacts on growth of global financial uncertainty. Moreover, they may be forced to tighten monetary policy to fight against capital outflows and associated exchange market pressure stemming from the rise in the global interest rate. All these developments, were they to be materialized, would surely drag down economic recovery or cause growth to stall out.

As such, the future challenges are enormous. To meet them, we need to be better prepared with a greater understanding of the macro-financial dynamics of an exit from the unprecedented monetary easing, even at an abstract level. To this end, it would be useful to review past experiences where possible. A good starting point would be to look into the U.S. experience in moving out from near zero interest rates during the 1930s and 1940s. Of course, the dearth of precedents makes it difficult to tell at what pace the unwinding of unconventional monetary policies should be carried out, and to predict what form its influences may take. And prediction may well become even trickier since multiple countries are now simultaneously engaged in quantitative easing and therefore create complex interactions.

I sincerely hope that central banks, governments, and academia will continue to work together to guide our search for new thinking on monetary policy and an affordable path to sustainable growth.

Role of central banks

Now allow me to move on to the second issue of the role of the central bank.

The global financial crisis came to us as a sobering lesson concerning the operating framework of monetary policy and the role of the central bank. Simply put, price stability did not ensure macroeconomic or financial stability. Ironically, it was rather the Great Moderation period – characterized by stable inflation and moderate growth – that spawned the global financial crisis. In consequence, there have been noticeable changes in thinking about the role of the central bank and the monetary policy framework in the aftermath of the crisis.

First of all, in terms of its roles, the central bank has now naturally taken on the responsibility, not only for price stability but for financial stability. In addition, its roles have been stretched to help restore real economic activity and employment beyond what would be normally considered as cyclical fine tuning. The Bank of England's launch of its Funding for Lending Scheme (FLS) and the U.S. Fed's large-scale purchase of mortgage-backed securities may be seen as examples of how the central bank has come to take on responsibility for credit policy. The ECB also took up some form of credit policy – although to a lesser degree than the Bank of England or the U.S. Fed – by way of its Securities Market Program (SMP) and Outright Monetary Transactions (OMT) that purchase the government bonds of crisis-hit countries. When constrained by a zero lower bound, these balance sheet operations were an effective tool to affect the entire yield curve or longer-term interest rates that matter more for the real economy. In retrospect, balance sheet operations by major central banks appear to have been effective in addressing tail risks and financial market volatility. Preliminary evidence also suggests that they have helped economic recovery or at least offered some backstop to the real economy.

But looking back, maintaining financial stability had been at the heart of the central bank's raison d'être, and credit policy has a longer history than monetary policy. As such, the wider range of roles, currently being undertaken by major central banks, may mark a significant departure from the central bank orthodoxy established over the past three decades that discredits large risk taking or quasi-fiscal operation by central banks. But it is by no means new by the older standards formed one or two centuries ago.

Nevertheless, it is not clear how the framework of monetary policy should look in the future. There is no clear answer as to whether it would be better to return to the pre-crisis monetary policy framework once the real economy returns to a normal path, or to establish a new framework drawing on our learning in the course of crisis resolution. Moreover, we still have no clear thinking on how best to mix monetary policy and other policies, most notably macroprudential and regulatory policies. How much weight should be placed on financial stability and price stability respectively in the decision to set the interest rate (Adrian and Shin 2008)? If a dual mandate situation is the case, should we attain each of the objectives using the policy proper to it (Blanchard et al. 2010) or an appropriate policy mix? In each of these cases, what will be the influence on the consistency and credibility of the monetary authorities? Should the so-called flexible inflation targeting be further modified or replaced by an alternative?

All these questions are interlinked and, arguably, have by no means trifling implications not only for growth over the business cycle but also for long-run growth if we accept the stylized fact that the pre-crisis output trend is never regained after a major financial crisis. I look forward to enlightening answers to these questions sooner rather than later.

Global jurisdiction for global coordination

Now let me turn to the last issue on the need for policy cooperation, and its feasibility, for the harmonious growth of the world economy.

Considering the two-way linkages running between advanced and emerging market economies, I think that we now stand at a critical juncture where global policy cooperation is vital for the resumption of world economic growth.

Theory tells us that, in the presence of externalities, a competitive or non-cooperative Nash equilibrium will be socially suboptimal. Given that economic policies and their consequences for growth at the national level have important international dimensions, this theoretical prediction makes a strong case for a global jurisdiction to coordinate policies by individual countries. A flagship example is the international cooperation for financial regulatory reforms as taking place under the aegis of the Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB).

In reality, however, international cooperation falls short in the area of monetary policy or other macroeconomic policies. Reflecting on this fact, a number of eminent scholars (Committee on International Economic Policy and Reform 2011), including Professor Shin who is with us today, have put forward the case for official agencies such as an International Monetary Policy Committee (IMPC), comprising the representatives of central banks. In assessing the effects on global liquidity of individual central banks' monetary policy, the IMPC may be seen as a form of global jurisdiction – a mechanism to internalize the external effects of individual countries on other countries. Of course, no global conciliation agency like the IMPC exists in reality, and instead international cooperation and policy coordination is undertaken in a rather loose manner under the umbrella of the G20.

Then again there are also pundits who are less supportive of the idea of international policy cooperation but more confident about the power play of the invisible hand. For example, one may argue that international cooperation in monetary policy would be redundant or unnecessary if free floating exchange rates are adhered to by all. To my mind, however, reality is far from what is assumed in theory. The international monetary system is made up of a mixture of floating and fixed regimes. And not all countries are price takers in the world economy or global financial markets, and big differences in influences exist among constituent members.

Of course it goes without saying that there is no guarantee that policy cooperation will always produce the best outcomes. In any event, political considerations, rather than economic welfare, may well be the dominant guiding principle of policy cooperation. But the world economy has become and will become increasingly more closely inter-connected and thus subject to greater externalities both positive and negative. For this reason, I speculate that the welfare cost of non-cooperation or inaction will grow larger than the welfare cost of politically compromised cooperation. With no effort being made for international cooperation, the world economy will overwhelmingly be characterized by the pursuit of local equilibria rather than a global equilibrium. In the course of this, if emerging market economies falter in their growth dynamism, it may entail negative consequences for advanced economies as well, and vice versa.

Again, I am waiting for renewed intellectual discussions in both policy circle and academia on how we can best achieve strong, sustainable, and harmonized growth through global cooperation.

Concluding remarks

Distinguished speakers, ladies and gentlemen,

Let me round out my speech with a few brief remarks.

For the world economy to return to a sustainable and robust growth track, it is essential that individual countries carry out necessary structural reforms to tackle the fragilities of their economies and set the stage for a takeoff. At this juncture, though, it is also important to break free of the economic doldrums by ensuring the continuity of the recovery momentum. The highly interconnected world economy should be the scene of cooperative policymaking for internalizing externalities of increasing importance.

I eagerly look forward to insightful presentations and discussions of the renowned scholars at this global gathering. I am truly honored to be with you here today.

Thank you.

References

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