Juyeol Lee: Challenges faced by small open economies and the appropriate monetary policy responses

Opening address by Mr Juyeol Lee, Governor of the Bank of Korea, at the BOK-KIEP-PIIE Conference, jointly hosted by the Bank of Korea, Korea Institute for International Economic Policy, and the Peterson Institute for International Economics, Seoul, 19 July 2016.

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Good morning,

Distinguished guests, Ladies and gentlemen!

I am delighted to welcome you all today to this conference, jointly hosted by the Bank of Korea, Korea Institute for International Economic Policy, and Peterson Institute for International Economics. Let me begin by expressing my special thanks to our conference co-hosts, President *Adam Posen* of the Peterson Institute for International Economics and President *Jung Taik Hyun* of the Korea Institute for International Economic Policy; and to the panelists, Swiss National Bank Governor *Thomas Jordan* and Bank of Israel Governor *Karnit Flug*; and to Professor *Olivier Blanchard*. I would also like to express my sincere appreciation to all of the session speakers, moderators, and discussants for their contributions to this conference.

As the global economy has become more integrated, the external effects of changes in the economic conditions and monetary policies of major countries have become greater than ever before. These effects are greater particularly in small open economies like Korea. And so I am very pleased that this conference, co-hosted by two outstanding think tanks in the area of international economics, provides an opportunity to discuss the challenges faced by small open economies and the appropriate monetary policy responses.

In the years since the global financial crisis, major economies have been implementing accommodative macroeconomic policy to cope with their economic sluggishness. However, most of them have failed to emerge from their low growth trends, due mainly to structural factors. In addition, the international financial markets are showing higher volatility, owing to uncertainty surrounding monetary policy normalization by the US Federal Reserve and the possibility of a recurrence of financial and economic unrest in emerging countries, combined with the UK's Brexit decision.

Small open economies are influenced greatly by the economic situations of major countries and international financial market conditions. In terms of their real economies they are experiencing economic slowdowns in line with sluggish exports. On the financial side, they are seeing high volatility in capital flows and price variables, such as exchange rates.

All of this makes for a complicated policy environment for the central banks of small open economies. They have to support economic recovery, while at the same time responding to mounting uncertainties in the financial markets stemming from external shocks. So with this background in mind, allow me to share my views on the policy tasks small open economies have to deal with.

First, in our conduct of monetary policy we should pay special attention to financial stability risks, while supporting the recovery of economic growth. We should maintain our accommodative monetary policy stances to ensure that the trend of low growth does not become entrenched. Yet at the same time, we must ensure that this does not undermine financial stability. Especially in the case of small open economies, we need to bear in mind that, if the degree of monetary easing is excessive, the risk that external shocks would trigger sudden capital outflows and currency depreciation is relatively higher.

Second, we should strengthen our efforts to reduce the negative impacts of overseas factors on domestic financial stability and economic growth. Since the global financial crisis, many countries have taken various steps to enhance their capacities to cope with external risks, for example by strengthening macroprudential policies, improving exchange rate flexibility and increasing their foreign reserves. At an international level, they have implemented the Basel III framework and strengthened regulations on G-SIFIs, in an effort to heighten the resilience of financial institutions to external shocks and improve the shock absorption capacities of their financial systems. Through this conference, I hope that we can share what we have achieved with these policies and what we have learned from them. I also hope that we can come up with new supplementary measures.

Third, we need to continue to pursue international cooperation to expand financial safety nets. They have been steadily improved at both the global and regional levels, with the establishment of the IMF's New Arrangements to Borrow, the conclusion of US dollar currency swap arrangements between major countries, and the increase in the Chiang Mai Initiative Multilateralisation(CMIM) fund. Going forward, we should continue our efforts on international cooperation for stronger global financial safety nets. To this end, we need to promote cooperation between the IMF and regional financial arrangements such as the European Stability Mechanism and CMIM, and expand international currency swap arrangements.

Finally, I would like to emphasize the necessity of structural reform. During the global financial crisis, and even after the crisis, we have witnessed numerous instances in which countries with strong economic fundamentals rapidly overcame external shocks. A great deal of research shows that structural reform involves difficulties in the short term, but in the medium and long term, it enhances the efficiency of resource allocation and accordingly has positive impacts on employment and economic growth. And if economic resilience is strengthened by structural reform, we can avoid excessively accommodative macroeconomic policy and thereby minimize its negative side effects.

Ladies and gentlemen,

I have talked about the challenges and policy tasks that small open economies currently face. It seems that monetary policy measures alone cannot resolve these multi-faceted difficulties. I would stress that we need to pursue efficient mixes of monetary, macroprudential and structural reform policies, as well as strive for international cooperation.

I hope that today's conference serves as an excellent venue for lively discussion and the free exchange of ideas regarding how to address these challenges.

Thank you.