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The Policy Response to the Crisis in Korea and Other Emerging Market Economies

Remarks by

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at the

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It is a pleasure to be able to participate in this conference on the occasion of the 60th anniversary of the Bank of Korea. I would especially like to congratulate Governor Kim on his recent appointment. Over the years, the Bank of Korea has made an important contribution to the impressive economic performance of South Korea, a performance that includes a more than 10-fold increase in the country's real gross domestic product (GDP) per person over the past four decades.

The global economic and financial crisis caused hardship around the world and tested central banks in both advanced and emerging market economies. Like their counterparts in the advanced economies, central banks in several key emerging market countries responded to the crisis by sharply lowering policy rates and by undertaking a variety of unconventional policy measures to support their economies. The Bank of Korea was among the first of the emerging market central banks to respond by reducing its policy rate by a cumulative 325 basis points between October 2008 and February 2009. It also took effective steps to increase the liquidity available to the Korean financial system, for example, by expanding the set of counterparties for repurchase transactions and broadening the pool of assets eligible as collateral. To help the banking system remain stable and able to continue lending to creditworthy borrowers, the Bank of Korea also helped set up a bank recapitalization fund.

Korean banks, like those in a number of countries around the world, experienced shortages of dollar liquidity during the crisis. To alleviate these shortages, the Bank of Korea drew on its foreign exchange reserves. It also established a dollar liquidity swap line with the Federal Reserve in October 2008, which provided short-term dollar funding to the Bank of Korea that it, in turn, could lend to financial institutions when the operations of private dollar funding markets had become impaired. The Bank of Korea's efforts were complemented by substantial fiscal stimulus put in place by the Korean government.

This suite of policy responses helped stabilize Korean financial markets and promote a swift recovery of economic activity. The equity market bottomed in late 2008 and has since then retraced much of its losses. Real GDP, which contracted at a remarkable 17 percent annual rate in the fourth quarter of 2008 as international trade collapsed, has rebounded decisively.

It is interesting that, just a few years ago, strong countercyclical policy actions of the type taken by Korea would not have been recommended for an emerging market country during a period of crisis, and might not even have been feasible. In earlier crises, foreign investors were not inclined to give emerging market policymakers the benefit of the doubt when they promised low inflation and sustainable fiscal policies. Attempts to support economic activity through conventional expansionary policies thus risked a vicious circle of capital flight, exchange rate depreciation, higher inflation, a worsening balance of payments, and more capital flight. As a result, monetary policymakers in emerging markets often reacted to crises--such as the Asian financial crisis of the late 1990s--by *raising* rather than lowering policy rates, in order to defend the value of the currency, slow capital flight, and bolster the credibility of monetary policy. Likewise, the scope for fiscal expansion was severely limited by concerns about medium-term fiscal sustainability.

Why was this crisis different? In particular, why was the Bank of Korea able to respond in a countercyclical manner this time, reducing rather than raising the policy rate in response to the downturn? One important difference, of course, was that this crisis originated in advanced economies, not in the emerging market economies. Financial institutions in Korea and other emerging market economies had little direct exposure to structured credit products and other troubled securities and entered the crisis in relatively sound condition.

In addition, following the Asian financial crisis in the late 1990s, Korea and a number of other countries in Asia, Latin America, and elsewhere took decisive steps to strengthen their macroeconomic frameworks and financial systems. On the macroeconomic side, these countries achieved strong economic growth through structural reforms and sound monetary and fiscal management. Like a number of other emerging market nations, Korea achieved fiscal and current account surpluses; it also took out insurance against volatility in capital flows by accumulating a large stock of foreign exchange reserves. On the financial side, Korea and other countries reformed their banking sectors and worked with banks to strengthen their balance sheets.

Currency and maturity mismatches were important problems for several countries during the Asian crisis, as they made financial conditions in these countries vulnerable to a loss of confidence by investors. Currency mismatches in particular--the fact that the assets of households, firms, and banks were largely denominated in the domestic currency while many liabilities were in foreign currencies--proved a constraint on monetary policy. Central bankers understood that any reduction in the policy rate would likely weaken the currency, which in turn would raise the value of domestic borrowers' liabilities relative to their assets, with negative consequences for the solvency of both the nonfinancial corporate sector and the banking system. However, in the years following the Asian crisis, currency and maturity mismatches were reduced substantially. In sum, stronger macroeconomic and financial fundamentals gave Korean policymakers the flexibility they needed to respond to the crisis with more expansionary monetary and fiscal policies.

Improvements in the Bank of Korea's monetary framework served the country well during the crisis and are likely to provide additional benefits in the future. Over the past decade, many emerging market economies, including Korea, have reoriented monetary policy toward domestic price stability and away from a focus on stabilizing exchange rates. The Bank of Korea, indeed, adopted a formal inflation targeting regime in 1998. Since then, the exchange value of the won has become more flexible, inflation has declined to an average of about 3 percent, and--as I have discussed today--the ability of the Bank to conduct appropriate countercyclical monetary policies has increased.

This anniversary is also a good time to consider the challenges that the Bank of Korea and other central banks will face in the future. In the medium term, like the Federal Reserve and many other central banks, the Bank of Korea will have to manage its exit from accommodative policies. As is typically the case in the early stages of an economic recovery, the Bank will have to weigh the risks of a premature exit against those of leaving expansionary policies in place for too long. Because economic conditions vary, the appropriate timing of the exit is likely to differ across countries. To guide these important decisions, each central bank will have to carefully monitor economic developments in its own jurisdiction.

Financial reform is another important challenge facing central banks, including those in emerging market economies like Korea. Even though the origins of the recent financial shocks were largely outside the emerging markets, the international transmission of these disturbances was extraordinarily rapid. In the emerging market economies, these disturbances manifested themselves principally in terms of volatile capital flows, with capital outflows earlier in the crisis and capital inflows today each creating significant financial and economic challenges. Strengthening the international financial system and ensuring that financial institutions are carefully regulated, well capitalized, liquid, and transparent will require extensive international cooperation. On a global level, the leadership of the Group of Twenty (G-20)--which Korea is currently chairing--will be essential in ensuring that reforms are not only strong and effective but also consistent and coordinated across countries.

Two important features of the crisis were the increased use of unconventional policies and enhanced cooperation among central banks, including between the Federal Reserve and the Bank of Korea. Yet another challenge for central banks will be to make good use of what we learned during the crisis--to determine whether and how the toolkit of central banks can be expanded, and to find ways to build on central bank cooperation during the crisis to develop stronger working relationships and collaboration in the future. Taking such steps now will improve our ability to respond effectively to any future crisis.

But even as central banks develop new tools to address new challenges, they must continue to place great weight on the factors that have been shown to enhance the credibility and effectiveness of monetary policy: central bank independence, accountability and transparency, and effective communication. Together with strong financial reforms, monetary policy built on these principles will assist the recovery and promote future growth and stability.

As emerging market economies become increasingly important in the global trading and financial systems, the world economy will depend even more on them to maintain strong domestic growth and economic and financial stability. Thus, the improvements in emerging market policies and policy frameworks I have discussed today have ramifications beyond the emerging market economies themselves. Emerging market nations also have a key role to play in the important efforts to reduce global imbalances in trade and capital flows. Again, the G-20 is in a position to lead. The fact that Korea is chairing the G-20 at this crucial time is a notable vote of confidence in Korea and its institutions. We look forward to continuing our cooperation with Korea as we tackle the global economic challenges before us and the ones yet to come. My best wishes for a productive conference and for the continued success of the Bank of Korea.