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Comments on: "Inflation targeting in Korea: a model of success?" by Soyoung Kim and Yung Chul Park

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First of all, I would like to thank the HKIMR and BIS for giving me an opportunity to attend this very important conference. I should start with the usual disclaimer. The view I am about to express is my own and not necessarily that of the Bank of Korea.

Professors Park and Kim have given us a quite comprehensive explanation on the Korean monetary policy system, its operation, performance and tasks. I would like to say in advance that I agree with many of the main findings of this paper. I will by and large not argue with the empirical findings except a few minor points, although I have some reservations on the conclusion. Having said that, I would like to start section by section.

In Sections I and II, I think the history of monetary policy implementation and the policy system of the Bank of Korea are well described in a objective manner. However, I would like to point out two things. First, the authors argue that "the expansionary monetary policy since 2000 has not been effective in bringing about economic recovery". In my opinion, however, while the expansionary monetary policy did not bring about a noticeable economic recovery, it did prevent business activities from sliding into a deeper slump. In a small open economy like Korea, it is typical that the demand management policy has limitations, especially during the course of an economic downturn arising from external shocks. While monetary policy is inevitably in a passive stance, its role to support economic activities should not be downgraded. Therefore, I think the monetary policy played its own expected role in that sense, in a rapidly changing economic environment involving various domestic and overseas shocks. I will come back to this point later.

My second point is about the date of full adoption of inflation targeting in Korea. The paper argues that in Korea pure inflation targeting was established in 2003, but it is fair to say that the complete transition to inflation targeting in Korea was made in 2001, when the monetary indicator M3 was no longer set as an intermediate target. This view is consistent with a paper by the IMF in 2005, where the monetary policy system of Korea has been classified as fully fledged inflation targeting since 2001.

The empirical analyses in Sections III and IV of the paper seem to give positive assessments of the performance of inflation targeting of Korea, after its introduction in 1998. Inflation targeting in Korea can be evaluated as successful in the sense that it has contributed greatly to price stability. The annual rate of increase in headline CPI inflation has stabilised at around 3%, as against 7.5% in 1998. Since 2002, core inflation has been held stable within a band of between 2.9% and 3.1%, a good match for the 3% midpoint of its current target range. Also, as shown by the paper, the volatility and persistence of inflation decreased after the adoption of inflation targeting, implying that there has been some enhancement of the credibility of monetary policy operations.

Concerning the interpretation of the results of the reaction function estimation in Section IV, I agree with the authors that the BOK has taken a flexible inflation targeting approach. While the Bank of Korea takes price stability as the primary objective of monetary policy as the

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Bank of Korea Act stipulates it, it also appreciates the reduction of short-term economic fluctuations and the stability of financial markets as policy goals. When these goals were moving in mutually contradictory directions, the BOK placed its focus on the objectives that it considers most important under prevailing situations, as long as price stability is not hampered. This is called employing a flexible approach. For instance, four cuts of the call rate target were implemented in 2003 and 2004 to promote economic recovery. In October 2005, however, the Bank of Korea raised the call rate target. It was the BOK's intention to shift the focus of policy to control potential inflation pressure in the medium term, as signs of the economic recovery emerged.

Meanwhile, financial stability has become another important objective of monetary policy. Financial development and stability are essential constituents of sustainable economic growth. While an advanced and stable financial system enhances the efficiency of the distribution of resources and bolsters economic development, financial instability can trigger serious economic crises. Furthermore, considering the fact that the effects of monetary policy are transmitted to production activities and prices through the financial sector, if the financial markets suffer from instability or do not function properly, then the transmission channel of monetary policy will not work smoothly. In this regard, the Bank of Korea also strives to achieve financial stability in the actual operation of its policy, although it is not specified as such in the Bank of Korea Act.

The evaluations of the transmission channels of monetary policy look mixed in Section V of the paper. There are merely differing views as to whether different channels work as well as the policy authorities expect. The transmission mechanism of monetary policy has not worked very well for an extended period in Korea, primarily due to episodes of financial instability and the inappropriate financial infrastructure.

After the adoption of an inflation targeting framework, the Korean economy suffered from the impact of the financial crisis of 1997-98, the financial collapse of Daewoo business group (September 1999), the severe financial difficulties of Hyundai business group (May 2000) and Hynix (May 2001), 9/11 terror (September 2001), the war in Iraq (October 2002), geopolitical risks related to North Korea (December 2002), a credit card boom and bust, and financial difficulties of major credit card companies (March 2003). All of these have contributed to destabilising financial markets and the Korean economy.

But one thing I want to point out is that notwithstanding turbulence in the economy and extraordinary volatility in the financial markets, empirical studies, which are based on variance decomposition analysis of a six-variable (overnight short-term interest rate, long-term interest rate, exchange rate, stock price, industrial production, and CPI) VAR model, show that the effects of monetary policy on inflation have been enhanced since the adoption of the inflation targeting framework.

Finally, on the conclusion, I agree with the first point that there were other factors which contributed to price stability, including a lack of domestic demand, the appreciation of the Korean won against the US dollar, modest wage increases, the decline of international prices of imported goods, etc.

However, the paper seems to reach somewhat pessimistic conclusions about future prospects for the Bank of Korea's monetary policy and inflation targeting system. These conclusions seem to stem from concerns that tightening policy, when incorporated in a policy mix with foreign exchange rate policy, may not be sufficiently effective in times when monetary tightening is needed. One area where I disagree with the authors is on the assertion that the BOK might have a two-anchor monetary policy system or intermediate exchange rate regime. Since Korea's adoption of the free floating exchange rate system in December 1997, evaluation of its exchange rate operations has shown that, on the whole, application of market mechanisms for exchange rate determination has been enhanced in comparison to previous periods.

On the other hand, some economists, including the authors of the paper, have expressed negative views on the policy perspective behind exchange rate operations, arguing that the authorities still have a fear of floating because of sharp exchange rate fluctuations. As a rationale for this argument, they point to: (i) the limited extent of exchange rate volatility; (ii) suspicions that the Korean authorities target a certain level of exchange rate to ensure export price competitiveness.

Notwithstanding these arguments, it is clear that the authorities in Korea have maintained the principle that the exchange rate should be determined in the market through the interaction of the demand for and supply of foreign exchange. Foreign exchange market intervention is implemented not to target a certain level but to smooth radical changes in the exchange rate when there is a transient external shock or a bid-offer gap due to one-sided exchange rate expectations.

As for the first rationale behind the pessimistic views, the fact of the matter is that won/dollar exchange rate volatility has increased significantly since adoption of the free floating system. That is, the daily ex post volatilities measured by the differences between each day's and each previous day's closing rates and between the daily highs and lows have both more than doubled compared to the period before introduction of the free floating system.

The second assertion that the Korean authorities have actively intervened in the market to target an exchange rate sustainable for maintaining price competitiveness is not unambiguous. The nominal effective exchange rate (NEER) indices show that since 1998 changes in yearly averages have been widening to 5.3%, from 2.0% during the periods before the currency crisis.

In 2003 and 2004, the figures represent a stable pattern, implying that the Korean won has kept pace with the movements of other currencies. Similarly, the yearly changes in the real effective exchange rate (REER) indices have also increased since adoption of the free floating system, from 2% to 5.2%, while the won has appreciated slightly compared to other currencies since 2002. These figures may imply that the won has not been operated for the purpose of targeting a specific exchange rate level, but that its value has instead been determined in the market, reflecting the global trends of major currencies.

The new monetary policy environment has come about with the complete opening of the financial market and the introduction of a free floating exchange rate regime. When there are changes in exchange rates between major currencies or in the pattern of foreign investors' stock investment, prices which are the most important variable for monetary policy will be affected by changes in the exchange rate of the won. In the case of the small open economy, the exchange rate is likely to be not so much adjusted endogenously as given exogenously. Accordingly, the central bank is forced to take a passive stance. Specifically, the BOK is obliged to change its monetary policy stance when the exchange rate is not in balance with the inflation target.

In closing, I would like to point out some tasks ahead. Above all, I think that various efforts should be continuously made to ensure effectiveness of the inflation targeting system. While the Bank's monetary policy operation has indeed advanced in terms of its system and practices, there are several new challenges and difficulties, and coping with them involves important tasks. The first of these that should be pointed out is that of heightening the Bank's economic forecasting capacity. The Bank of Korea forecasts GDP growth and inflation with fan-charts to take account of forecasting uncertainty. However, individual economic agents' demand for more sophisticated forecasting has been growing in Korea recently. In order to satisfy that demand as well, greater effort to increase the accuracy of forecasting is also needed.

The second major task is to enhance the communication channel between the financial markets and the BOK. The central bank should make an effort to gather financial market reactions and improve public understanding of its monetary policy by explaining its policies and desirable policy initiatives. The Bank of Korea submits a Monetary Policy Report to the

Congress twice a year, and recently started to publish the minutes of the Monetary Policy Committee with a six-week lag on the website. In this way, I believe the accountability and transparency of monetary policy operation in Korea has increased substantially.

Lastly, we should set the transmission mechanism of monetary policy to rights and maintain it constantly by, for example, nurturing the development of the money and capital markets.

Thank you for your attention.