

# QUARTERLY ECONOMIC REVIEW

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# Monetary Policy and the Role of the Central Bank

Address by  
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Governor, the Bank of Korea  
at  
the Government Roundtable  
arranged by Economist Group  
Seoul, Korea  
May 11, 1995

Distinguished Guests, Ladies and Gentlemen,

It is a great pleasure for me to be with you here today and to be able to talk about the central bank's monetary policy. I would like, first of all, to express my deep appreciation to the Economist Group for providing this valuable opportunity.

When I heard that I was invited to address a Round Table, my mind was cast back to all I had read in the history books about King Arthur and the Knights of the Round Table. In a way, it is very appropriate for me since we central bank governors are engaged in a perpetual quest for the holy grail of monetary stability.

So I will begin my saga by briefly introducing recent changes in the monetary policy environment in Korea. Then I would like to touch upon the tasks that the Bank of Korea has now to tackle.

As is now generally acknowledged, the charge laid upon central banks, in brief, is to secure two types of stability. The first is the stability of the pur-

chasing power of money or price stability and the other is the stability of the overall financial system.

But this exercise has been increasingly arduous, with the rapid changes in the financial environment grouped under the three headings of liberalization, innovation and internationalization.

I do not need to remind you of how the world financial markets have been transformed these last few years. Numerous regulations have been lifted or eased and this allowed the enthusiastic spawning of an array of innovative financial instruments including derivatives.

The removal of restrictions on cross-border banking and capital movements has accelerated financial internationalization, gradually integrating national financial markets into a single world market. What is more, the waves of financial liberalization and internationalization sweeping the advanced countries have recently spread around the world.

To enhance financial efficiency, Korea, too, steadily pursued financial reforms from the 1980s. And greater momentum was given to the whole process from the turn of the 1990s, especially once the new government took office in February 1993.

A comprehensive program of financial reform is now underway, embracing all its essential aspects such as interest rate deregulation, capital market opening, foreign exchange liberalization and the phasing-out of policy-based lending.

In Korea, as elsewhere, financial liberalization and internationalization undoubtedly contribute to the improvement of financial efficiency. Nevertheless their implications for the formulation and conduct of monetary policy are far-reaching and not a little disturbing.

Firstly, as new financial instruments combining both liquidity and high returns are actively introduced and the substitutability among financial assets increases sharply, the narrow monetary aggregates have become less reliable as guides to the implementation of policy.

Especially in Korea, these new instruments have largely been offered by non-bank financial intermediaries. Thus, the authorities, in order to secure the effectiveness of monetary policy, ought to monitor other variables along with  $M_2$ .

Secondly, financial liberalization and internationalization strengthen the linkages between monetary aggregates and other price variables; namely, interest rates and the exchange rate. This means that a trade-off situation may arise more often than ever between achieving monetary growth targets and stabilizing the movements of interest or exchange rates.

The channels for the transmission of monetary policy are also diversified in the process, with policy working not only through availability effects but also through the price effects of interest rates and exchange rate.

Beyond this, the widening of capital market opening may well trigger very large in-and out-flows of funds, primarily in the form of short-term speculative capital. This would make the conduct of monetary policy extremely difficult and result in unwarranted fluctuations in the value of the Korean won.

Not only is this the case, but we have to recognize that the new financial environment adds to the difficulties of the central bank in its second major objective of securing financial stability.

In the deregulated markets, as we are well aware, the variability of financial asset prices and the ensuing financial risks may increase. The higher cost of funds in the competitive environment may also well tempt financial institutions to focus on high-yield, high-risk investments in their overall portfolio strategy, leading to a build-up of non-performing assets if the situation turns sour.

Furthermore, as financial markets are becoming increasingly integrated, destabilizing impulses generated in one institution or market tend to spread quickly through the whole financial system. As we have seen in recent crises such as Black Monday or the Mexican peso's collapse, a financial panic in any one country exerts a stronger ripple effect around the world than in the past.

In the case of Korea, the increase in financial riskiness has not yet been so much in evidence as in advanced countries. But as competition becomes fiercer, financial institutions are pursuing more aggressive management strategies and some have already experienced some losses on their investments.

Ladies and Gentlemen,

Let me now turn to the policies and measures that the Bank of Korea is adopting in the face of these tremendous forces of change.

First, I believe that price stability is not only a prerequisite for sustainable economic growth but an essential factor favoring successful financial reform. In particular, macroeconomic stability is now crucial for a soft-landing for the Korean economy after its recent period of rapid growth above what is regarded as its potential growth rate.

As the guardian of price stability, the Bank is doing its utmost to keep total liquidity at a proper level. To this end, we set the  $M_2$  growth target for this year at 12 to 16 percent, which is lower than that of 14 to 17 percent last year.

Second, the Bank is attempting to shift toward a completely indirect system of monetary control in which the reserve position of banks is controlled through market-oriented instruments.

Until recently the Bank's rediscount policy was largely utilized in support of policy-based lending on an automatic basis, leading to an expansion in the supply of base-money. To mop up the excess liquidity, the Bank had no option but to issue at below market interest rates a large volume of Monetary Stabilization Bonds, which are special negotiable obligations of the Bank, and to set reserve requirements at a high level.

However, in an effort to improve the current style of monetary control, the Bank replaced its automatic rediscount facility with an aggregate credit ceiling system in March last year, and the overall ceiling will be progressively ratcheted downwards. At the same time, the competitive bidding method used in most advanced countries will be employed for a steadily increasing share of both its RP transactions and issue of MSBs. Once rediscount window lending has been reduced to a normal level, we will be able to cut minimum reserve requirements gradually.

Third, as I pointed out earlier, it is incumbent upon the Bank of Korea to maintain the systemic health of the overall financial industry. From this perspective, we are strengthening the central bank's oversight function and prudential supervision. The capital adequacy standards set by the Basle Accord will be applied to commercial banks in full from the end of this year.

We are also in broad agreement with the risk management proposals of the BIS to handle the increasing market and credit risks concerning derivatives trading. In addition, an early warning system, similar to CAMEL in the U.S. regulatory system, will be introduced to pick up on adverse symptoms at an early stage.

Fourth, to keep pace with the increasing volume of payments and to establish a well-functioning payments and settlements system, the Bank introduced a real time gross settlements system, known as BOK-Wire, last December. We intend to expand steadily the scope and functions of this new system, providing a sound financial infrastructure for Seoul as a well-developed and highly-efficient financial market.

Finally, as the international linkages in the monetary policy environment deepen, it is important to strengthen policy coordination with other central banks and the multilateral financial organizations. The Bank of Korea, of course, stands ready to cooperate closely with them in solving any international financial incident that poses a threat to the global order.

Ladies and Gentlemen,

The theme of your deliberations is “Globalization and Competitiveness in the New Korean Economy”. Other speakers have no doubt spoken of the meaning of competitiveness at some length.

But I would like to add that competitiveness can be obtained only on a sustainable basis of price stability. In this regard, at the risk of appearing partisan, let me draw my remarks to a close by noting that the soundness and credibility of monetary policy are crucial to Korea’s long-term competitiveness.

Thank you very much.