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Does the Bank of Korea Need New Mandates?

The probability of a recession in major countries has been going up in recent months. The reasons for the recession worry are many including China slowdown, the plunge in commodity prices, the banking problems in Europe and the hike in the interest rate by the Federal Reserve.

Since the Great recession which ended in 2009, central banks have been very active in supporting their economies. The Federal Reserve, the ECB, the Bank of Japan and even the People's Bank of China have adopted Quantitative Easing (QE). In Denmark, Sweden, Japan and the Eurozone, negative interest rates have been adopted. In contrast, the Bank of Korea has been very timid in reacting to global and domestic economic malaise.

In order to boost confidence in the Korean economy, a decisive monetary policy is needed. What is a decisive monetary policy and how would it help the Korean economy?

The Bank of Korea should cut the key interest rate by an amount unexpected by the people in financial markets. Traditionally, the Bank of Korea has cut the interest rate by 0.25 percentage point. Something significantly higher, such as 0.5 or even better 0.75 percentage point cut would surprise the market and have a positive effect in lifting the depressed psychology in the economy. A 0.25 percent cut a time would have little or no effect on the expectation wasting limited bullets in the arsenal of monetary authorities.

This is exactly what the Federal Reserve and the Bank of Japan have done and the European Central Bank is trying to do the same.

Since the Great Recession after the 2007-9 financial crisis, the U.S. Central Bank has engaged in three different rounds of QE. The first round of QE was most effective because the market was caught by surprise. The confidence in the economy was lifted and an economic recovery followed. The second and third rounds of QE were not very effective because the market expected them and did little to change expectations in the positive direction.

Similarly, the Bank of Japan lifted the expectation in the economy when Prime Minister Abe appointed a Governor Kuroda who started a massive QE. What governor Kuroda did was somewhat of a surprise to the marketplace. The stock market jumped and consumer confidence rose helping the economy. The key variable helping the economy was not the amount of liquidity, nor the level of the key interest rate in the economy. Rather, it was the expectation factor in the economy moved by the surprise factor.

Once the surprise factor was gone in both the U.S. and Japan, the net effect on the economy through monetary policy was negligible because expectations did not change.

The Bank of Korea should move decisively in order to boost the psychology and move expectations in the positive direction. Nevertheless, there are people who argue that lowering the interest rate by a surprising amount is a bad idea for a couple of main reasons.

The first objection against the Bank of Korea lowering the key interest rate more decisively is the high level of household debt in the country. But, Korea's household debt is not as worrisome as it sounds. Korea has one of the largest underground economies among the OECD nations understating the GDP. Actual debt-to-GDP ratio (therefore debt-to-income ratio) after including the underground economy is much lower. Unlike their counterparts in the U.S. and other developed countries, Korean households as a group have very liquid assets such as cash, bank deposits and marketable securities more than covering liabilities. The ratio of financial assets to liabilities is close to its peak. Fortunately, the delinquency rate of the Korean consumers is very low. Since about 70 percent of the household debt is floating, lower interest rates will help increase consumption.

If the government decides that the level of household debt is indeed a serious problem, macro-prudential government regulation, not monetary policy, should be used to correct the problem. Monetary policy is a blunt tool designed for the macro economy, not a specific segment of the economy like the household sector.

The second objection is that the U.S. Federal Reserve has begun to hike the interest rate. Easing moves by Korea's central bank would result in capital outflows. However, the increase in the interest rate by the Federal Reserve has been well anticipated and has been a surprise to no one. In addition, the officials at the Central Bank has promised that the interest rate won't rise very fast. Given the sluggish economy and low inflation, there is good chance that the U.S. central bank may not raise the interest rate for the rest of the year. In other parts of the world, the ECB and the Bank of Japan are engaging in more aggressive easing moves.

The thought that small increases in the interest rate would move money out of Korea is not valid. There are many speculators everywhere , but foreigners invest in Korea not because of a small advantage in the interest rate. They come to Korea because of the strength of the Korean economy and the financial markets. If the interest rate were the primary consideration, there are other more attractive countries to go to than Korea.

Besides, Korea has amassed foreign-exchange reserves approaching $400 billion *in part* to protect the economy from the vagaries of international financial markets. During the IMF crisis, Korea did not have enough foreign-exchange reserves exacting a heavy price on the Korean economy. The situation today is quite different. The Korean economy is far healthier and the ratio of short- to long-term external debt ratio has declined significantly. Given the size of the economy and the confidence foreign investors have on the Korean economy, any outflow would be manageable. After all, we save reserves in part for precautionary reasons. The foreign-exchange reserves should be allowed to go up and down along the long-term rising trend.

Monetary policy is a blunt tool. It will have undesirable effects in some parts of the economy to be sure, but the Bank of Korea should focus on the big picture: economic growth and inflation. In the U.S., this is one of the reasons for enacting a law in 1978 called Humphrey-Hawkins. The law mandates the Federal Reserve to focus on "full-employment and price stability", not on other things like household debt, foreign-exchange rate etc. The ECB is even more focused on price stability even though employment is an important consideration. The Bank of Japan has laser focus on price stability, nothing else.

The 1950 law which created the Bank of Korea states "the primary purpose of the Bank of Korea is pursuing price stability so as to contribute to the sound development of the national economy." Has the

Korea's central bank been following the mandate? Maybe not. The 1950 law may have to be amended to be more specific about what the mandate of the Bank of Korea is.

The goal is to change the depressed expectation in the economy by surprising the financial markets. This does not necessarily require the key interest rate going to zero immediately. However, a cut in the interest rate should be large enough to surprise the market. A quarter point cut at a time is not useful wasting precious resources because no one is surprised with no effect on the expectations factor. A clarified mandate for B of K could help.