Chang Yong Rhee: Speech - Korean Economic Associations annual meeting

Speech by Mr Chang Yong Rhee, Governor of the Bank of Korea, at the opening dinner of the Korean Economic Associations Annual Meeting, Seoul, 13 February 2024.

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Chairman Yoon-Jae Whang of the Korean Economic Association, Vice Chairman Hongkee Kim, esteemed presidents of various economic societies who are hosting this joint academic conference, and distinguished guests,

I would like to express my gratitude to you for inviting me to this congratulatory dinner celebrating the 2024 Korean Economic Associations Annual Meeting. I am also thankful to the many professors here who have provided significant assistance to the Bank of Korea over the years through a wide range of research and consultations.

It would be difficult for me to pretend to be knowledgeable about the topics that have recently been of primary interest across academia, as it has been a long time since I quit my professorship at the university. Instead, I would like to present five topics related to monetary policy issues that I have encountered while working at the Bank of Korea over the past two years, in lieu of my dinner speech, hoping that academia and the Bank of Korea will be able to find solutions together.

Conditional Forward Guidance

The first topic is "Conditional Forward Guidance." Recently, the Bank of Korea has been explaining the views of Monetary Policy Board members on the policy rate over a three-month horizon. In the media, this is referred to as the "BOK's Dot Plot." It is considered to be a new attempt, departing from the tradition of maintaining as much "strategic ambiguity" as possible, by not clearly mentioning any future interest rate policy.

There may be disagreement regarding which communication strategy will be more desirable for the Korean economy, between forward guidance and strategic ambiguity. On the one hand, there is concern about the possibility that market volatility may increase if the future policy path is clearly outlined but then the policy changes in a different direction due to sudden shifts in economic conditions and outlook. On the other hand, there is the contrasting opinion that if the central bank effectively convinces economic agents that policies may change in response to changes in the assumptions underlying the forecasts, they may adapt more proactively to changes in economic conditions, leading to market stabilization.

The Bank of Korea is planning to announce major economic forecasts quarterly starting in the second half of this year, instead of semiannually. Given this situation, we are currently considering whether it is desirable to further develop our Conditional Forward Guidance in the future and, if so, to what extent we should extend the horizon for announcements. Since it has been about a year and a half since the announcement of the BOK's Dot Plot, an empirical analysis of its results seems possible, albeit at a limited level. Therefore, we believe that it would be beneficial to seek answers to our concerns together with academia.

Bank Intermediated Lending Support Facility

The second topic revolves around the utilization of the Bank of Korea's Bank Intermediated Lending Support Facility. The Bank of Korea selectively provides low-interest funds to banking institutions based on their performance in lending to SMEs. The program currently stands at around 30 trillion won. There are conflicting views as to whether the Bank of Korea should continue this program. Some argue that it falls within the domain of fiscal policy, rather than that of a central bank, as it is essentially designed to redistribute credit to specific sectors. Others emphasize that, given the nature of interest rate policy, in that it affects the economy indiscriminately, the burden of sustaining a high-interest rate policy can be mitigated by providing selective and temporary support to vulnerable sectors that are more likely to be adversely affected by tightened monetary policy.

Furthermore, in the medium- to long-term, if a central bank faces a zero lower bound as the economy falls into secular stagnation, the Bank Intermediated Lending Support Facility may be a useful tool when interest rate policy is no longer a valid option. For example, in the case of Korea as a non-reserve currency economy, an all-out implementation of an unconventional monetary policy such as quantitative easing, as utilized in advanced economies, might be challenging even if it is confronted with the zero lower bound. However, relying solely on fiscal measures to escape from structural stagnation presents its own set of challenges, as a widening fiscal deficit could lead to a decline in sovereign creditworthiness. In this regard, there is an essential need for discussion about whether the Bank Intermediated Lending Support Facility can serve as one of the central bank's policy tools in a zero interest rate environment.

Neutral Interest Rate

The third topic is the estimation of the neutral interest rate. As you know, estimating the neutral rate, which would support the economy at potential output while keeping inflation constant, plays a crucial role in determining the monetary policy stance. In the case of Korea, if we do not take external factors into account too much, there is a possibility that the neutral interest rate will decline in the long run driven by internal factors such as demographic shifts due to the low birthrate and the population aging.

Contrastingly, there is a view that developed economies, especially the U.S., might see a reversal in the downtrend of their neutral interest rate as fiscal deficits are expected to widen, investment demand to increase significantly in response to climate change, and productivity to rise due to technological innovations, such as AI.

In an open economy heavily influenced by external factors, how the neutral interest rate is determined when internal and external factors work in different directions is a key element in determining future monetary policy. So we would like to see some further academic research on this issue.

Preparing for Digital Bank Runs

The fourth topic concerns improvements to the central bank lending facility in preparation for the potential occurrence of a digital bank run unfolding more rapidly than anticipated. The most valuable lesson learned from the SVB collapse last year was that large-scale bank runs can spread very rapidly in a digitalized financial market, and that deposits are not a stable funding source anymore. Based on this lesson, the Bank of Korea announced its 'Reorganization of the BOK's Lending Facility' last July. To be specific, the Bank came up with reorganization to lower the loan interest rate and to expand the scope of eligible collateral in an attempt to enhance accessibility to Liquidity Adjustment Loans, the equivalent of the U.S. Fed's Discount Window.

Regarding this matter, two more tasks still remain. The first is about the inclusion of non-bank financial institutions (NBFIs). Although the proportion and the role of such NBFIs have been steadily growing across financial markets, it remains challenging for the Bank of Korea to implement inspections of them and request documents from them under the current Bank of Korea Act. Therefore, it is necessary to conduct studies on how collaboration between the BOK and the government should evolve in terms of supervision and investigation, in order to be able to add NBFIs to the list of eligible entities for Liquidity Adjustment Loans.

The second issue is to strengthen the function of Liquidity Adjustment Loans, a standing facility. Under the current BOK Act, the Bank cannot accept loans receivable from banking institutions as collateral during normal times. Taking loans receivable as acceptable collateral is only possible when there is a need for emergency credit operations, which requires at least four MPB members' concurrence, in accordance with Article 65 of the BOK Act. In this case, financial institutions' concerns about the stigma effect could intensify. Follow-up measures are necessary to ensure that banking institutions can use loans receivable as collateral without fear of the stigma effect. For example, it may be necessary to revise the BOK Act to expand the range of eligible collateral for the standing facility under Article 64 to include loans receivable from banking institutions. If this is made possible, accessibility to the Bank of Korea's lending facility would be enhanced. However, simultaneously, we need to conduct reviews and studies into how to handle the moral hazard issue that could arise as a consequence.

Open Market Operations

The last topic pertains to the relationship between open market operations (OMOs) and the money market. Early last year, short-term rates, such as call and RP rates, hovered significantly below the policy rate. This was attributable to the substantial expansion in funds under management at asset management firms, which do not have direct access to RP transactions with the Bank of Korea, as short-term funds flowed into the MMF market. Although short-lived, concerns were raised about the effectiveness of the conduct of monetary policy as short-term rates remained below the policy rate. Therefore, the Bank of Korea decided to include asset managers in the list of institutions eligible for OMOs to address this problem.

Until now, the Bank of Korea has primarily utilized seven-day RP transactions as the main instrument for its open market operations framework. In fact, Korea's money market instruments include Monetary Stabilization Bonds with various maturities of less than three years - such as 91 days, 1 year, and 2 years - in addition to ultra-short-term RP transactions. This means that, unlike central banks in advanced countries, the Bank of Korea can exert significant influence not only on ultra-short-term interest rates but also on short-term interest rates of less than three years. Considering the unique structure of Korea's money market, it is essential to pose fundamental questions. What is the optimal approach for open market operations? How should the role of Monetary Stabilization Bonds be defined in our conduct of open market operations?

Concluding Remarks

These are just five examples of research topics for monetary policy. In the future, whenever new challenges arise, I will continue to seek assistance and advice from academia. I believe that if scholars can provide policy recommendations through their research and if the Bank of Korea can incorporate them into our policymaking process, Korea's monetary policy can advance even further.

One unfortunate reality is that during personal meetings with young scholars, when I ask them to conduct research on these topics, their responses aren't always as I expect. They explain that their research is only recognized as a scholarly achievement when it is published in international journals. Unfortunately, it seems that papers that focus on the Korean economy face some difficulty in being accepted, causing scholars here to shy away from such research. It is disheartening that at a time when high-quality research on our own economy is urgently needed, talented young professors are reluctant to engage in it due to its lack of recognition. Although it may seem like an unsolicited suggestion, I do believe it is time for economic associations to consider ways to address this unfortunate reality.

I apologize for this long speech. I sincerely wish all of you good health and prosperity throughout the year, and I express my hopes for the continuous development of Korea's economic community.

Thank you.