Chang Yong Rhee: An Integrated Policy Framework - application to Korea's monetary policy

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Introduction

Today, I would like to discuss the Integrated Policy Framework (IPF), which is emerging as a new holistic approach to the implementation of monetary policy, and share with you how this framework has been applied to the Bank of Korea's monetary policy through two practical examples.

Over the past two and a half years, the BOK has faced criticism for what some view as hesitation and delay concerning policy decisions. One of the criticisms has been that, despite adopting an inflation targeting framework, the BOK has not focused solely on price stability, but that it has also considered other factors, such as exchange rates, household debt, and real estate prices. This broader focus has led to concerns that the BOK may have missed the optimal timing in terms of adjusting interest rates during both the tightening and easing phases.

However, since the Global Financial Crisis, there has been a growing consensus among international organizations such as the IMF and the BIS, as well as across academia, that emerging economies without reserve currencies could benefit from complementing traditional monetary policy with other policy tools, such as foreign exchange intervention and capital flow management, all as part of an IPF. The IMF has acknowledged the effectiveness of such tools, like foreign exchange intervention and capital flow management policies, that were previously under-appreciated. Indeed, I contributed to these discussions during my time as the IMF director for the Asia-Pacific Region. Thus, today, I will illustrate how the BOK has implemented this integrated approach through two cases: the financial and foreign exchange market instability we saw in late 2022, and the decision to hold the policy rate steady in August 2024.

The Integrated Policy Framework

Non-reserve-issuing economies face constraints in achieving both price stability and financial stability through traditional monetary policy alone. This is primarily due to the high volatility in capital flows and exchange rates that arises from their heightened sensitivity to changes in global financial conditions. More fundamentally, these economies are limited in their ability to act as lenders of last resort in the foreign exchange market.

As a result, international organizations such as the IMF and the BIS have begun analyzing how non-reserve-issuing economies can more effectively achieve price stability and financial stability by employing a combination of policy tools, all as part of an IPF.[1] This framework is particularly effective when the traditional policy objectives of price stability and financial stability conflict. By adopting an IPF, the IMF has expanded

the scope of policy tools that it recognizes, to cover capital flow management measures and foreign exchange interventions, especially through experiences such as the Asian Financial Crisis and the Global Financial Crisis.

The IMF and the BIS have categorized the available policy tools under an integrated framework into four broad areas: monetary policy, macroprudential policy, capital flow management measures, and foreign exchange intervention. Monetary policy includes tools like interest rate adjustments and liquidity provision, while macroprudential policy involves domestic credit management measures such as LTV (Loan to Value) and DSR (Debt Service Ratio) regulations. Capital flow management measures include tools like foreign exchange stability levies and ceilings on foreign exchange derivatives positions. However, the IMF has yet to provide an official stance on policy coordination between monetary and fiscal policies within an integrated framework.

Application of an IPF to Korea's Monetary Policy

Next, I will discuss two recent cases where an IPF was applied to the monetary policy of Korea. The first case involves the period of financial and foreign exchange market instability seen in the second half of 2022, and the second case concerns the decision to hold the policy rate steady in August 2024.

The period of financial and foreign exchange market instability in late 2022

First, let's take a look at the domestic and external economic conditions we faced during the period of financial and foreign exchange market instability in the second half of 2022. In the aftermath of COVID-19, combined with supply shocks and rising international oil prices following the outbreak of the Russia-Ukraine war, inflation began to rise sharply in the first half of 2022, particularly in advanced economies. As a result, major central banks, including the U.S. Federal Reserve, began to substantially raise policy rates, and the BOK also continued to tighten monetary policy by raising the policy rate at the fastest pace in history to bring inflation back to its target level.

Throughout this period, the tightening stance of the U.S. Federal Reserve was much stronger than initially expected, leading to a sharp depreciation of the Korean won against the U.S. dollar. In the second half of 2022, short-term financial market stress rose, triggered by real estate project financing, which quickly spread to the commercial paper and corporate bond markets.

The BOK sought to balance the conflicting goals of price stability and financial stability by exploring a combination of layered policy measures to address both domestic and external factors. Domestically, the BOK addressed inflation and financial instability separately. The BOK continued to raise the policy rate to ensure price stability while simultaneously implementing liquidity provisions to secure financial stability. As credit tightening caused by the real estate project financing crisis drove market interest rates much higher than intended by monetary policy and led to a contraction in bond issuance, the BOK judged that it was necessary to reduce the risk premium to ensure that the monetary policy transmission channel worked properly. To this end, the BOK expanded the range of eligible collateral for loans and conducted temporary repurchase agreement purchases (repos) as liquidity measures. These stabilization measures were

temporary and targeted, which did not run counter to the macroeconomic monetary policy tightening stance. They were also consistent with the principle of avoiding fiscal dominance in monetary policy, as collateral was required and high interest rates were applied.[2]

In response to external challenges, particularly the unexpected sharp depreciation of the currency, the BOK implemented a combination of policy measures. These included the so-called "big step" - a 50 basis point increase in the policy rate - taken in October 2022 for the second time, following the first big step in July 2022, as well as foreign exchange interventions to control the pace of depreciation. Due to structural weaknesses in Korea's foreign exchange derivatives market, such as its small size and the high portion of short maturities, a rapid depreciation of the currency can trigger margin calls on derivatives and hedging transactions. This, in turn, could cause an adverse feedback loop by further driving up domestic interest rates.
Therefore, foreign exchange intervention is aimed not at targeting a specific level, but at controlling the speed of depreciation. These interventions contributed to stability in the foreign exchange market by managing the pace of depreciation and allowing market participants to adjust their expectations. This combination of monetary policy and foreign exchange intervention is a good example of the application of an IPF, particularly suited for economies with relatively underdeveloped foreign exchange markets.

Moreover, during periods of sharp currency depreciation, the BOK set up a foreign exchange swap with the National Pension Service (NPS) to stabilize the foreign exchange market. This helped mitigate demand for foreign exchange purchases in the spot market for the NPS's overseas investments. Hedging through foreign exchange swaps during such periods can benefit the NPS in terms of risk management and profitability. Thus, this measure was a mutually beneficial strategy for both the NPS and the BOK.

At that time, there was an argument that a currency swap with the U.S. Federal Reserve was necessary due to the sharp depreciation of the Korean won. However, global conditions did not meet the criteria for a currency swap, so a cautious approach was required. In order to conclude a temporary currency swap with the Federal Reserve, the following three conditions must be met.[3] First, there must be a shortage of global dollar liquidity in international financial markets. Second, this liquidity shortage must have a significant impact on the financial and economic systems of major emerging markets. Third, the shocks from these major emerging economies must result in spill-back effects, such as disruptions in credit supply to U.S. households and businesses, thus causing strains in the U.S. financial system. However, the situation in the second half of 2022 did not meet these conditions.

It is worth noting that the U.S. Federal Reserve has standing swap arrangements with the Bank of Canada, the Bank of England, the European Central Bank, the Bank of Japan, and the Swiss National Bank, which will remain in place until further notice. It also worth noting that during the Global Financial Crisis and the COVID -19 pandemic it established temporary swap arrangements with the Reserve Bank of Australia, the Banco Central do Brasil, Danmarks Nationalbank, the Bank of Korea, the Banco de Mexico, the Reserve Bank of New Zealand, Norges Bank, the Monetary Authority of Singapore, and the Sveriges Riksbank.

To elaborate further, according to FOMC minutes from back in October 2008, the Federal Reserve assesses the shortage of dollar liquidity in the global market based on indicators such as the Libor-OIS spread. In the second half of 2022, the Libor-OIS spread remained at low levels, showing no signs of global dollar liquidity tightening. Additionally, when looking at exchange rate movements in countries that had previously set up temporary currency swaps with the U.S. Federal Reserve, currencies like the Korean won and the Australian dollar depreciated sharply, while resource-exporting currencies, such as the Brazilian real and the Mexican peso, appreciated, leading to differing opinions as to the necessity of a currency swap.

Back to our case, although the currency depreciated sharply, with the USD/KRW exchange rate rising above 1,400, the BOK was able to respond more flexibly to the depreciation. This was due to the country's substantial foreign exchange reserves, which exceeded 400 billion U.S. dollars, and thanks to structural changes in the domestic foreign exchange market that helped mitigate the negative effects of any currency depreciation. Korea has accumulated significant foreign exchange reserves, providing it with the capacity to respond to volatility in the foreign exchange market. Furthermore, since 2014 Korea has become a net external creditor, leading to an improved absorption capacity at domestic financial institutions to withstand any currency depreciation shock. Specifically, this improvement has reduced the risk of default or of any financial crises arising from the negative balance sheet effect caused by a currency depreciation, especially when the economy is a net external debtor. Furthermore, the ratio of short-term external debt has remained low since the Global Financial Crisis, enhancing the quality of its external liabilities.

Thanks to these improvements in the structure of the foreign exchange market, the IMF has concluded that Korea's level of foreign exchange reserves should not be assessed quantitatively in the same way as other emerging markets. Instead, it should be evaluated qualitatively using stress tests and traditional ratio indicators. As a result, since 2023 the IMF has excluded Korea from its quantitative assessments of foreign exchange reserve adequacy (the IMF ARA assessments), which are applied to deepening financial markets.

As the NPS has steadily expanded its overseas investments along with the growth of its fund reserves, it now accounts for a significant portion of resident overseas portfolio investment (up to 69% in 2023). As a result, its influence on the foreign exchange market has substantially increased. This expansion of overseas investments by the NPS has been one of the factors contributing to depreciation pressure on the currency in recent years through increased net foreign exchange purchases. Conversely, as demographic changes, such as aging and an increase in pension recipients, lead to a decline in the NPS reserve fund, the NPS will sell its overseas assets, which in turn will exert appreciation pressure on the currency through net foreign exchange sales. Therefore, when formulating overseas investment strategies, the NPS must consider not only micro-level aspects but also the macroeconomic impact on the foreign exchange market, ensuring an optimal portfolio strategy that accounts for these broader effects.

The decision to hold the policy rate steady in August 2024

Next, I will explain the background behind the decision to hold the policy rate steady in August this year, as the second case of applying an IPF to monetary policy. Looking at domestic and external conditions at the time, inflation was showing signs of stabilization in many countries, including in Korea, creating sufficient conditions to adjust the degree of monetary tightening. In fact, some advanced economies had already started to reverse their policy stance, lowering interest rates ahead of Korea. In particular, as expectations of a pivot at the Federal Reserve rose significantly, domestic market interest rates had already dropped faster and more substantially, even though the BOK had not yet begun to reverse its monetary policy stance. This over-anticipation of interest rate cuts led to a preemptive easing of domestic financial conditions beyond what was intended. Following this, from August onward, the previously subdued rise in household debt and real estate prices accelerated sharply, and financial imbalances began to expand.

The Monetary Policy Board assessed that, while conditions for an interest rate cut were developing in the real economy - such as inflation and private consumption - there were growing concerns that an interest rate cut would fuel rising real estate prices and exacerbate financial imbalances. Therefore, it was deemed more prudent to recommend to the government that it strengthen macroprudential policies and to observe their effects before making any rate cuts, leading to the decision to keep the policy rate steady in August. Another factor in the decision to hold the rate steady was that, despite sluggish domestic demand, economic growth was still projected to exceed the economy's potential growth at that time.

The high level of household debt itself does not necessarily imply a risk to the financial system, as household debt is typically backed by collateral. More importantly, however, the economy's heavy reliance on real estate distorts resource allocation by expanding the credit supply to non-productive sectors like real estate, which could act as a constraint on consumption and growth in the medium to long term. Korea's disproportionate focus on real estate within the household and financial sector balance sheets, compared to other countries, requires appropriate measures to mitigate this imbalance and credit misallocation.

Thanks to the BOK's decision to hold the policy rate steady in August and the government's strengthening of macroprudential policies, the rate of increase in housing prices in Seoul and the growth of household debt began to slow from September onward, and financial imbalances started to ease. The reduction in pressure from financial imbalances following the rate hold in August demonstrates the effectiveness of policy coordination between monetary policy and macroprudential measures. This, I believe, paved the way for the possibility of two consecutive rate cuts in October and November.

Concluding Remarks

The BOK operates under an inflation targeting framework, similar to those at advanced central banks. However, as a central bank in a non-reserve-issuing economy, the BOK faces limitations in achieving both price stability and financial stability solely through monetary policy, compared to central banks in reserve-issuing economies. There

remains the constant possibility of financial and foreign exchange market instability due to external shocks, and the potential conflict between policy objectives, such as price stability and financial stability, is more pronounced.

Going forward, the BOK will continue to prioritize price stability as its main policy objective through inflation targeting, while combining a range of policy tools under an IPF to enhance financial stability and to mitigate any foreign exchange market volatility.

Thank you very much.

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[1] IMF Integrated Policy Framework, BIS Macro-Financial Stability Framework.

[2] Bagehot's Dictum

[3] "Addressing Global Dollar Liquidity Strains: The Role of the Federal Reserve's Swap Arrangements." FRB Notes, October 2016.