

General Discussion

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Today's seminar topic is an optimal monetary policy in an environment of low inflation. It is an irony that now the world economy is deviating from the current seminar theme and facing again the inflationary pressure. Currently we are more concerned about how to cope with asset market bubbles and the renewed worldwide inflationary pressure.

In the early 2000s, many people felt that we were no longer afraid of the inflation of general prices even though in many countries the stable general prices had gone together with rising asset prices.

Inflationary pressure, however, did not disappear at all and inflationary pressures have come again. To deal with today's inflationary pressures, we have to give answers to the following three questions. First, we have to explain why we enjoyed such a low inflation in the late 1990s and early 2000s. Second, we also need to clarify why we suddenly begin to face inflationary pressure these days. Finally, we have to think of optimal mix of monetary and foreign exchange rate policies in an environment of rising asset prices and global imbalance. Naturally my answers to the above three questions are mainly based upon the Korean experiences.

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We are living in a world of free capital flows. This means that the Korean economy is no longer free from the overseas monetary and exchange rate policies. At the same time, monetary policies are no longer separable from exchange rate policies in the sense that monetary policies have direct impacts on exchange rate movements. It is time to think about optimal mix of monetary and exchange rates policies in an environment of rising asset prices and global imbalance.

Over the last several years, favorable supply shocks had contributed to the stability of general prices. Supply of cheap manufactured goods from China to the world market was one contributing factor for the stability of general prices. In addition, raw materials and oil prices stood at low levels and contributed to the stability of general prices. Under this circumstance, inflationary pressure from easy monetary policies tended to be offset by the favorable supply side shocks. However, prices of assets with fixed supply such as real estate began to rise with loosening monetary policies. General prices responded to easy monetary policies with a time lag through a full realization of wealth effects or bubbles in asset markets. In this sense, the movements of asset prices may be regarded as one of the leading indicators of future movements of general prices.

Why do we then care about the price hikes in asset markets? We care about them because of all the risks involved in rapid asset price increases. With prolonged easy monetary policies, speculative bubbles used to take place in asset markets. As professor Ito mentioned, bursting of bubbles might drive many individuals and corporations to bankruptcies and banks would be beset with nonperforming loans. This kind of bubble-bursting cycle in real asset markets may lead to a banking crisis if it goes together with either external adverse shocks or fragile domestic financial systems. To prevent bubble and its sudden bursting in asset markets, monetary policies must take into account the movements of both real asset and general prices. In a small open economy, it is not difficult to identify a bubble as opposed to a new

economy characterized as macro-fundamental changes toward high productivity growth.

As well known, Korea had the currency and banking crisis in 1997. After complying with the IMF direction of tight monetary policies for the first six months immediately after the crisis, the Bank of Korea took expansionary monetary policies in the mid 1998 to boost the economy and overcome the crisis in a short period. As a result, the money supply to GDP ratios rose by a significant amount after the crisis.

The Bank of Korea continued to pursue expansionary stance even in the face of rising asset prices. The Bank of Korea lowered call rates further down from 4.25% in June 2002 to 3.25% in November 2004.

Initially the expansionary monetary policies did not cause the general prices inflation. However, as the more money was poured into capital and asset markets, it set off the spiral of stocks and housing price hikes. In this period, asset prices were increasing sharply, while general prices were remaining stable and expected to remain stable.

Higher asset prices tend to raise consumption and investment through the wealth effects and higher collateral values. In the US, due to the wealth effects and massive refinancing of home mortgages with lower interest rates, the household increased consumption and saving rate fell sharply from 2.5% in the summer of 2003 to minus 1.6% in summer 2005. An increase in asset prices also tends to stimulate investment via Tobin's q-theory-like investment decision.

In Korea, it is not difficult to identify the symptom of bubbles in asset markets. When Korea suffered from asset price bubbles in 1991, the ratio of apartment prices to personal income in the south of Han River area reached 20 and then came back to

10 prior to the banking and currency crisis in 1997. At the end of 2005, however, the ratio reached again 20. With the introduction of blueprint of developing Korean peninsular, land prices also rose very rapidly from 2002 to 2005.

Rapid hike in asset prices did not contribute much to the economic recovery. Instead, impacts of real asset prices on consumption and investment were rather modest. With housing price hike, many households expected the continued increase of housing prices and borrowed heavily from banking sector to purchase houses in a promising area. There had been some sort of speculative demand for housing. Therefore, the proportion of household loans made by commercial banks rose very sharply at the end of 2005, reaching more than 50% of their total loans and more than 60% of them were housing collateral loans. In addition, more than 86% of household loans were made out in terms of floating rates. Burdens of interest payments on new housing loans dampened the rate of increase in household consumption.

Contribution of rising asset prices to overall investments was not so significant either. This was because investors were more concerned about prospects of economic future rather than the current q value.

With a time lag, increase in money supply began to raise the general prices. Also increase in raw materials and oil prices brought price hikes on the supply side. In the face of inflationary pressure, the Bank of Korea reversed its interest rate policies and raised call rates 4 times, each time by 25 basis points from October 2005. Currently call rate stands at 4.25%. Increase in interest rates aimed at stabilizing both general and real estate prices.

We know that the expected welfare losses involved in bubble and sudden burst are volatile fluctuation of incomes and prices as well as instability of financial system resulting from accumulation of non-performing loans. Even though a bubble was

allowed to take place in the asset markets, it is in the best interest of Korea to have gradual downward adjustments of asset prices. Therefore, call rates were raised gradually to cope with inflationary pressure as well as to prevent hard landing of the Korean economy due to a sudden burst of bubble. It is believed that the deflationary costs of sudden collapse of the bubbles in later period outweigh those costs associated with gradual adjustments over several periods.

In Korea, lax monetary policies were directly linked to bubbles in asset markets. To some extent, asset price increases were due to speculative demand in asset markets. Interest rate influence on the bubble busting probability is quite high. And the cost of sudden collapse of bubble is very high. It might lead to financial instability with a large amount of housing collateral loans. Welfare loss from volatility of inflation and output due to a boom and bust is expected to be high.

Under this circumstance, it is right for the Bank of Korea to respond to sharp asset price increases with restrictive monetary policies, taking gradual adjustment approach since costs of sudden collapse of bubbles are expected to outweigh benefits.

In the face of inflationary pressure, the Federal Reserve Bank raised federal funds rate from 1% in mid 2003 to 5% in early 2006. The Federal Reserve Bank raised federal funds rates to cope with inflationary pressure and current account deficits. Recent monetary policies in the US will undoubtedly contribute to stabilizing general and asset prices and reducing current account deficits.

As well known, the current account deficits in the US at the end of 2005 reached 800 billion dollar and this was more than 6% of its GDP. Asset price hikes reduced savings and increased consumption on imports, leading to a large amount of current account deficits.

If the US is ready to cope with inflationary pressures as well as global imbalance, the optimal policy mix will be restrictive monetary policies and depreciated dollar. The dampening effects of restrictive monetary policy will be partially offset by the increased net exports with more competitive dollar. The US can pursue the policy of competitive dollar without worrying much about hard landing of its own economy. Since the US dollar is vehicle currency, it can finance its current account deficit with its own currency and the debt outstanding of the US is denominated in dollar terms. Therefore, the dollar can be depreciated without adverse effects that followed currency declines in other countries.

The recent rise in call rate of Korea to 4.25% reduced gap between the US federal funds rate and the call rate. Reduced gap between the two rates will help reduce the influence of capital flows on the foreign exchange rates movement. Since Korea still enjoys substantial amount of current account surplus, Korea might be under pressure to appreciate Korea Won in correcting global imbalance. Therefore, it is not desirable that widening gap causes the outflow of foreign capital and thus leads to further depreciation of the Korean won. Foreign exchange rate policies should be aimed at preventing over-fluctuation of foreign exchange rates and working in the direction of correcting global imbalance.