

# New Challenges Ahead For Central Banking

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## Opening

Governor Lee of the Bank of Korea, Governor Narube of the Reserve Bank of Fiji, President Poole of the Federal Reserve Bank of St. Louis, Professor Mishkin, distinguished guests, ladies and gentlemen.

It is a true pleasure for me to be here at this luncheon. I also feel extremely honored to have this opportunity to comment on the conduct of monetary policy in an environment of low inflation.

## Changes in Economic Environment and Conditions for Monetary Policy

Since the 1990s, the world economy has enjoyed a long and sustained period of low prices, while at the same time experiencing steady growth.

It has been frequently noted that there are two main factors contributing to this economic picture.

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One is the recent increase in industrial productivity stemming from technological advances. We have seen earlier periods in history when prices have fallen due to technological innovation and, at the same time, robust economic growth has occurred. What we are seeing in today's world has some features in common with these periods in the past.

The other major factor shaping today's economic environment has been the huge new supply of labor from developing countries such as China and India. According to Professor Freeman at Harvard University, the global labor force has nearly doubled since the integration of China, India, and the former Soviet bloc into the world economy. This large workforce, especially China's, contributes to keeping prices at low levels, as low price goods from these countries are now made available to consumers around the world.

At the same time, I think it is important to also note the role that central banks have played, in successfully defending their economies from inflationary pressures. Most industrial countries experienced double-digit inflation in the 1970s, while simultaneously suffering from high unemployment. Under these circumstances, central banks were determined to achieve price stability by implementing vigorous policy measures to lower inflation. In the early 80s, for example, the U.S. Fed raised short-term interest rates to unprecedented levels, which effectively restored its credibility in keeping inflation low. For the Fed's strategy succeeded, and it now still enjoys a high reputation for its ability to maintain price stability.

In a world economy that has experienced continuing low prices for an extended period of time, most central banks are faced with new challenges.

With prices expected to remain at low levels, financial market interest rates are expected to remain low as well. When interest rates are extremely low, however, there may be little room for lowering them further, even if current and prospective

economic conditions require expansionary monetary policy. Thus, in an environment of low inflation, monetary policy might not be as effective as before.

It is also interesting to see how general prices have remained stable while asset prices have risen rapidly in many countries. Whether or not the central bank should intervene in this case is still debated. Some argue that the central bank should in fact react to this sharp increase in asset prices, since the welfare of most people depends greatly upon prices of assets such as housing. Others, on the other hand, contend that it is undesirable for a central bank to respond to rising asset prices unless they affect the level of general prices as well.

The recent rapid progress of globalization poses additional new challenges to central banks. As international capital markets become more integrated, and with the increasing capital flows between countries, price variables such as interest rates, stock returns, and foreign exchange rates are more closely linked among countries than before. It therefore becomes harder for any single central bank to implement its monetary policy independently of the policies of central banks in other countries.

The Korean economy has of course also experienced the changes I have described here in its own economic environment long-term price stability, rising asset prices, and rapid globalization. Thus, the Korean economy also faces the very same challenges I have mentioned.

## **Monetary Policy in a Changing Economic Environment**

With the economic environment changing dramatically, both domestically and abroad, it is a challenge for the Bank of Korea to implement an appropriate monetary policy.

I believe that the first priority of the Bank of Korea should lie in maintaining price stability, and currently price stability is the sole objective prescribed under the Bank of Korea Act. The Bank of Korea Act, for everyone's information, was revised at the end of 1997, when Korea was undergoing its financial crisis. With the revision of this act, the Bank of Korea became more independent from the Korean Government, and since that time has employed an inflation targeting system for its conduct of monetary policy.

In this regard, as Professor Mishkin pointed out in his keynote speech today, it is generally believed that the low inflation worldwide, since the 1990s, is partly attributable to the greater independence of central banks and to their adoption of strong nominal anchors.

At this stage, therefore, I consider it quite appropriate that the Bank of Korea embrace an inflation targeting system, one of the strongest nominal anchors for keeping inflation under control. For this purpose, of course, working to establish greater credibility with market participants is crucial. This can be done through more precise analyses of the economy, through better communication with the market, and through greater monetary policy consistency. In addition, if it finds the effectiveness of its monetary policy to have diminished over time, the Bank of Korea will also need to develop better and more effective policy instruments.

I also believe that the Bank of Korea should play a greater role in both the real economy and the financial system. I hope that the Bank of Korea will in the future take on some responsibility for the achievement of full employment and for maintaining the stability of the financial system.

For a central bank to fulfill such responsibilities successfully, it of course needs to be independent of political pressure. I should stress as well, however, that the central

bank also needs to be independent from the market. Although the central bank should communicate with market participants effectively, this does not imply that the central bank must always follow the opinions of market participants. The central bank should lead the market, and implement pre-emptive policy measures when necessary.

### **Concluding Remarks**

The Korean economy's prices and interest rates have remained at low levels in recent times, and what is at issue for us now is the effective implementation of monetary policy in this new environment.

This is the reason why the Bank of Korea has chosen "Monetary Policy in an Environment of Low Inflation" as the subject for this year's conference.

I am sure that this conference will be a great opportunity to explore this subject and search for effective ways of coping with the policy challenges I have just described.

Thank you very much for your time.