Comments on "Monetary and Exchange Rate Policies for Sustained Growth in Asia"

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Three trends and a big danger in Asian economies

- Three general trends in Asian economies
  - The growth rates of the major economies have slowed down.
  - Inflation rates have remained low since the GFC.
  - Real interest rates have dropped in line with the global interest rate trends.
- The dangers of ultra-low inflation
  - Costs of ultra-low inflation:
    - Relative prices become more difficult to change.
    - Fear of deflationary spiral
  - Raising inflation back to 2% is much harder.
  - Low inflation will reduce monetary policy space when the next recession comes.

  * The case of Korea: Inflation rate (1%) + Equilibrium real interest rate (0%) = New normal policy rate (1%)

Some Asian economies need further expansionary MP

- Monetary policy is still a valid tool.
  - The Phillips curve is not dead/dormant/non-linear.
- AEs have the scope for unconventional monetary policy.
  - Negative policy rate
  - QE
  - B/S policies
- CBs may have to make greater use of B/S policies to offset impacts from another taper tantrum.

Financial stability concern should not constrain MP

- Higher policy rate would not solve the quandary of financial stability.
  - Costs of higher interest rate would be larger than its benefits.
  - There is little historical evidence that low interest rate environments are inherently unstable.
  - Monetary policy should focus on price and output gaps rather than financial stability issues.
- Prudential policies need to be adapted to curb risks for financial stability.

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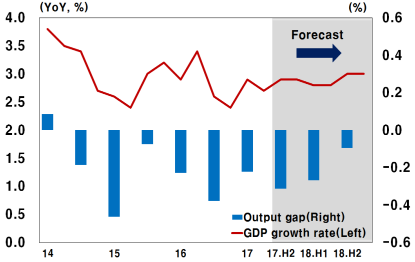
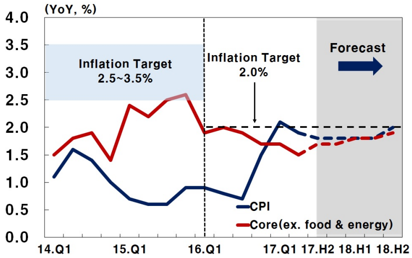
Recent trends and prospects of output and inflation

- The economy has improved with the help of the recent global recovery. The output gap is forecast to shrink gradually.
- CPI inflation has risen from 1% to around the inflation target of 2% this year.
- Core inflation has been hovering at the upper 1% range, and the gap is expected to close next year.

GDP Growth



Inflation Trends

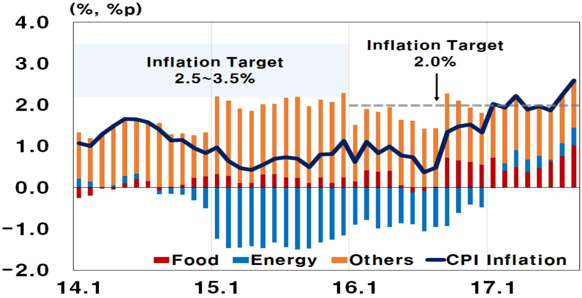


Source: The Bank of Korea

Underlying factors of the low inflation rate before 2017

- Oil prices are the main driver of the deviaton of inflation from the target.
- The negative contribution of energy products to CPI inflation turned positive after the 1st quarter of this year.

Contributions to CPI inflation

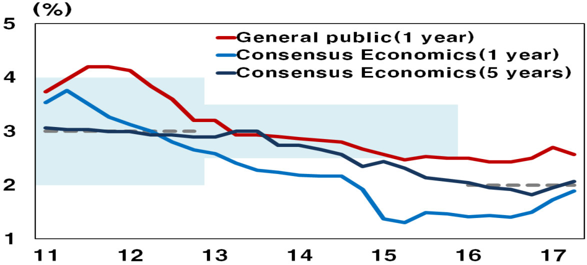


Source: The Bank of Korea

Inflation expectations are not stuck at a low level

- Inflation expectations don't seem to be stuck at a low level as in Japan.
  - Recently, the inflation expectations of professionals have picked up following actual inflation rates.
  - The inflation expectations of the general public have stayed well above 2%.

Inflation Expectations



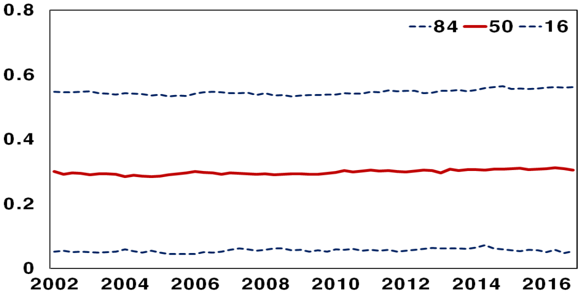
Source: The Bank of Korea

The Phillips curve is not flat

- The Phillips curve estimation is sensitive according to its specification.
- However, in a Phillips curve augmented with inflation expectations, its slope is estimated at around 0.3 and is quite stable after 2000.

$$\pi_t = \pi_t^e + \theta_t \ gap_t + \phi_t \pi_t^m + \epsilon_t$$

Trends of Phillips Curve Slope (θ_t)

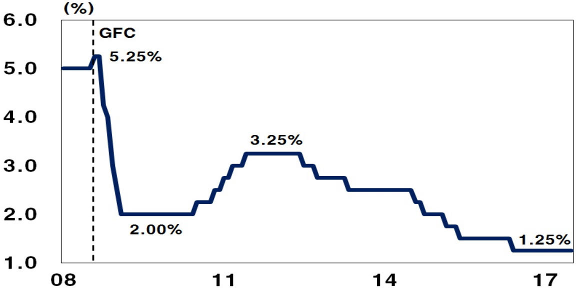


Source: BOK staff estimation

Policy Rate Trends

- The Bank of Korea has held its policy rate down to the historically lowest level of 1.25% since Jun 2016.

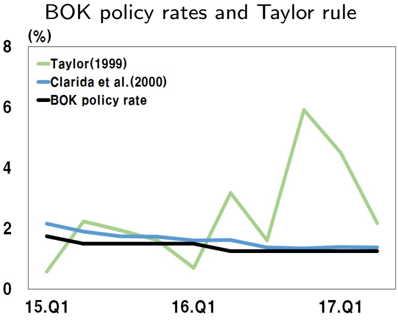
Policy rate of BOK

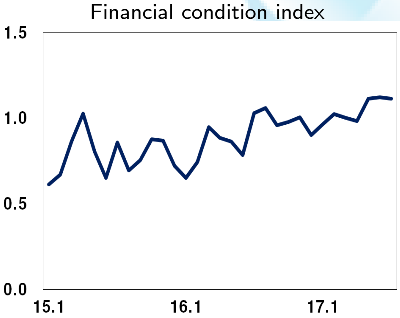


Source: The Bank of Korea

Evaluation of monetary policy stance

- Policy rate has been lower than Taylor rule rates and neutral rates.
- Conditions in financial markets have remained loose.



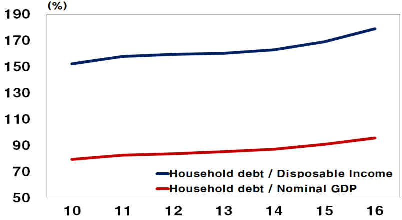


Source: BOK staff estimation
Taylor (1999) $i_t = 2 + \pi_t + 0.5(\pi_t - \pi^*) + (y_t - y^*)$
Clarida et al. (2000) $i_t = (1-\rho)\left\{i^* + (1-\beta)\pi^* + \beta\pi_{t+4} + \gamma(y_t - y^*)\right\} + \rho i_{t-1}$

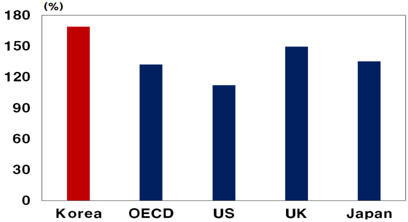
Limitations of prudential regulatory policies on financial stability

- Prudential regulatory policy may not be effective enough to constrain the side effects of the sustained low interest rates.
  - Houshold debt has been increasing since the GFC even though prudential regulations were strengthened.
- Coordinations for policy mix are not always warrented when authorities are separated.

Trend of household debt



Houshold debt to disposable income

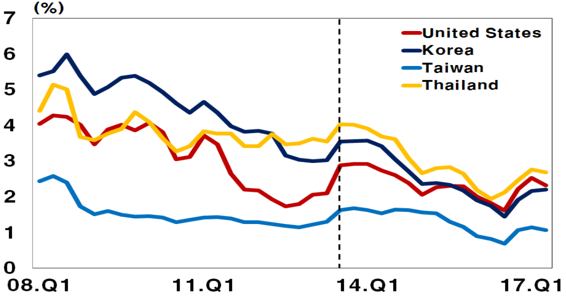


Sources: BOK, OECD

Preparing for another possible "taper tantrum"

- Another taper tantrum in the near future is one of major concerns.
- The BOK is on the alert and ready to react with various policy tools.

Bond yields and the taper tantrum



Source: Haver Analytics

Thank you!