Current Policy Challenges Faced by Emerging Market Economies and Korea

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1. Introduction

I would like to begin with a discussion of the policy responses of emerging market economies (EMEs) to monetary policies of advanced economies. I will suggest the likely response of EMEs to tapering of quantitative easing (QE). One of the recent interesting developments in this regard is that they did not respond uniformly to Chairman Bernanke's announcement of possible QE tapering in May and June 2013, which sheds light on the present heterogeneity within the EME group. EME policymakers should consider various factors ranging from economic fundamentals to the long-term challenges that their economies are facing. As a specific example, I will describe current challenges faced by the Korean economy.

2. Monetary Policy Normalization and EME Policy Options

Prospects for Monetary Easing and Portfolio Rebalancing

First I will discuss advanced economies' monetary policy normalizations and policy options for EMEs. Central banks' active provision of liquidity, dubbed unconventional monetary policy, is now widely accepted as a weapon belonging to the central bank arsenal. With the U.S. economy recovering, policymakers are steering the economy toward a new normal—a process accompanied by normalizing the central bank balance sheet and thus reducing liquidity supply. QE tapering in the United States is expected to start in the near future, but the European Union and Japan have not yet witnessed any clear signs of recovery or inflation to presage a change in course. The U.S. Federal Reserve's reduction in liquidity provision will initiate global portfolio rebalancing, forcing EMEs to deleverage or unwind the liquidity that flowed into them during the time of QE.

The driving force behind global portfolio rebalancing would be the U.S. recovery and the concomitant normalization of U.S. interest rates. As expectations of the Fed's QE tapering build, investors in advanced countries become concerned about a projected depreciation of EME currencies. If the Fed decides

to initiate tapering, the markets will turn bearish in the short run, but the decision may also reassure the markets that the economy is on the right track for recovery. Recovery in advanced countries is good news for exporters in EMEs.

Global Liquidity and EME Responses

Along with portfolio rebalancing on a global scale, changes in policy-driven liquidity from advanced economies have a direct impact on EMEs. My understanding on this matter is largely based on the recent study I conducted with my colleagues at the Bank of Korea.[1]

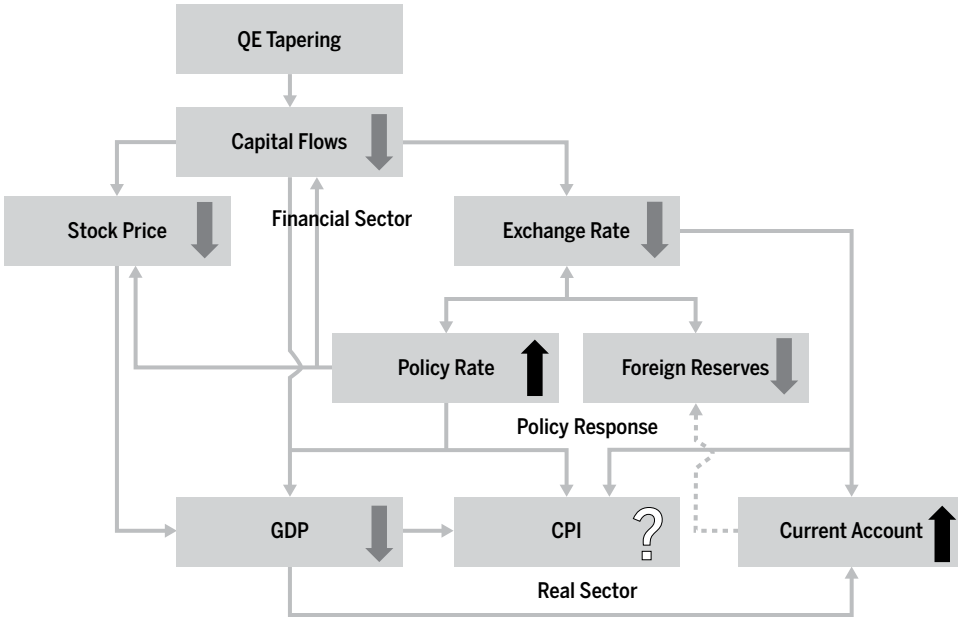
This study derives three global liquidity catalysts from financial data of advanced economies and then analyzes their impacts on EMEs using a panel vector autoregression. The three global liquidity catalysts are exogenous liquidity, endogenous market liquidity, and risk aversion (negative risk appetite). The exogenous liquidity momentum is identified as a policy-driven factor: It increases with the monetary base and decreases upon a policy rate hike.

In the context of this study, QE tapering is regarded as a negative exogenous global liquidity shock to EMEs, having impacts on their financial sectors, which induces policy reactions. The shock and reactions together determine QE's overall impacts on growth, inflation, and the current account in each country.

As summarized in Figure 1, a negative exogenous liquidity shock brings about capital outflows from EMEs, causing the exchange value of the national currency and stock prices to tumble. In response to nominal effective exchange rate depreciation, the authorities increase the policy rate and release foreign reserves to support the currency in a bid to fend off a crisis. Output then suffers from a lack of funds because of the outflow of foreign funds and the scarcity of domestic funds owing to monetary policy tightening. If foreign funds had been directed mainly toward the demand side of the economy, the shock that unwinds foreign funds will exert deflationary pressure. This deflationary pressure is offset by an inflationary pass-through effect from currency depreciation, leaving the ultimate impact on the price level unclear. A silver lining to this economy characterized by sluggish demand and depreciation is a current account surplus, which may moderate concerns over the crisis to some degree.

Tighter policy and release of foreign reserves to avoid leakages of foreign funds are rationalized in terms of the aim of retaining the foreign funds domestically and limiting exchange rate volatility. However, a policy rate hike is controversial since it may further worsen already sluggish growth, leading eventually to enlarged outflows.

FIGURE 1
Effects of QE Tapering and EME Policy Responses



QE Tapering and EME Responses

What I have just described is the average response of EMEs as drawn from data analysis. The recent reaction of global investors to the Fed's announcements regarding the possible QE tapering sheds light on the pattern of differentiation within the EME group (see Figure 2). Between May and October 2013, most Asian EMEs saw their currencies depreciate, and some EMEs suffered a loss of more than 5 percent in their stock market capitalization. The two main exceptions were China and Korea, whose currencies strengthened and whose stock markets turned bullish. Countries with external vulnerabilities—such as the so-called fragile five (India, Indonesia, Brazil, South Africa, and Turkey)—faced sudden capital outflows.

Capital outflows in turn are attributable to persistent deficits on the current account (see Figure 3). The fact that the fragile five also run persistent and large budget deficits suggests that their current account deficits may be engendered by weak fundamentals associated with fiscal deficits and that mounting concerns over external and fiscal sustainability may call for capital outflows.

FIGURE 2

EME Market Responses to Bernanke's Remarks

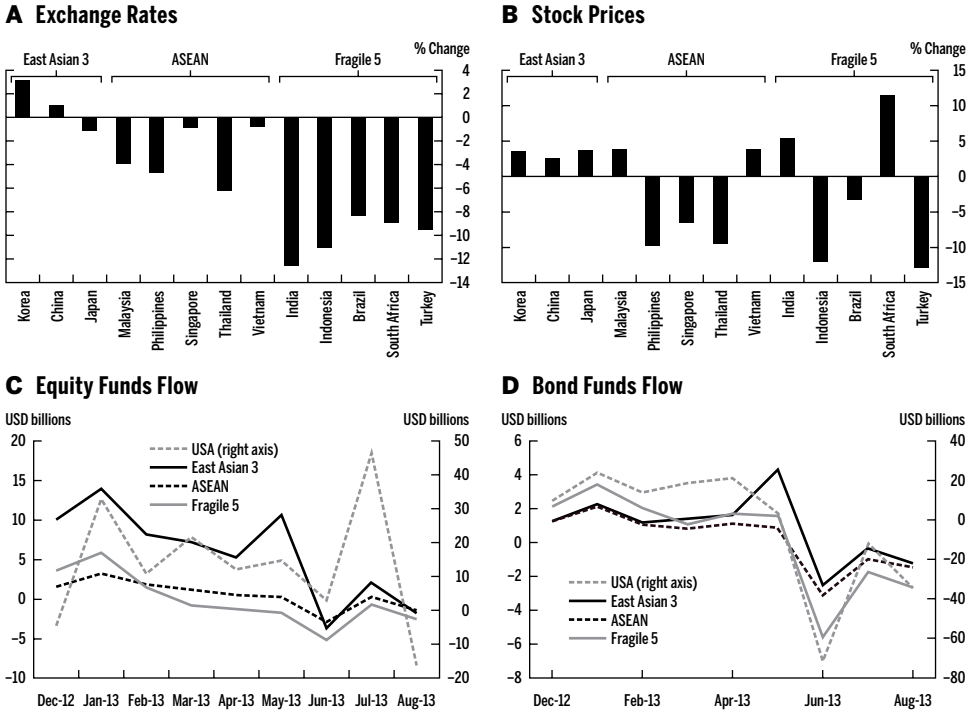
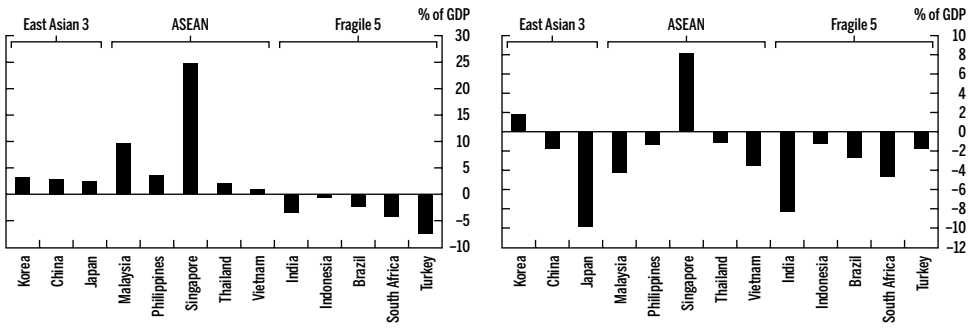


FIGURE 3

EME Fundamentals



Note: Percent of GDP is calculated as three-year average.

EME Policy Choices

In retrospect, the signaling of possible QE tapering served as a test run. The differing outcomes within the EME group left individual countries with two policy options: a defensive policy to fend off a crisis, or a domestic-oriented policy to neutralize or cushion the impact of fund outflows.

A defensive policy would be the conventional choice, as in the panel VAR model I mentioned. Such a policy incorporates a hike in the policy rate and the release of foreign reserves. However, the higher interest rate entails the weakening of the domestic economy, rendering its equity markets less attractive to foreign investors, thereby accelerating fund outflows and currency depreciation. Releasing foreign reserves may also backfire if the level of remaining foreign reserves is perceived as inadequate or if the pace of reserve drawdowns is too fast.

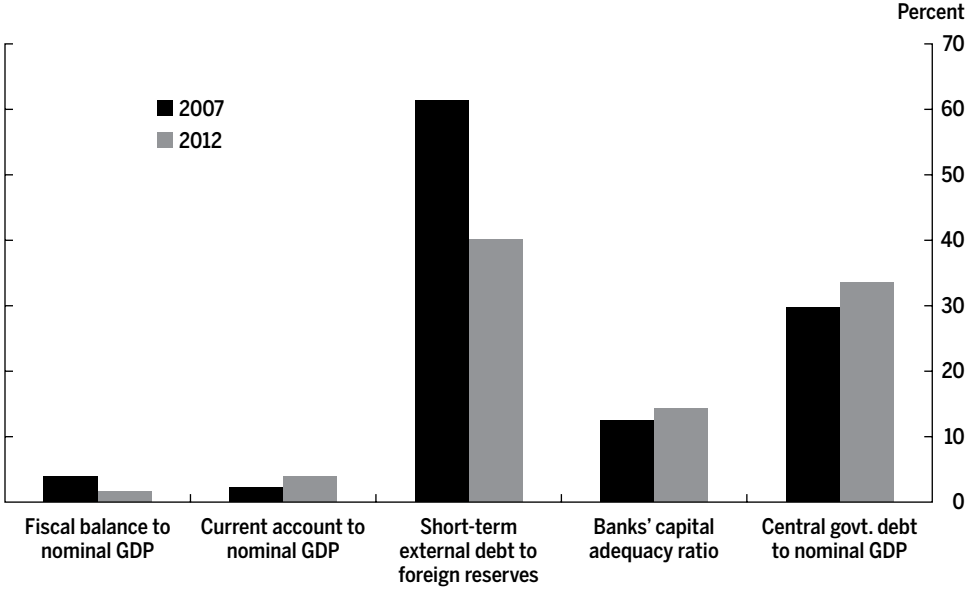
The alternative choice would be a domestic-oriented policy. Countries with solid fundamentals can determine the policy rate to achieve a policy objective in terms of inflation or employment. They may opt to maintain the policy rate while other EMEs increase theirs. If there is little concern about a financial crisis, policymakers may craft their policy for domestic goals even under an external shock that temporarily destabilizes the foreign exchange market. They could also deploy foreign reserves to smooth out excessive volatility in the foreign exchange market. The downside of this policy is that the relatively low interest rates speed up the draining of foreign funds from the bond market, further weakening the domestic currency and raising concerns about financial stability. Where the domestic financial system is still far from being mature, the additional liquidity resulting from the low policy rate may not penetrate those sectors in need of liquidity but be hoarded by financial institutions.

The choice between the two policy options will depend largely on the macroeconomic fundamentals of the particular economy and the nature of the driving shock—a push or pull factor. Having said that, those countries with weak fundamentals—such as twin deficits and high inflation pressure—do not have sufficient room for policy maneuvering. If global factors dominate the nature of the external shock, the efficacy of monetary policy may be limited.

3. Korea's Challenges in Policy Implementation

Now I turn to the case of Korea. Korea has experienced currency appreciation and stock price increases since May 2013. To my mind, these strong developments are attributable to the country's improved fundamentals since the 2008 financial crisis (see Figure 4). In particular, Korea's policy efforts have

FIGURE 4
Indicators of Macro-Financial Soundness in Korea



brought about banks' improvement in capital adequacy and a sharp drop in the ratio of short-term external debt to foreign reserves. The current account has improved—owing to the strong performance of globally competitive Korean firms and weak domestic demand. In the meantime, the budget surplus has shrunk upon the implementation of stimulative fiscal programs.

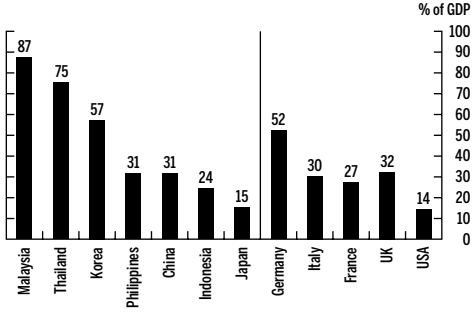
Although short-term fundamentals do not pose an immediate concern, Korea has its own share of challenges. The first challenge is imbalance between domestic demand and export-driven demand. Exports account for more than 50 percent of Korea's GDP (Figure 5A). This imbalance may be partly attributable to the slow pace of the development and integration of regional financial markets, especially the bond markets (Figures 5B and 6).

The second challenge is the combination of disparity in sectoral savings and subdued corporate investment. While the total saving rate has been slowly decreasing, the increase in the corporate saving rate has largely compensated for the decrease in the household saving rate since 2000 (Figure 7). This implies that retained earnings are neither being reinvested nor paid out as dividends to boost household income. While the saving-investment gap in Asia has narrowed

FIGURE 5

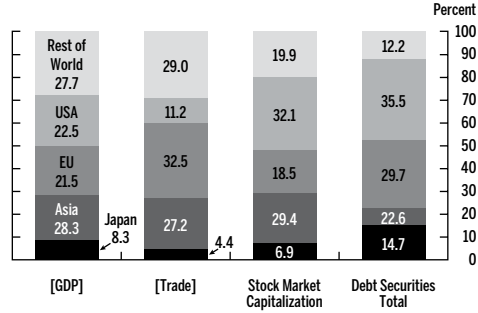
Imbalance between Domestic Demand and Export-Driven Demand

A Export of Goods and Services (2012)



Source: World Bank, WDI, 2013.

B Asia: Share in the World Economy (2012)

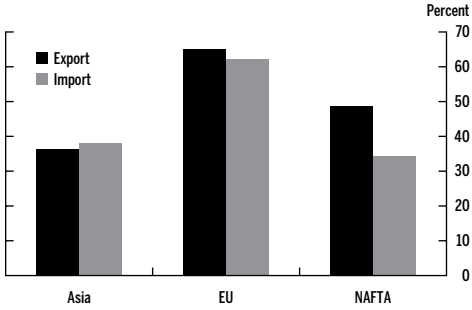


Source: IMF, GFSR, 2013, World Bank, WDI, 2013.

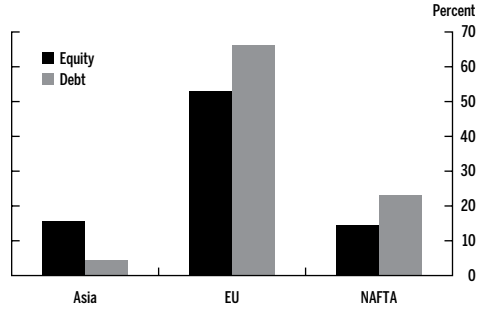
FIGURE 6

Intraregional Trade and Stock/Bond Investment (2012)

A Intraregional Trade



B Stock/Bond Investment

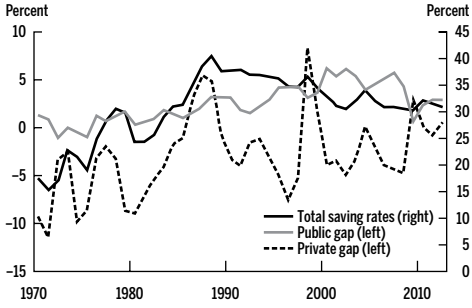


Source: IMF, DOTS and CPIS database.

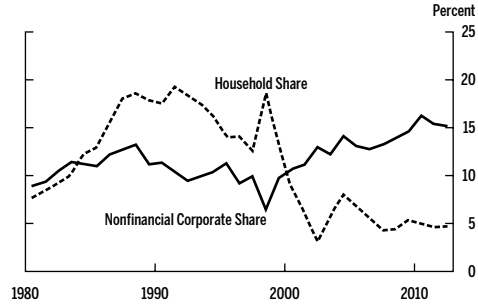
FIGURE 7

Saving Rates in Korea

A Saving-Investment Gap



B Private Saving Rate

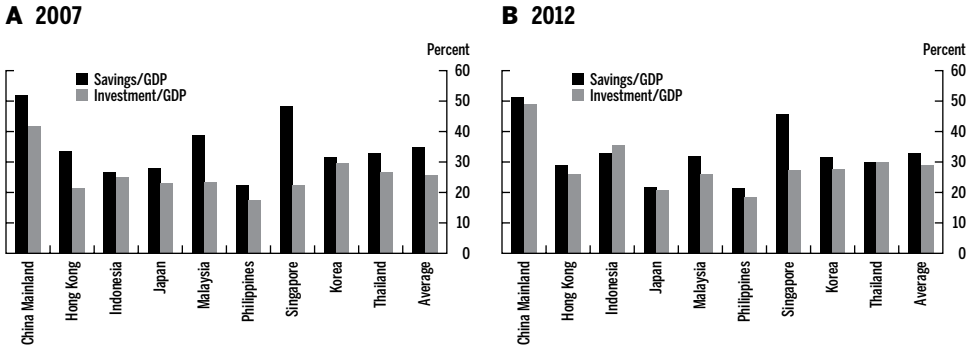


Source: Bank of Korea, ECOS.

since the global financial crisis (Figure 8), reduced savings are coupled with lower investment. In Korea, the recent sluggishness of investment—substantially attributable to heightened policy uncertainty—could weigh on the economy in the long run by constraining its growth potential.

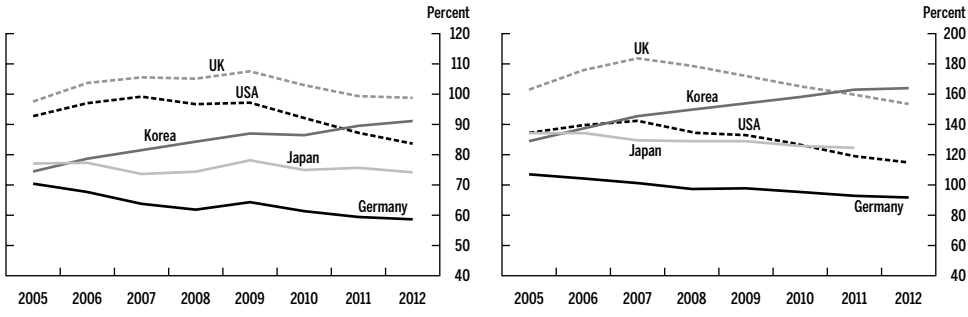
The third challenge is household debt. The ratio of household debt to disposable income in Korea now stands at 160 percent, having steadily increased even after the global financial crisis, in contrast to the situation in the major economies (Figure 9). At this point, household debt does not seem to drag down demand, and the associated risks are under control. Household debt will be manageable unless very large shocks strike. However, prudent caution should be exercised, especially for vulnerable groups (say, multiple-loan borrowers,

FIGURE 8
Savings and Investment in Asia



Source: IMF, WEO.

FIGURE 9
Household Debt



Source: BOK staff calculation.

low-income or old-age groups, and self-employed households) to ward off potential spillovers.

4. Closing Remarks

To sum up, the prospective QE tapering will call for global portfolio rebalancing whose impacts on individual countries in the EME group will be diverse. Individual countries may opt for a defensive policy to ward off a crisis, even at the cost of domestic goals. Alternatively, they may choose a domestic-oriented policy which has its own set of benefits and risks. The challenge is then where to place a fulcrum between global and internal factors in forming the policy positions. While Korea currently benefits from strong and seemingly resilient fundamentals, it faces eventual structural challenges such as the shortfall of domestic demand, weak linkages between savings and investment, and household debt overhang—not to mention the presage of demographic changes.

I close my remarks with some suggestions for policy coordination. Governor Powell suggested the gradual restoration of advanced economies' monetary policy, taking into account international linkages. In this regard, I would like to note as follows. Advanced economies and EMEs are more than ever intertwined, and global policy coordination is critical for the sustainable growth of the global economy. Advanced economies are asked to provide transparent and consistent policy signals to reduce policy uncertainty. EMEs, for their part, have to improve the macroprudential soundness of their financial systems and implement structural reforms to strengthen their fundamentals. Furthermore, once global investors suspect a crisis in one or two vulnerable countries within a peer group, this could provoke panic reactions across comparable EMEs. Against this backdrop, efforts to strengthen the global/regional financial safety net should be a matter of high priority. Korea has recently agreed on bilateral currency swap lines with Indonesia, the United Arab Emirates, and Malaysia. Our moves are likely to help the entire cohort of EMEs better withstand negative external shocks.

Finally, in the event of a global liquidity crunch, central banks would need to carry out appropriate policies of credit easing to ensure the seamless supply of funds to those vulnerable sectors hit by an abrupt credit crunch. EMEs are prone to financial market failures owing to information asymmetries and financial infrastructure shortages. The Korean economy is faced with sectoral liquidity shortage amid ample aggregate liquidity. Funneling aggregate liquidity by the central bank into market liquidity and loans for investment could be called a "modern reincarnation" of credit policy. In light of this, a contemporary

reincarnation of credit policy could help restore growth potential and rebalance liquidity flows.

NOTE

1 The results of the research project, entitled "Global Liquidity Momenta and EMEs' Policy Responses," were presented at the 2013 Bank of Korea annual international conference.