Safeguarding Financial Stability in a Diverging Global Economy

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1. Upcoming Fed Rate Hike and EMEs: How Is This Time Different?

→ Growing disconnect between real economy and financial cycle

1-A GDP Growth Rates

1-B Composition of Foreign Investment

1-C Bond Term Premiums

1-D Private Credit/GDP

Note: Based on 10-year government bonds. Source: Bank of Korea
2. Macroprudential Policies in Korea since Global Financial Crisis
→ To make financial system more resilient and less procyclical

- Macroprudential policy more desirable than monetary policy for preemptively addressing financial imbalances in open EMEs (Hahm, Mishkin, Shin and Shin, 2012)
  - Financial cycles in open EMEs often driven by global liquidity conditions
  - Tighter monetary policy to lean would only attract additional capital inflows

- In aftermath of global financial crisis, Korea has introduced diverse macroprudential policy tools, to ensure that capital inflows through banks and bond markets do not lead to excessive procyclicality, and to avoid credit and housing bubbles
  - Leverage cap on FX derivatives positions (introduced in 2010)
  - Macroprudential bank levy on non-core foreign currency bank liabilities* (2011)
    * As evidenced in Hahm, Shin and Shin (2013), and in Bruno and Shin (2015), rapid accumulations of non-core bank liabilities signal vulnerabilities to systemic risk spillovers in EMEs, and fluctuations in non-core bank liabilities are directly linked to cross-border capital flows
  - Taxation of foreigners’ bond investment (reinstated in 2011)
  - LTV and DTI regulations for home mortgage loans (strengthened in 2009)
  - Loan-to-deposit ratio regulation (reinstated in 2010)
2. Macroprudential Policies in Korea since Global Financial Crisis

→ Helped to contain build-up of financial imbalances

2-A Corporate Credit/GDP

2-B Household Credit/GDP

2-C Bank Non-core Liabilities/GDP

2-D Bank Short-term External Debt Ratio
3. Potential Financial Vulnerabilities and Policy Challenges:

1) Capital Outflow Risk

- US policy rate hike could trigger outflows of short-term capital, giving rise to significant negative externalities for real economy
- Foreign capital flows remain stable, as Korea differentiated from other EMEs
- However, possibility of capital outflows despite our robust economic fundamentals, as share of portfolio investment has grown rapidly
  * Volatility of portfolio flows relatively high in Korea compared to other EMEs
  * Share of global institutional investors high, and portfolio flows thus much affected by global factors

3-A Outstanding Balance of Foreign Financial Investment in Korea

3-B Impulse Response of Won-US Dollar Exchange Rate to VIX Shock
3. Potential Financial Vulnerabilities and Policy Challenges

2) Rising Household Debt

- Trend of increasing household debt has accelerated, owing to temporary easing of LTV and DTI regulations along with reduced policy interest rate

- Korea’s household debt-to-GDP ratio 85% - possibly approaching threshold level beyond which it may begin to constrain consumption spending

- However, at this point possibility of systemic risk materializing judged to be low, according to stress test results (Bank of Korea, 2015)
  * Under combined shock of 200bp rise in interest rates and 10% housing price decline, proportion of households at risk would increase to 14.2% (from 10.3% at present), and proportion of debt at risk to 32.3% (from 19.3%)

- Housing prices also do not seem greatly overvalued in Korea

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4-A Price-to-Income Ratios

4-B Price-to-Rent Ratios
4. Financial Stability Policy Framework and the Central Bank

→ Harmonization of monetary and macroprudential policies crucial

- **Macroprudential policies**, the first line of defense in open EMEs, not always sufficiently effective due to political pressures. Further, accommodative monetary policy without consideration of financial stability concerns may lead to excessive risk taking.

- Possible approaches to considering financial stability risks in formulating MP strategies:
  - Consider financial stability implications in setting medium-term inflation target.
  - Consider financial stability risks in setting target path for output.
  - Consider financial cycles when estimating real neutral interest rate.

* But caution needed about risk of reducing inflation expectations through weakening public confidence in central bank’s commitment to inflation targeting.

- Essential to conduct macroprudential and monetary policies in harmonized and complementary manner:
  - Need effective, operating macroprudential policy governance scheme, which guarantees timely information sharing and cooperation among related institutions.
  - Need relevant institutional devices within policy framework, to maintain monetary policy independence and secure political neutrality in macroprudential policy.

- For open EMEs, ultimately, effective coordination of monetary and macroprudential policies will be key to simultaneous achievement of price stability, output stability and financial stability.