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The Bank of Korea in Historical and Comparative Perspective

by Thomas F. Cargill

Introduction

This paper reviews and evaluates the development of Bank of Korea policy in historical and comparative perspective. The historical perspective focuses on the most recent of the three stages of Bank of Korea development: the period from its establishment in 1950 to the start of liberalization in the early 1980s; from the early 1980s to the Asian financial crisis of 1997–98; and from the financial crisis to the present. The comparative perspective considers the Bank of Korea in the context of the Bank of Japan and the U.S. Federal Reserve System. The Bank of Japan and the Federal Reserve are meaningful bases for the Bank of Korea because of the historical and economic relationships among Korea, Japan, and the United States; the role Japan and the United States play in the world economy; and the influence at various times of the Bank of Japan and Federal Reserve on the institutional design and development of the Bank of Korea.

Central bank policy is a necessary foundation for sustained noninflationary economic growth, financial stability, and limited business fluctuations. Central bank policy errors in monetary control and lender-of-last-resort responsibilities have serious consequences for the real economy; and, although proper central bank policy is not sufficient to generate economic stability, it is a necessary condition for economic stability. The post–World War II experience of a large number of countries provides ample evidence of the adverse impact of central bank policy errors, especially those that generated high and unstable inflation rates and stagflation in the 1970s and 1980s. In response to these failures and in the context of advances in the theoretical, historical, and institutional understanding of central bank policy, central bank policy outcomes improved after the 1970s when judged by the general decline in average inflation rates after 1990 (***Table 1***). Improved central bank policy outcomes have been accompanied by major institutional redesign of central banks during the past two decades.

Central banks are now more accountable, more formally independent from government, and more transparent than at any time in their history. In a

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Dr. Cargill is a Professor of Economics at the University of Nevada, Reno.

***Table 1*: Average Consumer Price Inflation Rates in Selected Countries, 1975–2002**

	1975–85	1985–95	1995–2000	2000–02
World index*	**14.1**	**17.4**	**5.9**	**4.0**
Industrial economies*	**8.0**	**3.4**	**1.9**	**2.1**
United States	7.2	3.5	2.5	2.2
Euro area	7.3	3.4	1.7	2.5
Japan	4.7	1.4	0.3	-0.8
United Kingdom	10.6	4.5	2.5	2.2
Canada	8.1	3.3	1.7	2.4
Australia	5.0	5.2	1.9	3.7
New Zealand	13.4	5.7	1.4	2.7
Switzerland	3.3	2.8	0.7	0.8
Sweden	9.7	5.4	0.7	2.5
Developing economies*	**30.2**	**43.0**	**10.8**	**6.2**
Africa*	15.8	21.8	9.4	7.5
Asia*	8.5	8.7	5.1	2.7
China	3.1	11.7	1.8	0.1
Korea	12.0	5.8	4.0	3.4
Europe*	24.8	89.2	37.4	22.5
Russia (1991–)		155.5	32.6	17.0
Czech Republic (1989–)		18.5	6.7	3.3
Poland (1989–)		83.9	12.7	3.7
Turkey	44.0	65.1	73.7	49.6
Middle East*	16.7	16.3	7.9	4.2
Saudi Arabia*	4.2	1.0	-0.3	-0.5
Western Hemisphere*	62.4	143.7	12.9	6.8
Brazil (1980–)*	146.2	704.3	7.5	6.9
Mexico	39.6	41.2	19.1	5.7

Sources: International Financial Statistics, International Monetary Fund; Organization for Economic Cooperation and Development; China National Bureau of Statistics; Goskomstat of the Russian Federation. Table 1 was originally presented in Thomas F. Cargill and Elliott Parker, "Why Deflation Is Different," *Central Banking* 14, no. 1 (August 2003): 35-42.

* Data for 2002 were not available when table was constructed.

frequently cited 1997 paper, Marvin Goodfriend concluded that monetary policy had come of age in the twentieth century.[1] Goodfriend chronicled how central bank policy shifted away from short-run demand management and multiple goals to a single goal of long-run price stability. In Goodfriend's view, by the 1990s the limits of central bank policy and what central bank policy could realistically contribute to economic stability and growth were better understood. Goodfriend's perspective is definitely correct in regard to price stability outcomes (see ***Table 1***), but the experiences of the Bank of Japan and the Federal Reserve suggest the perspective might have been premature.

In Japan, the Bank of Japan played a major role in the run-up of real estate and equity prices in the second half of the 1980s. Easy monetary policy combined with a flawed financial liberalization process that encouraged imprudent lending were the direct causes of Japan's asset bubble from 1985 to 1989. The Bank of Japan then pursued tight policy until 1992 and then only gradually shifted to ease. As a result, Japan experienced a sharp disinflation from 1990 to 1994 and then deflation for the next decade.[2] The enhanced formal independence of the Bank of Japan in 1997 had no meaningful impact on policy outcomes as the deflation continued until at least 2005.

In the United States, the Federal Reserve likewise contributed to the run-up in residential housing prices from 2001 to 2005 by driving interest rates to their lowest levels in the post–World War II period. Even though the Federal Reserve shifted to tighter policy in June 2004, much of the liquidity generated from 2001 to 2004 had worked its way through the financial system to support a housing bubble aided by lax regulatory oversight, government subsidization of housing for low- to moderate-income households, and a willingness to justify imprudent lending standards by the expectation that house prices would continue to increase indefinitely. As a result of the financial crisis of September 2008, the Federal Reserve has dramatically expanded its balance sheet and involved itself in supporting specific sectors of the economy. Some have concluded that this amounts to a de facto industrial policy.[3] There is widespread concern that the large expansion of liquidity in the financial system represented by unprecedented levels of excess reserves held by depository institutions will provide the foundation for inflation. At a minimum, the Federal Reserve's commitment to price stability will be tested during the next few years.

The record of the Bank of Korea since 1997 is more positive. The 1997–98 Korean crisis made a fundamental impact on Korea's attitudes and willingness to redesign its economic institutions to be more competitive, open, and transparent. The December 1997 and August 2003 revisions of the Bank of Korea Act significantly changed the institutional design of the Bank of

Korea. The Bank of Korea is more transparent and independent than at any time since its establishment in 1950.

Bank of Korea policy contributed to rapid recovery from the 1997–98 crisis (***Table 2***) and stabilized inflationary expectations by a successful focus on price stability in the context of an inflation-target framework. Although many observers conclude the Bank of Korea has been successful in pursuing price stability,[4] at the same time, Bank of Korea policy is not without criticism. Easy monetary policy from mid-2001 to mid-2005 contributed to the run-up of consumer debt and housing prices although there is some debate as to how important monetary policy was to Korea's real estate bubble.[5] In any event, Korea recovered, and the Bank of Korea's "leaning" against the real estate bubble reduced the potential for a collapse of real estate prices as occurred in Japan and the United States.[6] Korea has not experienced a bursting of the real estate bubble to the degree of either Japan or the United States. Korea's financial system withstood the shock, and, despite a turbulent few months of economic and financial distress after the U.S. financial crisis of 2008, Korea appears to be recovering as 2009 comes to a close. The Bank of Korea in late October 2009 announced that GDP increased 2.9 percent in the third quarter following a 2.6 percent increase in the second quarter. The third-quarter increase in GDP was the strongest since the first quarter of 2002. The Bank of Korea also announced that the composite consumer sentiment index for October 2009 stood at 117, an increase from 114 in September.

In sum, Bank of Korea policy through 2008 can be judged successful in terms of price stability, and it has provided a clear message to market participants that price stability will be maintained in the future. This is a major policy success. Bank of Korea policy did contribute to a run-up of consumer credit and housing prices; however, general government policy and supply conditions were also important. In any event, despite the drop in house prices and the shift toward tighter policy in 2005, the Korean economy did not experience the degree of economic and financial distress of either Japan or the United States when real estate prices in those countries collapsed. In sum, the recent economic decline cannot be attributed to errors made by the Bank of Korea during the past decade.

Korea's current problems are not internal but are due to external shocks to the export sector and disruptions in the international financial system. Korea's economy has been hit hard by the financial crisis of 2008. Unemployment increased (it was 3.8 percent in July 2009) and real GDP declined 5.1 percent in the fourth quarter of 2008; it increased by only 0.1 percent in the first quarter of 2009. As stated above, however, the second and third quarters of 2009 saw significant GDP growth, and industrial production has

Table 2: **Macroeconomic Performance of Japan, Korea, and the United States, 2000–2008**

Country	Economic indicator	2000	2001	2002	2003	2004	2005	2006	2007	2008
Japan	Real GDP, annual percentage change	2.86	0.18	0.26	1.41	2.74	1.93	2.04	2.39	-0.64
	Inflation, average consumer prices	-0.78	-0.69	-0.89	-0.30	0.00	-0.30	0.30	0.00	1.40
	Unemployment rate	4.72	5.03	5.36	5.25	4.72	4.43	4.13	3.85	3.99
	General government balance as percentage of GDP	-7.64	-6.30	-8.03	-8.01	-6.15	-5.04	-4.00	-2.52	-5.55
	Current account balance, billions of $	$119.6	$87.8	$112.6	$136.2	$172.1	$165.7	$170.4	$211.0	$157.1
Korea	Real GDP, annual percentage change	8.49	3.97	7.15	2.80	4.62	3.96	5.18	5.11	2.22
	Inflation, average consumer prices	2.26	4.07	2.76	3.52	3.59	2.75	2.24	2.54	4.67
	Unemployment rate	4.43	4.02	3.28	3.57	3.68	3.73	3.47	3.25	3.20
	General government balance as percentage of GDP	1.08	0.55	2.22	2.53	2.08	1.79	1.72	3.47	1.12
	Current account balance/billions of $	$12.3	$8.0	$5.4	$12.0	$28.2	$15.0	$5.4	$5.9	-$6.4
United States	Real GDP, annual percentage change	3.66	0.75	1.60	2.51	3.64	2.94	2.78	2.03	1.11
	Inflation, average consumer prices	3.37	2.82	1.60	2.30	2.67	3.38	3.22	2.86	3.80
	Unemployment rate	3.97	4.74	5.78	5.99	5.54	5.08	4.62	4.63	5.81
	General government balance as percentage of GDP	1.62	-0.39	-3.79	-4.83	-4.35	-3.26	-2.24	-2.89	-6.07
	Current account balance/billions of $	-$417.4	-$384.7	-$461.3	-$523.4	-$625.0	-$729.0	-$788.1	-$731.2	-$673.3

Source: World Economic Outlook Database, International Monetary Fund, April 2009.

rebounded to its precrisis level. While these developments are encouraging, Korea's continued overreliance on exports, continuing U.S. economic and financial distress, and growing protectionism pose serious challenges for Korea's economy.

The post-1997–98 crisis performance of the Bank of Korea along with the institutional redesign in 1997 and 2003 suggest the Bank of Korea has come of age and is better positioned than at any time since its establishment in 1950 to contribute to a stable financial and monetary environment. This does not mean the Bank of Korea has not made mistakes during the past decade, but, compared with the precrisis period and the experiences of the Bank of Japan and the Federal Reserve, Bank of Korea policy outcomes have been positive. The remainder of the paper outlines the major features of the coming of age of the Bank of Korea.

A historical overview of the three phases of Bank of Korea development is provided in the next section. Then the key factors generating institutional redesign of the Bank of Korea and how developments in macroeconomic theory and the study of central banking practices guided institutional redesign of the Bank of Korea are described. Following that is a consideration of the 1997 and 2003 redesign of the Bank of Korea in comparison with the Bank of Japan and the Federal Reserve and in the broader context of the meaning of central bank independence. Then the transparency of the Bank of Korea is compared with the Bank of Japan and the Federal Reserve. A concluding section ends the paper.

Phases of Bank of Korea Development

There are three distinct phases of Bank of Korea development. The first phase covers the period of Korea's nondemocratic government from 1950 to the mid-1980s, during which Bank of Korea policy was constrained by authoritarian governments that used central bank policy as part of a government-directed industrial policy. Policy conflicts on occasion resulted in dismissal of Bank of Korea governors.[7] Price stability and prudential responsibilities took second place to government industrial objectives. The Bank of Korea under the administration of the government contributed to wide swings in the rate of inflation, supported financially weak corporations by making policy loans to specific sectors of the economy, and operated its discount window with the objective of preventing failures of financial institutions (mainly banks) and markets. The effects of unstable prices, support of financially weak corporations, and the moral hazard implicit in Korea's industrial policy were masked by the rapid industrialization of the Korean economy through the 1970s. By the 1980s, however, economic and financial distress

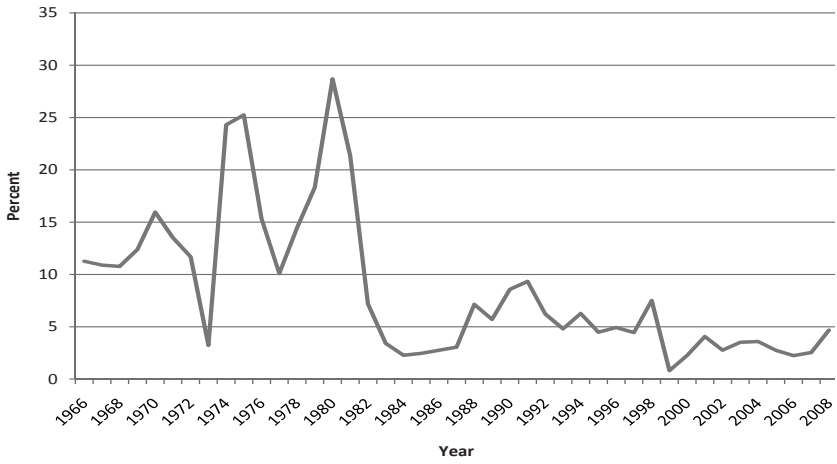
had accumulated to a point whereby the Korean government initiated its first liberalization efforts designed to stabilize the macro economy.

The second phase started in the late 1980s as government industrial policy began to unravel, and it ended with the economic and financial distress of 1997–98. During this period, Korea also completed a transition from military rule to democratic government. The Bank of Korea continued to be constrained by government policy objectives because of inertia from the past, continued to operate under administrative dominance by the Ministry of Finance and Economy, and suffered under the willingness of a growing class of elected politicians to use central bank policy to support client industries and sectors. As in the first phase, many of these problems were masked by rapid growth driven by exports as the world expanded in the 1980s and early 1990s.

The third phase commenced with the crisis of 1997–98 and the major institutional redesign of the Bank of Korea in 1997 and 2003. Revision of the Bank of Korea Act in December 1997 and August 2003 resulted in a major redesign of the Bank of Korea. The Bank of Korea became more focused on price stability, more independent of government, and more transparent. These institutional changes contributed to improved policy outcomes, especially in terms of price stability.

Figure 1 indicates the inflation rate of Korea's consumer price index during the period from 1966 to 2008. ***Table 3*** presents the average, standard error,

***Figure 1*: Inflation Rate of Korea's Consumer Price Index, 1966–2008**



Source: Bank of Korea, Economic Statistics System (ECOS), various years.

and coefficient of variance of the inflation rate over three periods: 1966–85, 1986–98, and 1999–2008. The rate of inflation declined significantly from the first to the second phase of Bank of Korea development. While the average inflation rate of 5.8 remained high, the variation of the inflation rate relative to the average declined significantly. The third period witnessed a continued decline in the inflation rate although the coefficient of variation remained essentially unchanged from the second period.

***Table 3*: Inflation in Korea's Consumer Price Index, 1966–2008 average, standard error, and coefficient of variance**

Period	Average	Standard deviation	Coefficient of variance
1966–85	13.14	7.64	0.58
1986–98	5.78	1.99	0.34
1999–2008	2.92	1.09	0.37

Source: Based on data from Bank of Korea, Economic Statistics System (ECOS), various years.

The Bank of Korea and Current Views of Central Bank Policy

The two major institutional redesigns of the Bank of Korea in December 1997 and August 2003 and the improved inflation policy outcomes since the crisis of 1997–98 can be traced to four sets of factors.

First, the Bank of Korea had failed in the precrisis period to achieve a low and steady inflation rate. Price stability is widely considered to be the primary objective of central banking and, in the case of the Bank of Korea, was explicitly required in the Bank of Korea Act that made the Bank of Korea responsible for both price and financial stability. High inflation and unstable inflation make it difficult for market participants to establish economic contracts in nominal amounts; and, in the context of interest rate ceilings, inflation generates gaps between regulated and unregulated interest rates that disrupt the financial and real sectors of the economy. The evidence is overwhelming: unstable inflation rates and unstable inflationary expectations impose real costs on the macro economy.

Second, political pressure from the United States, the International Monetary Fund, and the Organization for Economic Cooperation and Development to liberalize Korea's financial markets and institutions in the late 1980s and into the 1990s included the redesign the Bank of Korea. Specifically, Korea was being urged to enhance the formal independence of the Bank of Korea

to render it a less active agent for Korea's industrial policies. Korea did not respond in substance with regard to financial liberalization in general, and in regard to the Bank of Korea made no effort to redesign the Bank. In fact, the only effort to redesign the central bank took place in 1997, and it failed because of labor union issues over the plan to shift bank supervision to the Ministry of Finance and Economy. The suddenness and severity of the 1997–98 crisis changed the environment, however, and Korea embarked on a major redesign of its financial and regulatory institutions, including the Bank of Korea.

Third, the Bank of Korea's redesign and improved policy outcomes reflected the general development of central bank policy in the 1980s and 1990s. Developments in macroeconomic theory, recognition of the public choice problems of central bank policy, and recognition of the importance of price stability guided Bank of Korea reform. Stagflation in the 1970s and new macroeconomic models focused on market clearing, and expectation formation shifted emphasis from short-run Keynesian-type demand management to long-run price stability. Central banks could make their most important contribution to macroeconomic performance by managing inflationary expectations through a reputable commitment to price stability. Widespread acceptance of lags in the effect of monetary policy and public choice perspectives on central bank policy shifted emphasis even more toward long-run price stability. Formal independence from government and greater transparency became widely accepted as a more optimal institutional design to ensure long-run price stability. Recognizing that formal independence may be insufficient to generate long-run price stability, inflation targeting has become increasingly embraced by central banks.

Independence of the Bank of Korea

The institutional relationship between central banks and government has been a subject of considerable interest ever since David Ricardo showed in the early nineteenth century how the close relationship between the Bank of England and government led to inflation and depreciation of the pound. Central bank independence was gradually accepted over time as a necessary condition for a stable monetary and financial environment, although independence from government was maintained more by adherence to the gold standard and eligibility rules for discounting than by formal independence.

The institutional design of the central bank became a more important policy issue since the collapse of the gold standard and, especially, during the past three decades, which have seen the enhanced role of price stability and establishment of stable price expectations in macroeconomic models. As

a result, establishing or extending central bank independence has occurred in a large number of countries: New Zealand (1989); Colombia, Italy, and Portugal (1992); Korea, Japan, and the United Kingdom (1997); and Sweden (1998). The 1992 Maastricht Treaty adopted formal independence as the foundation for the eventual establishment of the European Central Bank. The IMF adopted independence as a policy goal and used the 1997 Asian financial crisis, especially in Korea, to encourage greater central bank independence.

The shift toward more formal central banks appears to be justified by policy outcomes. A large body of literature based on correlations between measures of central bank independence and inflation over time and across countries shows that more formally independent central banks generate lower inflation outcomes.

The details of the December 1997 revision of the Bank of Korea Act as it relates to formal independence have been discussed previously.[8] The 2003 Bank of Korea Act revisions have been summarized.[9] The 2003 revisions clarified and enhanced the independence of the Bank of Korea but still left some ambiguities about who is responsible for financial stability. This section reviews the independence of the Bank of Korea from a historical and comparative perspective and evaluates the contribution of central bank independence to proper central bank policy outcomes.

An index of independence for the Bank of Korea shows that, although the Bank of Korea became more independent (0.27 to 0.32 on a scale of 0 to 1.0), the change was not dramatic when compared with the enhanced independence of the Bank of Japan (0.17 to 0.38).[10] The declaration that the Bank of Korea should conduct monetary policy independent of the government represented a historically significant change; however, the fact that the inflation target was to be decided in consultation with the government, the presence of outside influence on the membership of the newly established Monetary Policy Committee, and the fact that the revised Bank of Korea Act was ambiguous about what, if any, role was assigned to the Bank of Korea for financial stability mitigated against the potential increase in independence.

The 2003 revision rectifies these shortcomings to a significant degree. The formal independence of the Bank of Korea is enhanced, and the Bank of Korea is given increased responsibility for the operation of the payment and settlement system, an important aspect of financial stability. Ambiguity continues, however, because the primary responsibility of the Bank of Korea is price stability without an explicit responsibility for financial stability.

It is not clear which government agency in Korea is responsible for financial stability. The responsibility appears to be shared among the Bank of Korea, Ministry of Strategy and Finance, Financial Services Commission, Financial Supervisory Service, and the Korea Deposit Insurance Corporation. In practice, the Financial Services Commission and Financial Supervisory Service have authority over the entire financial system and have de facto primary responsibility for financial stability. Adjusting the index[11] of independence cited above to incorporate the 2003 revision of the Bank of Korea Act increases the index from 0.32 to 0.36.

The Bank of Korea is more formally independent than previously, and its independence is now on a par with the Bank of Japan; however, the Bank of Korea remains one of the least formally independent central banks.[12] With the use of a different index framework than cited above, the Bank of Korea's independence can be compared with 25 other central banks over the period from 1988 to 2000. The central banks of Korea and Australia during the period 1988–2000 had the lowest ranking—73 out of 100—with the highest ranking of 96 achieved by Germany. The United States had a ranking of 92.[13] The 2003 revisions of the Bank of Korea Act would likely increase Korea's ranking, but Korea would continue to remain in the lowest quartile of central bank independence.

Despite this ranking, the current level of Bank of Korea independence is more than sufficient to generate price stability over time. In fact, formal independence is neither a necessary nor a sufficient condition for generating price stability. Other factors are important. The Federal Reserve has generated two major departures from price stability—deflation in the 1930s and inflation in the 1970s—despite being one of the most independent central banks in the world. The Bank of Japan achieved reasonable inflation policy outcomes while being one of the world's most dependent central banks, but it permitted deflation after achieving enhanced independence in 1998.

In addition, the widely published correlations between measures of central bank independence and inflation outcomes are seriously flawed.[14] Thus, although the Bank of Korea remains less independent than other central banks, it has become sufficiently independent to conduct monetary policy, especially when considered in the context of enhanced transparency.

Bank of Korea Transparency

In the past two decades the institutional redesign of central banks has focused on three areas: elevation of the role of long-run price stability as the primary objective of central bank policy; enhanced formal independence from government; and enhanced transparency and communication with

the public about the formulation, execution, and policy objectives of the central bank. Central banks have clearly focused more on price stability, as illustrated by inflation policy outcomes across many countries (see Table 1). Central banks have been redesigned to provide greater formal independence from government. Likewise, the Bank of Korea has become more focused on price stability and is more formally independent from the government than it was previously.

Transparency and communication with the public have also become major objectives of central bank redesign. In fact, the literature on transparency has increased from only a few contributions before 1980 to a great number of publications, most of which have been published in the past two decades.[15] In the past, central banks provided so little meaningful information about their goals and operating frameworks that it was said that central bankers conducted operations as if they were "secrets of the temple."[16] This section defines transparency, indicates why transparency is important, reviews trends in central bank transparency, reviews the role of inflation targeting in transparency, and provides a historical and comparative perspective of Bank of Korea transparency.

Transparency defined. Central bank transparency or communication with the public is defined as providing meaningful information on six topics: (1) objectives of monetary policy, (2) rationalization of specific policy decisions, (3) economic outlook, (4) projections of future economic performance, (5) projections of likely monetary policy, and (6) economic and financial data. Central banks implement this transparency through the release of public statements and communication with the government made available on the Internet in English. Advances in computer and Internet technology provide an important foundation for communication with the public.

Basis for transparency. The advances in computer technology such as the Internet were not the catalyst for enhanced transparency although they provided a platform for greater transparency. The foundation is more fundamental. There are economic and political foundations.

In terms of economic modeling, transparency can be understood in the context of a Taylor rule in which the central bank sets the current interbank rate according to three conditions: (1) the long-run policy rate or neutral rate consistent with price stability, (2) the output gap between actual GDP and potential GDP, and (3) the inflation gap between actual inflation and the inflation objective. In this framework, the current interbank rate will be higher than the long-run policy rate if the output gap or the inflation gap, or both, are positive. The current interbank rate will be lower than the long-run policy rate if the output gap, the inflation gap, or both, are negative.

Although the Taylor rule is simple, central bank policy, including the Bank of Korea's, in many countries tends to follow it.

The current interbank rate has little impact on spending. What is far more important is the public's expected series of interbank rates because interest rates on longer-term assets are equal to the current short-term rate plus expected short-term rates over the maturity of the asset. Hence, the greater the degree of transparency, the better the ability of the public to develop the expected path of short-term interest rates. The more the central bank communicates with the public about this framework, the greater the public's expectation of future interest rate stability. To illustrate: if the output gap or inflation gap is positive (or negative), increases (or decreases) in the current interbank rate are understood to be temporary. Thus, the central bank has greater influence over a range of interest rates. Transparency also helps the central bank commit to price stability because the more transparent the central bank is, the more it reveals its commitment to price stability.

The political dimension is also important. Central banks are powerful institutions run largely by individuals not directly subject to the voting process. Central banks have been increasingly independent of government, and the shift away from exchange rate targets provides them with considerable discretion. In the context of recent events, the increased role of central banks in supporting weak financial institutions and markets emphasizes the importance of transparency. Transparency is an important foundation for democratic accountability.

Trends in transparency. Efforts have been made to measure central bank transparency; one comprehensive effort was carried out by Nergiz Dincer and Barry Eichengreen.[17] Their transparency index has multiple dimensions: political transparency with respect to policy objections, economic transparency with respect to economic data, review of current economic conditions and projections of economic conditions, procedural transparency with respect to the decision-making process, policy transparency with respect to disclosure and rationalization of policy decisions, and operational transparency with respect to implementation of the central bank's policy actions. Dincer and Eichengreen collected information for 100 central banks for every year from 1998 to 2006 and found a general increase in transparency, and preliminary econometric evidence suggests transparency has a favorable impact on price stability.

Inflation targeting (IT). It is well known that central banks, in the absence of an inflation target, are subject to time inconsistency; that is, they have a tendency to conduct policy that pursues short-run objectives that are suboptimal in the long run. IT is offered as a solution to the time-inconsistency

problem, and many central banks have adopted the framework. Since New Zealand's pioneering adoption of IT in 1990, more than 20 industrial countries have successfully adopted IT. IT contributes significantly to transparency and anchors the public's expectations of future inflation. One survey of a large number of studies concluded that inflationary expectations are more anchored and inflation forecast errors are smaller in IT countries than in countries without IT.[18]

Transparency and the Bank of Korea. In 1998 the transparency index (which runs from 0 to 15.0) was 6.5, 8.0, and 8.5 for Korea, Japan, and the United States, respectively.[19] In 2006, the index was 8.5, 9.5 and 10.0 for Korea, Japan, and the United States, respectively. The Bank of Korea had the lowest index in 1998, but the greatest percentage increase in transparency compared with the other two central banks. The most transparent central banks in 2006 were New Zealand (14.0) and Sweden (14.5).

The most significant aspect of Bank of Korea transparency is IT combined with the primary objective of price stability in the Bank of Korea Act. The Bank of Korea is one of the more explicit central banks concerning this aspect of transparency. The U.S. Federal Reserve continues to operate under a confusing and contradictory set of objectives. According to the Federal Reserve Act, the Federal Reserve shall maintain long-run growth of the monetary and credit aggregates commensurate with the economy's long-run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates. None of these goals is defined, nor is there recognition that price stability and maximum employment may conflict. Nonetheless, the Federal Reserve has increasingly emphasized price stability, which, based on a reading of Federal Reserve documents, is defined in the range of 0–3 percent. The Bank of Japan Law is much clearer: the Bank of Japan is required to pursue price stability and financial stability. Like the Federal Reserve, however, the Bank of Japan does not operate with IT, but a reading of Bank of Japan documents suggests the Bank defines prices stability within the 0–2 percent range.

The Bank of Korea currently targets the CPI inflation rate at 3 percent, plus or minus 1.0 percent. This range is determined in consultation with the government. Since IT was established in 1998, the target inflation rate has ranged from 9.0 percent for a short period in 1998 and then to 2.5–3.5 percent thereafter. The importance of IT and the goal of price stability are made clear on the home page of the Bank of Korea's Web site, http://eng.bok.or.kr/, which prominently states "The Bank of Korea Pursues Price Stability." The statement is followed by the inflation target and the target

base rate. In this regard, the Bank of Korea stands out from both the Bank of Japan and the Federal Reserve.

Concluding Comment

Korea recovered from the 1997–98 crisis rapidly and exhibited noninflationary economic growth for the next decade. The Bank of Korea contributed importantly to this development by achieving price stability, providing transparency about its operations and goals, and by conducting policy more independently of the government. The future of the Korean economy is uncertain despite recent improvements in the economy. Economic and financial distress continues in the United States, and fundamental changes in consumer spending in the United States will adversely impact export-oriented economies like Korea's. As a result, the Bank of Korea faces many challenges. Aside from any longer-run problems facing the Korean economy and if the Korean economy is indeed on the path to sustained recovery, the Bank of Korea will be required to adopt an exit strategy from easy policy without slowing the economy; at the same time it must maintain price stability. There is every indication the Bank of Korea will be able to accomplish these tasks.

The Bank of Korea will continue to evolve toward being a more independent and transparent central bank. Although there is room for improvement, the transparency of the Bank of Korea is remarkable, especially compared with the level of precrisis transparency. Although the Bank remains subject to government pressure, it has been showing more independence. The Bank of Korea has pursued policy in some cases against the wishes of the Ministry of Finance and Economy.[20] All considered, the Bank of Korea has come of age in the first decade of the new century.

Endnotes

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Authors:

John Feffer

Myung-koo Kang

Thomas Cargill

Gilbert Rozman

Ki-sung Kwak

Keith Dinnie

Hyunjin Seo & Stuart Thorson

Bruce E. Bechtol, Jr.

Martyn de Bruyn & Sangmin Bae

Korea Economic Institute of America
1800 K St. NW, Suite 1010, Washington, DC 20006
Ph: 202.464.1982 Fx: 202.464.1987 www.keia.org