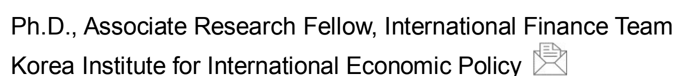
KIEP Opinions

Policy Measures and Exchange Rate Policy: The Case Study on Korea

KIM Kyunghun

Ph.D., Associate Research Fellow, International Finance Team
Korea Institute for International Economic Policy



Several research institutions have forecast that global economic growth this year will be slow and weak, as in the past few years[1]. Key contributing factors are China's rebalancing process, the US monetary policy normalization, and slowdowns in emerging market economies (EMEs). Korea is not an exception. The country has been recording minus growth in exports for 16 consecutive months. Of particular concern are the shipbuilding and shipping industries, which are the backbone of the Korean economy, and have been showing extremely poor performance during the last couple of years due to deficient global demand and excessive supply. The total amount of loans provided by government-run banks to major companies in the shipbuilding and shipping industries reaches over 20 trillion won. Since this could give rise to financial instability, the Korean government, at this stage, is considering "Korean Quantitative Easing".

Korean Quantitative Easing (QE) differs from QE in the US. In the case of Korean QE, the central bank buys bad debts from government-run banks and gives out loans to insolvent companies or the government.

[1] IMF and Oxford Economics

This is a more aggressive type of credit creation. It must be noted that this policy can only succeed when conditional on restructuring. Otherwise, it will merely serve as a temporary painkiller that simply delays bankruptcy, without presenting fundamental solutions.

The fact that Korean QE is being considered at all implies that conventional monetary and fiscal policies are not as effective as in the past. In the integrated financial market, it is not easy for emerging market economies to gain monetary policy independence regardless of the exchange rate regime, which is not consistent with the "trilemma"; conventional wisdom in open macroeconomics[2]. The sovereign debt to GDP ratios of most EMEs are above their 2007 levels[3]. Korea's sovereign debt to GDP ratio is in a relatively better situation, but the growth rate of the debt to GDP ratio in recent years has been considerably high, and calls for adjustment. Fiscal policy is also limited in this sense, and has a much weaker effect compared to the past.

Under such circumstances, we should make the best use of the set of policy instruments already in place. The macroprudential policy can be useful as a supplementary monetary policy, and the exchange rate policy can also prove effective as a limited set of policy measures for not only EMEs, but also Korea. Many economists agree on the need of capital control or macroprudential policy to correct the procyclicality and interconnectedness of the financial market, which can harm financial stability. When it comes to exchange rate policy or foreign exchange market (FX) intervention, however, it is not easy to reach a consensus.

Recently, Korea was designated as one of the countries on the "monitoring list" of currency manipulators, along with Japan, Taiwan, and China. The US determines that there is a distortion in exchange rates due to a huge intervention in the FX market, based on the gap between declining growth rates and a big current account surplus. This is an oversight, however, of the Korean population structure (rapid aging), and the fact that the Bank of Korea doesn't always try to keep the Korean won at low value. There have been FX interventions to defend the value of the Korean won from depreciating. Allowing for exchange rate flexibility does not really solve the global imbalance, because of the GVC structure, and could rather harm long-run growth, especially for EMEs[4].

[2] Hélène Rey (2015), "Dilemma not Trilemma: The Global Financial Cycle and Monetary Policy Independence," NBER Working Paper

[3] IMF, Fiscal Monitor (April 2016)

[4] Lee, Kim and Kang (2015), "Exchange Rate Flexibility, Financial Market Openness and Economic

It is not easy for EMEs to acquire monetary policy independence in the integrated financial market, regardless of exchange rate flexibility. High exchange rate flexibility for EMEs could rather hinder long-run economic growth if kept above a certain threshold. Thus, EMEs and Korea must be very cautious about allowing for high exchange rate flexibility. Given the limited set of policy instruments for EMEs, holding exchange rate policy as a policy measure can extend policy space for policymakers. In terms of exchange rate policy, FX intervention can be justified under the following conditions: i) FX intervention to mitigate high exchange rate volatility; ii) symmetric intervention to defend the Korean won from unduly abrupt appreciation and depreciation; iii) FX intervention on a reasonable scale - trading of foreign currency no more than 2% of a country's GDP in a one-year period[5]. KIEP

Growth," KIEP Staff Papers

[5] Three criteria of a currency manipulator: A trade surplus with the U.S. larger than $20 billion, a current account surplus larger than 3% of its GDP, and one-sided intervention in the currency market (purchases of foreign currency above 2% of a country's GDP in any given year). If a country meets all three criteria, it is designated as a currency manipulator. If a country meets two, it is included in the US Treasury's watch list.