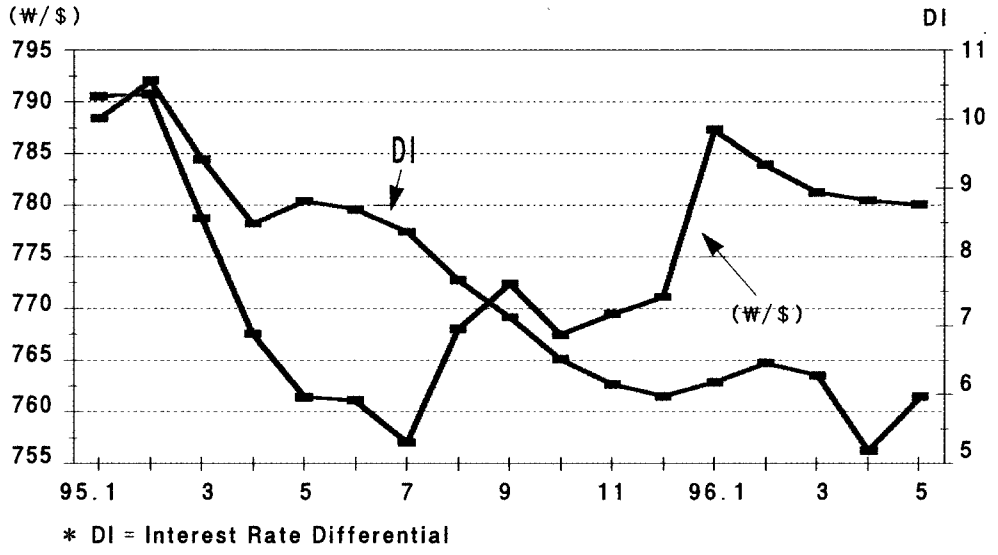
COORDINATING THE MONETARY AND FOREIGN EXCHANGE POLICIES

"The problem is that even though it is an economic downturn, interest rates are rising and in spite of the lifeless exports, the won is appreciating."

The Korean economy is showing signs of a full-scale economic downturn, making interest rates and foreign exchange rates a pressing new issue. This is because the strong growth trends in exports and facility investment which had bolstered the economy up until now have slackened more than expected. In the short run, exports are greatly affected by foreign exchange rates. The weaker the Korean won becomes relative to the dollar or the yen, the more price competitive Korean exports become in the short term. As exports become more and more active, the more facility investment increases. In addition, the more interest rates drop, the lesser financial costs become for export industries, which of course helps to increase exports. On top of this, the opportunity cost for facility investment also decreases, which can provide a big boost to a stagnant economy.

The problem is that even though it is an economic downturn, interest rates are rising and in spite of the lifeless exports, the won is appreciating. Interest rates, which bottomed out at 10.46% in the middle of April, have risen back up to 12.5% as of the end of August. High interest rates weaken a firm's competitiveness, and if the differential between domestic and foreign interest rates increases, it sets off a large influx of foreign capital. This in turn increases demand for the won in foreign exchange markets, which causes the won to become overvalued. As a result, exports slump even further while imports increase, thereby wors-

<Figure 1> Trends of ₩/$ Exchange Rates and Interest Rate Differentials



* DI = Interest Rate Differential

ening the balance of payments.

As of the end of May this year, Korea's trade deficit stood at US$7.4 billion, an increase of 15.8% over the comparable figure last year. On the one hand, the won/dollar exchange rate has continuously dropped from a peak of 792.40 on January 17 to 778.2 on May 22, meaning that the won has appreciated 1.8% in those four months. Since the middle of May, the value of the won has depreciated in response to the strengthening of the dollar in international foreign exchange markets and the worsening trade balance; however, this is viewed as a temporary phenomenon.

Exchange rates, interest rates, and prices are all closely interlinked. In Figure 1 we can see that if interest rate differential between the won and the dollar shrinks, the won/dollar exchange rate rises (i.e., the won depreciates). Accordingly, in order for the won to depreciate, domestic interest rates must fall more than U.S. interest rates.

At the same time, Figure 2 shows us that when Korean prices rise more than U.S. prices, again the won/dollar exchange rate rises and the won becomes weaker. However it is conventional wisdom that when prices rise, nominal interest rates also rise. Accordingly, we have the following phenomenon: when prices rise, the value of the won depreciates, but the rise in interest rates resulting from the rise in prices causes the won to appreciate. Conversely, when prices fall, the value of the won appreciates, but the resulting drop in interest rates causes the won to be devalued. These variables—prices, interest rates, and foreign exchange rates—being so interrelated makes policy implementation an extremely difficult task. This being the case, is there any way of keeping both prices and interest rates low and stable, while at the same time suppressing the won's over-appreciation?

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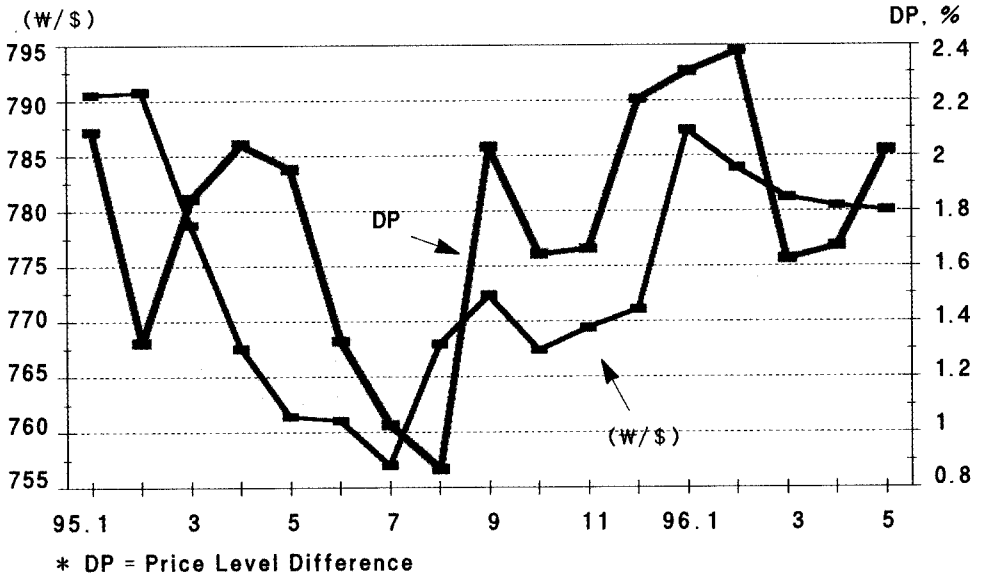
<Figure 2> Trends of ₩/$ Exchange Rates and Price Level Differences



* DP = Price Level Difference

Of course, in order to obtain such a policy effect, a special and more comprehensive macroeconomic policy is needed; in other words, it is probably impossible to solely rely upon monetary policy or foreign exchange policy. For example, if the government increases the money supply, the excess supply of money in financial markets will cause interest rates to drop in the short run. At the same time, the increase in the domestic money supply can cause the won to depreciate in foreign exchange markets. If this occurs, though, the drop in interest rates and the resulting won depreciation will stimulate inflationary expectations and thereby cause stock prices to fall, which in turn will cause the won to depreciate even further and cause tremendous inflationary pressure. While real interest rates will have fallen temporarily, the continuous depreciation of the won will lead to an outflow of foreign capital, and in order to stop this, the nominal interest rates must inevitably be raised in the mid-term.

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These effects of a short-term interest rate drop and won depreciation are not by accident. If one compares Korea to its competitors—Taiwan, Singapore, and Malaysia, the nominal interest rate in Korea is virtually identical to the real growth rate plus the inflation rate, whereas in Taiwan and the others, the nominal interest ranges from 53% to 80% of their added totals.

The reason for this is two-fold. First, the level of financial intermediation ability in Korea lags behind those of its competitors, and so an expansion of the money supply directly translates into

<Table 1> Comparison of Interest Rates, Growth Rates and Inflation Rates Between Korea and Its Competitors

	Nominal Interest Rate (A)	Real Growth Rate (B)	Consumer Price Incr. Rate (C)	A/(B+C)
Korea	11.9	7.0	5.0	0.99
Taiwan	7.9	6.5	3.5	0.79
Singapore	6.5	8.1	2.4	0.62
Malaysia	7.0	9.7	3.5	0.53

Source: The Hyundai Research Institute

Notes: 1) Interest rates are as of the end of 1995, while the growth rates and price increase rates are based on the WEFA Group's 1990 forecasts, except for Malaysia's, which are the actual figures from the end of 1994 and 1995.

2) For Korea, the figure given for the interest rate is the yield on 3-year corporate bonds; for Taiwan, the prime lending rate; for Singapore and Malaysia, the commercial bank lending rate.

an increase in the price of goods in the economy. Even if the amount of money supply in excess of that which is needed in real transactions increases, there is a lack of adequate financial products to effectively absorb this surplus. Second, in a country with a large non-tradable goods market and a low degree of market opening, an increase in the money supply and the increase in prices can have a propagating effect. This is because if domestic prices rise, it should be possible to directly import substitute goods from foreign countries, but the larger the non-tradable goods market is, the less effective this becomes and in addition, the higher import barriers are, the harder it becomes to relieve inflationary pressures on prices in the domestic goods market. Accordingly, this makes it all the more pressing to solve this problem. In addition, it would be ideal if the expansion in the money supply could be channeled into investment which would help expand the economy. This is because increasing the domestic supply capacity could help lower inflation in the long run.

To keep the foreign exchange rate stable in the long run while minimizing the pressure caused by the issuance of new money, an appropriate policy mix of monetary policy, fiscal policy and foreign exchange policy is needed. For example, in the past when market liquidity rose beyond the optimum level, monetary authorities would issue monetary stabilization bonds as a sterilization measure to counteract this. However, since the market to absorb these bonds was not fully developed, the authorities would force banks to buy them. As a result, the monetary authorities would pay the interest costs while banks would be faced with a shortage of capital, thereby causing market liquidity to rapidly drop. Pursuing this kind of "hot water, cold water" monetary policy of rapidly increasing the money supply when the monetary situation is bad, then shrinking the money supply once the situation has improved continued to lower trust in the monetary policy. There are also many instances where the Korean foreign exchange market did not properly reflect the true economic situation. The won would become overvalued during times of low market liquidity because people would exchange their foreign exchange holdings for won, and also because of the influx of foreign capital with the opening of the domestic capital markets.

To remedy this situation, the government should build up a government bond market open to the public to replace the monetary stabilization bonds. The bonds should not be forcefully alloted but rather sold based upon the real market prices in order to minimize the distortion effect on the financial markets. At the same time, a suitable fiscal policy is needed. First, the fiscal policy must be sufficiently tightened. If a tight fiscal policy is adopted, it will help to alleviate the pressures for prices to rise and for the real exchange rate to appreciate caused by the lowered interest rates. Second, the fundamental solution for alleviating the pressure of the inflow of foreign capital is to establish basis for stable economic policy implementation and to stabilize interest rates by making financial markets more efficient. In order to stabilize interest rates, the most important things are reducing financial transaction costs through better maintenance of the secondary market and the promotion of competition among financial institutions, and revitalizing the financial market so that interest rates accurately reflect the true market situation.

Finally, the government must veer away from its method of directly controlling interest rates centering around the M2 money supply and instead steer toward a more indirect method which relies upon the market mechanism. VIP

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