Strengthening the Global Financial Safety Net: Challenges and Prospects

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Distinguished Participants, Ladies and Gentlemen,

It is my great honor to deliver a keynote speech at this conference on global financial stability. I would like to thank Dr. Joon-Kyung Kim, President of the Korea Development Institute, for inviting me to speak. I would also like to congratulate Mr. Hee Nam Choi, Deputy Minister for International Economic Affairs, Ministry of Strategy and Finance; Professor Ali M. Kutan, Managing Editor, Emerging Markets Finance and Trade; together with President Kim of the KDI on organizing this important conference successfully. This afternoon, I would like to share with you my views on where the current global financial safety nets stand and how they should be strengthened to better function.

1. Introductory remarks

Let me begin by describing some important conceptual and practical issues of the global financial safety net, in short GFSN. The notion of GFSN has attracted much public attention since the outbreak of the global financial crisis (GFC). We know well that the world economy experienced numerous financial and economic crises during the past century. But global crisis differs from regional or national crises in several respects. Specifically, the underlying cause is systemic risks rather than idiosyncratic vulnerabilities, and cross-border contagion is more widespread and amplified through interconnectedness. As such, innocent bystanders at a distance from the epicenter were also hit hard by global crisis despite their sound macroeconomic fundamentals. Therefore it became compelling to protect those bystanders from spillovers, which in turn helps stabilize global financial markets and minimize contagion.

The idea of strengthening the GFSN has emerged in this context. GFSN was one of key global agendas at the Korean and French G20 presidencies in 2010 and 2011, respectively.

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New ideas and measures at local, bilateral, regional, and global levels were explored but failed to yield visible progress in subsequent meetings. I guess one reason for the lack of policymakers’ attention to GFSN is that policymakers have been keen on crisis resolution but less so on crisis prevention.

To be specific, on the one hand, policymakers seem to have different perceptions about the need for GFSN between emerging market economies (EMEs) and advanced economies (AEs). GFSN is generally perceived to be useful in protecting innocent emerging market bystanders from spillovers and contagion. This perception, I think, is too narrow focused and even biased. It is indeed both EMEs and AEs that could and did benefit from GFSN. We have witnessed over the past several years that financial and economic spillovers are running both ways—not only from North to South but also from South to North. If GFSN can contribute to stability of global financial markets, it is a public good for both AEs and EMEs. Moreover, the recent developments in Europe such as the establishment of the European Stability Mechanism (ESM) proved that AEs also need financial safety nets. In sum, the benefits of GFSN have not been fully recognized—more so by policymakers of AEs.

On the other hand, policymakers of AEs are concerned about debtor moral hazard that an expanded GFSN may promote while policymakers of EMEs are more concerned about the stigma attached to the use of financial resources made available by the GFSN. It is well known that crisis-hit Asian countries in the late 1990s suffered from severe stigma effects when they sought assistance from the IMF that came only with harsh and even unnecessary conditionality. Korea is a prime example in this regard.

It would not be an exaggeration to say that crises will become more frequent in the future as globalization will continue. Some has argued that too rapid financial globalization was a source of systemic risks that caused the GFC. It is ironic, however, to see that the world economy is now more integrated and connected than prior to the GFC due in part to common and coordinated regulatory reforms like the Basel III because the presence of an internationally harmonized regulatory system will promote incentives to globalize for both investors and borrowers alike. As global financial crisis will recur, the importance of being well prepared for the next crisis cannot be overemphasized. In this context, I should stress that the global community needs to step up its efforts to strengthen the GFSN.

At present, GFSN has a multi-layered structure including self-insurance with foreign exchange reserves, bilateral currency swaps by central banks, regional financial arrangements (RFA), and global arrangement like IMF facilities. No single layer alone would be sufficient to deal with global crises given the scale of spillovers and economic damage that they can generate. Concerted efforts from all layers would thus be needed. I will look into policy issues at each layer of the GFSN and conclude by sharing my views on some newly emerging global agendas.
2. First layer: Self-insurance

Let me now discuss the first layer, self-insurance. One of many lessons that we have learned from past crises is that foreign exchange reserves contribute to keeping financial market stability in crisis times. Most EMEs recognized the importance of foreign exchange reserves as self-insurance.

The global saving glut hypothesis put forth by Ben Bernanke suggests that saving glut during 1996 and 2004 created global imbalances which became one of the major causes of the global financial crisis. In this context, intense policy debates were undertaken to find a way to resolve global imbalances and resulting misalignments in the exchange rate. I still remember vividly serious policy discussions about how to avoid currency wars at the G20 Finance Ministers and Central Bank Governors Meeting in 2010. Most notably, surplus countries were asked to undertake some corrective macroeconomic measures to reduce their surpluses.

What we are observing now is, however, a substantial increase in foreign exchange reserves held by EMEs, which is also a reflection of the effects of quantitative easing policies of AEs. Specifically, according to the IMF statistics, official foreign exchange reserves of AEs increased from 2.4 trillion to 3.8 trillion US dollars between the third quarter of 2007 and the third quarter of 2014. For emerging and developing economies, during the same period, the official reserves increased by more, from 3.9 trillion to 7.9 trillion dollars. As a result, the gap between the EMEs and AEs widened from 1.5 trillion dollars to 4.1 trillion dollars.

What could explain such a widening gap which is contrary to our expectations? A couple of policy considerations as to foreign exchange reserves deserve attention. Countries with large reserves know that there are substantial opportunity costs of holding excessive reserves. It is quite clear that the domestic sterilization costs are larger than the returns from investments in safe assets. Moreover, there are additional costs or quasi-fiscal loss related to the balance sheets of central banks as the exchange rate fluctuates. In theory, countries with free floating exchange rate do not need such excessive holdings.

Then what motivated them to accumulate reserves continuously? EMEs know from their experiences that holding reserves is a form of self-insurance that helps reduce financial market instability when crisis breaks out. They observed how severe damages their economies suffered due to the radical downgrading of their sovereign ratings by credit rating agencies during crises, particularly when their foreign exchange reserves are low or about to be depleted. What this indicates is that there are some latent factors in the estimation of the benefit of foreign exchange reserves, namely, upgrading of the country risk premium due to sufficiently large foreign exchange holdings. Needless to say, costs of capital borrowings will become cheaper with the upgraded ratings and export increases following exchange rate stability are other known benefits. And there are also some inestimable but potential benefits from socio-political perspectives like restoration of public’s confidence in the ability of the government in handling crisis difficulties in addition to economic ones. Therefore, EMEs
would have legitimate incentives to hold reserves for self-insurance particularly when an effective GFSN is absent.

But we also know that self-insurance in a rising scale would not ensure global stability in the long run. Global imbalances should be contained rather than promoted from the global viewpoint. Many EMEs do not adopt the free floating exchange rate system because it can function properly only when domestic financial and capital markets are adequately developed. Moreover, as there are no agreed criteria for the optimal size of foreign reserves, policymakers of EMEs would want to err on the side of over-insurance and over-accumulation of reserves. A collective outcome would likely be the continued trend of reserve accumulation by EMEs.

A policy dilemma is that sterilized intervention, which is justifiable in the short term, may give signals to the markets as the direction of exchange rate fluctuations, which may create policy-induced vicious cycles between currency appreciation and capital inflows. A criticism against excessive reserve holdings in terms of high opportunity costs and government policy induced price distortions can be clearly understood during the normal times. But as the costs of the global crisis are so enormous, policymakers cannot help but to rely upon reserves as a first line of defense. This is actually a compelling reason why GFSN should be strengthened. Otherwise it is not surprising to find an increasing trend of reserve accumulation by EMEs.

### 3. Second layer: Bilateral Central Bank Swaps

Now let me move on to bilateral central bank swaps as a second layer of GFSN.

We found that the role of central bank as a lender of last resort is crucial in overcoming the crisis. But we also found that the ability of a single central bank is limited if the nature of the crisis is global rather than domestic. Thus central banks began exploring ways to cooperate with other central banks. This is a relatively recent phenomenon.

International policy cooperation has long been discussed and, in theory, considered to be welfare improving for involved parties. But in reality, it has not been practiced well. Lack of cooperation has been apparent for the central bank community primarily because the mandates of central banks are intrinsically domestic. A commitment to global cooperation by central banks could sometimes conflict with independent operation of its monetary policy. More recently, rethinking on the roles of the central banks, particularly regarding the relevance of central bank independence, has been under way as the globalization trend and global crisis make a strong case for global cooperation among central banks.

It is widely agreed that the bilateral currency swaps signed in 2009 between the US Fed and other major central banks and also several EM central banks as well were crucial in stabilizing the global financial markets. Some have even argued for making such bilateral currency swaps with the Fed a permanent facility. However, such proposal did not get enough
traction because the US Fed would be burdened to maintain swaps with many central banks for long and also concerned about possible moral hazard.

Two interesting questions emerge. First, why was the borrowing from the US Fed not subject to the same stigma effects from which EMEs suffered when using IMF facilities? What made market perceptions differ between the two borrowings? Is it because of differences in institutional characteristics between the Fed and the IMF? Is it due to the difference in the terms of using money between the approval by the Fed and the harsh conditionality of the IMF? Second, besides market perceptions, central banks did not seem to be concerned about the terms of the US Fed approval in using the money, which appeared to conflict with the central bank independence. Does this mean that central bank independence is relevant only during the non-crisis normal times?

A hurdle to a wider use of bilateral currency swaps is market expectations that these swaps will provide liquidity in reserve currencies, notably the US dollar. However, not all central banks can supply reserve currencies in a sufficient amount for a short notice. In addition, liquidity-supplying central banks are likely to be under domestic political pressure as their citizens would oppose to using valuable reserves for other purposes than protecting their own financial markets. This reminds me of the so-called “original sin” argument of EMEs.

While dollar liquidity is clearly preferred by EM central banks given its universal purchasing power, local currency liquidity would also prove useful for countries that are major trading partners to each other. Local currency swaps can play a role in reducing the burden of accumulating reserves during normal times, and help finance imports in local currencies during crises when dollar liquidity is scarce. Korea and China already institutionalized using their local currencies for trade settlements. It will certainly take time until local currency swaps are actively utilized to support trade settlements in local currencies.

I would therefore argue that EM central banks, particularly those in Asia, should make more use of local currency swaps. In light of the advent of multi-polar currency regime and the Triffin’s dilemma, I think a wider use of local currency swaps will help fill the gap in the current international monetary system and improve global welfare.

4. **Third layer: Regional Financial Arrangements**

The third layer of GFSN is RFAs. While RFAs were established in several regions, let me focus on Asia with which I am more familiar.

At the aggregate level, Asia faces substantial imbalances in its economic linkages to other regions and the world economy. To be specific, there is a large gap between Asia’s trade integration and financial integration. For instance, while Asian countries trade actively with their trading partners in the region, they turn to Western financial institutions for funding and asset management as the developments of their financial institutions are lagging behind.
Moreover, it has often been predicted that the international monetary system will evolve into a multi-polar regime in which the global equilibrium could become less stable with higher possibility of multiple regional equilibria. If so, I conjecture that there will be a growing demand for a well-functioning RFA in Asia that can help achieve financial stability while at the same time promoting investment for growth funded by regional financial resources.

In Asia, new initiatives have emerged to establish its own RFA since the Asian crisis of the late 1990s. The first gathering of ASEAN+3 Finance Ministers took place in Chiang Mai, Thailand, mainly to discuss the establishment of a network of bilateral swaps. Thirteen bilateral swap agreements were concluded by October 2003 to launch successfully the Chiang Mai Initiative (CMI). The CMI was then transformed into a multilateral institution named as the CMI Multilateralisation (or CMIM in short) in March 2010 with a committed resource of US$120 billion and a platform for mutual surveillance and dialogue. In the process, efforts were also made to develop regional bond markets. The total size of committed resources was later doubled at the Finance Ministers and Central Bank Governors’ Meeting that took place in Manila in May 2012.

Since the facility has never been activated since its inception, it is premature to assess the performance of the CMIM. But we can think of what it can and should do for the regional financial stability. The ASEAN+3 Macroeconomic Research Office (AMRO) was established in January 2012 as a core institutional body to undertake research and mutual surveillance on behalf of the membership. I would like to make several comments about the Asian RFA.

First, time is ripe for Asia to have its own RFA given that Asia will continue to expand its relative economic power with rising share of world GDP. Second, it is the region of countries with ample savings and foreign reserves. Therefore, committing substantial financial resources to CMIM would not be an onerous task for members. Third, countries in the region know each other relatively well with good knowledge about economic situations of neighbors, suggesting great potential for information sharing among members. Such information advantage is crucial in containing contagion and promptly activating support programs when deemed warranted.

Despite positive outlook for CMIM, a few concerns remain which are worth noting. First, we must understand that RFAs are not substitutes for global insurance offered by the IMF but should remain complementary to the safety nets at the global level. A key policy concern in this regard is how to align and link the two effectively. In light of the fact that all economies are now interconnected although at varying degree, addressing even intra-regional contagion requires macro-financial information about other regions. Although RFAs may have information advantage on region-specific issues, they need to rely on the IMF and its analysis to become better informed about other regions. Second, the institutional capacity of RFAs must be strengthened to a level comparable to the IMF in order to ensure credibility and consistency of regional surveillance and other activities. I believe efforts to enhance capacity building of the CMIM should receive immediate policy attention.
Third, it would be desirable for the CMIM to expand its membership to include economically influential countries in the region such as India and Australia. Such action will make the CMIM a more representative institution for Asia. Fourth, given the pivotal role of central banks in RFAs, it may be a good idea to officially link the CMIM to the existing central bank networks in the region such as the EMEAP (the Executives’ Meeting of East Asia-Pacific Central Banks). Such networking would help maximize the synergy effects among institutions whose membership overlaps. Last but not least, future success of the CMIM as a RFA will depend on how to minimize, if not eliminate, possible stigma effects associated with members’ access to resources, and also on how to establish high credibility and rigor of its surveillance and research activities to the market.

5. Fourth layer: Global insurance

The fourth and final layer of GFSN is global level insurance facilities offered by the IMF. Since GSFN became a global agenda at the Seoul G20 summit in 2010, the IMF has developed new lending facilities with a qualification bar and no ex post conditionality for drawing the resources such as Flexible Credit Line (FCL) and Precautionary Credit Line (PCL), expanded later as Precautionary and Liquidity Line (PLL) to help ease short-term liquidity shortage of crisis bystanders. While carefully designed, it turned out that FCL arrangements were made for only three countries, and PCL arrangement for only one country.

What made the usage of the facilities so low? The first thing that comes to my mind is fear on the borrower side of stigma effects attached by the market to access to IMF resources. The track record shows that access by a country to IMF resources has typically been perceived as a sign of serious economic problems rather than a beginning of a recovery from the crisis. Moreover there was a perception that crisis countries would not be able to fulfill the suggested structural reforms listed in the stern conditionality. On the creditor side, the IMF appears to have been concerned about borrower moral hazard that easier access with light or no conditionality may create. For instance, governments and private sectors of crisis-prone economies are likely to take excessive risks that are counterproductive to global financial stability, expecting an easy bailout by the international community. For a wider but efficient use of IMF resources in the future, it is warranted that the right balance must be found between fear of stigma and fear of moral hazard.

A couple of comments are in order in this regard. First of all, we must understand why so many EMEs are in fear of stigma effects. Korea’s experiences offer a good hint. Despite the largest financial rescue package relative to quota was assembled by the IMF in 1997, Korea’s sovereign ratings were immediately downgraded from A1 to junk-bond grade by major credit rating agencies (CRAs). Simply, CRAs were skeptical of Korea’s capacity to meet tight program conditionality including difficult structural reforms within a given time frame. Since then, policymakers of EMEs—particularly those in Asia—seem to have strong belief that the
political and economic cost of stigma effects could easily outweigh the positive benefits of seeking assistance from the IMF.

The IMF has recognized well such negative sentiments among EM policymakers through a series of conditionality review, and responded with an earnest effort to re-design its lending facilities in such a way as to strike the right balance between concerns about stigma and moral hazard. To address the fear of stigma effects, the IMF created a new facility the access to which is almost automatic if a country is verified through surveillance process during normal times to have met pre-specified ex-ante conditionality. Moreover, access to some new facilities is granted to a group of countries simultaneously that meet certain criteria so that no country in the group will be singled out and thus would fall victim to stigma effects.

Use of ex-ante conditionality in program design also helps address at least in part the debtor moral hazard problem because it makes access reasonably costly to borrowers by requiring borrowers to meet a series of qualifications. This does not mean to deny access by crisis countries but to minimize the risk of debtor moral hazard. In concept, it is analogous to the well-known Bagehot Dictum for central bank lending as part of its role as a lender of last resort which stipulates that lending should be made only against good quality collateral and at a penal rate.

While most agree on the need to preventing moral hazard, a difficult practical issue is how much ex ante conditionality or ex post penalty should be applied. For example, the CMIM offers liquidity to member countries in two tracks—up to 30 percent with no conditionality and the remaining 70 percent with link to the IMF program only—mainly for concerns about moral hazard. But 70 percent is quite high considering the comparable figure of one third for the euro area rescue package assembled by the European Union.

In the design of the GFSN, how to strike the right balance between stigma and moral hazard problems boils down to a question of how to distinguish innocent bystanders from those in crisis primarily because of home-grown vulnerabilities. Two considerations deserve attention in this regard.

First, we need to find a better way to estimate the cost and benefits of the GFSN. Standard economics indicates that optimality would be achieved when marginal cost equals marginal benefit. The cost of the GFSN is most apparent in terms of moral hazard and associated inefficiencies, both of which are never easy to measure. The most significant benefit is of course crisis prevention. But a fundamental problem here is that you can find good examples of successful crisis resolution as they are visible in data but you may not easily find evidence of successful crisis prevention. For similar reasons, in the central bank community, the “lean against the wind” argument attracted less policy attention than the “clean” argument until recently. Only after it became apparent that the economic cost of global financial crisis can be devastating, policymakers began realizing that higher policy priorities should be placed upon lean than on clean strategy.
In reality, both costs and benefits of the GFSN would be very hard to quantify and, as a result, would become a matter of judgment by policymakers in the end. For good judgment, it is prerequisite to have forward-looking views. We can say that as nobody is able to form perfect foresight or judgment in this complex and highly interconnected world, it is evermore wise to strengthen the networking of all parties concerned.

Second, it may be worth trying to require a good macro-prudential policy framework as part of ex-ante conditionality for IMF lending facilities. Numerous countries have experimented with macro-prudential policies as an instrument to stabilize their domestic financial markets. For example, Loan to Value (LTV) and Debt to Income (DTI) ratios are the two most frequently used measures where property markets have been a major source of credit booms and busts. For countries with an open capital account but less developed domestic financial markets, macro-prudential policies can be designed to deal with financial risks stemming from fickle capital flows. Along this line of thought, Korea introduced measures such as leverage caps on foreign exchange derivative positions and financial stability levy. The purpose of such regulations is to deal with excessive volatility of short-term capital flows and financial risks associated with non-core liabilities of banks. I believe these measures contributed to financial stability. Related empirical evidence on the effectiveness of such regulations can be found in my presentation at the IMF conference on Rethinking Macro Policy II on April in 2013.

I should note that Korea’s macro-prudential regulations on capital flows are being discussed at the OECD for their consistency with the liberalization code. I hope that discussions will produce positive conclusions about those macro-prudential regulations. Some may argue that Korea’s measures do not conform fully to the conventional view of the OECD on liberalization principles. But we have witnessed that systemic rather than individual risks were the main causes of the global crisis, and also that contagion spreads very quickly into many regions and countries. In this regard, macro-prudential regulations would prove very desirable if they contribute to stabilizing the foreign exchange markets. As long as there is no discrimination based on residency, such regulations will certainly do more good than harm.

6. New global issues: Further thoughts

Before concluding my speech, let me share with you my personal thoughts on a few emerging global issues and their implications for GFSN.

I would first like to emphasize that we are more likely to live in a world of possibly unstable multiple equilibria than in a world of a unique, stable global equilibrium. More globalization, changing landscape of world economic power with the emergence of EMEs, diverging policies of AEs, multi-polarized international monetary system—all these trends will make multiple equilibria more likely to occur than ever before. And we may never be able to go back to the pre-crisis state. The increasing likelihood of multiple regional equilibria, I believe,
is a compelling reason for why we should pay greater attention to RFAs such as the CMIM as an important layer of the GFSN.

Second, I think central banks should play a greater role in ensuring financial stability and, to that end, should be more proactive in establishing an effective international network. No doubt, central banks were indeed lenders of last resort during the global financial crisis. It is also true that bilateral currency swaps between central banks were essential to bringing stability to global financial markets.

Now is the time to think more seriously about the active cooperation among central banks of non-reserve currency countries. Facilitating local currency swaps as a tool for trade settlements can be helpful in dampening the fluctuations at times of international liquidity shortage. Competition and cooperation are two essential pillars of doing business in global markets. Central banks can no longer remain as an exception to these principles. Any institution that remains far away from these principles will eventually become a source of economic problems.

Third, the global economy needs a global jurisdiction that can coordinate diverse national interests for the public good of the world economy. There was a growing argument for an establishment of international lender of last resort (ILLR). Pros and cons of such an argument are well documented in academic literature. In reality, however, central banks have tendencies to distant themselves from involving with international entanglements—perhaps for good reasons. But the global financial crisis taught us an important lesson that international cooperation can yield superior results. Of course, there are many hurdles and bumps on the road to better cooperation ranging from political constraints related to their mandates to just lack of interest. Nevertheless, I think we can begin in small steps such as promoting international networking of central banks. Rome was not built over night.

7. **Concluding remarks**

Now let me conclude with a few remarks. Global crisis is not an event of the past. What we have tried and achieved during the past several years to overcome the crisis must be good only to prevent the last crises. Unfortunately, the next crisis will more likely to come in a different form.

Among many financial crises, according to the IMF study, four systemic crises were identified by the severity of the financial and economic stress and the extent of contagion. They include the 1982 Latin American debt crisis, the 1992 European Exchange Rate Mechanism (ERM) crisis, the Asian crisis of the late 1990s, and the 2008 Global Financial Crisis. Interestingly, EMEs and AEs alternated in taking the center stage of these four crises. I do not dare to conclude that the next turn is EMEs. But I would not be surprised even if it happens. The crisis-hit countries or region are likely to undertake financial and economic reforms more seriously as part of their effort to overcome the crisis. Indeed, in the aftermath
of the global crisis, significant deleveraging or debt reduction was undertaken by the private sector in AEs but less so in EMEs. Those who did undertake painful adjustments will be rewarded in the form of stronger fundamentals and competitiveness, and those who did not will likely pay the cost.

Furthermore, possible policy conflicts between AEs and EMEs will have bearing on the global economy and finance. For example, strengthened regulations on funding liquidity in the Basel III framework may make long-term lending more costly and thus conflict with the increasing demand for infrastructure investment in EMEs. Thus, global efforts are needed to find a harmonious compromise between avoiding regulatory arbitrage and enhancing long-term investment productivities of EMEs.

I have to reiterate that now is the time to re-conceptualize GFSN in accordance with the changing global environment. It goes without saying that GFSN is not a panacea. But we explored many aspects of GFSN and found that there are many ways that GFSN can contribute to crisis prevention and financial stability. I am aware that there is an argument that GFSN cannot prevent the crisis just as safety belt and insurance cannot prevent the car accidents. But I think this view is misleading. With an efficient and effective GFSN being in place, there will clearly be less pressure for accumulating foreign exchange reserves, which in turn help ease global imbalances. Moreover, if crisis bystanders are adequately protected, any local or regional crisis will less likely develop into a global one through spillovers and contagion. Moral hazard may remain an issue but we examined several ways to deal with it.

I believe that the only certainty is that we will continue to live in an uncertain world. Under uncertainties, we know from past experiences that herding behavior is likely to prevail. Of course, herding behavior is not necessarily irrational under asymmetric information. But what makes matters more complicated is that herding behavior is often self-fulfilling.

It is a matter of when, and not if, that the US Fed will normalize its monetary policy. I expect that the Fed will take very cautious steps in its course toward normalization. Despite that, I would not be surprised if we see some turbulence in financial markets around the world. EM policymakers have to understand that once such an event occurs, their response to counteract the negative spillovers from the US Fed policy for domestic purposes will also impact their neighboring EMEs. In other words, EMEs will inevitably be involved in policy competition against their neighbors, which could yield the worst outcomes. No country can stay insulated from such global policy competition.

GFSN is a good instrument to deal with such problems as it is premised on the principle of international cooperation. It is the responsibility of policymakers of EMEs to take initiatives to strengthen GFSN through collective efforts. This is the policy agenda that Korea introduced at the G20 summit and I have high expectations for Korean policymakers to endeavor further efforts to accomplish its goal with forward-looking perspectives.

Thank you very much for your attention!
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