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Andy Mukherjee is a columnist for Bloomberg News. The opinions expressed are his own.

Asian Central Banks Should Follow South Korea: Andy Mukherjee

Oct. 17 (Bloomberg) -- The more Asian central banks try to convince the markets that their judgment on interest rates isn't clouded by political interference, the less anyone believes them.

Probably the only way monetary policy makers from Jakarta and Manila to Bangkok and Mumbai can close the credibility gap is by emulating the Bank of Korea.

Earlier this month, the South Korean central bank defied the finance minister's plea for a cut in interest rates, spooking investors who had bet that the government's view would prevail.

The central bank's Oct. 7 decision to hold the benchmark rate at 3.5 percent saw the yield on the three-year bond rise 18 basis points in a day, the most since April. It also prompted Finance Minister Lee Hun Jai, who had been calling for a ``more aggressive, accommodative'' monetary policy, to say that although he respected the verdict, he found it ``somewhat disappointing.''

If the Korean central bank can stick to its guns -- in the face of a lackluster domestic economy and rising political pressure to make record-low borrowing costs even lower -- it will gain a reputation for inflation control, which it agreed to pursue single-mindedly six years ago.

Inflation Targeting

Before 1998, the Korean central bank was responsible for the health of the financial industry. And the finance minister used to be the chief of the monetary board. No longer.

The Bank of Korea is now ``truly independent,'' Dominique Dwor-Frecaut, a Barclays Capital economist in Singapore, said in a note to clients after the bank's rate decision. ``Those who have not yet accepted this new order suffered painful losses.''

Since the 1997 Asian financial crisis, Korea, the Philippines, Thailand and Indonesia have all adopted ``inflation targeting,'' a policy mechanism that requires a central bank to make controlling prices its primary objective.

The logic is that money supply -- which is what the central bank determines -- has a permanent impact on prices, not on jobs or output. Therefore, for a central bank to choose anything other than an explicit inflation target as its main occupation is wasted effort at best, and a dangerous distraction at worst.

Developed nations such as New Zealand, Canada, the U.K. and Australia embraced similar regimes in the 1990s to improve their track record in managing prices.

Oil Plays Spoilsport

Luckily for the Asian central banks, adoption of inflation targeting didn't present any immediate challenges in a global environment of falling prices. That left them free to pursue other goals, such as buying dollars to keep their national currencies competitive, says Ramkishen Rajan, an economist at University of Adelaide in Australia.

It's only this year when oil prices have gone through the roof that Asian central banks' resolve to combat inflation is being tested. Thai consumer prices had their fastest gain in six years in September. The central bank raised its benchmark rate by a quarter percentage point to 1.5 percent in August.

Korea's core inflation, which excludes food and energy costs, is accelerating and will

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probably average 3.5 percent this year, the central bank's stated limit, Governor Park Seung estimates. Bank of Korea cut the interest rate by 25 basis points, or a quarter of a percentage point, in August, and has refused to pare it any further since then.

`Only Dream'

Bank Indonesia -- which made a mistake by loosening its grip on prices in 2000 and 2001, even after adopting an inflation- targeting framework in 1999 -- says it won't take its eyes off the ball now. As it indeed shouldn't. Consumer prices in Indonesia increased 6.3 percent from a year earlier in September, picking up speed from 4.8 percent in January.

``As the governor,'' Burhanuddin Abdullah of Bank Indonesia said in an interview last month, ``my only dream is to have low inflation.'' Still, economist Ross McLeod of the Australian National University says that Bank Indonesia chooses easy inflation targets and ``tends to give higher priority to holding down interest rates in order to boost growth, rather than to holding down inflation.''

In Thailand, central bank Governor Pridiyathorn Devakula said last month that he would have to be careful in raising rates because many banks have lent too much money to individual consumers. ``An increase in interest rates,'' Pridiyathorn said, ``does affect the repayment ability of households.''

One way to ensure that conflicts like these don't get in the way of inflation-targeting monetary policy is for the government to take away the job of financial-sector oversight from the central bank and give it to a separate regulator.

South Korea has already separated the two functions. And according to a report last week in Post Today, a Thai newspaper, Prime Minister Thaksin Shinawatra plans to do the same.

If Bank of Korea can keep fending off political pressure to come to the aid of the domestic economy, it'll raise the bar for the central banks of Indonesia, Thailand, and the Philippines.

They too will then be expected by investors to tighten their vigil against inflation, and leave growth and employment worries to the finance ministers -- and the exchange rate to the market.

To contact the writer of this column:
Andy Mukherjee in Singapore amukherjee@bloomberg.net.

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