April 7, 1997
No.5, 1997

IIMA
Institute for International Monetary Affairs
Newsletter

# Current Condition and Future Prospects of the Korean Economy

This is the transcript of a lecture given in Japanese by the Honorable Kim Kihwan, Ambassador-at-Large for Economic Affairs, Republic of Korea, at IIMA on May 27, 1997, and is introduced here by his permission.

Today I would like to speak on the subject of the Korean Economy's current circumstances and future prospects, including what problems it faces now, how they have been brought about, and how the government of Korea has been dealing with them.

The Korean economy is currently having two difficulties. The first is related to economic slowdown, which began in the last quarter of 1995. The growth rate of the GDP in 1995 was 9.0%, but last year was only 7.1%. The growth rate for the first quarter of this this year was 5.4%. Although this is still high as compared with growth rates seen in western countries, the drop is disturbing indeed for Koreans who have been used to 8−9% annual growth for nearly forty years. Because corporations, as well as individuals, are long accustomed to planning with high growth rates taken for granted, the 6% rate expected for this year is low enough that they feel it is a crisis.

Korea's current economic difficulties are not confined merely to a drop in the growth rate, serious as it is. Korea's current account deficit rose from $8.9 billion in 1995 to $23.7 billion in 1996, an amount equal to about 5% of its GDP. For the first quarter of this year, the deficit equalled $8 billion. Outstanding external debt reached $105 billion, which is about 22% of the GDP. This situation is better than in many other counties, but problematic in view of OECD standards. The annual increase in the consumer price index for the past two years has also been high, at 4−5%, which is much improved by the Korean standard, but still higher than OECD averages.

I think we can refer to three groups of factors to explain not only how the current slowdown came about, but also why a recovery is slow in coming. The first has to do with cyclical elements. When the economy was on its upswing during the 1993—95 period, many businesses behaved as if it would last forever. That is, they over-invested and over-produced. This inevitably resulted in excess capacity and excess inventory, necessitating adjustments which led to a typical cyclical downturn.

The second group of factors has to do with a decline in exports. As you know, Korean exports are concentrated around a limited number of important items. The world-wide market for semi-conductor chips, one of the most important export items, dropped dramatically as the world economy declined in 1995. For example, the average price of a 16-megabyte semi-conductor chip was nearly $50 at the beginning of last year. By the end of the year, the price fell to less than $8. As semi-conductor chips accounted for nearly 20% of total Korean exports in 1995, it is not at all difficult to figure out what a drastic impact the drop of the chip price of 80% had not only on total exports, but also on the total output of the economy. Similar stories could be told about other key Korean exports, such as petro-chemical and steel products, though their price drops were not as dramatic as in the case of semi-conductors.

Furthermore, the depreciation of the Japanese yen has had a great impact on Korean exports. As all of you know quite well, Korean exports are very similar to Japanese exports in terms of their composition. That is, both Korea and Japan export similar industrial goods, and as a result, they are highly competitive with each other in international markets. Although the appreciation of the Japanese yen before it reached its peak in April 1995 gave Korean exports a tremendous competitive edge to grow 30% in 1995, the depreciation of the yen since then has had the opposite effect on Korean exports with a time lag of about 6—8 months. Korean exports saw a small growth of only 3% last year. The rise of oil prices to $23 per barrel in 1996 also had an adverse effect on the current account as well as on the trade balance.

The third group of factors has been, in a way, more important than the others. This has been referred to as structural factors, meaning that there has been too long a delay in implementing fundamental structural reform in several key sectors of the economy, including labor, capital, and land markets. This has resulted in a decline of productivity.

Labor management relations in Korea were highly advantageous to management and employers prior to the democratization process begun in 1987, but since then the balance of power between management and labor unions has reversed. Under new labor laws adopted in the course of democratization, labor unions gained greater bargaining power over management. As a result, wages increased faster than did improvements in labor productivity. (*During 1987—95, wages increased by about 15% per annum, while productivity rose by 7–8% per year.*) This resulted in a rapid rise in unit labor cost which, in turn, undermined the competitiveness of Korean exports. However, no serious efforts were made to correct this situation until fall of last year, as the appreciation of the Japanese yen helped conceal the problems.

Another sector in which reform

was long overdue is the financial sector. Due to extensive government intervention, the financial market in Korea was over-fragmented, and each sub-sector of the market was protected from the others while the government took an incremental approach to opening it to the outside world. Direct access to foreign capital markets by Korean companies was restricted. As a result, the entire financial sector was extremely inefficient. Largely reflecting this inefficiency, the average interest rate in Korea even today, in both real and nominal terms, is about 2－3 times higher than that of other OECD countries. In short, Korean companies are suffering from high interest rates.

The ownership and use of land represents another area in which government regulation has been extensive. There are still no less than 100 individual statutory laws that regulate ownership and use of land. Such extensive regulation has limited the supply of land available for industrial and urban use, which explains why the cost of land for industrial use in Korea today is almost as high as in Japan, if not higher.

Since the current government came into power, it eliminated or modified about 2000 regulations in an effort to solve such problems. However, some important areas still remain regulated, and many businesses operating in Korea, both domestic and foreign, feel that deregulation has not gone far enough toward reducing the high costs resulting from it.

You may ask then: what has the Korean government been doing to deal with the economic difficulties I have just outlined? The answer is that it has been concentrating its efforts in five major areas.

First, the balance-of-payments deficits are regarded as very important. As any country that faces deficits would do, the Korean government believes it necessary to raise the national savings rate to deal with the difficulty. As the current account deficit equals the gap between national investment and national savings, the government should persuade people to decrease their consumption in order to raise the savings rate. And it was thought better for the government to set an example, reducing its own spending first, by which it intends to reduce its budget for the current year by some two trillion won. In addition, to deliver to the people a message that it intends to set a stringent budget, it has announced in advance of the adoption of the budget (which usually falls in July or August), that it will limit the increase in budget for next year to a one digit level, departing from the practice of a two-digit increase that has prevailed in recent years. Apparently, this setting of an example by the government is bearing fruit. During the first quarter of this year, the growth of the overall GDP was estimated at 5.4%, but the growth of personal consumption increased by only 4.4%.

Secondly, the Korean economic slowdown is continuing. Historically, the average length of a typical downturn of the Korean economy is 16–22 months. On the basis of this historical record, one would expect that by now the economy has hit the bottom of the cycle and begun to be on an upward move again. However, because of the reasons mentioned above, there are no signs of this happening. In addition, although economic recoveries of the past followed a strong V-shaped upturn path, we can expect only a U-shaped, slow recovery; some pessimistic economists forecast even an L-shaped stagnancy. In short, firms are still suffering from accumulated inventories and a stagnant market.

One would expect that as an economic slowdown or recession is prolonged, it is bound to cause serious financial difficulties for some firms. This is precisely what has happen in Korea. In early January this year, Hanbo Steel Company was forced to declare bankruptcy. As you may already know from reports in the media, their total amount in defaulted loans was estimated at 5 trillion won. As if that was not enough of a problem, the Hanbo bankruptcy was followed by the bankruptcy of Sanmi Steel Group and by the financial difficulty of Jinro Group. This series of bankruptcies in turn has generated a great deal of uneasiness and concern in the nation's financial market. In order to assure that there is no premature withholding of credit to clients by financial institutions due to the current nervousness, the central bank has announced its firm intention to fulfill the role of lender-of-last-resort.

Encouraged by this move, individual banks and some non-bank institutions have recently reached an agreement whereby they would take time—about two months—and conduct thorough examinations before deciding to cut off credit to certain clients who experience difficulties in honoring their obligations related to promissory notes they have issued. In Korea, there are two kinds of promissory notes: one is similar to the Japanese type which, if not honored, instantly becomes a criminal case. The other is a traditional and informal promissory note which is not subject to a criminal case even if it is dishonored, and for that reason it is easily issued. If any informal promissory notes are dishonored, however, credits are cut instantly, raising difficulties for both the issuing company and the banks concerned. Especially in the case of Jinro Group, it was considered that the traditional manner of cutting credits would cause more serious problems, which was why banks and non-bank institutions came to such an agreement. In this way, banking and other financial institutions are trying to distinguish between businesses that have run into liquidity problems due to credit crunches and those that have run into liquidity problems owing to serious defects in their operations. The central bank, on the other hand, announced that it would extend credit to Korean banks from its foreign exchange reserves when and if they face difficulties in borrowing funds from overseas.

To deal with the fundamental structural problems of the labor market, the Presidential Commission for Labor System Reform was established last year and drafted a reform bill to the labor act by autumn. The government forced the bill through the Diet on the day after Christmas with only ruling pa1rty-member votes. Such an inept political strategy provoked a strong rebuke from opposition parties and labor unions. It was in March when the revised labor bill was passed, after some of the key reform provisions had been watered down. However, one should not overlook the fact that a number of important concepts, such as the power of management to lay off workers for restructuring purposes, the ability to replace striking workers, the introduction of flexible work hours, and alternative ways in which severance payments can be made, are incorporated in the new legislation.

These changes not only redressed the problem of imbalance in power between management and unions, but also will increase flexibility in the mechanics of the labor market in the years ahead, especially after the grace periods allowed for certain key provisions have expired.

The Korean government is determined to implement far more genuine reform in the financial sector. In January of this year, a Presidential Commission for Financial Reform was launched. (Incidentally, I am a member of this Commission.) The Commission has been working very hard over the past several months, and it happens that it will present its second report to the President this coming Friday. The previous report, presented in mid-April, with the forthcoming report contain strong recommendations such as:

- Strengthening the managerial autonomy of banks and other financial institutions, and reducing governmental and political interventions.
- Relaxing barriers to both entry and exit in promoting competition. Until now it seemed as if Korean financial institutions had eternal life. However, inefficient institutions should be encouraged to exit while new institutions should be allowed to establish in due course of time if they satisfy clearly defined criteria.
- Allowing the entry of conglomerates into the financial industry by raising the limit of their holding of stocks of financial institutions from the present 4% to some 10 %, and also by allowing their representation on boards of directors.
- Establishing a strong independent central bank by giving more authority to the Monetary Board.
- Instituting a highly professional and independent supervisory authority.
- Establishing transparent disclosure and accounting systems to make the acquisition of banks by companies easier.

The recommendations by the Commission will be soon drafted into a bill by the Ministry of Finance and Economy. It is both the expectation of the Commission and the plan of the government that most of the recommendations be translated into new legislation in a special parliamentary session to be called specifically for this purpose toward the end of June.

Unfortunately, I do not yet have anything particularly worthy of note in terms of reform to be carried out in the area of ownership and use of land. I know for a fact, however, that the Ministry of Finance and Economy is deliberating on some policy ideas pertaining to this sector, so I am expecting that they will soon come up with some concrete proposals. In other areas of the economy, it is understood that deregulation is not enough, about which a committee headed by Prime Minister is now considering the matter. Its principal concepts are:

- If new regulation is needed, it should be introduced on a sunset-law basis as it would create a problem if it were maintained despite changes in the situation.
- Social cost-benefit analysis should be obligated before introducing new regulations, in order to prevent the overburden of regulation. New regulation could be introduced only when the

benefit is larger than the cost.

At this point, you might be wondering to what extent the current economic policies and reforms of the Korean government that I have outlined will be implemented and what effects they will have on Korea's future economic prospects. In this regard, I want to make three points. First, I have no doubt that the bulk of the reforms will be implemented. The main reason is that due to the current economic difficulties, there is a widely shared commitment to reform, and also a strong feeling that, for the time being at least, management of the economy should be left in the hands of "technocrats." The Deputy Prime Minister in charge of economic reform possesses an ideal background for this. Although he is now a member of the Diet, he used to work for the MOFE and has a strong interest in reform. I therefore expect he will lead the Diet in that direction.

Another point I want to make is that since Korea is now a member of the OECD, it will have no choice but to upgrade its institutions and policies and, at the same time, increase their transparency. This will keep the momentum for reform regardless what government will come to power in the future. Especially since the current government has given a clear message that at present we need economic stability and that it is important to improve the balance of payments, I expect that by the second half of this year we will begin to see distinct signs of improvement in the balance of payments. For one thing, there is a sign of decreasing deficits in trade balances, from $3 billion in January to some $2 billion in February and March, and $1.7 billion in April. It seems to be the inclination of the Japanese people that the yen-dollar exchange rate should stabilize at around ¥115 to the dollar. For another, the prices of semi-conductors, as well as cars and steel, are beginning to recover.

What is most encouraging is that there is widespread support by the Korean people to reactivate the economy. Therefore, it is expected that the economy will follow at least a U-shaped recovery, rather than L-shaped one. Implementation of the reforms mentioned before in many sectors of the economy, supported by pressure from the OECD, will enable the country to make use of its still very formidable growth potential. In the opinion of many economists in Korea, the maximum growth rate that Korea is capable of achieving without developing inflationary pressure will be around 6–7% for another ten years.

Supporting this scenario is Korea's high level of education. Currently, about 40% of high school graduates enter universities. This ratio is lower only than the UK. The gross population of university entrants is only slightly smaller than that of China, which can serve as an interesting comparison since China has a total population 30 times larger than Korea's. Judging from these factors, it is my expectation and hope that the Korean economy will return to the 6–7% growth path, if not 9% as seen in the past, by next year.

Now, I would like to take your comments and questions.

**Q:** *I was recently asked by Korean business people that, while interest rates in Japan are at almost zero, and those in Korea are as high as 15%, making it very hard to compete with Japan in the world market, what could be done? Reflecting on the experience of Japan, it seems to me that the*

*Korean economy has reached a turning point at which to facilitate a structural change from high growth to more moderate and stable growth. In Japan, the economy underwent a big transition in the 1970s, from a high growth structure to the one for more stable growth, with companies making difficult restructuring efforts toward leaner production. Also, partly assisted by financial liberalization following the Yen-Dollar Committee, the money market began to reflect market conditions in a more stable fashion. In Korea you still have both very high savings and investment rates at around 35%, but if you can manage to pursue the 5–6% growth, instead of 9%, wouldn't it be better for Korea to strike a better balance between savings and investment as well as lower interest rates?*

**A:** I agree with you. It is impossible to maintain 9% growth forever, and the recent worsening of balance of payments deficits can basically be accounted for by too-high economic growth. Most research institutes, including KDI, estimate the recent potential growth rate at 6–7%, although they lowered it a little this year. I think a growth rate around this level is desirable to achieve non-inflationary growth and that it will improve the gap in the IS balance. The government is arguing for it and trying to take steps in that direction. The problem is the nation's mentality. It is very difficult, both politically and socially, to lower the growth rate from 9% to 6%, by almost 30%, because it is something like decelerating the speed of a car on the highway from 100 miles per hour to 60 miles per hour, giving us an impression that we have come to a total standstill.

After the Olympic games in Seoul were over, the economy slowed from the 9–10% of pre-Olympic years. Although the new government was advocating policies for stable economic growth, it was forced to take stimulative measures due to strong demand by the opposition parties. There was only one choice left, which was to stimulate domestic demand and accelerate the growth rate, since Korea had suffered from weakened external competitiveness because of rising wages. Thus, Housing Construction Plan 305 was implemented and apartments were constructed in a short period of time. In that process, however, some of the materials ran short and had to be imported from China and other countries, which weakened Korea's competitiveness further. This experience shows that we need to endure a great deal of difficult adjustment processes to lower the growth rate to an appropriate level.

**Q**: *In the transition period from high growth to low growth as an economy matures, even a small deceleration of the growth rate, by 1–2%, may have a great impact, especially with the perception of the people still clinging to old ways of thinking, as was seen in Japan. In the process of economic slowdown, it has also been a common experience to many Asian countries, such as Thailand, that problems which had been hidden by high growth resurface to varying degrees. It is forecast that Korea will continue to grow at around 6 –7% for a few more years, which is very high compared with the OECD average. It would be difficult to maintain such high growth rates while converging with OECD averages in other fields. There seems to be a dilemma between achieving high growth rates and lowering interest rates to OECD average levels. What do you think of its balance?*

*I would also like to ask two*

*other questions regarding the balance of payments. Firstly, because the composition of Korea's exports is limited to a small number of items, they are greatly affected by such factors as price changes of semi-conductors on the world market. In this sense, Korea will continue to be subject to a big fluctuation in exports unless it changes its export structure, and in turn, its industrial structures. What kind of measures are intended to address this?*

*The second question is on the exchange rate. I do not know to what extent the Korean authorities can manage foreign exchange operations, but it seems to me that changes in dollar-yen exchange rates tend to have too much of an impact on the Korean economy, as well as on its trade balance. Wouldn't it better to adopt a foreign exchange rate policy which will weaken, in the long-run, the undue impact of dollar-yen exchange rates on the Korean economy?*

A: Membership in the OECD has two meanings to Korea. Although it incurs new obligations to meet, and in the process may well restrict economic growth rather than stimulate it, it also makes Korea's various systems and policy standards more internationalized and transparent, which will benefit not only Korean firms, but also foreign companies operating in Korea.

Although we are not going to liberalize the exchange rate as extensively as in Japan, we will encourage Korean companies to utilize cheap funds from overseas by allowing them easier access to foreign markets. I think this will have a positive impact on the economy. It is a general phenomenon that the growth rate will decelerate as the economy matures, but Singapore still enjoys high growth rates, with its per capita GDP exceeding 20,000 dollars. If we can utilize foreign capital and liberalize institutional systems as Singapore has done, I think we can also expect a high growth rate for more years to come.

Since Korea is not as large as Japan, however, economic theory tells us that it would not be advisable for a country of small economic scale to foster all kinds of industries. It would be better, therefore, for Korea to participate in the international division of labor through the globalization of its industry, rather than to follow the industrial specialization path that Hong Kong has taken. Therefore, instead of producing all the finished goods by itself, it is considered more important to promote specialization in producing parts with a comparative advantage by collaborating with industries in neighboring and other countries. Especially, cooperation with Japan will be promoted in the area of specialized parts rather than competition in finished export goods.

As to foreign exchange policy, we currently utilize a market average rate system. In the past, the Korean won had been linked to the dollar, and to a basket at a time before the market average rate system was adopted under pressure from the United States in the late 1980s. Currently the exchange rate is not linked to the dollar, but as the dollar is used as a major international means of payment, its weight is still large in Korea.

High fluctuations of exchange rates have been caused because the domestic market is not so fully linked that an inflow of capital leads to a pushing up of the exchange rate of the won. As the reforms we are now implementing proceed, I hope that the linkage of the domestic and international markets will be strengthened and that the exchange rate will increase its flexibility and resiliency.

**Q**: *Although it would be useful in the short-run to improve the I-S balance by tightening the budget, it would be necessary in the long-run to strengthen the savings of households. In that process, Korea will face a problem of uneven distribution. How is the income distribution changing under the economic slowdown? Is it improving? If the savings rate is raised in such a way as to enlarge inequality as is seen in the U.S., it will become a source of future trouble.*

*In the field of financial reform, Korea seems to be proceeding at a rather high speed, as compared with Japan's standard, and the President's Commission, established in January, is soon going to submit a report to the President. It seems to me that Korea has thus far taken a step-by-step approach to implementing the financial reforms as is also seen in Japan. Is Korea continuing to take this approach or has it changed to a financial "big bang" style?*

**A**: Strengthening of savings and a fair distribution of income are very difficult problems to deal with. While higher savings are desirable—and for that purpose high interest rates are welcome—, high interest rates weaken our competitiveness, and there is strong pressure from business circles such as the Federation of Economic Organizations to lower the rates. In the end, economic reform of the financial industry will make it more cost-effective and efficient, thus enabling it to lower interest rates, but it will take time to achieve this. It is urgently needed to narrow the interest differentials between domestic and international rates as demanded by companies. On the other hand, however, there is also strong opposition to the lowering of interest rates, especially by those who derive most of their income from interest. As financial reform proceeds and interest rates fall in that process, therefore, I think we will see a greater leveling of income distribution statistically.

The speed of the President's Commission on Financial Reform is accelerated by the Korean characteristic to make haste in everything. This characteristic has been formed due the confrontation between North and South Korea in the past half-century. The curfew imposed under the old military junta also fostered this tendency, as we had to drink and eat in a hurry before midnight.

Domestic situations also helped quicken the discussion. In January the Commission planned to submit recommendations to introduce a bill to the Autumn Session of the Diet before enacting it by the end of this year. The bankruptcy of Hanbo Steel Group in January, however, heightened the demand by the people to accelerate financial reform, and it was decided that the report should be submitted in May, much earlier than the originally scheduled September.

Although opinions vary among technical experts on the speed of implementing financial reform, the majority believes that reform should be implemented in a quick "big bang", and that it would become a "weak bang" if it is made step-by-step. I think that it will surely lead to a big bang if the recommendations mentioned above are adopted. In any case, we are in much of a hurry.

Address: 2-2, Nihombashi Hongokucho 1-chome, Chuo-ku. Tokyo 103, Japan
Telephone: 81-3-3245-6934, Facsimile: 81-3-3231-5422

e-mail: admiima@ppp.fastnet.or.jp
URL: http://www.fastnet.or.jp/iima/