



Republic of Korea

A loss of confidence in its financial markets led the Republic of Korea (henceforth referred to as Korea) to ask the International Monetary Fund (IMF) for a bailout. In the meantime, contractionary monetary and fiscal policies and an extended recession are expected, and the government should strictly implement overall economic reforms.

RECENT TRENDS AND PROSPECTS

Korea grew steadily during the 1990s, reached a peak of 8.9 percent in 1995, and then began a steady slowdown, declining to 7.1 percent in 1996 and 5.5 percent in 1997. The 1996 slowdown was caused by a slackening of external demand, falling prices of semiconductors, and sluggish capital investments. In 1997, even though exports experienced growth in real terms, the downward trend of the previous year continued in other major sectors. Investment in equipment decreased throughout 1997 because of excess capacity and high uncertainty. Investment in construction stayed at much the same level as in 1996, even though infrastructure-related construction remained robust. The growth of consumer spending dropped steeply because of concerns about job security and the wave of corporate bankruptcies. As an outcome of slower economic growth, the unemployment rate rose from 2 percent in 1996 to 2.6 percent in 1997.

However, the slackening of economic growth did not give rise to serious concern until the third quarter of 1997. Even when the Southeast Asian countries had already experienced the financial and currency crisis, the Korean economy was in relatively good shape. For the first three quarters of the year, the inflation rate remained at 3.8 percent, and the ratio of the current account deficit to GNP was 3.7 percent.

At this time, a series of insolvencies of large business conglomerates or *chaebols* led to an accumulation of bad loans by financial institutions that undermined their soundness. At the same time, instability in international financial markets because of the currency crisis in Southeast Asia had a contagion effect. This led to a deterioration of Korea's creditworthiness in international financial markets and reduced inflows of capital. Finally, in December 1997, the government sought help from the IMF in the form of a bailout package totaling \$57 billion, which included assistance from the IMF itself, from the World Bank, and from the Asian Development Bank. In accordance with the standby arrangement, Korea undertook a number of measures to strengthen its economy and pledged to continue implementing more reform policies in the coming years.

Budget expenditure increased by 12.4 percent in 1997, resulting in a budget deficit of around 0.5 percent of GDP. As concerns monetary policy, the stance was contractionary. The growth rate of the targeted money supply (a slightly broader definition than M2) decreased throughout 1997 except for December. This mainly reflected a recession, and therefore a decrease in demand for liquidity. It was also affected by a structural change unrelated to a liquidity condition, that is, shifts between financial assets. In December, the money supply increased more rapidly, reflecting the Central Bank's efforts

Table 2.2 Major Economic Indicators: Republic of Korea, 1995-1999
(percent)

Item	1995	1996	1997	1998	1999
Gross domestic product growth	8.9	7.1	5.5	-1.0	3.1
Gross domestic investment/GDP	37.0	38.2	34.6	26.4	29.4
Gross domestic savings/GDP	36.8	35.2	34.5	34.9	33.9
Inflation rate (consumer price index)	4.5	4.9	4.5	9.8	7.2
Money supply (M2) growth	15.6	15.8	14.7	13.1	13.2
Fiscal balance/GDP	0.5	0.0	-0.5	-0.9	-1.0
Merchandise exports growth	31.5	4.1	7.2	5.8	5.6
Merchandise imports growth	32.1	12.2	-2.3	-12.3	14.0
Current account balance/GDP	-1.8	-4.8	-2.0	6.9	3.4

Sources: International Monetary Fund (1998), National Statistics Office (1997), and staff estimates.

to ease the credit crunch created by the shaky financial markets.

The increase in the growth of consumer prices dropped slightly to 4.5 percent in 1997, down from 5 percent in 1996. The prices of agricultural, forestry, and marine products showed unstable movements, recording higher increases than in 1996. Charges for services slowed, reflecting a steep rise in 1996, as well as stability in the prices of private services. The prices of manufactured goods showed a large increase in the first quarter of 1997 because of the rise in the prices of petroleum products and in the fourth quarter of 1997 because of depreciation. Producer prices rose 3.9 percent during 1997, which was higher than the 2.7 percent recorded in 1996. The pace of wage increases, which have affected economic performance, fell from 12.2 percent in 1996 to 7.5 percent in 1997.

The balance of payments deteriorated significantly in 1996; however, exports reversed their downward trend in the second quarter of 1997 and expanded strongly in the third quarter. Exports increased by 7.2 percent during 1997, in contrast to the 4.1 percent growth registered in 1996. This was helped by the sharp pickup in exports of heavy industrial and chemical products, such as semiconductors and refined petroleum products. Meanwhile, export prices fell, partly because of the steady weakening of semiconductor prices. Imports showed a slight decrease of 2.3 percent in 1997, down from a

12.2 percent increase in 1996, largely in response to sluggish consumption and the decrease in investments. The trade balance registered a deficit of \$2.8 billion during 1997. Overall, the current account improved quarter by quarter in 1997. It recorded a deficit of \$8.8 billion, or 2 percent of GDP, far less than the 4.8 percent in 1996.

The Korean won depreciated by 15.4 percent, on average, in nominal terms in 1997, and by 43.5 percent year-on-year in response to the crisis. As concerns exchange rate policy, the authorities widened the band for daily movement from 2.2 percent to 10 percent, and then finally abolished it as of 16 December 1997.

The IMF agreement demands extreme contraction in both fiscal and monetary policies. The main objective of monetary policy is to maintain inflation at 9 percent in 1998 and to limit downward pressure on the won. The targeted money supply indicator was further broadened to M3 in 1998, and is projected to increase by only 13 percent, compared with 16.5 percent in 1997. The government will maintain tight fiscal policy to alleviate the burden on monetary policy and to provide for the still uncertain costs of restructuring the financial sector. To this end the government has increased special excise tax and transportation tax rates. It has also widened the bases of the value-added tax, corporate taxes, and income taxes by curtailing or abolishing tax exemptions or reductions, which were,

in any case, inconsistent with international standards. On the expenditure side, the government will make major cuts in infrastructure outlays and defense expenditures. As a result, the fiscal deficit is likely to be about 1 percent of GDP in 1998.

These policies imply that the economy will contract, and expectations are that it will take longer than two years for it to return to its potential growth path. Provided that the government implements the IMF agreement faithfully, the GDP growth rate is expected to decline to -1.0 percent in 1998 and rise to 3.1 percent in 1999. The unemployment rate will increase to 4.3 percent in 1998 because of the contractionary policies and the restructuring of the economic system. Even if replacement investment is active, new investment is likely to be suspended or reduced. Thus total investment in real terms is expected to decrease by 28.7 percent in 1998, and then to increase by 12.3 percent in 1999. Consumption in real terms will decrease by 4.2 percent in 1998 because of greater fears of future unemployment as well as actual high unemployment, but will then increase by 1.6 percent in 1999.

Reflecting the lagged effects of the steep depreciation of the Korean won on input costs in 1997, both consumer and producer prices are expected to rise by around 10 percent in 1998, higher than the initial target set by the government and the IMF. Nominal wages are likely to stay at their 1997 level in the coming years, or even to decrease, in response to contractionary policies and corporate restructuring.

Exports will grow by 5.8 percent while imports will decline by 12.3 percent in 1998, mainly because of the depreciation of the won in 1997. The trade balance is expected to record a surplus of \$22.4 billion. The steep depreciation of the won in 1997 and the extended economic recession will help improve the trade balance in the next few years. The current account balance is expected to yield a large surplus of \$21.1 billion in 1998 and \$11.4 billion in 1999. However, a decrease in the imports of investment goods is likely to have a negative effect on the economy in the longer run.

POLICY AND DEVELOPMENT ISSUES

After the economy slowed down in 1996, concerns were voiced about the "high-cost and low-efficiency economic system." The government's

reaction was swift and focused on structural adjustments. While the government rapidly reached consensus about some policy measures and started to implement them, it needed more time to reach agreement on other issues, such as financial reforms.

The government's economic reforms turned out to be insufficient to protect the economy from the financial and currency crisis, even though they were generally in line with the IMF package. The effect of the financial crisis and the IMF package was to provide the momentum for reforms that were broad in scope and immediate in implementation. As such, the distinction between short-term and long-term policy issues disappeared and prioritization was difficult. The issues discussed in the following sections are the most urgent and have the greatest impact on the economy.

Financial Market Reform

In terms of international competitiveness, the financial sector is far behind the real sector. The key source of the financial sector's weakness was the predominantly state-led distortion in credit allocation. This practice deprived the financial sector of its primary function of screening and monitoring, and led to excessive risky investments by the corporate sector, and eventually to the current crisis.

The government became aware of this problem, and in response established the Financial Reform Committee in January 1997. The committee produced a report in June; however, the crisis hit before the government implemented full-scale reforms that reflected the report's recommendations. The IMF package, which shared many ideas with the report, called for restructuring financial institutions to construct a sound and competitive financial industry. Measures to be taken included protecting deposits, closing troubled merchant banks, resolving nonperforming assets of banks and merchant banks, facilitating mergers, and strengthening prudential supervision standards. To strengthen supervision of the financial sector, three agencies responsible for supervising banking, security, and insurance institutions were consolidated into the Financial Supervisory Commission. In addition, the Central Bank was given greater autonomy.

While to date the financial reforms appear to have touched on all major issues and to comply with

market mechanisms, they will confront many challenges, mainly because of the unprecedented business environment characterized by competition. The government can no longer avoid the challenge of competition by resorting to protection. Instead, autonomy of and accountability by each financial institution can enhance the efficiency of the financial sector.

Trade and Capital Account Liberalization

The IMF agreement required the government to set a timetable for trade liberalization in line with World Trade Organization commitments; and the government promised to shorten the timetable for abolishing trade-related subsidies, restrictive import licensing schemes, and its import diversification system. The government opened stock and bond markets wider and ahead of schedule, promised to liberalize money market instruments, increased the ceiling of domestic bank shares that foreign banks could acquire, and allowed domestic corporations to borrow long-term loans from overseas.

One question in this context is the extent to which these measures will help protect financial markets against volatile capital movements. Considering the high interest rate target of more than 20 percent, capital account liberalization could stimulate hot money movements and cause the performance of already highly leveraged domestic firms to deteriorate. It will also increase interest rate risk, exchange rate risk, and credit risk and hamper the development of long-term capital markets. To mitigate this undesirable situation, the interest rate target needs to be lowered to a level that the weak corporate sector can manage. At the same time, sufficient monetary policy instruments need to be developed so that the Central Bank can stabilize interest rates.

Corporate and Labor Market Reform

Much of the blame for the crisis has fallen on the *chaebols*, because of their excessive capacity expansion and industrial diversification. The government has recently encouraged the restructuring of corporate finances, including measures to reduce corporations' high debt-to-equity ratios and to facilitate mergers and acquisitions. To achieve these goals, the government has prepared legislation that would require corporations to prepare financial statements on a consolidated basis. Another item of legislation would gradually reduce the cross-debt payment guarantees among group affiliates that had enabled the *chaebols* to take on excessive debt.

The *chaebol* problem is intimately related to labor market rigidity. Because trade unions have developed through confrontations with *chaebol* management, labor market flexibility could be greatly improved if promoted at the same time as corporate reforms. The IMF package provided a good opportunity for labor, government, and industry representatives to form a committee to examine and discuss the current crisis, especially in relation to layoffs and how to maintain workers' living standards. While providing a sufficient social safety net is a good idea, given its high costs it will be possible only after the crisis is over. In addition, more transparent corporate management would help workers regain confidence in their employers.

To the extent the crisis originated from a loss of confidence, strict implementation of the economic reforms is crucial for the recovery of foreign investment. One of the main features of the crisis is that it is a private sector problem, and therefore involves a complicated combination of vested interests of many firms and financial institutions. Thus to keep the reforms on track, the emphasis should be on transparency and accountability.