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January 18, 2005

Statement by Mr. Misra on Republic of Korea
(Preliminary)
Executive Board Meeting
January 21, 2005

We thank the staff for an excellent report backed by another excellent set of Selected Issues Paper. The analysis in the Selected Issues paper offers policy advice on many of the current challenges facing the Korean economy. We also thank Mr. Oh for his perceptive buff statement and share his optimism about Korea's ability to overcome the current challenges and get back on a more sustainable growth path early. Some of the issues, such as restructuring the SMEs and development of government and corporate bond markets are issues that are being grappled with by other countries as well. Reform in these areas are difficult, yet essential and time consuming. The conclusions of the staff in the paper on Government intervention is balanced. We agree with the staff that it is not possible for the Government to credibly pre-commit to a non-interventionist policy because ultimately, as past evidence has shown, whether it is a crisis of the private or public sector, the Government has to intervene or bail-out in case of a systemic consequence. Hence, as the staff have alluded to, the solution lies in good policies that foster a good credit and risk mitigation culture in the economy. Government intervention must be limited to situations that threaten to acquire a systemic consequence or prevent contagion runs of solvent institutions.

As the staff have rightly noted, the key policy question is what can be done to put the South Korean economy back on the path of sustained, rapid expansion. There are good reasons to stimulate the South Korean economy. Domestic demand had been sluggish, export growth has shown signs of slowing recently, and growth has faltered. Under the circumstances, the authorities have responded commendably and appropriately with a mix of fiscal and monetary easing. Like the staff, we support the monetary policy stance of the authorities. The strong currency against the US dollar gave leeway to the central bank to cut interest rate to stimulate domestic demand. It is encouraging to note that private consumption is expected to revive in 2005 and growth would accelerate from 2005 onwards. Nevertheless as the central bank had recently observed in its Monetary Policy Report, the monetary situation calls for caution since an upward adjustment of charges for some public goods and services is scheduled and the medium-term evolution of oil prices is still unclear. While we note the upside and downside risks to the staff projections, we are encouraged by the staff assessment that Korea's vulnerability to crisis is very low in view of the strong fundamentals and the cushion in terms of large forex reserves, both reflective of the reform undertaken by the authorities.

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We view the central bank's intention (in its Monetary Policy Report of September 2004) "of operating the aggregate credit ceiling in such a way as to heighten the practical effectiveness of financial support for SMEs in view of the worsening of their fund raising conditions brought about by the stagnation of domestic demand and financial institutions strengthened credit differentiation" as appropriate under the current circumstances. We also fully support the Government's plan to phase out guarantees and establish a credit bureau for SMEs. In this context, what in the staff's views are the merits of the financial institutions instead of Government sponsoring a credit bureau in the spirit of non-interventionism ?

We cannot but agree more with the staff suggestions on the measures listed out to improve the investment climate. But, these are difficult areas and spans legal, regulatory and market microstructure. In the area of labor reforms, it is important to convince and take all the stakeholders on board to gain their confidence and proceed in a non-disruptive manner. We are encouraged by the Government's commitment to take steps in all these areas. While there is some progress on the resolution of credit card debts, we encourage the authorities to pursue their market-based approach, he personal bankruptcy reforms as also the Personal Debt Rehabilitation Program more vigorously towards a speedy resolution.

We agree with the staff that the exchange rate regime has served the economy well, especially since it has encouraged firms to hedge their exposures. We also find the stance of the authorities regarding intervention in the market to smooth the currency's path when it came under speculative pressure to be appropriate. However, we would like the staff to discuss more on the competitiveness of exchange rate on South Koreas' exports and on the recent intervention by the central bank in the exchange market.

The Korean authorities have shown great commitment to reforms so far and the agenda for the future is ambitious. We wish the Korean authorities all success in their endeavors.