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Statement by Mr. Lynch and Mr. O'Loghlin on Republic of Korea
(Preliminary)
Executive Board Meeting 05/5
January 21, 2005

Key Points

- ***We agree that concerted effort by the Korean authorities to reignite domestic demand is appropriate, to aid recovery of growth towards potential as well as to contribute to resolving global imbalances in view of Korea's strong current account surplus.***

- ***There seems significant macroeconomic scope for the authorities to act to underpin a recovery of domestic demand – which seems necessary, given stagnant consumer demand and the parlous state of the SME sector.***

- ***Recent monetary easing was appropriate, as is the preparedness of the Bank of Korea to "stand ready in case additional actions are required".***

- ***We concur with the staff on the merit of a supplementary (2005) budget, since:***
    - ***Budget 2005 is economically neutral;***
    - ***The planned heavy frontloading of budget execution (59 percent by June) implies significant contraction of public demand thereafter, very probably before personal and business activity picks up enough to sustain growth near potential;***
    - ***We are doubtful that the private-sector-led comprehensive investment plan will deliver momentum quickly – assuming "value for money" is accorded appropriate priority.***

- ***We would welcome confirmation that the authorities intend publication of a PIN and the associated Article IV papers, as last year.***

1. Korean growth recovered appreciably through 2004 from a relatively poor performance the previous year. However, as in 2003 success on external markets, rather than domestic demand growth, made the key contribution – with an increasing current account surplus adding to ongoing global imbalances (even if modestly, relative to the size of the latter), and consumer demand stagnant after contracting in 2003. In these circumstances, the staff argue

for policy-led "sparks" to reignite domestic demand, both at the consumer and (small) business levels, and for further structural reform to build recovery into sustainable, strong growth – which healthy chaebol balance sheets and still-well-capitalized banks seem well-placed to support. We agree that concerted effort to reignite domestic demand is appropriate, both to underpin a return to Korea's potential growth rate and to support the resolution of global imbalances.

2. We agree with the thrust of the staff analysis and recommendations in this context. There seems significant macroeconomic scope for the authorities to act to underpin a recovery of domestic confidence, and demand. Policies hitherto have provided several "cushions" for an element of fiscal activism. The Korean balance of payments surplus, now close to 4 percent of GDP, points to more than adequate external competitiveness – as confirmed by the expectation, noted in Mr. Oh's comprehensive Buff, that "exports will remain the engine of growth". Despite appreciation through 2004, this must reflect, in some measure, two successive years of (limited) real depreciation of the won. External reserves are more than healthy, and appear to be continuing to grow. The fiscal balance is in very modest deficit (excluding the social security surplus, a factor in confidence, given prospective population ageing). Public indebtedness is comfortably modest. We agree with the staff view that "Korea's vulnerability to crisis is very low".

3. We welcome the steps which have been taken to address the household debt problem – most particularly, the focus on establishing a market-friendly framework for resolving debts, which appears to be delivering useful results, and the associated decision to stand firm against calls for an interventionist approach; the ending of the practice of blacklisting credit delinquents; and the planned refinement in their classification – which, we hope, will be broadened to provide the basis for the more comprehensive credit reporting that underpins access to personal credit in other countries. We also look forward to the enactment of the personal bankruptcy reforms now before the National Assembly which, we believe, will add a key new dimension supportive of resolution.

4. But such steps will take time to overcome the legacy of the run-up in credit of recent years. Hence, in our view, the two-step monetary easing in the latter months of 2004 was fully appropriate. And, given adverse implications for household confidence and demand of the still-high level of ongoing delinquency, we welcome Mr. Oh's indication that the Bank of Korea "will monitor the economy closely to see if further interest rate adjustment is necessary, and stands ready in case additional actions are required".

5. We are more dubious about the supportiveness of fiscal policy to a sustained recovery of domestic demand. Despite its several useful initiatives (notably, employment tax credits, personal and indirect tax cuts, and a lowered corporate tax rate and tax incentives to investment), the 2005 budget as a whole is economically neutral. Perhaps more important, the planned execution of 59 percent of the budget over the first half of 2005 noted by Mr. Oh necessarily implies a significant contraction of public demand thereafter. We assume one objective of the private-sector-led comprehensive investment plan is to counteract this. But we share the staff uncertainty about the prospect of early, substantial results from the CIP. Apart from the normal "lags" in building up an investment program, ensuring that "value-for-

money" is accorded appropriate priority – as should be the case – argues against placing undue reliance on the potential of this approach to add momentum to economic activity. On both counts, we believe that a 2005 supplementary budget, as called for by the staff, may well be needed to support economic momentum for long enough to allow consumer and business demand to recover sufficiently to support growth approaching its estimated potential rate of 5 percent.

6. On the business side, while recovery in personal demand should assist SMEs – especially those in the services sector affected by the cyclical downturn – we have sympathy with the staff view that lagging SME productivity growth, in part reflecting the "support for the status quo" implicit in substantial loan guarantees to existing businesses, is a factor limiting the dynamism of the sector. Accordingly, we welcome Mr. Oh's indication of an intended reduction in the volume of large and long-term credit guarantees, and of a refocus towards venture capital for start-ups – which, we assume, will be essentially market-driven. While we also welcome the intended reforms to regulations which hinder competitiveness and aim to promote fairness and competition in markets more broadly, we are somewhat discouraged by adverse signals about the potential depth of reform implicit in other steps – namely, the bills which propose prohibiting "unreasonable discrimination" against non-regular workers vis-à-vis their "regular" counterparts (when high costs of labor restructuring appear to be adversely affecting investment incentive) and the apparently meagre "opening" of Korea's agricultural market implicit in a commitment to raise the rice import quota by as little as 3 percent of domestic consumption over 9 years.

7. Noting that the authorities concurred in the publication of an end-mission statement in October, we trust that Korea will consent again, as last year, to the publication of a PIN and the associated Article IV papers on this occasion, and would welcome confirmation of this intent.

8. With these remarks, we wish the authorities every success in the delicate task of reigniting domestic demand on a sustainable basis, and relaunching the more broadly-based growth which Korea proved so well able to achieve in the past.