

February 29, 1980 - 80/49

Statement by Mr. Whitelaw on Korea  
Executive Board Meeting 80/34  
March 3, 1980

Korea is perhaps the prime example of that category of country which has recently come to be labelled, rightly or wrongly, the NIC's or "newly industrialized countries". Korea is not richly endowed with natural resources and, like Japan, its main inheritance has proved to be the quality of its people - a much underestimated factor of production. Korea has to live by trading. It imports basic materials and fuels and it exports manufactured goods. On the basis of this export expansion it has been able to maintain a rate of economic growth which has averaged 10 per cent in real terms per annum over the past fifteen years - a truly remarkable performance by any standard.

Along with a high rate of growth has come rapidly improving standards of living. The per capita income, in real terms, of the people of Korea has increased 3½ times since the early 1960s. This improvement, however, has started from a very low base and it is still no higher than around \$1600 per capita per annum. For the period immediately ahead, the rate of improvement in the Korean standard of living is likely to be a good deal slower than in the past.

Korea has had a long association with the Fund. It has drawn under a number of stand-by arrangements, under the Compensatory Financing Facility and under the Oil Facility. But Korea has never been a big borrower from the Fund. The Fund's present holdings of won (excluding the Oil Facility) amount to no more than 88 per cent of quota. This situation is now set to change. In 1979 Korea experienced a severe and unprecedented setback in its economic performance and has come to the Fund with the request for a substantial drawing under the credit tranches and under supplementary financing. Korea is looking now, not just for advice from the Fund, but for substantial financial support from the Fund. What lies behind this sudden change in Korea's economic fortunes?

When economies run into trouble it is only too easy to think of excuses, outside the control of the authorities, for faltering performance. In Korea's case, however, an important part of their problems do seem to have had their origins in developments abroad.

- Most obvious, of course has been the impact on the economy of the 1979 increase in oil prices. The higher cost of oil imports accounts for about half of the \$2.5 billion deterioration in Korea's trade balance between 1978 and 1979. Likewise the increase in oil prices accounts for a significant part of the increase in the rate of inflation in wholesale prices from 12 per cent in 1978 to 24 per cent in 1979. Oil prices would also have been a factor in the deterioration in Korea's terms of trade from a positive 7 per cent in 1977 to a negative 1.7 per cent in 1979.

Although oil prices are important, much more lay behind Korea's economic setback in 1979 than the increased cost of oil imports. For a long time Korea's economic growth has been based on export expansion, as mentioned earlier. Over the period 1975-1978, for example, Korea maintained a rate of expansion in export volume of about 23 per cent per annum on average. In 1979 the rate of expansion in the volume of exports fell to minus 2 per cent. So Korea was in difficulties on the export side as well as the import side. Two things in particular were prejudicing exports. By the end of 1979 world economic activity was slowing down, particularly in the industrial countries which were an important market for Korea's products; and the prospects for world trade suffered as a consequence. Added to that, and indeed associated with declining levels of economic activity, was the rise in protectionism, again particularly in the industrial countries. This protectionism tended to have a special impact on the exports of the newly industrializing countries whose exports were proving uncomfortably competitive in world markets. The industrial countries, in resorting to protectionism, were defending, not so much their balances of payments, as their domestic levels of employment.

Beyond that it has to be admitted that not all the factors behind Korea's sudden economic troubles were external and outside Korea's control. On the contrary, economic strains had begun to show themselves in the Korean economy well before the 1979 oil price increase, and well before the impact that had on economic activity, and prospects of economic activity, in the industrial countries. As internal demand pressures increased, price inflation began to accelerate. The labor market began to show signs of tightness, an unusual development in Korea. Particularly important seems to have been the rapid rise in money wages over the period 1976-1978. Not only were money wages rising rapidly but so too were real wages. There was an increase in real wages of 17 per cent in 1976, 21 per cent in 1977 and 17 per cent again in 1978. Not even the Korean economy could absorb such sharp increases in costs and Korea rapidly began to lose what had been its main strength through the years, namely its competitiveness. In retrospect, monetary policy also seems to have been too accommodating. Money supply (narrowly defined) rose 30 per cent in 1976, 40 per cent in 1977 and 25 per cent again in 1978. Adding to the effects of the rise in costs and prices internally on Korea's external competitiveness was the depreciation of the Japanese yen in 1979. All these factors played their parts, by weakening Korea's export performance, in bringing about a substantial trade deficit for Korea in 1979.

The Korean authorities were not slow to take corrective action in respect of both the external and internal pressures. All this is set

out clearly in the staff papers and there is no point in elaborating on that here. It is useful, however, to remark on two general features of the economic policy changes:

- Firstly, the 1979 changes in Korean economic policy were not limited to action in the demand management area. It was recognized quite early in the piece that more was required than simply to curb demand and that a fundamental structural reform of the economy was called for. For instance as early as mid-1978 the Government had embarked on a policy of import liberalization followed by deregulation of prices.

Secondly, what is particularly impressive is the resolution with which the Korean authorities have stuck to their task of stemming inflation and structurally adjusting the system. It would have been only too easy, given the political incidents which took place in late 1979, for the authorities to have deferred further development of their economic policy measures, such measures always involving political hazards. This they have not done. They set out early in 1979 on a course of tough economic policy measures to correct the economic situation and they have maintained that course. It is their intention that the new Korean Government which is to be established after constitutional reform is completed will inherit an economy once again firmly based and in good running order. The proposed two-year stand-by with the Fund would see this period through.

What of the future? It seems likely that the Korean economy, over the longer term, will be basically different in some respects from that which has existed up to the 1979 setback. In particular it will be a more open economy. This follows from some of the decisions being taken at the present time:

- there will be less government interference in the economy, particularly in the area of price regulation and control of the financial system;
- there will be more flexibility in the exchange rate and in interest rate policy;
- import controls will be more liberal and Korea will be more open to investment from the outside world both of a direct and portfolio nature; and
- the tax system will continue to be reformed with the objective of achieving both greater efficiency and greater equity.

There are of course problems ahead. It is not going to be easy for Korea to establish a more secure energy sector, both in terms of supply and in terms of price. And it is not going to be easy for Korea to persuade the industrial countries to reduce their protectionism. But Korea

has certain factors working in its favour. Its work force is still growing rapidly and there is still room for substantial transfer of workers from the agricultural sector which is less competitive than the manufacturing sector. Its entrepreneurial class have shown an ability to cope with swiftly changing technologies and its mobility in this area will be a force in its favour over the longer term. As per capita income increases and as the work force grows, the domestic market will become more important in Korea than it has been in the past and this will provide a kind of insurance against sudden changes in external circumstances. All in all, Korea's long-term prospects are not unfavourable and rumours that the Korean miracle is over are probably much exaggerated. In the meantime, however, the restructuring period has to be survived and this will involve substantial financing from abroad.

I commend the Korean request to the Board.