May 5, 1982 - 82/66

Statement by Mr. Prowse on Korea
Executive Board Meeting 82/65
May 5, 1982

First of all I wish to record the thanks of the Korean authorities to the staff for their fine report. For my own part I would wish to acknowledge the enormous amount of work done by the staff and the professional standard of the report.

The substance of the staff report begins on page 2 with some background where it refers to the expansionary policies of the late 1970s and the 1979/80 increases in oil prices. The expansionary policies of that period are seen as having severely negative effects, and policies of the last two years are described as having been dominated by the need to adjust to these two factors. Yet it is the view of most objective observers that the external environment in the form of depressed and restricted markets for Korean exports, the severe socio-political disturbances of late 1979 and 1980, and the disastrous crop season in 1980 were also major elements in the formulation of Korean economic policy. Moreover, when the Board last reviewed the Korean economy, there was considerable approval of the successful adjustment which was being made to the effects of these severe adverse factors. Indeed it would not be unfair to say that from about October 1980 until the end of 1981 the Korean economy was doing pretty well, all things considered, and it is not unreasonable to say that what happened then was to a considerable extent that the world recession, and particularly the US recession and US interest rates--finally caught up with Korea.

It is important to record, and my Korean authorities would certainly want to do so fully, the value of the Fund's assistance over this period and particularly of the Stand-by Agreement which was completed a few months ago. It should be further noted in that regard that Korea, as always in the past, met and indeed more than met, all of the performance criteria under the stand-by program.

As to the program targets under the stand-by, the growth, price and current account performance was better than originally envisaged. Only the public sector deficit was larger than expected, mainly reflecting the efforts of the Korean authorities to offset to some extent the depressing effects on their economy of the slow-down in world trade. Real GNP grew by about 7 per cent in 1981, compared with a program target of 5-6 per cent, and the volume of exports rose by almost 19 per cent during 1981, despite the fact that Korea's terms of trade declined some 20 per cent over 1980 and 1981.

During these last two years the Korean authorities also initiated several important structural reforms with a view to increasing the productivity and effiency of the economy and considerable progress has been achieved in implementing these reforms, many of which are being supported by an IBRD structural adjustment loan approved in December 1981.

These structural reforms involve, amongst other things, streamlining of the industrial structure in six major heavy industries, a continuing thorough review of industrial and export incentive schemes, the adoption of an energy conservation program which emphasises full pass-through to domestic prices of any increases in energy costs, and efforts to reduce through government-sponsored energy audits the relatively high energy-intensity of industrial production.

A comprehensive set of reforms in the tax system has been implemented in 1982, broadly in line with the recommendations of the Fiscal Affairs Department of the Fund. Importantly, the Government has also initiated a major reform of the financial sector with the principal objective being to enhance the role of the market mechanism. A major element of this restructuring is the gradual transfer of the Government's share in the ownership of commercial banks to the private sector, the liberalisation of financial markets, and a reduction in the differential between preferential and general interest rates.

Additionally, Korea continued to liberalise its import arrangements in 1981, and the proportion of unrestricted categories rose from 69 per cent at the end of 1980 to 75 per cent at the end of 1981. Under the Fifth Five-Year Plan, the goal is to raise this ratio to a level comparable with that of most industrialised countries.

These achievements and reforms are, of course, consistent with the broad framework of the recently published Fifth Five-Year Plan for 1982-1986. The Plan emphasises prudent demand management, reductions of the public sector deficit, a reduction of direct government intervention in economic activity, and a strengthening of the market mechanism, and as indicated above it is generally strongly oriented towards structural reform in the industrial system, the tax system, the financial sector and the structure of import arrangements. The improved profitability envisaged, and the associated restrained fiscal policies, are designed to foster increases in business and government saving.

The principal external goal of the Plan is to reduce the current account deficit of the balance of payments to 2.5 per cent of GNP by 1986, though I note the staff refers to this objective as "about 3 per cent of GNP" on page 11.

In brief, the objectives of this Plan are, I suggest, worthy of strong endorsement.

Perhaps the main focus for the Board today, however, will be on the management of macro-economic policy within this broad framework and against the background of developments over recent years. In this regard there is first the question of policy objectives.

The Korean Government is putting a very strong emphasis on curbing inflation and eliminating inflationary expectations. They accept wholeheartedly the view endorsed by the Fund itself that such objectives are

essential for the long-run health of any economy. In terms of achievement to date, we may reasonably expect that they will achieve this objective. Thus, while the prices were rising at a rate of 44 per cent in 1980, the rate was reduced to about 12 per cent in 1981, and for the first three months of 1982 the wholesale price index increased by only 1.4 per cent compared with December 1981. For the same three months the consumer price index rose by about 2.0 per cent. Given this major achievement it seems that consumer prices for the year as a whole might not increase by much more than 7 per cent or so above the level of 1981.

This breakthrough in regard to inflation is, of course, the result of deliberate policy as well as developments in the external sector, and deliberate policy will continue to thrust strongly at countering inflation. Thus the average level of wage settlements will, we expect, be at 10 per cent or less this year, there will be important further measures on the supply side with the rigid enforcement of the Fair Trade Anti-Monopoly Act, import liberalisation, the lowering and simplifying of tariff rates, and the encouraging of inflows of foreign investment and technology.

The authorities also note that they will be pursuing tight fiscal and monetary policy through this year.

In regard to fiscal policy, the objective is to reduce the consolidated public sector deficit from the equivalent of 4.4 per cent of GNP in 1981 to about 2.7 per cent in 1982, with about one half financed from outside the domestic banking system.

Monetary policy is intended to be consistent with the inflation objective and the targets for real growth and the balance of payments. Presently the target for M2 is in the 20-22 per cent range, compared with an outcome of 25 per cent in 1981 and a target of 27 per cent for that year. The ceiling for domestic credit is 25 per cent, compared with 33 per cent in 1981.

The staff express some concern about these targets for money growth but, given the sharp deceleration in inflation, it is reasonable to anticipate a reduction in the velocity of money and it is to be noted that the liquidity of the Korean private sector needs, to some extent, to be rebuilt. More important, perhaps, is the clear recognition of the Korean authorities that they would regard these figures as ceilings rather than objectives and that they would be flexible in a downward direction if it became clear during the year that lower figures were appropriate. It is to be noted in this regard that the Deputy Prime Minister and Minister for Economic Planning, Kim Joon-sung, is on public record that it would be "unthinkable to boost the economy at the cost of price stability", including through monetary expansion which he has made very clear could not provide a fundamental improvement.

The other high policy objective of the Korean Government presently is a continuing favourable adjustment in the balance of payments. The authorities' present expectation is for a current account deficit of

US$3.6 billion to US$3.8 billion. This would represent a reduction of from US$300 million to US$100 million in the original projection.

The current account objective, of course, cannot be considered without reference to exchange rate policy. It is quite evident from the staff paper that there is a difference of view about how the exchange rate should be managed in the coming period. As discussion in the Executive Board repeatedly demonstrates, this aspect of economic policy is surely one on which reasonable men can, and often do, differ, but there has been considerable support in the Executive Board's recent discussions for the view that the reduction of inflation and rising productivity should be the means of promoting international competitiveness, with exchange rate management in a relatively subsidiary role. However that may be, it is interesting to note that in the debate about the appropriate direction of policy the authorities are propounding what seems to me to be the conservative low-risk path that the Fund would commonly support as compared with the relatively high-risk prescription of significant devaluation propounded by the staff, which, if it is to be successful, would have to be supported by very comprehensive strong domestic policy across the board, and effective penetration of markets which generally speaking are not only restricted in access, but are also the target of other industrialised and industrialising nations, some of whom may also be contemplating a policy of downward adjustment.

There are a couple of particular points to keep in mind when considering the possible substantial downward adjustment of the exchange rate as a policy prescription in the case of Korea. First, it is notable that around 70 per cent of Korea's imports are industrial raw materials and that another 20 per cent or so are capital goods. Moreover devaluation directly affects the cost to domestic industry of its heavy overseas debt. Thus, experience suggests that a depreciation of the Korean won, producing a 10 per cent increase in the domestic price of imports, may be expected to produce approximately a 5 per cent increase in the wholesale price index (see page 21 of the RED).

Moreover, there is considerable evidence in the experience of Korean exporters to suggest that the penetration of new markets, quality improvement, the development of new products and new technology, the simplification and improvement of export procedures, and the deliberate development of export promotion activities, are all areas where there is room for greater effort and achievement, and they feel indeed that these factors may even be dominant in the present perceived slowing down of Korean export growth.

Of course, the staff has made its measurements and speaks factually about appreciation in relation to Korea's trading partners, but as has been discussed very recently in the Board, it may be that the more significant comparison is with Korea's trading competitors. In any case since the prospect is that Korean inflation could be broadly in line with that in the US, while at the same time Korean productivity will be rising possibly much faster than that in the US, it could well be the case that Korean competitiveness vis-a-vis the US will improve within the framework of existing exchange rate policy.

In the view of the Korean authorities the anticipated decline in wage increases, the reduction in interest rates, the expected gains in productivity combined with higher capacity utilisation and the helpful effect of relatively stable exchange rates on the cost of foreign currency denominated debt, will improve both profitability and competitiveness. These factors, together with the anticipated pick-up in world demand should, in their view, ensure achievement of the target of 10 per cent growth in export volume during 1982 and, therefore, the predicted reduction in the current account deficit as well.

The Korean authorities at any rate are not dogmatic about the exchange rate and as the staff has noted, they agree that with the current exchange rate policy, somewhat lower monetary expansion might be required to accomplish the inflation and balance of payments targets if export growth is slower than they presently project, but they are of the view that it is too early to say whether their policies focussing on wage moderation and productivity improvements and the more direct measures noted above, will not be effective. For the present, they are of the view that their package of policies, together with the expected strengthening of world demand, may be sufficient to achieve their macro-economic objectives. Nevertheless they agree that economic developments, including the performance of exports, should be closely monitored during coming months and should external developments be less favourable than they anticipate, then exchange rate and monetary policies would be reviewed. That is a very reasonable position for the authorities to adopt and I hope it is one that the Executive Board will feel able to endorse.

The staff recognise that interest rates must also be appropriate and that in the present state of evolution of the Korean financial structure this cannot be left to the market alone. The staff support the authorities' stated policy of maintaining positive real interest rates and say that real interest rates are now "slightly" positive. In fact, a comparison of actual interest rates with the current rate of price increase would indicate that real interest rates for Korea are very substantially positive at the present time. Moreover, the Korean authorities are fully aware of the need to monitor the relationship between relevant domestic interest rates and those in the international financial markets. In this regard, it is of some guidance that in Korea at present the average interest rate on commercial loans is around 14 per cent, and that as of April 30 the three-month Eurodollar deposit rate in the United Kingdom was 13.63 per cent. There are other markets, of course, and there are other borrowing costs involved in actual transactions, but so far as it goes this comparison does not indicate a serious, adverse differential.