PROGRESS IN KOREAN ECONOMIC REFORM

Address to a
Korea-Australia Economic and Business Seminar

Sponsored by Asialink and the Embassy of the Republic of Korea

Carillon Room
Hotel Sofitel, Melbourne

1 May 2000

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Dr Perkins, Ambassador Hyo-hun Shin, Minister Chung, distinguished guests from Korea and Australia, ladies and gentlemen: thank you for the honour and privilege of being able to share with you my thoughts on the progress of Korean economic reform.

Korea's recovery from the financial crisis of late 1997 and early 1998 deserves to be ranked among the economic miracles of our time - different, to be sure, from Korea's extraordinary achievements in the decades which followed the dramatic re-orientation of economic policy by President Park in 1961, but a remarkable achievement nonetheless.

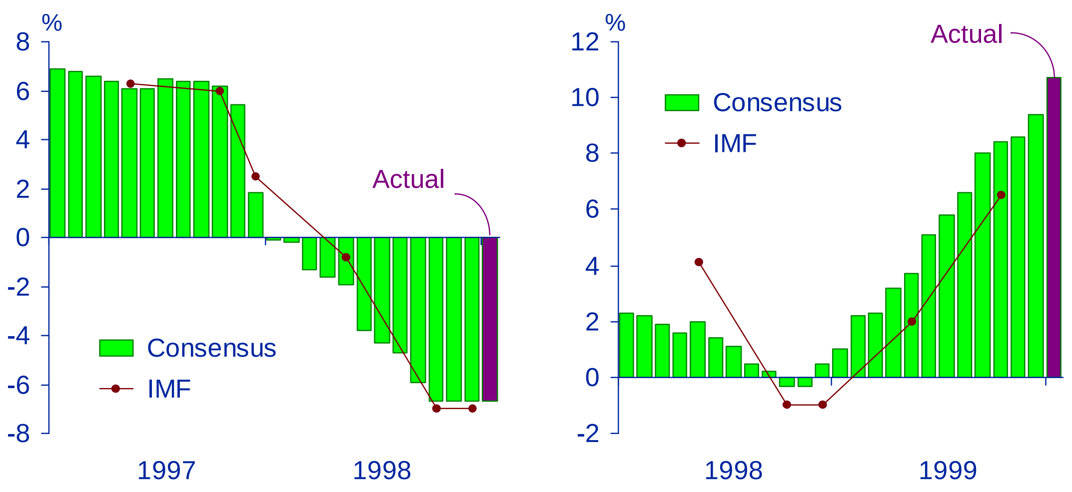
The significance of this achievement can be seen by contrasting Korea's economic performance with the expectations which were held for it at various times during the crisis, and with the performance of other countries which have undergone similar experiences.

At the height of the financial crisis, in early 1998, the consensus of private sector opinions was that Korea's economy would shrink by a little more than 1% that year, and grow by less than 2% in 1999. The IMF was a little more optimistic, forecasting in its May *World Economic Outlook* that the Korean economy would shrink by 0.8% in 1998 and rebound by 4.1% in 1999. *The Economist*, in a survey of East Asian economies published in March, argued that Korea's economy was "ill-equipped for change, so that [it] is likely to have a tough time over the next few years", whereas Thailand, in the magazine's opinion, 'should [be able to] restructure faster".

Sentiment deteriorated as the year unfolded. By November, the private sector consensus forecasts for 1998 and 1999 had been revised downwards to -6.7% and -0.3% respectively; while the following month, in a special update to the *World Economic Outlook* which it had released in October, the IMF downgraded its outlook for Korean GDP growth in 1998 and 1999 to -7% and -1%, respectively.

Forecasts of Korean real GDP growth

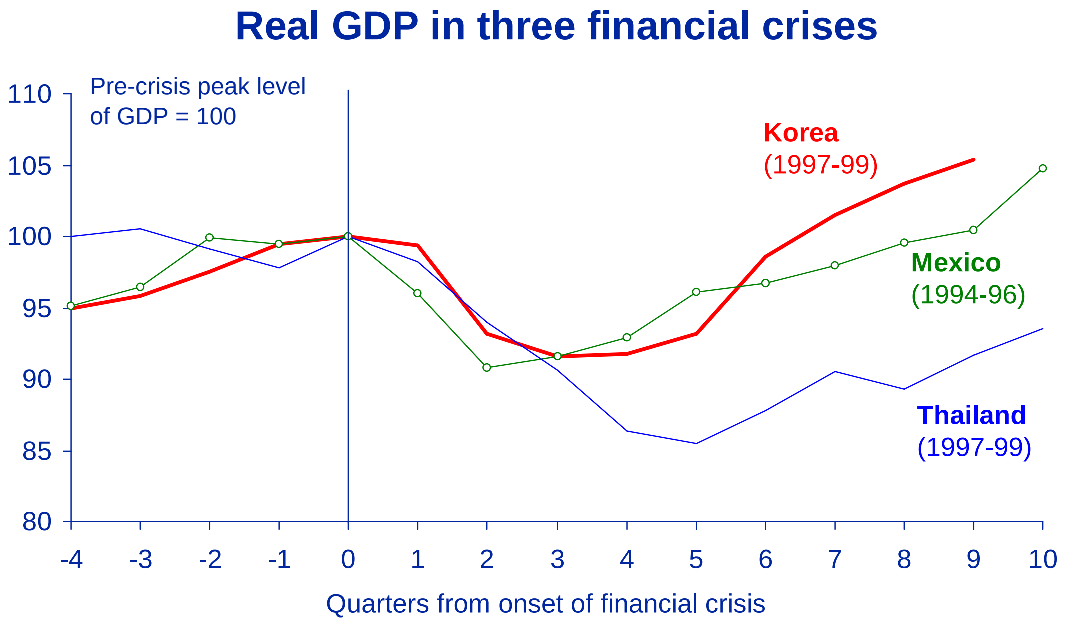
1998



Sources: Consensus Economics Inc., *Consensus Forecasts;* IMF, *World Economic Outlook*.

In the end, as we now know, the Korean economy contracted by 6.7% in 1998, but rebounded by an astonishing 10.7% last year. We expect it to grow by a further 7½% this year.

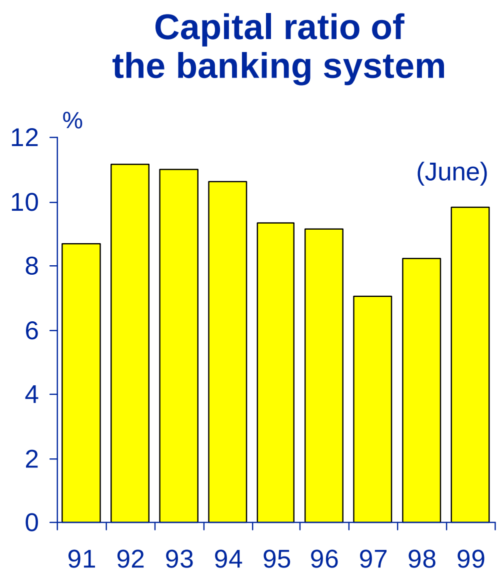
To the best of my knowledge, no other economy has recovered as rapidly from a currency and banking crises as dramatically as Korea. A 1998 study of 212 financial crises in 53 countries over 22 years published by the IMF reported that, when banking and currency crises occurred together (as they did in Korea), it took an average of 3.2 years for output growth to return to its pre-crisis trend. In Korea's case, it took - arguably - less than a year.

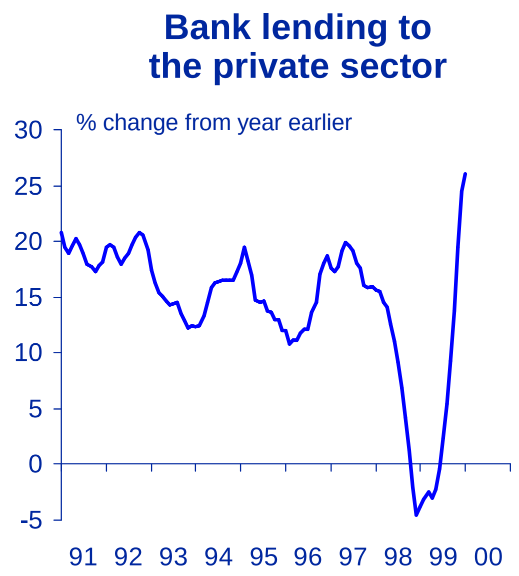


Sources: National statistical agencies; Primark Datastream; seasonal adjustment by Economics@ANZ.

A comparison with Mexico is instructive. Mexico's economy shrank by 6.2% in 1995, the year immediately following the peso crisis. It rebounded by an average of 'only' 5.1% in 1996 - with 'through-the-year' growth peaking at 8.4% in mid-1997, compared with 13.0% (so far) for Korea. This is despite Mexico having received some US$50bn in financial assistance from the IMF and the US Treasury, compared with around $13bn for Korea, and despite the advantages available to Mexico through its free-trade agreement with the United States, the market for more than three-quarters of its exports.

The speed and strength of Korea's turnaround owes much to the fact that, as *The Economist* observed last year, it "acknowledged its faults with remarkable candour. It has not tried to blame foreigners for its troubles, not has it hid behind tariff barriers or currency controls". And, as the analysis of post-crisis developments in Asian financial markets prepared by the East Asia Analytical Unit last year points out, Korea had "the cleanest, most transparent and efficient approach to bank restructuring and refinancing". By the end of last year, non-performing loans had been reduced to 8.7% of total financial system assets, from a peak of 24% in June 1998, facilitating a rapid rebound in bank lending beginning in the second half of last year. And KAMCO has already disposed of more than 40% of the NPLs which it acquired from banks.





Sources: Financial Supervision Commission; Bank of Korea.

Of course, some significant problems still remain in the non-bank financial sector, and especially among the investment trust companies, which were heavily exposed to the Daewoo bankruptcy. Again, however, the fact that Korea was able to handle such a large bankruptcy without major dislocation to the financial system testifies to the effectiveness of the earlier reforms.

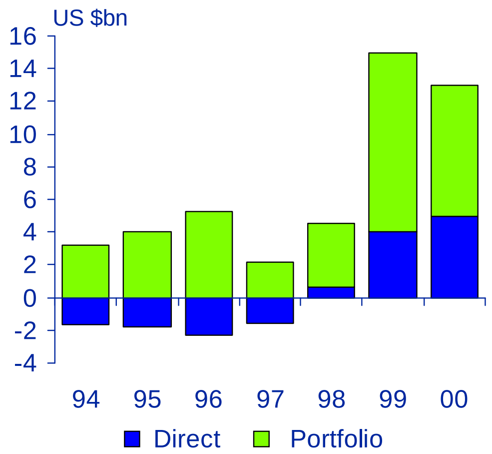
Much of the re-capitalization of the banking system was financed by the government itself, and has been a major factor in the more than doubling of public sector debt from Won 79 trn (17% of GDP) to Won 202 trn (42% of GDP) over the past two years. I draw attention to this not as a criticism - far from it - but rather to underscore the importance of now moving on with the privatization of the banks which have effectively been nationalized as part of the recapitalization program.

Korea’s reformist approach was undoubtedly facilitated by the change of government which occurred at the same time as the financial crisis. Importantly, this relieved the incoming administration of the need to defend the policies which had been pursued (and the individuals and institutions which were pursuing them) in the period leading up to the crisis - which was a major problem for Indonesia and Malaysia.

Korea’s energetic response to the financial crisis has been rewarded with a significant upsurge in foreign investment. Foreign direct investment, which (largely as a result of prohibitive or hostile regulation) had been minuscule prior to the crisis, is estimated to have been around US$4bn last year, and should easily surpass that amount this year. Portfolio equity investment likely exceeded US$10bn in 1999, notwithstanding the selling prompted by the Daewoo crisis in the third quarter of last year.

Foreign buying contributed significantly to the recovery in the Korean share market (up more than 100% from its post-crisis low), which in turn facilitated the raising of some US$34 billion of new equity capital to underwrite corporate restructuring, as well as aiding the recovery in consumer confidence and spending..

Foreign equity investment into Korea



Some examples:

- **Newbridge Capital's 51% stake in Korea First Bank for US$442 mn**
- **Philips Electronics purchased half of LG Electronics Inc's flat screen business for US$1.6 bn**
- **Interbrew of Belgium acquired a 50% stake in Oriental Brewery for Won 350 bn**
- **Fairchild Semiconductor Int'l paid US$417 mn to Samsung for a non-memory chip operation**
- **Volvo bought Samsung Heavy Industries' construction equipment business for US$572 mn**

Foreign investment inflows, combined with the dramatic turnaround in the current account balance, have also assisted the early repayment of loans from the IMF and other external debt

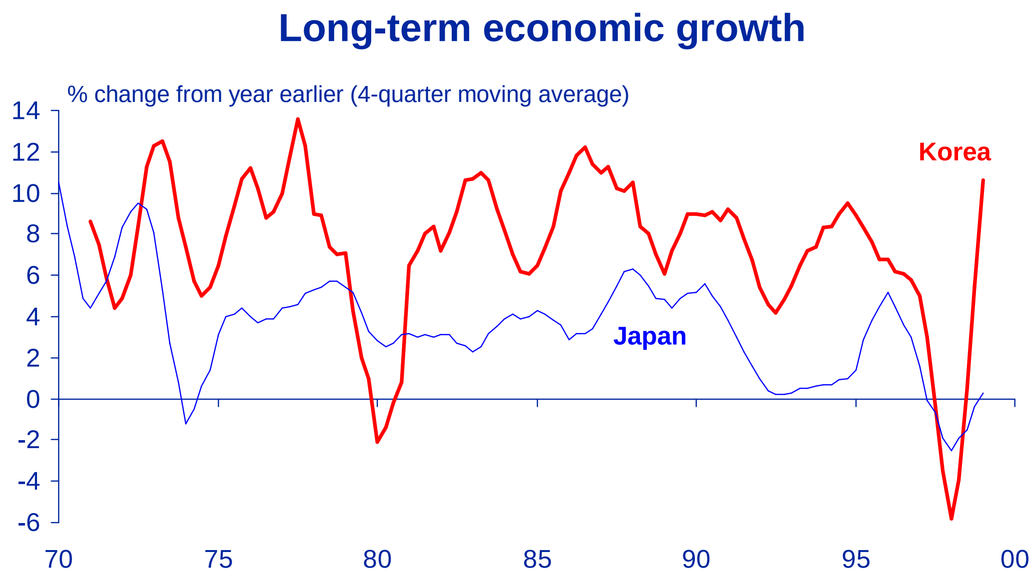
It is vitally important for Korea's longer-term prospects - including its ability to withstand the financial shocks which will surely occur again in the future - that the return to prosperity does not weaken the resolve to implement structural reforms or preclude the pursuit of stability-oriented macro-economic policy: in other words, that Korea does not slip back into comfortable habits acquired during the pre-crisis era.

Please allow me to illustrate what I am trying to say here by the use of two propositions.

First, much of the reform agenda now confronting could be encapsulated by saying that Korea should lay aside forever the notion that Japan represents a model or template for Korea to follow as it continues along the path of economic development. That is a challenge because for most of the past four decades Korea and other Asian economies have consciously looked to the example of Japan for guidance as to how to achieve rapid economic progress whilst preserving important aspects of their social fabric and culture.

And indeed it has to be said that the Japanese example has for much of this period served other Asian economies, and especially Korea, very well.

But, and I say this as a friend of both Korea and Japan, if Japan is now a model of anything it is a model of what *not* to do in order to promote economic growth and development in an increasingly integrated and potentially unstable world economy.



Sources: Bank of Korea; Japan Economic Planning Agency.

The contrast between Korea's vigorous recovery, and Japan's continued flirtation with recession, reflects Japan's deep-rooted resistance to structural change, its instinctive pre-disposition to suppress market forces, its innate hostility to foreign influences and practices, its natural inclination to believe in the all-knowing wisdom of its bureaucrats (despite boundless evidence to the contrary), and the inability of its political system to respond to the wishes of the majority of its people. There are, to be fair, some signs that in some respects some of these things are changing. But the pace is glacial. And so is the Japanese economy.

Thus Korea needs to entrench the changes in business culture and practices which the administration of President Kim Dae Jung has been seeking to promote, such as the use of profit as opposed to market share, export receipts or assets as the benchmark for determining whether resources have been sensibly allocated. It needs to ensure that companies and financial institutions provide sufficient information to allow domestic and foreign investors and lenders to make those judgements. It needs to allow banks to make business judgements, not require them to act as instruments of government policy; and it needs to facilitate the growth of forms of finance other than traditional bank loans. It needs to allow, as it did with Daewoo, business mistakes to be recognized, exposed and dealt with. It should resist pressure to discriminate against foreign investors. It needs to be willing to allow its people freely to choose between domestically-produced and imported products, just as it quite properly demands that Korean products be allowed to compete on fair terms in foreign markets.

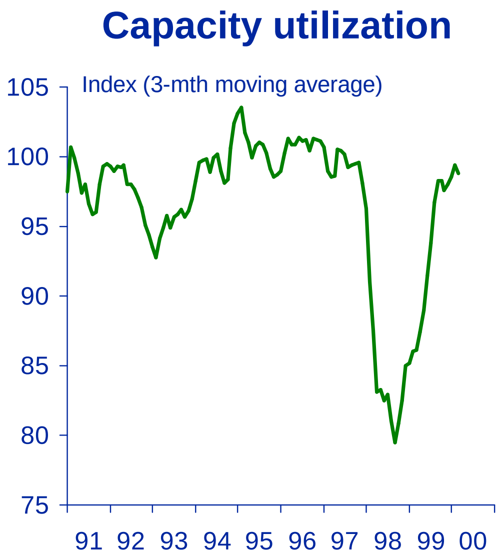
In short, Korea needs to transit from a largely State-directed to a primarily market-based economy. (Note that I do not say 'wholly'market-based economy; nor do I say 'market-based society').

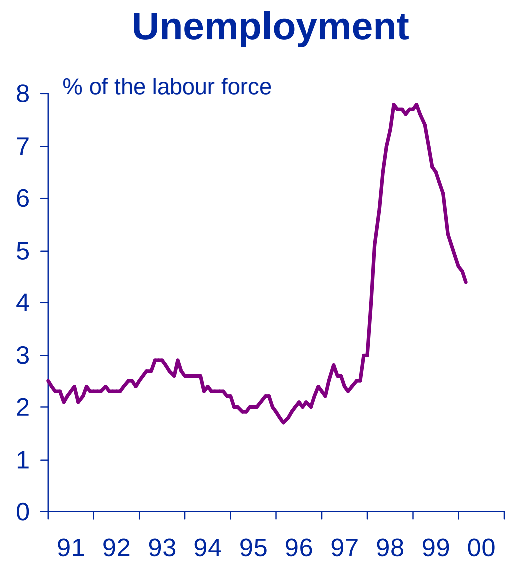
These are momentous, some might say revolutionary, goals. They are not going to be attained overnight, literally or metaphorically speaking, although in many cases considerable progress has already been achieved. It is important that the momentum of, and commitment to, reforms in these directions are maintained.

The second proposition I would put is that Korea ought not return to its pre-crisis practice of making the exchange rate a target of economic policy.

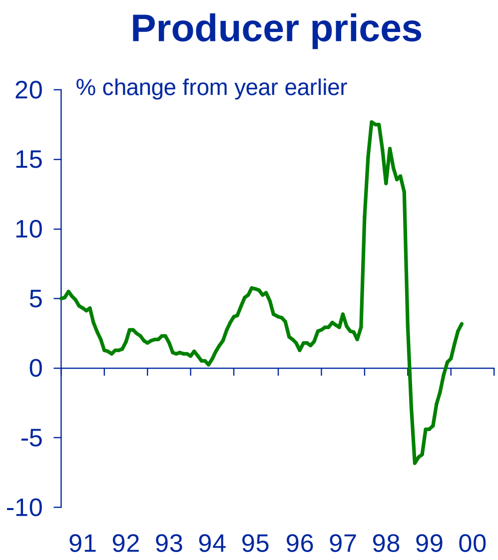
In the past, the pursuit of exchange rate stability at the expense of other objectives led banks and corporations to take on excessive foreign exchange rate risk, in the mistaken belief that there was no such risk. And it left the Korean economy vulnerable to bouts of inflation, as the desire to maintain a stable exchange rate precluded the central bank from using monetary policy to pursue price stability.

The Korean economy is now returning to full capacity utilization, and there are clear signs that inflation has passed its cyclical trough and is once again rising (albeit from a low level). Winding back the fiscal deficit, as the government intends, will help to alleviate the emerging cyclical strains. But it is also likely that monetary policy will be need to be tightened by more than has occurred thus far.



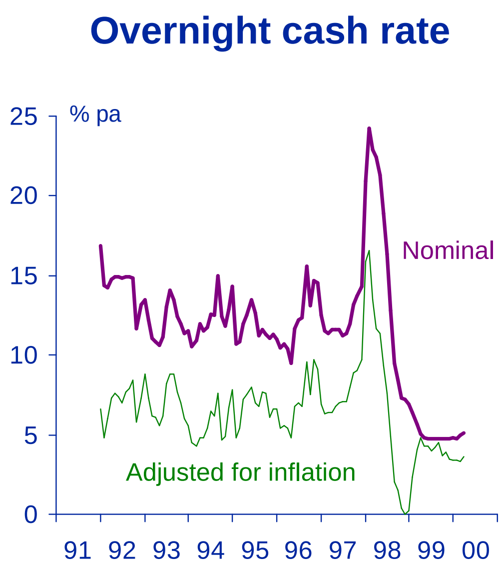


Source: Korea National Statistical Office.



Source: Bank of Korea.

Some of this should occur through an appreciation of the exchange rate. In real terms, the won is still more than 10% below its average for the five years prior to the onset of the crisis. The current account surplus, though declining, is still relatively large (at around 3% of GDP). Domestic credit growth is now rising rapidly, suggesting that monetary conditions are highly accommodative.



Source: JP Morgan; Primark Datastream; Economics@ANZ.

It would be very dangerous were the Bank of Korea to hold back (or be held back) from raising interest rates for fear of what that might imply for the exchange rate.

One thing of which we can be absolutely certain is that Korea will at some stage face a very significant financial shock in the form of re-unification with the North. Indeed I would expect that an overwhelming majority of Korean people welcome that prospect, and will be hoping that the forthcoming summit between President Kim and Kim Jong-Il will bring it closer to realization.

However, those hopes for eventual re-unification should not obscure - and I am sure that for those here today they do not obscure - the fact that re-unification of the Korean peninsula will impose a much greater economic burden on the people of South Korea than the re-unification of Germany did on West Germany. North Korea's population is much larger, relative to the South's, than East Germany's was relative to the West's; and the gap between per capita living standards in the two halves of the Korean peninsula is more than six times larger than was the corresponding difference between East and West Germany at the time of their re-unification.

Thus the South Korean economy will need to be in a very strong condition if the aspirations of the Korean people for their country are to be achieved without renewed major economic dislocation. And that is without considering the risks which still exist of further turbulence in the global economy.

	Korea (1997)		Germany (1988)	
	South	North	West	East
Area (sq km)	99	123	249	108
Population (mn)	46	23	62	17
GDP per head (US$)	9 530	741	19 500	9 300
Life expectancy (years)				
Males	69	61	70	69
Females	76	65	77	75

Sources: Economist Intelligence Unit; *The Economist*; World Bank.

Korea's recovery from the financial crisis of 1997-98 has indeed been a modern miracle. But it is not the end. It needs to be seen, as Winston Churchill suggested in an altogether different context, as at best the end of the beginning.

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