

## **Seung Park: The recent state of the Korean economy and the policy response**

Speech by Dr Seung Park, Governor of the Bank of Korea, at the Seoul Foreign Correspondent's Club, Seoul, 16 December 2003.

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### **Opening remarks**

Ladies and gentlemen,

Let me begin by expressing my deep thanks to Ms. Sohn, Jie-Ae, the President of Seoul Foreign Correspondent's Club and other members for having invited me to address today's gathering. Over the past half-century, correspondents of the Club have acquainted the entire world with Korea's politics, economy, society, and culture. At times you praised and encouraged for Korea's astonishing development. At others you criticized and advised about Korea's outmoded practices not in keeping with global standards. In this way, you have contributed to Korea's growth as a member of the international community.

Today I would like to brief you on the movements of the Korean economy over the past year, the prospects for the next year, and what needs to be done to achieve sustainable growth. I intend to focus especially on the desirability of North-South economic cooperation on the Korean peninsula.

### **Movements of Korean economy over the past year and policy initiatives**

As all of you may well be aware, this year the Korean economy has been going through its most difficult period since overcoming the 1997 currency crisis.

In the early part of the year, geopolitical risks ran high over the war in Iraq and the North Korean nuclear issue while the world economic recovery was still awaited. Along with these woes, the spread of SARS greatly undermined consumer and business confidence. After that, the situation was worsened by production setbacks arising from labor disputes and the damage caused by Typhoon Maemi. Despite the now-evident recovery of the world economy and the matching improvement of exports, the household sector's over-indebtedness and the inefficiency of the country's social structure are acting to hinder the recovery of consumer and business confidence. As a result, Korea's GDP growth is considered to have fallen from 6.3 percent last year to 2.9 percent this year.

On the front of prices and current account position, the picture is rather more satisfactory. Core inflation has been showing stable movements at around the 3 percent mark, the midpoint of its target range. The current account is expected to register a surplus of around 12 billion dollars for the year thanks to the briskness of exports.

In spite of price stability and a current account surplus, economic activity has remained in the doldrums. Thus the Bank of Korea lowered its call rate target by 50 basis points in all to support a recovery of economic activity, bringing it down in May and July from 4.25 percent to the current 3.75 percent. For its part, the government has expanded fiscal spending. It drew up supplementary budgets of 6.3 billion dollars (7.5 trillion won) in all during this year.

### **Prospects of Korean economy for the next year**

Looking ahead, as the effects of this pump-priming policy become evident and the world economy, notably that of the United States, continues to show clear signs of recovery, we expect a gradual improvement in the Korean economy. In the third quarter, GDP growth already increased to 2.3 percent from the 1.9 percent of the second quarter. It is thought that the economy has now bottomed out and moved into a phase of mild recovery. Next year Korea's GDP growth is expected to rise to 5.2 percent.

For its part, core inflation for the next year is anticipated to show stable movements at 2.8 percent. We are looking to see a current account surplus on a scale of around 6 billion dollars.

## **Changes in the growth environment and tasks for sustainable growth**

If we judge the Korean economy only by the prospects for next year's growth, prices and current account position, we might think that it has no serious problems.

Seen from a long-term perspective, however, the growth environment surrounding the Korean economy has been changing very fast. How appropriately we respond to these changes will be decisive for the future of the Korean economy.

These changes in the growth environment can largely be summarized under three headings. The first is the Korean economy's shift from a low wage system to a high wage system. The second is the dynamic rise of the neighboring Chinese economy with its unlimited resources of low wage labors. And the third is that the Korean economy is inevitably exposed to the worldwide revolution of openness.

Due to the combined shock of three major changes, Korean companies and products that have grown up under the previous low wage and protectionist framework are destined to lose much of their competitiveness.

Therefore, short-term pump-priming measures are insufficient to sustain a solid growth path for the Korean economy in the long run. Heightening competitiveness through the structural reform I am about to describe is of over-riding importance.

Firstly, efforts for financial structural reform should be stepped up more than ever. It is true that Korean financial markets have developed greatly in terms of quality and quantity thanks to its drive for structural adjustment since the 1997 financial crisis. More recently, however, some new factors making for instability in financial markets have emerged. They include the worsening of management status in some credit card companies and investment trust companies, the rise in the overdue ratio on household loans, and the increase in number of individuals on the bank's credit blacklist. Worse still, they act as a hindrance to economic growth, causing the shrinkage of consumer and business confidence. Therefore, it is important to resolve the problems posed by these destabilizing factors at an early stage through more intensive financial reform so that the Korean economy can enjoy continued growth.

Secondly, the problem of high costs, which is deeply rooted in all areas of Korean society, should be solved. The major high costs I would identify are the high housing cost caused by the steep rise in property prices, the high education cost caused by the fevered atmosphere of private tutoring institutes, and the high transportation cost caused by urban traffic congestion. These high costs consequently lead to high wages. Though the causes of these high social costs are varied and complicated, we can say the main factor lies in the development imbalance between the regions. For this reason, it is important to promote balanced development between the regions to solve the problems of these high costs. And in particular, it is highly necessary to devise countermeasures for easing the concentration of the population on Seoul and notably the Kangnam area.

Lastly, but not least, the problem of low social efficiency should be tackled. Typical examples of this low efficiency are immature labor-management relations, the influence of vested interest groups, the unproductive political structure, and the anti-globalization sentiment. These phenomena mainly arise from the underdevelopment of the structure of popular consciousness. Therefore, Korea should overcome them by reinforcing social leadership and steady efforts for the reform of consciousness. That is, Korea should shift in labor-management relations from a mind-set oriented toward conflict and confrontation to one focused on understanding and cooperation. And it should shift from a wearisome and unproductive political process to one that is constructive and productive, and from closed mental attitudes to outward-oriented ways of thinking.

## **The Importance of North-South economic cooperation on Korean peninsula**

So far, I have outlined three paths to enhance the Korean economy's competitiveness. However, they are all medium- or long-term tasks that will need a long time to bring to fruition.

So then, what can provide a short-term breakthrough for strengthening competitiveness? The answer is to promote North-South economic cooperation on the Korean peninsula.

North-South economic cooperation could open up a new path toward absorbing the impact on the Korean economy of its high wage costs, the dynamic rise of the Chinese economy, and the revolution of openness. North Korea offers very low production costs, particularly low-cost labor, and there is also the possibility of direct inland transport between the North and the South. It should also be

relatively unproblematic for South Korea companies to locate operations there because of the shared language and historical traditions. In addition, people in the two halves of Korean peninsula have the sense of belonging to one and the same nation.

On the basis of these advantageous conditions, the combination of South Korean capital and technology and North Korean work force can lead to stronger competitiveness in the high-end information technology sector as well as, of course, the more labor intensive sectors.

Needless to say, the setting-up of brisk economic cooperation between the North and the South is also very important in terms of preparations for reunification. At the present time, North Korea is in great need of basic necessities because of the backwardness of its industrial facilities. If reunification were to take place without adequate preparations under these circumstances, huge number of North Korean people would flow into the South looking for work. This could turn into a national disaster.

For the timely prevention of such a situation, we need to narrow the economic gap between the two Koreas by stepping up investment in North Korea.

In this respect, a great deal depends on whether or not the industrial complex at Kaesong, the southernmost city of North Korea, proves a success. With the ground-breaking ceremony on June 30, the construction of the first stage of the Kaesong industrial complex is underway with a ticket of some 180 million dollars(200 billion won). Kaesong is a very important staging post on the road between Seoul and Pyongyang, and it is located only some 60 km north of Seoul. And it is understood that within the factory complex, the minimum wage will be only 57 dollars and 50 cents per month. The rate of tax will be very low. There are also guarantees that firms will have autonomy and flexibility in the management of locally-hired human resources. Consequently, many South Korean companies are planning to set up in the Kaesong industrial complex. Whether they succeed or not will provide a touchstone for future investment in North Korea and for economic cooperation between the two halves of the peninsula.

When we look at the overall picture of the relationship between North and South Korea, we can say that the thaw has now arrived, even though there remain some factors making for tension such as the North Korean nuclear issue. The proportion of the population on both sides who went through the horrors of the Korean War is declining rapidly and mutual hostility is easing. Meanwhile, bilateral exchanges and cooperation are constantly expanding in the academic, cultural and sporting areas as well as the humanitarian dimension. It is absolutely essential to reach a peaceful solution to the North Korean nuclear issue in order to sustain this desirable atmosphere and foster economic cooperation between the two Koreas. It is indispensable also for the firmer assurance of security throughout the Asian-Pacific region.

I would like to ask you as members of the fourth estate, to give your supportive cooperation so that progress can be made on the North Korean nuclear issue.

### **Closing remarks**

As I have pointed out today, the Korean economy faces many difficult problems.

But as you have probably observed, Koreans have a long tradition of uniting as one in their efforts to overcome adversity. Korea brought about the "Miracle on the Han River". It rose from the ashes of the Korean War and utter destitution to become a member of the so-called rich countries' club of the OECD within less than half a century. Korea also offers a successful example of what can be achieved under the IMF's structural adjustment program. Through bold structural reform, it was able to overcome, in a prudent manner, the foreign currency crisis that broke out in 1997, again exhibiting a characteristic dynamism.

For my part, I am convinced that Korea will again move on from the present difficult situation, drawing on the strong foundation built by such historical experiences and the sense of self-confidence that they have provided.

Thank you for listening so attentively.