Seung Park: Economic situation and monetary policy in Korea

Contribution by Mr Seung Park, Governor of the Bank of Korea, to the Korea Times, 24 September 2003.

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1. The Korean economic situation and outlook

From early this year, Korea has been experiencing the most difficult economic situation since overcoming the 1997 currency crisis. Last year's strong GDP growth of 6.3 percent was achieved against the backdrop of the depressed world economy. This year, though, Korean GDP grew only 3.7 percent in the first quarter compared to the same period of the previous year before sliding further to 1.9 percent in the second quarter. Although economic activity appears not to have worsened from its trough in the second quarter, no clearly marked recovery trend has yet become evident.

This lackluster economic performance came primarily from unfavorable external factors. The recovery of major economies worldwide and most significantly that of the U.S. proved to be delayed. Uncertainty also mounted in response to the war in Iraq, the North Korean nuclear issue and the widespread outbreak of SARS within East and Southeast Asia. Unsurprisingly, domestic demand contracted greatly, particularly in the form of consumption and facilities investment.

Lately, external conditions have been showing a gradual improvement. After the early end to the war in Iraq, the economies of the U.S. and Japan have shown clear signs of a recovery. Euroland has not yet shaken off its recession, but there too indicators of consumer and business confidence are picking up. China is again seeing strong economic growth now that SARS has been contained. All in all, the general outlook for the global economy is brightening. In addition, hopes are growing that the North Korean nuclear issue can be peacefully resolved as, prompted by the holding of multilateral talks, all the countries involved have stepped up their efforts to bring this about.

The effects of the various pump-priming measures taken by the Bank of Korea and the government are expected to become progressively more tangible. For its part, the Bank of Korea has lowered its policy rate twice this year. Meanwhile, fiscal expenditure is being expanded by the drawing-up and approval of a 4.5 trillion-won (nearly 38 billion-U.S. dollar) supplementary budget. Measures to reduce the tax burden have also been taken including the lowering of the rate of special excise tax and the granting of increased tax credits for investment.

Given the upturn in global conditions and the emerging effects of the economic stimulation package, the Korean economy is expected to move onto a moderate recovery track in the near future, though there may be some impact from the damage inflicted by the recent typhoon.

The problems we confront, though, are by no means simple. Above all else, we have the issue of the high social costs exemplified by the recent confrontation between labor unions and employers and the prevalence of actions placing the interests of vested interest groups above those of society as a whole. The timely resolution of this conundrum is crucial to the long-term health and viability of the country's economy. We also have to tackle the potential threats to financial stability including the mounting number of Koreans on credit blacklists, swelling overdue loans in the household sector and the frail management status of certain financial institutions.

One of the characteristics of Korean society inherited from a history of adversity is that when people share the perception that the country faces a crisis, they unite as one in enduring whatever hardship it takes to overcome it. This was the wellspring from which Korea drew the strength to surmount the currency crisis. And helped by these social dynamics, Koreans will, I am confident, deal skillfully with the present challenges. There are already signs that a social consensus has been reached on the need to overcome the problems that I have mentioned for the good of the Korean economy. The government is now also directing its attention toward curing the evil of spiralling social costs.

2. Monetary policy

In the light of the shifting economic environment, the Bank of Korea has conducted monetary policy so as to support the economic recovery while smoothing out the internal and external disequilibria.

Early this year, because of the current account moving into the red and the upward price pressures brought about by the steep run-up of international oil prices, we had difficulties in making use of the interest rate policy lever to deal with the downturn in economic activities. We therefore left our target rate, the overnight call rate, on hold.

But the current account shifted into surplus and price movements settled down once international oil prices showed downward stability following the early end of the war in Iraq. For this year as a whole, too, our forecasts pointed to core inflation being held stable within its target range at the 3 percent level and to the current account maintaining its underlying surplus trend since the 1997 currency crisis. Under these circumstances, the Bank of Korea moved to revive business and consumer confidence. In May and again in July, it reduced its overnight call rate by 50 basis points in all, bringing it down to its present historically low level of 3.75 percent.

A number of actions have also been taken by the Bank of Korea to stabilize the financial markets. It has ensured an adequate supply of liquidity through open market operations in order to counter temporary financial market unease. This emerged in March following the revelation of accounting malpractices at a few large companies and worries about credit card companies going under. It resurfaced in June when the staff of Chohung Bank went on strike.

The Bank of Korea will continue to adopt a "look at everything approach" in the future, taking into overall account the impact of changing conditions at home and abroad on growth, prices and the balance of payments. In the course of conducting monetary policy, particular attention will be paid to alleviating potential risk factors including household debt so as to ensure the stability of the financial markets.

From the start of next year, the revised Bank of Korea Act will come into effect, substantially increasing the Bank of Korea's powers and its degree of independence. Under the revised central banking legislation, the existing practice of setting an inflation target every year will be replaced by a medium-term inflation targeting system. The central bank is also given greatly increased responsibilities for the comprehensive management and oversight of the payments and settlements system. In keeping with its heightened role, the Bank of Korea will strive even harder to be effective in achieving the twin goals of its monetary policy: macroeconomic stability and financial stability.