

Mr. Chon reports on recent economic trends in Korea and the Bank of Korea's monetary policy response to them Speech by the Governor of the Bank of Korea, Mr. Chol-Hwan Chon, at a press conference hosted by the Seoul Foreign Correspondents Club in Seoul on 4/11/98.

I - Introduction

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I am very pleased to be with you today to talk about the recent economic developments in Korea.

Nowadays almost all countries around the world have become closely linked to each other in a global information community, owing to the rapid advances in telecommunications. The advisory role and influence that the international press exercises over the economic development of any one country have correspondingly increased. You yourselves as foreign correspondents in Korea have shown keen interest and provided valuable advice, admonition and encouragement in our attempts to defuse the crisis that broke out a year ago.

We are most grateful. So, let me take this opportunity to voice my sincere thanks to you all. And I hope that today's meeting, although all too brief, will help you gain a clearer understanding of the Korean economy today and the thrust of monetary policy in the future.

II - Recent Economic Trends in Korea

Real Economy

First, let us look at the recent performance of the Korean economy.

As you know, we have been going through serious hardships. Domestic demand in terms of both consumption and investment has been deeply depressed by the shock of the currency crisis and the effects of structural adjustment.

Exports have also been sluggish mainly because of the severely subdued demand in our major markets, including Japan and Southeast Asian countries.

GDP growth for the first half of this year was down sharply to -5.3 per cent as against the 4.9 per cent of the latter half of the previous year. Viewed by quarter, the second quarter's growth rate slid further to -6.6 per cent from -3.9 per cent in the first quarter. GDP statistics for the third quarter have not been compiled yet, but indicators related to production, consumption and investment remained subdued.

Unemployment rose to 7.3 per cent in this September from 3.1 per cent at the end of last year, as the economic recession deepened and firms downsized in the process of restructuring.

And the number of unemployed shot up dramatically to 1.6 million in September, which was more than three times as many as the half million a year before.

Consumer prices had risen steeply in the period from last December to this February, affected by the massive depreciation of the Korean won. But they have held broadly steady since this March. This can be put down to the stable movements of the exchange rate and international raw material prices, along with the depressed domestic demand.

Turning to the current account, we have seen a swing from a deficit of 8 billion dollars in 1997 to a large surplus of some 31 billion dollars for the first three quarters of this year.

Much of this improvement, though, must be attributed to the sharp reduction in imports, brought about by the subdued domestic demand, which has more than offset the effect of the decline in exports.

Foreign Exchange and Financial Markets

Now let us move on to the foreign exchange and financial markets.

Helped by the large surplus on the current account and the conversion of most of the outstanding short-term foreign debt of financial institutions to long-term obligations, the foreign exchange market has stabilized substantially. Usable foreign exchange reserves rose to 45 billion dollars at the end of this October, which was above the year-end target level of 41 billion dollars agreed as a conditionality element of the IMF's standby arrangements.

Since mid-March, the exchange rate has regained stability, moving in a range of some 1,300 to 1,400 won per US dollar.

Total foreign debt, as defined by the IMF standard, has also been reduced by 4 billion dollars since the end of last year. It stood at 151 billion dollars at the end of this August, thanks largely to the considerable contraction in the foreign liabilities of the financial and private sectors. Moreover, the environment for the rollover of outstanding borrowings by Korean financial institutions has become markedly more favorable in the international financial markets. Fresh foreign borrowings, though, are still not so easy.

In step with the improved foreign exchange market conditions, the Bank of Korea has steadily reduced its market intervention rate from a high of around the 35 per cent level in December 1997 to its current 7 per cent. This has brought about a matching decline in market interest rates, particularly since it cut its repo rate by 1 per centage point on September 30. The overnight call rate is running at a level of 7 per cent and the long-term interest rate in terms of yields on corporate bonds is at the 10 per cent level, both lower than prior to the outbreak of the currency crisis.

Turning to money supply, the Bank of Korea has essentially maintained a stable monetary policy stance. But, when necessary, it has been prepared to respond flexibly in order, for instance, to soothe financial market instability that might arise in the course of corporate and financial sector restructuring. As a result of the authority's focus on stability, at the end of September, reserve money reached 22 trillion won, which was somewhat below the IMF's indicative limit. And the growth rate of M3 has slowed smoothly from 15.9 per cent in last December to 14.0 per cent this August.

As financial markets have regained stability, the incidence of corporate failures has declined gradually. From this March onwards, the per centage of bills and checks dishonored, which had shot up to 1.49 per cent toward the end of last year, has constantly receded. Recently it has been running at around the 0.3 per cent level. The monthly numbers for corporate insolvencies have shown a sharp decrease, from 151 this January to 42 this September.

Having said this, I must point out that the credit crunch has not yet eased. Financial institutions are very prudent in lending to firms, mainly because of the heightened credit risk of enterprises in the course of structural adjustment. Their need to maintain acceptable BIS capital adequacy ratios is also, in part, a factor. Accordingly, most small and medium enterprises, which mainly rely on indirect financing from banks, have been going through serious financial difficulties.

III - Monetary Policy Response

Expected Economic Environment

Before I explain the thrust of monetary policy in the future, let me first sketch out the expected economic environment. The recession will be prolonged into the fourth quarter due to the ongoing slackness of private consumption and investment demand, and the substantial slowing of export growth. Although the current account is likely to continue to run a surplus during the fourth quarter, its scale will be somewhat reduced.

Meanwhile, consumer prices seem likely to continue the stable trend of movements they have maintained since this March.

In the foreign exchange market, the favorable supply-demand conjuncture will be sustained thanks to the continuing current account surplus and inflows of foreign capital both from inward foreign direct investment and the proceeds of overseas disposal of corporate assets. Consequently, the foreign exchange rate should continue to move within a stable range for the time being. However, there are potential factors making for exchange rate instability including the unrest in emerging markets, such as Russia and Latin American countries.

The overall demand for funds in Korean financial markets is unlikely to be large given the deep-seated economic recession. Nevertheless the steady worsening of the cash flow of enterprises will add to the demand for working capital.

So far this year, the burden that maintaining the BIS capital adequacy ratio places on financial institutions' management has been eased through the injection of public funds and the disposal of non-performing loans. However, no major expansion of their lending is foreseen in the near future, due to the persistently high credit risk of enterprises.

The Thrust of Monetary Policy

Although structural adjustment is never without pain, a deep and prolonged depression could erode the country's industrial base and sap Korea's growth potential.

Therefore, the emphasis of future monetary policy is being placed on preventing further contraction of the real economy and on promoting structural adjustment.

First, the Bank of Korea will maintain a policy stance favoring the stability of interest rates in order to encourage the recovery of the real sector, insofar as this does not conflict with sustaining foreign exchange market stability. Seen in this context, the recent substantial reduction of market interest rates and banks' lending rates will contribute to relieving the financial expenses of the corporate sector, and to restoring consumer and investment confidence.

So far this year, banks have not reduced their lending rates in keeping with the decline in market interest rates. However, the overall cost of their funds has come down with the share of outstanding high-cost deposits declining as well as the rapid reduction in rates on new deposits.

Thus there would seem to be greater scope for them to lower their lending rates.

Second, while maintaining the stable stance required under the agreement with the IMF and this year's inflation target, the Bank of Korea will manage market liquidity in a flexible manner, closely watching financial market conditions. Action might be required, hypothetically speaking, should interest rates rise to unacceptably high levels in response to the large-scale issue of government bonds, or if there were fears of bottlenecks in the flow of funds, or financial system instability in the process of structural adjustment.

Third, and most importantly, we intend to take such initiatives as may be needed to solve the credit crunch that continues to bear so heavily on firms in a situation where they are unable to access funds smoothly, despite the ample liquidity in the financial sector.

In this context, we will do all we can to encourage banks to expand their lending to small and medium enterprises by strengthening incentives. In this connection, we are now considering a change of allocation standards for individual bank quotas under the aggregate credit ceiling, to put more emphasis on lending performance to small and medium enterprises.

IV - Concluding Remarks

The Korean economy is now placed in an extremely difficult situation, where previous experience and received wisdom provide little guidance. However, all economic actors fully realize that in order to tackle the problems which led to the crisis, there is no alternative other than swift and intensive structural adjustment. And we are now resolutely and patiently fitting the blocks carefully together to build a sound new economy.

The Bank of Korea will do its utmost to support this structural adjustment, while maintaining monetary stability. Of course, to some foreigners, Korea's structural adjustment may appear inadequate or incomplete in some aspects.

But may I ask you as informed commentators on the Korean economy to have confidence in our resolute determination to carry out thoroughgoing structural adjustment. Your counsel and advice in this process will be greatly appreciated.