

Mr Chon speaks on the topic of restructuring and monetary policy in Korea

Speech given by Mr Chol-Hwan Chon, Governor of the Bank of Korea, to the European Union Chamber of Commerce in Korea, in Seoul on 12 October 1999.

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It is a great pleasure for me to speak on the topic of “Restructuring and Monetary Policy” to embassy staff and businessmen from the EU, who are contributing so greatly to furthering the economic cooperation between Europe and Korea.

The European Union opened up a new chapter in the history of the world economy this year with its successful launch of a common currency, thereby creating a true single market and becoming a single economic entity. Economic exchanges between Europe and Korea will become more dynamic thanks to the integration. In particular, more and more European companies are expected to enter Korea since it is opening up for foreign inward investment. Such investment will serve as a basis for further strengthening the relationship between Europe and Korea.

Prospects for the Korean economy

Before I launch myself into the topic, I would first like to give you a brief introduction to the Korean economy and its prospects.

The Korean economy, which recorded negative 5.8% growth last year due to the ramifications of the foreign exchange crisis, is now recovering at a considerable speed. The GDP growth rate stood at 7.3% for the first half of this year and when the continuous increase of manufacturing and consumption related indexes are taken into consideration, the growth rate for the whole of this year is forecast to be as high as 8.8%. Imports have increased but thanks to strong exports, Korea’s current account is seen to continue in surplus this year, reaching about US\$21 billion. The annual average rise in the CPI is expected to be around the 1% level despite destabilizing factors such as the rapid growth of the economy and the international oil price hike.

As is clearly illustrated by the GDP growth numbers, the Korean economy has rediscovered its vitality. This is due to hard efforts by all participants in the Korean economy.

The foreign currency crisis erupted in part because of some fault lines in the international financial architecture, but in retrospect, the structural problems of the Korean economy were the major cause. Based on this recognition, the Korean government is strongly pushing for restructuring measures to overcome fundamentally the frailties of the Korean economy that have surfaced in the wake of the financial crisis. The topic of my speech has been selected with this in mind.

The role of the central bank in the restructuring process

Rather than explaining in great detail about Korea’s restructuring measures or their outcomes, I would like to focus on how the central bank is contributing to the process through its monetary policy.

The restructuring process requires both a micro and an administrative approach since it aims to reform individual companies and financial institutions. Therefore government ministries in a position to draft and revise legislation, or those government agencies which oversee or monitor the detailed management of financial institutions, should be in charge of the process. The central bank, on the other hand, faces natural limits on the extent to which it can share actively in the restructuring process. It conducts monetary policy based on the efficient workings of the market rather than on administrative devices or legislation. Moreover, monetary policy influences economic entities as a whole rather than acting on individual institutions or businesses.

Despite these limitations, a central bank can contribute to the restructuring process within the monetary policy framework. There are four ways in which it may do so.

I. Create a macroeconomic environment conducive to the restructuring process

First, the central bank creates an economic environment which helps the successful implementation of restructuring measures.

The economy needs some degree of dynamism if restructuring measures are to be implemented smoothly.

Looking back, most restructuring was carried out when the real economy had contracted due to the ripple effects of a crisis. Korea is not the only country to experience negative growth after a crisis. Several countries which suffered a crisis in the 1990s including three Scandinavian countries, Mexico, Thailand and Malaysia all went through a period of negative growth lasting for one or two years.

However, a deep economic downturn is likely to act as an obstacle to successful restructuring. If a company or a financial institution is to improve its financial structure, it should pay back its debt by realizing profits or increasing its capital through a public offering. During a recession, such attempts do not yield the desired outcomes. Moreover, since job mobility decreases significantly in a recession, bold management rationalization which inevitably entails large-scale job shedding, is difficult to carry out.

Another reason why a certain degree of economic vitality is necessary for successful rescheduling is related with the problem of the “black sheep” of the economy. When a specific sector clearly needs emergency surgery, but it is feared that there would be a heavy toll in terms of unemployment and financial market disturbance, then the government will be tempted to put off the operation, especially when the economy is depressed. This sector will remain the “black sheep” of the economy for as long as the economy does not pull itself out of recession, gradually turning into a time-bomb for the economy as a whole. For example, if the Korean economy had not recovered this year, the restructuring of the Daewoo Group (a large *chaebol* some of whose interlinked companies have been placed under a workout program) and the problems involving investment trust companies - two major issues which have come to the fore since July - might have remained under the surface with the potential to cause even greater trouble in the future.

This all leads to the conclusion that economic recovery is vital for the smooth implementation of restructuring measures. Having said this, we must bear in mind that if the economy recovers too quickly and exuberantly, causing overheating, economic units may not feel the need to restructure themselves.

Too low interest rates choke off companies’ incentives to reduce their debt. With the improved cash flow, companies are lured into expanding their business. Also, financial institutions become less interested in clearing bad debt from their books since the opportunity cost of holding it decreases with lower interest rates.

Another problem can spring up in the choice of monetary policy stance when inflationary pressures begin to rise due to an over-accommodating policy. In most cases, the period of restructuring corresponds to a deflationary phase so that the central bank can ease monetary policy without worrying about inflation. However, if inflation raises its head before the restructuring has proceeded very far, the central bank may be in a position where it has to choose between price stabilization and maintaining an environment favorable to the restructuring process. This is a dilemma for the central bank because either choice will have negative effects. If the central bank, for example, adopts a monetary-tightening stance to fight inflation, then the short-term profitability of companies and financial institutions will deteriorate, which may blunt the momentum for restructuring. On the other hand, if a relaxed monetary policy stance is maintained to keep restructuring on the road, prices rise and companies may once again turn to their debt-dependent, expansionary management style, which ran riot in the past. As a result, people will come to lose faith in restructuring itself.

For successful restructuring, therefore, the economy must not be allowed to overheat nor should the recovery be less than adequate. Achieving a well-balanced, unbiased economic environment for sustainable growth creates the best condition for reform measures. In other words, the central bank has to conduct monetary policy supportive of economic recovery, but subject to the constraint that adequate discipline is exercised over economic entities so that they have their own incentives for change. Such a policy, by its nature, does not attract the spotlights, but it is quite important in that it may affect the final outcome of the restructuring measures.

In this regard, the Bank of Korea has been steadily lowering interest rates since the second quarter of 1998. As a result, the Korean economy is showing clear signs of recovery and on the basis of these trends, the restructuring process is well under way. However, in May 1999, the Bank decided against a further lowering of the overnight call rate, which is its policy rate, taking the view that the economic recovery was proceeding at a faster pace than expected, and that asset prices had risen sharply within a short period.

Recently, even though the economic recovery has been gaining greater momentum, the Bank of Korea has maintained call rate unchanged, which implies that it takes a neutral position. The reasons behind this decision are that no signs of imminent inflation are visible, and that the financial markets have been unsettled by the restructuring of the Daewoo Group.

2. *Supply liquidity to ensure financial market stability*

Second, the central bank should supply liquidity flexibly in response to the financial market turmoil which may arise in the course of restructuring.

It is quite common for the financial market to become destabilized during the process of structural adjustment due to high credit risks and reduced trust among market participants. As a result, a credit crunch may occur, which brings about a prolonged economic recession because financial institutions and corporations may not be able to raise sufficient money for their normal operation. In addition, market participants favor the short-term end of the market. The consequent large pool of short-term funds makes the movements of interest rates and stock prices extremely volatile, while financial institutions may become illiquid because of the short-term nature of their liabilities and the long-term nature of their assets.

Admittedly, financial market unrest is unavoidable in the process of restructuring. However, if the degree of unrest becomes so acute as to be insupportable, it may threaten to cut short reform itself. Therefore, the central bank, which is supposed to be responsible for stabilizing financial markets, can take an active role by providing liquidity through open market operations.

At the outset of the crisis, the Bank of Korea provided funds to stabilize the financial markets in response to market turbulence, and it induced banks to expand lending to small and medium enterprises in order to ease the credit crunch whose effects were concentrated on them.

A central bank can play a role as a lender of last resort in order to maintain financial market stability. However, the role of the lender of last resort must be carried out following strict rules, since a central bank's right to issue paper money can be easily abused and invite moral hazard on the part of financial institutions. First, the central bank must maintain "constructive ambiguity" to prevent individual financial institutions from becoming too dependent on it. This phrase means that although the central bank is able to intervene in the market to insure financial stability, it must not give any assurance of a bailout to individual financial institutions, whether covertly or overtly. Second, even if support is given to individual financial institutions, punitive rates or at least market interest rates must be applied in order to avoid the exploitation of the interest rates differential. Lastly, an element of conditionality including a resolute self-rescue plan must be clearly imposed and its performance closely monitored by the central bank.

3. *Mediate structural adjustment*

Third, the central bank may play the role of a mediator in the process of restructuring.

There have been examples of some central banks mediating in debt rescheduling negotiation among interested parties. The Bank of England, for instance, was actively involved in corporate sector restructuring from the 1970s until quite recently upon the voluntary request of creditor banks. The Federal Reserve System of the United States has also served as a mediator when cash-strapped financial institutions were on the brink of failure.

There are many reasons why the Bank of England and the Federal Reserve System were able to mediate in the restructuring process. One of them, I believe, is that at that time they both undertook the responsibilities of financial supervision. If a central bank supervises banks, it can accurately analyze their current business conditions and status. Moreover, it can also get easy access to information on individual companies which borrow money from them. The central bank, therefore, can be an effective mediator. In addition, the strong credibility arising from their carefully cultivated reputation for neutrality and fairness, may well have helped in reconciling the conflicting interests of the groups involved.

In the case of Korea, the relationships between financial institutions and enterprises, and those between individual enterprises are closely intertwined. Therefore, structural reform in Korea cannot be restricted to one or the other specific sectors: rather, it should be very broadly based. This implies that in Korea, perhaps more than in any other country, accurate analysis of financial institutions and enterprises is badly needed for successful restructuring. However, since the revision of the related legislation in April last year, the Bank of Korea can no longer supervise banks directly. Consequently, it is not easy for it to monitor and scrutinize the business conditions of individual banks and enterprises, making it hard for the Bank to serve as a mediator.

4. *Foster international cooperation to improve overseas confidence*

Lastly, the central bank can contribute to brightening the country's external credibility by closely cooperating with international financial circles.

Restructuring entails extensive friction and conflict on the domestic front. So if the process is to proceed smoothly, it is imperative to avoid extra turbulence stemming from international investors who have large claims on Korea. This requires that international confidence in the country be maintained at the existing level or, if possible, improved. To be sure, international credit ratings will be upgraded with substantial progress in the reform drive, but it is also very important to reassure foreign investors and to keep them well posted as to the domestic economic situation. Towards this end, international cooperation is necessary, and the central bank, I believe, is well suited for this job, in particular, on financial matters.

A number of cooperative groupings linking central banks like BIS (Bank for International Settlements), EMEAP (Executives' Meeting of East Asia and Pacific Central Banks) and SEACEN (South East Asian Central Banks) have already been set up. They allow governors and working level officials of the central banks ample opportunities to discuss current issues and build up mutually-cooperative relationships. In an emergency, central bank governors are thus able to tackle issues very promptly thanks to their close contacts and cooperation. By the influence they hold over their domestic financial institutions, the central banks are well-placed to persuade them to prolong the maturities of overseas credits and provide fresh loans at the request of a fellow central bank, and to promote a better understanding of the economic situation of the debtor countries.

Closing remarks

The Bank of Korea has supported the smooth implementation of structural reform through open market operations and financial market stabilization policy. In the future, the Bank intends to conduct a balanced monetary policy both to ensure the success of restructuring and to support economic

recovery. It is also supporting structural adjustment indirectly through the strengthening of cooperative links among central banks worldwide.

I am fully aware that there are critics overseas who rate Korea's structural reform as far from satisfactory. However, as the experience of other countries attests, it is difficult to achieve satisfactory outcomes in a short time because restructuring by definition entails conflict and pain. Considering these points, I venture to ask for your continued warm interest and support for Korea's restructuring efforts. I hope the Korean economy will become more advanced thanks to its restructuring and also wish that its practical cooperative relationship with the EU may continue to deepen in the future.