Korea and the Global Economy: The Outlook for 2002-2003*

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Before I begin my presentation on "Korea and the Global Economy", I would like to make three caveats. First, this is not original work. Unlike some of the other presentations in this series, this is not solely my output. This presentation reflects the work of many of my IMF colleagues.

Second, this is not a presentation of the IMF's official economic outlook. There is a semi-annual report from the IMF called the "World Economic Outlook" that is coming out shortly. This lecture is certainly not a substitute for that. There will be a formal press conference and presentations around the world showing that effort.

Third, there are some issues where I cannot go into too much detail. These include sensitive policy discussions with the government. I am sure you can appreciate this. Nevertheless, I would like to give you a flavor of what those discussions would include and some of the trade-offs the team will be looking at. Our annual consultation mission comes to Korea next month.

Outline

To begin, I will give you an assessment of the global recovery and talk about some of the main risks to the outlook. I will also talk about a number of other issues that are important to consider when thinking about the global economy.

Then I am going to go into more detail about the Korean economy. This will include current policy issues and some of the challenges facing the Korean authorities. Since we are now beyond the crisis and in a new economic model, there are some potential lessons for other countries, particularly in East Asia. So thirdly, I want to highlight some of those lessons towards the end of my presentation.

As to references, the fall 2002 version of "World Economic Outlook" is coming out this week. There is also a document called the "Global Financial Stability Report" that looks at trends and risks in international finance. Those two volumes, as well as a many other publications, are available at our website, www.imf.org.

We hosted a conference last year with the Korean Institute for International Economic Policy (KIEP). It was an academic conference entitled "Korea: From Crisis to Recovery". The conference volume has just been released; my predecessor, David Coe, and Kim Saejik of KIEP, are the editors. If you are interested in a more detailed and theoretical view of Korea, that is a very good source.

Global Outlook

The global economy has done relatively well, even though there have been a number of serious shocks over the past couple of years. First, the IT bubble burst in early 2000. Then there were the events of Sept. 11, which generated an enormous amount of uncertainty. That was followed this year by a spate of accounting and corporate scandals. But if we compare this slowdown to previous ones, it actually

* This is a transcription of a speech given at the Institute for Global Economics' Distinguished Lecture Forum on Tuesday, Sept. 24, 2002.

looks positive.

Looking ahead, the fundamentals are very good. That would suggest that the medium outlook is rather positive, although the recovery has been delayed somewhat from earlier expectations.

Also, I will make by presentation in the "IMF style." We always look at the outlook, and then at the risks to the outlook.

Global Slowdowns

To begin, let us look at a longer view of world GDP developments over the last thirty years. We can look at annual data up to 2001. Of course we do not have annual data for 2002, but 2002 is starting to look like 2001 in many ways, so perhaps we can extrapolate.

The four main slowdowns in the world economy over the past generation occurred in 1975, 1982, 1991 and 2001. If we look at the earlier three years and compare them to the current slowdown, we can gauge whether this one is better, worse, or about average.

We look at two variables. One is GDP growth for the global economy. In all these episodes, GDP growth was between 1½% and 2½%. This is significantly below the average growth rate for the global economy over the past thirty years.

The second variable is GDP growth per capita. To calculate this, we subtract population growth from GDP growth. Looking at these four slowdowns in that way, the current slowdown looks relatively favorable. In 1975, 1982 and 1991, per capita GDP growth was zero or negative. In 2001, per capita GDP growth was above 1%. That's not great, but it certainly suggests that this slowdown has been less severe than previous ones.

Another way to look at slowdowns is to study their composition. GDP is composed of consumption, fixed investment, inventories, net exports and government spending. Typically in a US slowdown, GDP shrinks by about 3%. However, in the current slowdown the decline is close to zero.

The current slowdown differs in the behavior of consumption. Indeed, the main difference between the current slowdown and previous ones is that personal consumption has stayed strong. This suggests that confidence is a very important factor in growth. But confidence is also very fragile, and economists need to pay close attention to confidence when assessing the risks to outlook.

Global Fundamentals

The global economy's fundamentals are good. A global recovery is in the works, though it is taking longer to realize than previously thought.

The first reason why fundamentals are strong is the policy responses by country authorities. In most countries, monetary settings have been eased over the last year and a half or so. That essentially means official interested rates have been lowered. Also, fiscal policy has been eased in a number of countries—governments are spending more and contributing more to domestic demand and output. Some of that stimulus is still in the pipeline. Overall, the policy response to the slowdown has been good, and some of the effects are still to be seen.

Inflation is low in most countries. Also, most countries have an improved fiscal position. What we would call external vulnerabilities—volatile, short term debt, foreign reserves, transparency in providing economic data to the market, etc—are also lower than before.

In the wake of some of major scandals like Enron and WorldCom there have been some confidence building measures. Firms are signaling that they are doing well in corporate governance and are trying to improve their institutional framework. Recent corporate corruption cases are a problem to be taken seriously. But looking ahead, and assessing growth potential, we think there is now an incentive now for firms to come out and be more transparent, and to follow better accounting practices.

Risks to a Global Recovery

We are behind our previous time path for the recovery. Six months ago, we thought we would now be in the beginning of an upturn. The first reason why we are not is because the US situation is still delicate. Confidence measures in the US have been volatile. It is now pretty clear that, until confidence takes hold in the US and consumption and investment pick up, the economy will not grow at its potential.

There are also a number of difficulties in emerging markets, particularly in Latin America. The concern there is that there may be some contagion, or spreading, of the financial crisis to other parts of the world. We saw this in 1997-1998 with the East Asia crisis, followed by the Russia crisis.

More of a medium term concern, and one that I am going to focus on, is current account imbalances, and what this could mean for exchange rates. There are some rather large imbalances in the global economy that eventually need to be resolved.

There is also uncertainty about world oil prices and events in the Middle East, with the risk of possible war. Though oil prices matter, they will have a larger impact on current accounts than with overall growth.

During the 1990s the contagion phenomenon came to the fore. This was very important for those of us who watch the international economy. During times of crisis, all emerging market assets tended to move together. You would see investors pulling their money in and out of countries across the board apparently with very little discrimination across countries.

Sometimes, countries with supposedly good fundamentals were hit just because they were a neighboring country or they looked similar to a country that was having difficulties. Contagion has diminished since the Asian Crisis. But we should note that there are still high bilateral and regional correlations. The best place to see this is in Latin America. The recent crisis began in Argentina, spread to Uruguay, and now Brazil is having arguably some contagion effects as well.

We see almost no evidence of contagion in East Asia. The one country that appears to be suffering some effects from the events in Latin America is the Philippines. In fact, the Philippines looks, in some respects, more like a Latin economy than an East Asian economy. So that might not be totally surprising.

What are the reasons for this reduction in contagion? Why are crises not spreading more these days? The key reason is that investors appear to be much more discriminating. Particularly since the Asian Crisis, data has become better available and better provided by all governments, adhering to the Special Data Dissemination Standards (SDDS). These standards are an IMF initiative that encourages countries to regularly publish data on their reserves, debt and other data the markets could use to distinguish between countries.

We think it is highly inefficient for all, say, developing countries to have their assets moving together. The countries' fundamentals are often very different.

Another reason why we do not see the contagion that we saw in the 1990s is that there is lower leveraging than in the past. The presence of hedge funds is much less than it was four or five years ago.

There has also been a general move towards transparency. Markets work better when timely and good information can be digested in order to allow them to make informed decisions. If there was absolutely no discrimination between any of the emerging markets, all of their assets would move together as everyone would pull their money out at the same time. In the past, in times of crisis discrimination decreases and investors act in the same manner.

In late 1994 and 1995, during the "tequila" crisis affecting Mexico and Argentina, there was a large jump in the correlation between assets, as everyone pulled their money out of emerging markets at the same time. During the Asian Crisis the same thing happened. There has been a smaller amount of contagion since the Russian default.

Since those crises, our correlation measure has gone down. Initiatives have begun to produce better, more timely data, and to release it more frequently to the market. There is also lower leveraging. This explains why the correlation has gone down over the last three or so years. The correlation measure has actually picked up over the last couple of months. But nonetheless, the peak is going to be significantly lower than it was during the "tequila" and Asian Crises during the 1990s. The message is that better data and more transparency has been helping the international financial system function better.

The other issue I mentioned earlier as a risk was current account imbalances. If a country consumes more than it produces, it incurs a current account deficit. Also, when you take the global economy as a whole, current accounts have to sum to zero; one country's surplus is another country's deficit.

Over the past few years, the US has been running an enormous current account deficit. It has basically been sucking in capital from the rest of the world. The US is seen as a very good place to invest, so this drives up the US dollar. Most other countries are essentially running surpluses and financing this deficit. The data for 2002 are going to show that the US current account may actually be bigger this year than it was last year.

What should we make of this current account imbalance? As I said, this is a medium term issue, and we need to look at this from the system level. We cannot point to one country, like the US, and say it is their problem, or point to a surplus country and say it is their problem.

The current constellation of imbalances is not sustainable from a historical perspective. We discuss this in more detail in the IMF's "World Economic Outlook", in Chapter 2. If you look over the history of economic data—and we have good data for over a hundred years now—you do not see imbalances of this magnitude lasting for very long. It does not necessarily end in a disaster, but eventually it has to be resolved. The US, at some point, will have to run a smaller current account deficit. Whether that is an adjustment in policies or an adjustment in the exchange rate, it remains to be seen.

The short-term policy prescriptions is that deficit countries should generally try to run stronger public finances. That would contribute to their savings and improve their current account. Similarly, surplus countries should push structural reforms in order to boost growth potential and import more from the rest of the world. The objective is to make these imbalances resolve in an orderly manner, not in a sudden violent manner which may be disruptive.

So the global economy has weathered a number of shocks very well. But the recovery has been delayed. The medium-term outlook on global growth is still positive, in part due to the policy responses. The balance of risks is now on the down side. Six months ago, we said there were some positive developments and some negative developments. We thought the risks to the outlook were balanced. The risks now—the contagion risk, the oil risk, the current account risk—are all on the downside.

Some observers_compare the world economy to a giant airplane. Right now, the airplane has to fly on one engine. It is really the US economy that has to pull the global economy. This has been the case for most of the 1990s. Growth in Europe has been positive, but certainly not spectacular. Growth in Japan has been largely absent for most of the past decade. Though China is a large economy, growing very quickly, it is not large enough by itself to propel global growth. It is also not large enough yet to make East Asia insulated from the global economy. We are still in a one engine world. For now, that is the US.

The Outlook for Korea

The reason we talk about the global economy first is that Korea is dependent on the global developments. China, is not large enough yet to generate sufficient demand by itself to pull the rest of East Asia along with it. So Korea looks beyond the region to the global economy for foreign demand.

Domestic demand has been very buoyant, and Korea's performance has been surprisingly strong. Some of that, though, is due to one-time factors. External vulnerability has been reduced since the crisis. Korea is now seen as a safe haven by foreign investors. Sentiment remains relatively high. Credit rating agencies have been very favorable to Korea this year. It is the first country ever to graduate from the emerging market bond index.

What is our outlook for Korea for 2002 and 2003? This has not changed very much throughout the year. We see growth at around 6¼% this year and 6% next year. The important thing to note is that even though these numbers look similar, there is a large compositional change. Right now, private consumption is contributing strongly to growth. However, consumption is going to moderate, and will be replaced by net exports as a source of growth as the global economy recovers. Facilities investment, which is highly correlated with exports, will pick up as well.

Keeping in mind the risks mentioned in the previous section, if the global economy does not recover as strongly as anticipated, growth in Korea might be lower.

Also, our estimate of potential output growth is around 5½%. This is a somewhat speculative exercise, and sometimes we see these numbers cited in ranges. So growth should be slightly above potential for the next two years.

The Risk to the Outlook for Korea

The first risk is rather obvious. A weaker than expected US recovery would depress Korea's exports and its growth. I do not want to give you a number, but last year growth was 3% with a weak global economy. Growth in Korea could be like that in the absence of strong external demand, especially if consumption growth moderates.

Our research shows that higher oil prices would make Korea's current account worse as imports rise, but it would have a lesser effect on growth.

We are in the middle of a consumer lending boom that needs to move smoothly to a new equilibrium. There is a risk that this transition will not be smooth. We know that defaults and delinquency rates are rising for consumer lending.

If the reform agenda falters or reverses for any reason, there could be a negative impact on sentiment in Korea.

Why has growth remained so high in Korea? This country has easily outperformed its regional peer group during the slowdown. As economists, we want to ask why this was the case.

The Korean economy is more flexible now. Structural reforms and market discipline, previously absent, have begun to take root. This is important. Korea also has a more diverse export base. A country like Taiwan, which is very heavily concentrated in IT, is very much at the mercy of the IT sector. Korea, on the other hand, exports cars and ships and IT and number of other goods. It is more diversified, which helps cushion against slowdowns.

The consumption mini-boom is a one time adjustment. For the first time, Korean consumers have access to bank credit. They have been borrowing rather heavily, spending and consuming. That has provided a cushion against the global slowdown.

As part of the financial crisis, bank balance sheets were cleaned up. The non-performing loans (NPLs) were taken out of the banks, repackaged and sold. Non-performing loans are now below 3% of all bank loans. Importantly, the focus of bank lending has shifted toward profitability. Before the crisis there was little emphasis on profitability. But now, there is a very strong emphasis.

Korean banks have discovered consumer lending. Consumer lending is a very profitable business. Formerly the household sector was repressed as households generally did not have access to bank credit. Most credit went to large business conglomerates. The government, though, provided incentives for household borrowing and credit card use, including lotteries and targeted tax breaks.

The result is that consumer lending has exploded in Korea. It now accounts for one half of bank lending, up from only one third a couple of years ago. Overall, this is a healthy development. Consumers now have access to credit. They have more choices. They can smooth their consumption. That is generally good for consumers, and banks are making a lot of profits off this process. They are, importantly, rebuilding their balance sheets, increasing their provisioning, and, in some cases, returning value to share holders. All of these are healthy developments.

The government, too, is "making money." Credit card incentive schemes for lotteries and tax breaks are paying for themselves. The government has announced it will extend these schemes for another three years.

The large business conglomerates, which used to exclusively go to the banks for financing, are now facing more market discipline. They have to go to the market to borrow, or they have to generate profits and fund themselves internally.

So across a number of sectors, this is a beneficial process. It is a move to a new equilibrium. We are moving from the old equilibrium, which was "repressed", for lack of a better word, toward a more advanced country, or OECD-type equilibrium.

The level of household debt and debt service—essentially interest payments—does not look particularly bad. They are about average for an advanced country. Of note is that the growth rate is very fast. My colleagues here joke that one year in Korea is equivalent to five years everywhere else. You can expect things to happen five times faster here than in other countries.

Delinquencies for overall household lending are actually still quite low. They are at about the same level as the US. But credit card delinquencies are high and rising. We will have to watch that rather closely.

The regulators at the banks need to remain watchful. The regulators are increasing provisioning requirements against credit card lending. Banks are using foreign expertise and knowledge to assess credit risk. They are pooling information on borrowers. They are doing a reasonably good job.

But the big unknown is the behavior of consumers. A consumer credit boom has never happened before in Korea. In other countries where there was a consumer lending boom for the first time, it did not always end smoothly and in an orderly way. There is no information about Korean consumers in this situation. It is a process where regulators and the banks must do a good job. We want consumers to be educated on how to borrow and how to budget.

Policy Challenges

What is the proper course of action with this outlook and these risks? Concerning monetary policy, inflation indicators are currently mixed. Any assessment would need to include asset prices. On fiscal policy, Korea has a tradition of over-performance. Since growth is stronger than potential this year, over-performance will probably be good. On exchange rate policy, we would ask that the government limit intervention. They need to let the market work and to encourage a hedging culture. On structural policy, we think the economy is strong; the window of opportunity is open to press on.

Monetary Policy

As an outsider in Korea, I see there is still some confusion on what the monetary policy framework is. Essentially, the Bank of Korea's (BOK) objective is to target the core inflation rate. Their objective is an annual core inflation rate of 3%, plus or minus 1%. How do we define that core rate? Food prices are not included an oil prices are not included. The core rate is supposed to be something that the BOK can influence.

One often reads here something like, "The spike in food prices means that the BOK has to raise interest rates." Or, "An increase in oil prices means that the BOK has to raise interest rates." Well, the BOK is not looking at any of those factors directly. The BOK only takes into account the core inflation rate, because that is what they can influence.

We may be entering a period, because of the typhoon damage in the south and potentially because of developments in the global oil market, where the core rate and the headline rate diverge. Then it will be the obligation of the authorities to explain very clearly to the markets that the rates are diverging, but that the BOK targets the core rate. We may see a situation where the headline rate goes outside that band of 2%-4%, but where the core rate stays within the band. That's fine. That would be consistent with the BOK's objective.

Obviously, the BOK has only one instrument. They control the call rate. They should therefore have one objective: core inflation. They cannot be targeting a lot of stuff with one instrument. That is how countries get into trouble. One example is the current account. Korea cannot control the core inflation rate and the current account with one instrument. They should only be trying to control the core rate.

Interest rates are obviously a sensitive topic, and I am not going to give you a recommendation for the BOK today. But let me talk about the considerations that go into monetary policy making.

When we look at potential inflation pressures, where do we look? We look at the standard indicators. We look at potential GDP, and then where GDP actually is to obtain an output gap. We still think there is a small gap in Korea. And growth is moderating, so we do not see much inflationary pressure there. The won has strengthened this year. That tends to make imports cheaper. It also means that inflationary pressures on that front are low. Though wage growth has been high, productivity growth has been at least as high. So unit cost of labor has been stable. All these indicate that there is not a lot of evidence of inflationary pressure from those quarters.

An issue that is very topical not only here in Korea but all over the world, in particular in the US, is the effect of asset prices on inflation. We need to ask a number of questions in this area. Mindful that the objective is core inflation and that asset prices now may have implications for inflation down the road, we need to ask if there is bubble or not. Is it all asset prices? Are equities, bonds or real estate involved? Is it only real estate? Are consumers or firms over leveraged? Did they borrow too much based on those inflated asset prices? What are the trade offs involved? If we let the process run its course, and it's a bubble, and it has to break, what is the cost of that? What is the cost of trying to pop the bubble now? These sorts of things need to be taken into account when thinking about monetary policy.

Fiscal Policy

Korea has a fine tradition of fiscal conservatism. This is recognized by the markets.

We think this tradition helped Korea substantially during the crisis. This year's budget has a surplus of 1% of GDP. That budget assumes 5% growth. Including the supplementary budget, which we think was a good idea given the damage from the typhoon, the surplus should be about 2% of GDP. But given that growth is going to be 6% instead of 5%, we think the over performance is fully justified.

Looking at fiscal policy over the medium term is done in many countries, but not yet in Korea. Overperforming every year is not necessarily good. When growth is stronger than projected, it is great to over perform because then the government takes the extra money and saves it for a rainy day. However, if growth is weaker than expected, I would argue that fiscal policy should be made looser. Thus, fiscal policy should be counter cyclical. When growth is stronger, fiscal policy can be tightened. When growth is weaker, it can be loosened.

The best way to think about this is to look over the economic cycle, or over the medium term. One would not say that in every year the budget surplus has to be a certain amount. One would say that over the economic cycle, we are going to target a surplus of, say, 2% of GDP per year. Then in good years you should do better, and in bad years you can do a little worse.

The reason I said 2% per year is that Korea is saving for the demographic transition. The National Pension Fund is currently running surpluses of about 2% per year. Those should be saved and not spent.

Exchange Rate Policy

Korea's exchange market is thin and volatile, especially compared to the size of the economy. Korea's economy, for example, is larger than Australia', but its foreign exchange market is a fraction of the size. That is partially because Korea had a longer history of a fixed exchange rate. The exchange rate was only recently floated, in December, 1997. There has not been much time to develop the market.

Government activity in the foreign exchange market should be limited to smoothing operations. That has largely been the case. The trade offs are pretty clear. When government goes into the market, it dampens trading, dampens profit and therefore dampens market development. If the government stays out of the market, it will be more volatile, but then people make money, people can enter the market and make the market deeper.

The government should not be in the business of providing exchange rate guarantees. Firms should use markets to hedge their foreign currency exposure. That will help develop the market as well. We would also encourage the government to increase the number of players in the foreign exchange market.

A related issue is of that of competitiveness. I would note that while the won/dollar rate has appreciated this year, if we look at the won against a basket of trading partners, the appreciation has only been on the order of 2% to 3%. It has not been that pronounced. Also, current export performance suggests that the won is competitive. We are not in a situation where the won is seriously over valued.

The data show that while analyzing exports, growth in Korea's trading partners, namely the US, is much more important than the level of the exchange rate. So even though the exchange rate is an important variable in export performance, foreign demand from trading partners is much more important.

Increasingly, Korea is going into niche markets: electronics, automobiles, etc. These are markets where there is less price competition and more non-price competition. So you may, in the future, see a lessening of sensitivity to the exchange rates.

Public Understanding of Macroeconomic Policy

I realize that I can only read a couple of newspapers in Korea, but I really feel that there is a rather poor understanding of macroeconomics here. I read a piece in a daily recently that called for a rise in interest rates by the BOK. The word "inflation" never appeared in the article. This is very telling of the lack of understanding.

In this country, the central bank governor has many "friends." You hear all sorts of government officials talking about monetary policy. This is certainly not best practice internationally. Private citizens of course can say anything they want about monetary policy. But government officials generally do not.

Policy announcements here generally characterize fiscal policy as expansionary. Sometimes that is true. Sometimes, like last year, it is not true at all.

There is also a role for the media to play in all this. The media, of course, reports the news and reports the economic statistics. But it also has a role in filtering and making clear what the statistics are showing and not showing. It should really look a bit deeper into some of these issues.

Structural Reform

A lot of progress on reform has been made since the crisis. Market discipline is more prevalent. Firms are now concentrating on their core competencies. Many have imported foreign practices and business models. The economy is more flexible and resilient.

But there is still a "Korea discount." Investors are not fully comfortable investing in Korea. There are three areas that are still of concern: the remaining corporate sector's reform agenda; the presence of the government in the ownership of commercial banks; and the supervisory apparatus.

There are still a lot of firms in Korea that are not viable. They are unable to cover (from earnings) the interest cost on their borrowing. Typically in an economy that is growing strongly, if a firm cannot cover its interest cost when interest rates are very low, there is a problem. About 25% of Korean firms are not viable. At some point, these firms need to be closed, merged or restructured. The creditor banks need to take action. But insolvency reform is also critical, so that the legal framework provides the proper incentives. The political economy is also a factor here. We are currently in an election year. It would not be politically possible to undertake some of these things at this time.

To strengthen market discipline even further, Korea should focus on the "software" issues: creditor rights, transparent accounting, corporate management, independent corporate directors, etc. The lack of progress on some of these is cultural. But Korea seems to be moving in the right direction, at various speeds depending on the issue. I am pretty confident that we will get there, even though it's not always a smooth or fast moving process.

On bank re-privatization, I would note that the commercial banks are profitable. It is a good time to sell the public shares. There was a plan announced in January 2002, which is a good one. The government has done a good job of being opportunistic, moving in a flexible manner to try to unload some of these shares.

I caution, though, that the government should not be pressured into selling some of these shares. The worst thing that could happen is the government sells an institution to an unqualified buyer. Then, say, five years later, we would have to go through the same ordeal all over again, and the government would have to put even more money into the non-viable entity. That would be a very bad result.

Perhaps it did not belong on the program, but the sale of Seoul Bank was a condition for IMF support back in 1998. It deserves some focus because it is now finally being resolved. We think the sale to Hana Bank is positive. Apparently, 100% of Seoul Bank will be sold, rather than 51%. The government, for the first time, rather than providing a guarantee actually holds the guarantee. That is a positive development. All of the upside risk is now on the side of the government. The actual net privatization of Seoul Bank, however, is zero. The government sold shares of Seoul Bank and acquired shares of Hana Bank. In terms of government ownership of the commercial bank sector, the change was zero. We would hope the government moves flexibly and in an opportunistic manner to unload its shares in Seoul Bank.

<u>The Use of Public Funds in the Financial Sector</u>

This is an area where public understanding is not at the level it should be. The indisputable fact is that, because the government had to inject money into the banking sector to save it, poor loan decisions were made prior to the financial crisis. That money will probably never be recovered. Any insistence on a 100% recovery rate is therefore very misplaced. Of course, we should make sure the funds were not abused. But insisting on 100% recovery is not a very good idea.

Now that the banking sector is stabilized, the objective should be to return the banks to the private sector. Inside of that objective, the government should of course be trying to maximize the value of what it is selling, and negotiate in good faith in the interest of the Korean people. We broadly agree with the strategy, but there is the issue that there is less than perfect understanding about banks and public funds here.

Supervision

These points come from the technical experts at the IMF. The Korean structure with a combination of the Financial Supervisory Commission (FSC) and the Financial Supervisory Service (FSS) is unique in the world. Normally, there is one supervisor. This sort of co-habitation that takes place in Korea is strange.

Supervision has been pretty good, and has been agile. The rules need to be clear, though. When the supervisors make a ruling on Bank A, that needs to be same ruling they provide for Bank B. That is not always the case.

We hear regular complaints and concerns from companies that the rule of law is not as well established here as it should be, and that regulations are sometimes too complicated.

Lessons from the Korean Experience

Now that we are beyond the crisis, there are a couple of lessons from Korea that can be shared with the region, if not with the rest of the world.

Ownership of the reform process was a very key variable in Korea's success. We can look at other countries in the region that took one step forward and then one step backward. They still have not done some of the fundamental measures that were called for early in their programs. That was not the case in Korea. There is something about the Korean psyche and group mentality that once the goal is fixed, everyone goes for it without asking questions. This is very good for resolving crises. The Korean people get very high marks for that.

The tradition of fiscal conservatism does not get enough credit in my view. People ask me what was overlooked in assessing the success of Korea. The one thing that often gets overlooked is the tradition of fiscal conservatism. This provided a valuable extra degree of freedom during the crisis.

The banking sector model emphasizing consumer lending that Korea looks to be successfully embarking upon is also being watched closely by the rest of the region.

The thrust and direction of the policies has remained largely unchanged, even though the IMF supported program is over and the IMF has been repaid in full. This has been very good for investor confidence. They know that the reform agenda has been internalized to a certain extent, and that it was not merely imposed. This also suggests that political risks are minimal. As we all know, this is an election year in Korea and there is very little discussion of changing the macroeconomic model. That is certainly not the case in a number of other countries.

The benefit of fiscal conservatism is that it provides room to maneuver. When a crisis hits, sometimes very unexpectedly as in Korea, if there is no public debt the government can undertake counter cyclical fiscal policy and spend more money, and resources are available to recapitalize the banking system and restore confidence. Latin American countries do not have these options. Argentina and Brazil are very highly leveraged countries. They cannot use fiscal policy, despite what Mr. Stiglitz claims, and they cannot recapitalize the banking system because they do not have the resources.

Korea is the first Asian country—let's forget about Hong Kong and Singapore—to embark on a consumer lending model. There are clear benefits. The initial results seem to be favorable. Consumer behavior, though, is the key and it is currently unknown. We have to wait another year or so to fully assess this process. If successful, this could be a model for the rest of the region.

Medium Term Prospects

Korea has changed enormously since the crisis. The reform agenda must be completed in order to realize Korea's growth potential. On balance, I am a Korea optimist. I think the potential is high, given that Koreans are who they are. If we want an indirect measure of a good outcome, it should be whether Korea's income level continues to converge with the OECD average. As the agenda facing Korea increasingly looks like any other OECD country's agenda—pension issues, labor market issues, and other rich country issues—success will certainly be evident.

Thank you very much.

Questions & Answers

Question #1: I have one comment on Hana Bank. As you mentioned, there was a swap between Hana Bank and Seoul Bank. But 60% of the Hana Bank stock held by the Korean government will be sold back to Hana Bank within the year in four installments. The remaining 40% will be sold later with the assistance of an international investment bank by issuing ADRs.

Answer #1: The sale of Seoul Bank to Hana Bank has only just been approved. Some of the details are still coming out. The ADRs are only one course of action. For example, Chohung Bank was supposed to do an ADR earlier this year. That had problems because of the lack of demand or interest at that time. But the plan for Hana Bank to do so is a good plan.

Question #2: I know that the IMF is not in the real estate business, but I am sure that you have been watching with concern recent developments in the real estate market in Korea, particularly the speculative boom and the consequent increase in the price of apartments in certain parts of Seoul.

As you know, there are two views on the cause and remedy. One, held by the government, maintains that this is a local phenomena due to an inappropriate tax scheme. The other view is that there is too much private liquidity in the market. This leads to consumer borrowing, half of which is spent on speculative purchases. The cause, as well as the remedy, can either be macroeconomic or monetary.

We think this could be a serious problem. Past recessions were always preceded by a speculative boom in real estate markets. That also, by itself, has very important social consequences.

A#2: That is one of the issues at the top of the agenda. It is something that our annual mission, which comes next month, will be discussing with the government.

Based on my less than perfect understanding of the market, I understand that it is probably a combination of all of these factors. The question is what weight each factor carries, the structural factors and liquidity factors.

The supply side of the market seems to be responding. As you know, following the crisis, the "output" of the housing sector fell by almost half. Just now, it is getting back to the pre-crisis level in terms of units of new housing being produced. That would suggest that pressures will be mitigated in the future. There was a supply shortage. Just now the industry has recovered its supply level from the pre-crisis period.

There are also structural issues. You mentioned taxes. I agree with that. Also, the deposit, or "key money", system is potentially open to speculation. Some regulations have tried to address that.

There is something called a housing affordability index. Even though the price of houses has been rising, the housing affordability index has not moved that much. I am not dismissing the dangers, but there are arguments on both sides.

The monetary argument is that there is excess liquidity in the market. Stocks do not look like such a good investment at the moment. So people channel their savings into real estate.

Those are the issues. A judgment has to be reached about what are the causes and what are the trade offs, in terms of letting it run its course or try to control it now.

Question #3: You mentioned that growth would be 6¼% this year and 6% next year. Why will the economy slow down? What will affect this?

Answer #3: In my view, there is not a big difference between these two numbers. Growth is healthy, and above potential. The way we do modeling is part science and part art. Since the economy is running close to potential, we take the current year's growth rate and try to make it converge smoothly with the potential rate over time.

Question #4: Do you take into consideration any Middle East war scenarios?

Answer #4: Our predictions incorporate an oil price scenario. The oil price is more of a current account effect than a growth effect. Of course, in a war scenario, all bets are off and we would have to re-do our numbers.

Question #5: The current US government economic team downplays the importance and the impact of oil prices on the global economy. They say that even if there is a war in the Middle East, they say that less than 0.1% of global growth will be affected. Does the IMF share that view?

Answer #5: I know that one possible scenario predicts a short war, if one is to take place. This also takes into account the US's work to find alternative sources of oil. That would include the Russians. Under those assumptions, you could have a relatively benign scenario. From my experience, we normally do not do line-by-line disaster scenario predictions, though.

Question #6: You talked about the Korean economy and the global economy as a whole. Korean small and medium enterprises (SMEs) play a very important role. They played a particularly strong role in recovering from the financial crisis. Does the IMF have any comments on these smaller businesses?

Answer #6: It is clear that SMEs play a big role in this economy. The largest number of firms and the largest employer are SMEs. The role is important because normally countries do not just exist with large firms. SMEs need to be a vital part of the economy. They need access to credit to survive. One of the healthy developments over the last year or so has been a growth in credit to SMEs, much more than before. It is definitely a vibrant sector in terms of employment and demand for labor. It is a sector that needs to remain healthy in Korea.

Question #7: You haven't mentioned Korea's neighbors. Do you see a similar growth trend in China or Japan?

Answer #7: Let me talk about China, as I used to work on that country. China is obviously Asia's big, dynamic market. However, they face a number of challenges. Some of these challenges were faced by Korea. But the magnitudes are much larger in China.

Non-performing loans in the Chinese banking sector are larger than in Korea. The problem is several orders of magnitude larger. The Chinese authorities have just started recently to address those problems. They are even using Korea's government expertise.

This effort to clean up the banks and the balance sheets will ultimately result in some injection of public money. When the hole in bank balance sheets moves on to the government's balance sheet, the public debt in China will be much more than it is at present.

The transformation of the economy from being state-run to market driven is well underway. But state owned enterprises (SOEs) must become profitable firms that produce products that people want to buy. Social costs at those firms—welfare, pensions, etc—must be taken out and placed in the public sector where they belong.

Wage and income disparity between rural and urban dwellers, as well as between provinces, is another major issue. This adds to political uncertainty. Finally, China has to open up under the WTO, but they have to do so orderly.

China is a kind of big juggling act. So far, in the IMF's view, the Chinese authorities get high marks for their skillful management of the macroeconomy. They were an important anchor for East Asia in the financial crisis. The way they partially opened up their capital account, avoiding the short term volatile flows, was very important for stability in the region.

Korea is the only country that has cleaned up its banking sector in the region. It is flanked by a huge neighbor on either side, each with enormous bank problems ahead of them. One is China. The other is Japan.

Japan's problems are very well known. Japan's banks need to be cleaned up. The authorities need to target a positive inflation rate to end a period of deflation. There needs to be a round of structural reform to cleanse the economy of its zombie firms and restore the growth rates that were found in the 1980s.

China and Japan could both be engines of the global economy. But it will probably be some time before that happens.

Question #8: You mentioned a couple of risks, simply touching on them and then moving on. The US deficit has been running 4% to 5% of GDP, which is very large indeed. If that is the only engine in the world, that is worrisome.

Secondly, the stock market collapse in both Japan and the US is causing a negative growth effect, so much so that the Bank of Japan has decided to pump in more money into the market.

How will both of these affect the market in the short term?

Answer #8: Historically, a country cannot run current account deficit of 4% or 5% of GDP. Those eventually get resolved.

Will the adjustment of the current account come about in an orderly way? If fiscal policy is tightened, there would be a moderate depreciation in the dollar. That would be good. The danger is that the correction will be violent. What if the markets do not want to finance this amount of deficit for the US? If the demand for US assets dries up suddenly, it will be a disorderly situation. There is no immediate danger of that. But we know that this is not a sustainable situation. That is why we think the policy subscription is fiscal consolidation. We would also hope for an orderly adjustment in the exchange market.

I am not an expert on Japan, but the move by the Bank of Japan was certainly a non-conventional, unorthodox move. To the extent that its shares are over valued, there is a down side risk to the strategy. I do not know the P/E ratio, or any of the valuation ratios in Japan.

It is striking, in Japan, that there has been an enormous increase in public debt. But you do not see the same effects that you would in other countries. The reason for that is the Japanese are prodigious savers. It is still a surplus country, despite all of these problems. It is still exporting its capital to the rest of the world. In terms of Japan and its relation with the international financial system, you do not see any potential dangers.

Question #9: You mentioned the IT industry bubble in brief. I am very interested in the prospects for the IT industry in both global and Korean economy.

Answer #9: The IT sector has some problems. When you do not count stock options as expenses, you get firms with very little economic potential that are recording a lot of profits. Their shares prices go up, based on those recorded profits. That is a prescription for a bubble. The US' NASDAQ has fallen by something to the tune of 70% or 75% since its peak. If you borrowed against those share values, then you have a big problem.

Maybe the second time will be a less irrationally exuberant process. But still in every country this is the sector that typically has the highest growth potential, the highest innovation and technical change. In the long run, technical change is what drives economic growth and well being.

If the sector is put on a better footing, with better accounting and more transparency, it will do well. Given the natural rate of technical progress and innovation, with a lot less exuberance and a lot less insider trading of IPOs, the sector could do well in the future.