Cambridge University Press
978-1-316-51498-6 — Monetary Policy and Central Banking in Korea
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Excerpt
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PART I

What Is the Goal of Korean Monetary Policy?

1 *The Goals of Economic and Monetary Policy*

Economic policy refers to the actions of the state in defining its objectives and using appropriate instruments to achieve them. The objectives of government in this regard are high long-run economic growth, equitable distribution of income and wealth, and stable prices and output. Macroeconomic policies, represented by monetary and fiscal policies, are just those intended to stabilise prices and output. This chapter begins by examining historically how these policy objectives have been addressed by the Korean government and, against this backdrop, looks at the goals of macroeconomic policy, especially monetary policy, in Korea.

1.1 The Evolving Goals of Economic Policy in the Korean Economy

As Figure 1.1 shows, economic policy in general pursues three objectives: (1) high long-term economic growth, (2) equitable distribution of income and wealth, and (3) stable prices and output. They are also the primary concerns listed in Adam Smith's *The Wealth of Nations*, Karl Marx's *Capital*, and John Maynard Keynes' *General Theory*, which John Kenneth Galbraith regarded as the three most important books in the history of economics (Galbraith, 1991: p. 227).

Since the launch of industrialisation in 1960, the Korean government has undergone three distinct phases with different priorities on these objectives. The first phase was the period from 1960 to 1979, under the military government of President Park Chung-Hee, during which the government's primary economic objective was to achieve higher economic growth. The second phase was the period from 1980 to 1997, during which the government's policy priority shifted to the objective of economic stabilisation. The third phase, from 1998 to the present day, began when Korea was hit by the 1997 Asian currency crisis. During this phase, the redistribution of income and wealth has

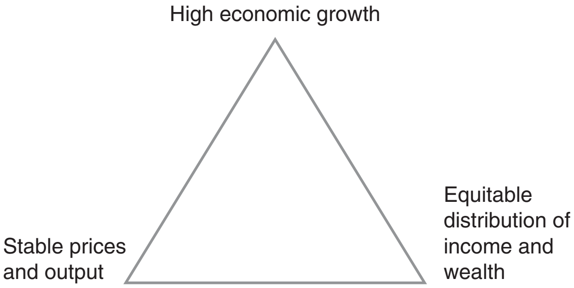

Figure 1.1 The three objectives of economic policy

started to gain importance over other objectives. These three phases are examined in the following three sections.

1.1.1 Growth Period 1960–1979

In order to attain the objective of higher economic growth, the Korean government has consistently intervened in the economy over the last sixty years. The government's actions covered not only trade, industry, competition, and technical policies but also wide-ranging institutional reforms in the quest for efficient resource allocation and in order to cope with market failure. All these actions on the part of the government, which could be described as structural policy today, affected the supply side of the economy, increased its productivity, and ensured its long-term sustainable growth.

Government intervention was particularly notable during the period from 1961 to 1979. Prioritising the enhancement of the long-term economic growth rate over all other goals, the government put two important policies in place. First, the Korean government adopted trade liberalisation policies. Adam Smith had stated, more than 200 years before, that international trade would increase the long-term growth rate of the economy by expanding markets and deepening the division of labour (Smith, 1776). Notwithstanding this, Korea had, for a long time, been obsessed by the then dominant ideology of 'the self-reliant economy', which led to the protection of the domestic economy against the intrusion of foreign economies, thereby opposing and rejecting the liberalisation of trade. The government of the day broke with this ideology and substituted the prevailing 'domestic market first principle' with the 'export-first principle'. Against this backdrop, the government joined the GATT in 1967, which resulted in Korea benefiting enormously from the MFN clause, and the tariff concessions from all GATT member countries. Trade liberalisation was a huge success, as Korea saw its export share increase from 7 per cent of GDP in 1965 to 28 per cent in 1980. Exports have since become the leading engine of economic growth in the country. Trade liberalisation led to financial liberalisation and the entry of Korea into the OECD in 1996. Furthermore, since the 2000s, these liberalisation policies have led Korea to conclude numerous bilateral and multilateral FTAs, including the Korea–EU and the Korea–US FTAs. This has helped Korea to mitigate the impact of the 2008 global financial crisis, as it enabled its exports to continue to grow. As Figure 1.2 shows, exports reached around 45 per cent of GDP in 2010.

Secondly, along with trade liberalisation, the government pushed for the rapid industrialisation of the country, in order to transform the country from a very poor agricultural country suffering from extreme poverty into a modern industrial state. Notably, the government aggressively drove an industrial policy which targeted the HCI. Figure 1.2 shows that the share of fixed investment as a percentage of GDP increased from a mere 15 per cent in 1965 to 32 per cent in 1980, peaking to 37 per cent in 1995. Although the exact costs and benefits of

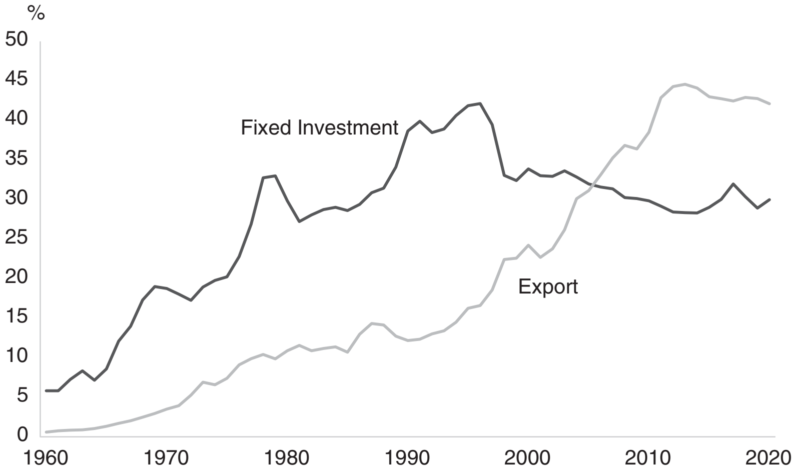

Figure 1.2 The share of exports and investments
Source: ECOS, BoK.

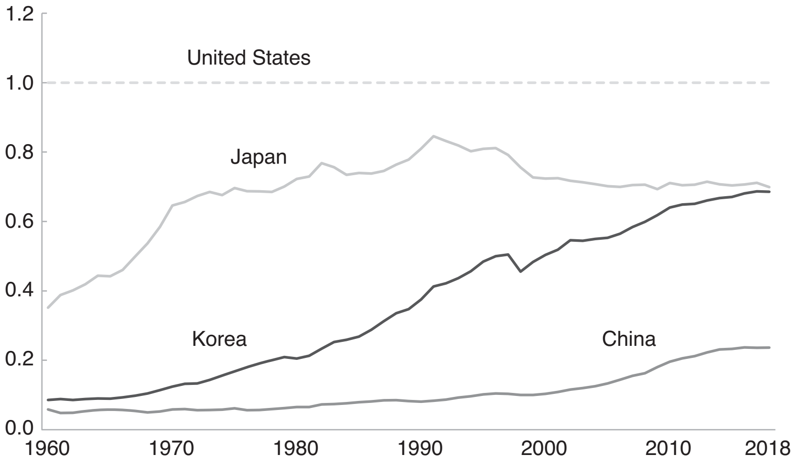

Figure 1.3 Growth in per capita GDP (PPP base and US per capita income = 1)
Source: Madison Project database 2020.

this industrial policy have not been clearly assessed, the policy has generally been considered to have been successful in transforming Korea into an industrial power. As a result, the Korean economy recorded spectacular long-term economic growth throughout this period. After the eruption of the Asian currency crisis in 1997, however, the massive financial and corporate sector restructuring demanded by the IMF made such industrial policy a legacy of the past. About half of the thirty largest Korean business groups went bankrupt or entered restructuring programmes, bringing about a substantial drop in fixed investment. Currently, the share of fixed investment is around 30 per cent of GDP. Nonetheless, the Korean economy continued to grow rapidly following the 1997 Asian currency crisis and has succeeded in catching up with the advanced economies, in particular, Japan. The current per capita income of Korea is around 70 per cent of the corresponding US income (see Figure 1.3).

1.1.2 Stabilisation Period 1980–1997

Unlike growth policy that is a supply-side policy intended to increase the long-term growth rate of the economy, stabilisation policy is a demand management policy through which it is intended to reduce economic fluctuations. All government actions which consist of keeping the inflation rate low and stable, as well as the short-term fluctuations in output and employment small, are elements of macroeconomic stabilisation policy (Taylor, 1995). Furthermore, policies to ensure financial stability and to prevent financial crises can be included in this category.

In Korea, as in other countries, the importance of economic stabilisation was highlighted by the emergence of high inflation during the 1970s, when Korea was hit by two oil price shocks. Nonetheless, stabilisation was not a priority under the government of President Park, who did not want to sacrifice growth in favour of economic stabilisation. As a result, Korea suffered continuing budget deficits, high inflation, and increasing current account deficits. The main reasons for this are as follows:

First, an increase in government spending was required to maintain political unity and social cohesion. Against this backdrop, the Korean government subsidised farmers' incomes by setting a minimum price for rice, the main staple in Korea. Given the meagre budgetary provisions for this task, the budget deficit relating to the purchase and management of rice was largely financed by the Bank of Korea (BoK). The money supply created by monetary financing soared, accounting for 37 per cent of the total increase in money supply during the period 1976–1978.

Second, financial markets were under strong pressure to serve the policy drive for the HCIs, and to provide low interest credit (policy loans) to the targeted industries and companies. The share of policy loans rose to approximately 50 per cent of total commercial bank loans by the end of the 1970s. Thus, monetary policy worked as a simple tool for providing what was called 'growth money'. Clearly, the BoK had no independent competence. The decision-making power in respect of monetary policy was in the hands of the minister of finance. Furthermore, the stabilisation of prices was not handled by the BoK but depended on direct price controls administered by the Economic Planning Board, which subsequently became the Ministry of Economy and Finance through its merger with the Ministry of Finance in 1994.

Third, the balance of payments deteriorated because the excessive investment realised in the corporate sector, particularly in HCIs, outweighed the aggregate savings of Korean households. The rise

> in the investment–savings gap and the resulting current account deficit had to be financed by foreign savings. Foreign debt soared, reaching 48 per cent of GDP in 1979, which drove the Korean economy to the edge of bankruptcy (Nam, 1984).

As a result, the Korean government launched the first important stabilisation policy in 1979, titled 'Comprehensive Economic Stabilisation Programme' (CESP), although its full implementation had to be postponed until a change in government leadership had taken place in 1980. It marked a paradigm shift in economic policies because it challenged the then dominant economic framework of the Korean government, which was based upon the drive for the HCIs and the government-led economic development strategy. Furthermore, unlike an ordinary stabilisation programme, consisting of stabilising inflation by implementing fiscal austerity and tight monetary policy, the CESP included much broader objectives, such as making the Korean economy freer and more market friendly through the promotion of market mechanisms, and more open through the enhancement of competition (Cho and Kang, 2013). Inflation dropped substantially, but growth did not, which showed that these two objectives could be compatible. Since the implementation of the CESP, the inflation rate has, to a substantial degree, been contained. Figure 1.4 summarises the performance of the CESP.

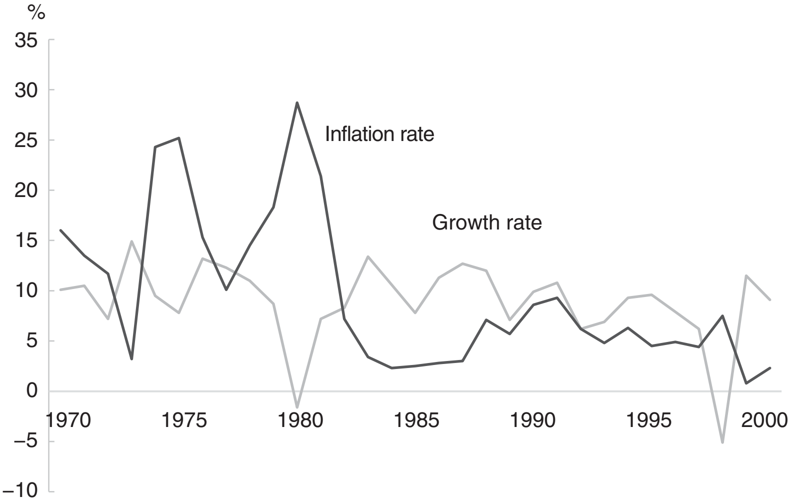

Figure 1.4 Growth and inflation
Source: ECOS, BoK.

1.1.3 The Redistribution Period from 1998 to the Present Day

Redistribution policies for the equitable allocation of income and wealth are without doubt some of the oldest economic policies carried out by any government. In Korea, the equitable distribution of income and wealth had been a crucial national objective since the establishment of the government in 1948 because Korea (South) had to compete with Communist North Korea regarding the superiority of their respective political and economic systems. To this end, government intervention for the attainment of the objective of income and wealth redistribution is clearly laid down in the Korean Constitution. In particular, the first Korean Constitution established in 1948 prescribed a 'mixed economy',[1] specifying income equity as a priority goal over other economic objectives. Praised as an 'East Asian miracle' by the World Bank (1993), the Korean economy had succeeded in combining high and rapid economic growth with an improvement in the distribution of income and the emergence of a middle class. Thus, the Korean government had little reason to emphasise the objective of equitable distribution of income and wealth. The continuation of economic growth was enough.

The currency crisis that erupted in 1997 was a landmark event for the Korean economy because the equitable distribution of income started to deteriorate for the first time since its take-off in 1960. Korean companies had been notorious for their high-gearing ratios, reflecting strong fixed investment demands relative to their international competitors. In particular, big Korean companies, known as '*Chaebols*', were highly criticised for over-investment and often relentless investment, as these investments were regarded as having triggered the currency crisis in Korea in 1997. The occurrence of the crisis changed this behaviour, leading to a massive restructuring of Korean companies and a huge reduction in their fixed investments, which was accompanied by the large-scale shedding of employment and a severe weakening of job-creation capacity. In particular, the massive restructuring of the corporate and financial sectors that ensued in the aftermath of the currency crisis allowed easy lay-offs in Korea, which led to a huge loss of employment and jobs. This drop in fixed investment was the principal cause of the deterioration

[1] The advent of communism in the Soviet Union, along with its central planning features, attracted the interest of many intellectuals all over the world, leading many countries to move towards a 'mixed economy' (Tanzi, 1997). Korea was no exception.

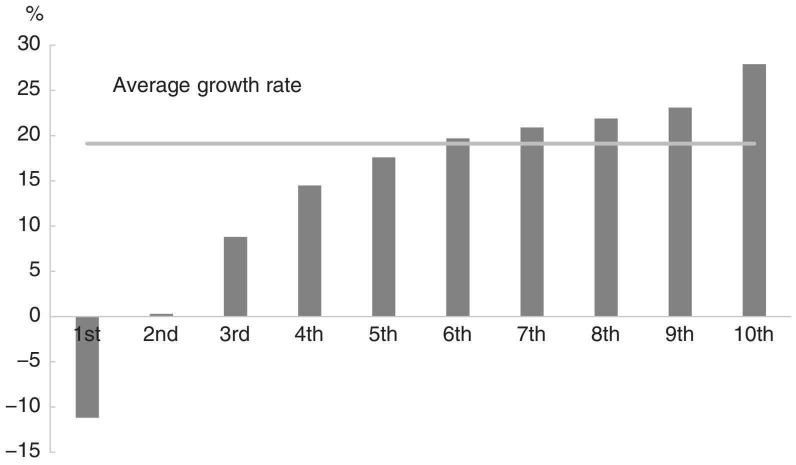

Figure 1.5 Growth rates in real household income by income brackets during the period 1997–2016
Source: Statistic of Korea.

in income distribution in Korea. The consequence of this was not just the increase in the inequality of income distribution, but also the increasing polarisation of Korean society. For an urban household unit comprising more than two people, for example, the first bracket (the bottom 10 per cent of the income bracket) saw its income in 2016 decrease by 11 per cent compared to 1997, while the tenth bracket (the top 10 per cent of the income bracket) increased its income by 27 per cent (see Figure 1.5).

As a consequence, in setting its policy priorities, the Korean government had to take the increasing inequality in income distribution into consideration, by strengthening the social safety net and expanding its expenditure on social protection and security. Against this backdrop, the current government has launched a so-called income-led growth policy, which has led to a spectacular rise in both the minimum wage and social spending, a rapid reduction in working hours, and the strengthening of job protection.

It is, however, notable that this policy has created a trade-off with the objective of economic growth and stabilisation. The 'income-led growth' policy pushed for by the current Korean government, contrary to its supposed complementarity with economic growth and the redistribution of income, has led to a significant decline in fixed investment, thereby damaging the growth potential of the Korean economy.

Furthermore, as the policy has not been managed properly, it has hurt macroeconomic stability.

1.2 Tools of Macroeconomic Stabilisation

Macroeconomic policy is a stabilisation policy intended to manage aggregate demand and thereby to react counter-cyclically to shocks that can affect output, employment, or prices. Monetary and fiscal policies are the two pillars of macroeconomic policy. As discussed earlier, a fully fledged macroeconomic policy was made possible in Korea only after the Comprehensive Economic Stabilisation Programme in 1980.

1.2.1 Fiscal Policy

Fiscal policy stems from the government's fiscal management, through which it collects taxes and makes all the necessary expenditures. But it was only after the establishment of the modern nation state that fiscal policy could be established as an instrument for counter-cyclical stabilisation policies.

In Korea, however, fiscal policy was rarely used for the goal of counter-cyclical stabilisation (see Box 1.1). The Korean government has prioritised fiscal consolidation and sound fiscal principles ever since it implemented fiscal reforms in the early 1980s, which helped to transform a Korean economy with chronic fiscal deficits into an economy with fiscal surpluses. Most fiscal expenditure was just for the long-term economic and development projects, while the fiscal deficit was always regarded as being harmful to the long-term competitiveness of the Korean economy.[2] As a result, fiscal policy was not flexible enough to address short-term economic fluctuations. Counter-cyclical fiscal policy, however, gained prominence in the aftermath of the 1997 currency crisis. Given its weak social safety net, the Korean government had to increase its social expenditure in order to mitigate the impact of the recession by supporting aggregate consumption. Since then, the Korean government has used fiscal policy more counter-cyclically. Fiscal balance went into deficit in the early 2000s and 2008 (see Figure 1.6).

[2] Korean government officials were more Classical economists than Keynesian in this respect.