

Macroeconomic Issues in Korea's

Post-OECD Financial Liberalization

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### Abstract

In October 1996, Korea gained admission into the Organization for Economic Cooperation and Development (OECD). During the course of negotiations between the government of Korea and the OECD which led up to Korea's admission, the Korean government committed itself to a blueprint for liberalizing the financial sector. The first section of this paper reviews the main elements of that liberalization program and provides a brief evaluation. The second section deals with the macroeconomic issues involved in Korea's move toward an open capital account. In particular, we analyze the extent to which Korea satisfies the standard pre-conditions for capital account liberalization, in addition to assessing the potential consequences of liberalization both quantitatively and qualitatively. The third section examines the various policy options available to Korean policymakers to counteract the undesirable side-effects of liberalization. More specifically, we look into fiscal policy, sterilization and exchange rate policy. In the conclusion, we provide an overall assessment of Korea's OECD-related financial liberalization efforts in the context of its broader efforts to develop a less regulated, more competitive financial sector. The strongest argument in favor of liberalization is that it would provide Korean manufacturing firms with access to the less costly funds available in international financial markets and those funds will facilitate their restructuring away from labor-intensive production techniques toward more capital-intensive ones.

## I.Introduction

The Organization for Economic Cooperation and Development (henceforth OECD), founded in 1961 and headquartered in Paris, is an international economic organization consisting of free market democracies. Its primary purpose is to seek solutions to global economic issues through consensus among its member states, who are largely developed countries and jointly account for 85% of the world's output. In particular, OECD provides a useful and influential forum for multilateral discussions on policy issues and directions.

The Republic of Korea (henceforth Korea) applied for membership in March 1995 and was accepted in October 1996. Broadly speaking, Korea's interest in joining OECD reflected the country's growing status as an economic power; by 1994, it had become the world's 11th largest economy. At the same time, as Kim (1995) notes, there were also two practical reasons for the interest. First, Korean policymakers viewed membership as a springboard for more active involvement in the evolution of the New International Economic Order and greater economic cooperation with the U.S., EU and Japan. Second, they felt that membership would help Korea take advantage of the vast knowledge and experience of the developed countries in areas in which it was relatively a newcomer, such as employment insurance, radioactive waste management and competition policy.

During the course of negotiations between OECD and the Korean government on Korea's accession, the issue of capital account liberalization took center stage. In fact, creating an environment for freer capital movement and international investment became the quid pro quo of Korea's accession although precisely how much freer was to be determined by the negotiations. The Korean financial system has traditionally been subject to extensive government interference, as exemplified by stringent interest

rate regulation on both deposits and loans as well as the allocation of sub-market rate policy loans to favored sectors and companies. Despite some freeing up over the last decade, the various controls which still constrain financial sector activity have left it in a state of backwardness, relative to both the real sector and to the financial sectors of the major OECD countries and certain East Asian countries. For reasons noted above, financial liberalization is expected to gather speed after Korea joins OECD.

This paper is essentially a brief overview of the key issues involved in this imminent process of liberalization. In Section II, we describe the primary elements of the government's blueprint for financial liberalization. Section III discusses the macroeconomic issues arising from opening the capital account while Section IV analyzes the policy options. In Section V, we provide an overall conclusion.

## II. The Main Elements of Korea's Post-OECD Financial Liberalization

As noted earlier, consultations regarding Korea's entry into OECD focused on financial sector liberalization. In this connection, the most critical phase of Korea's entry process was to obtain the approval of the following 2 OECD committees – CMIT (Committee on Capital Movements and Invisible Transactions) and CIME (Committee on International Investment and Multinational Enterprises). The two committees gave their approval in July 1996.

CMIT and CIME have as their basic objective the harmonization of the member states' policies and rules on services trade and capital movements. In order to promote services trade and capital movement among the member states, the two committees enforce and oversee the Code of Liberalization on Capital Movements and the Code of Liberalization on Current Invisible Transactions. Compliance with the requirements of the two codes serves as an important criterion for membership. The codes are OECD "decisions", which are binding on the member states, unlike the weaker

“recommendations” or “declarations”. As such, they provide mechanisms for reporting, inspection and consultation so as to facilitate effective compliance. We should also note that the Code of Liberalization on Capital Movements is the only multilateral code which seeks to promote comprehensive liberalization of international capital movements.

In connection with Korea’s entry into OECD, the government has recently announced a year-by-year liberalization plan for 1997-2000. The plan is divided into a section for capital movement liberalization and another section for opening up financial sector industries to foreign participation. We describe the highlights of both sections and provide a brief evaluation of the liberalization program below.

#### 1. Capital movements liberalization

##### i. Foreigners’ purchase of Korean equity

In 1996, the ceiling on foreign equity ownership of a Korean company was 20%. This will be raised to 23%, 26% and 29% in 1997, 1998 and 1999, respectively. In the year 2000, the government will eliminate the ceiling altogether. The ceiling for equity ownership of a Korean company will rise to 20% by 2000.

##### ii. Overseas bond issue by Korean companies

By 1997, private companies engaged in social overhead capital projects or other large-scale national priority projects will be allowed to issue bonds overseas. By 1999, the limit on the amount of overseas borrowing will be abolished and the eligibility for borrowing overseas will be expanded so that only those potentially capable of damaging Korea’s creditworthiness will be prevented from issuing bond abroad. If there is continuous macroeconomic stability and the interest rate differential between Korea and abroad narrows to within 2%, there will be complete liberalization in this area.

### iii. Foreigners' purchase of Korean corporate bonds

Foreigners will be allowed to purchase non-guaranteed convertible bonds of small and medium enterprises up to a specified limit by 1996 and their non-guaranteed long-term bond within a specified limit by 1997. Foreigners will be allowed to purchase non-guaranteed convertible bonds of large corporations up to a specified limit by 1998 and their long-term bonds up to a specified limit by 1999. If there is continuous macroeconomic stability and the interest rate differential between Korea and abroad narrows to within 2%, there will be complete liberalization in this area.

### iv. Trade-related borrowing

Borrowing overseas for the purpose of purchasing capital goods will be permitted. Small and medium enterprises will be allowed to borrow for trade in 1996 and high-tech large corporations in 1997. By 1999, there will be complete liberalization in this area.

### v. Non-trade borrowing

By 1997, private companies engaged in social overhead capital projects or other large-scale national priority projects will be allowed to borrow overseas to pay for domestic construction costs. If there is continuous macroeconomic stability and the interest rate differential between Korea and abroad narrows to within 2%, there will be complete liberalization in this area.

### vi. Foreign direct investment(FDI)-related borrowing

By 1997, companies in Korea in which there is foreign investment may borrow within specified limits from their foreign parent companies to purchase capital goods provided that the loans' maturity is at least 5 years. By 1999, in connection with such borrowing, the government plans to ease end-use restrictions for manufacturing companies in Korea in which there is foreign investment. If there is continuous

macroeconomic stability and the interest rate differential between Korea and abroad narrows to within 2%, there will be complete liberalization in this area.

vii. Trade credit

Small and medium enterprises will be permitted to delay their import payments for a period of up to 180 days by 1997 while large corporations will be permitted to do so by 1999. The limit on the amount of advance payment receipt for exports will be expanded to 15% of the previous year's exports by 1996, 20% by 1997, 30% by 1998-1999 and completely eliminated by 2000.

2. Opening up financial sector industries to foreign participation

i. Bank

Foreign parties will be allowed to establish local corporations by 1998.

ii. Investment trust

By 1997, the ceiling of 10% for investment by a single foreign party in an existing investment trust company will be abolished as well as the ceiling of 50% for total foreign investment. By 1998, foreigners will be able to establish new companies as well as joint venture companies.

iii. Stockbrokerage firms

The ceiling of 10% for investment by a single foreign party in an existing stockbrokerage firm will be abolished by 1997. The ceiling of 50% for total foreign investment will also be abolished and foreign parties will be permitted to establish local corporations by 1998.

iv. Short-term financing company and integrated financial services company

The ceiling of 50% for total foreign investment in an existing short-term financing company and integrated financial services company will be abolished.

#### v. Insurance

Life insurance has already been fully liberalized. In addition, by 1997, the government will abolish the ceiling of 49% for foreign equity ownership in joint venture life insurance companies as well as allow foreign participation in non-life insurance, warranty insurance and re-insurance. Foreign parties will also be able to establish independent insurance agencies by that year. Foreign participation in insurance agency & brokerage and claim appraisal will be permitted by 1998.

#### vi. Investment consulting

The ceiling of 10% for investment by a single foreign party in an existing stockbrokerage firm will be abolished and foreign parties will be permitted to establish local corporations by 1997, and the ceiling of 50% for total foreign investment will be abolished by 1998.

#### vii. Mutual funds, credit card and credit research

Foreign participation will be allowed in mutual funds for selected groups of consumers by 1997. Foreign parties will be able to engage in the credit card, installment financing and credit evaluation industries by 1997. Finally, foreign participation in the credit evaluation industry will also be permitted by the same year as long as the foreign equity ownership is below 50%.

### 3. Brief evaluation of the liberalization program

As a rough guide to see how far Korea has progressed in its financial liberalization, it is instructive to see how Korea compares with the newer OECD members, which are at a broadly similar level of development, as well as the OECD as a whole. For this purpose, we refer once again to the Code of Liberalization on Capital Movements (CLCM) and the Code of Liberalization on Current Invisible Transactions (CLCIT). A practical although admittedly inaccurate index of liberalization is the proportion of

articles in the 2 codes each country is complying with or has committed to comply with in the near future. The possible inaccuracy stems from the fact that not all articles of the codes are equally significant. The table below shows the compliance rate.

	Capital movements	Current invisible transactions	Overall
OECD average	89% (10)	88% (7)	89% (17)
Korea	55% (41)	81% (11)	65% (52)
Mexico	71% (26)	75% (14)	73% (40)
Czech Republic	65% (32)	82% (10)	72% (42)
Hungary	58% (38)	81% (11)	67% (49)
Poland	56% (40)	79% (12)	65% (52)

Table 1:CLCM and CLCIT compliance rate of selected OECD countries

Note: numbers inside parentheses indicate number of articles not complied with

As Table 1 shows, Korea's overall compliance rate is quite similar to that of Mexico, the Czech Republic, Hungary and Poland. However, it is still well below the OECD average. It is interesting to note that while Korea shows a relatively high compliance rate for current invisible transactions, its compliance rate for capital movements is the lowest in OECD. This simply reflects the broader pattern of the state of liberalization in Korea, which has a relatively open current account along with a relatively closed capital account. It also reflects a compromise between the Korean policymakers, who argued for a gradual and limited opening up, and OECD, which wanted a quicker, more complete transformation. The final result indicates a tradeoff between gradual liberalization in exchange for a detailed and credible blueprint of a more complete liberalization in the future.

While some may be disappointed by the speed and extent of the policy changes Korea has committed itself to during the course of its negotiations with OECD, these changes nevertheless do represent a fundamental break from the heavyhanded repressiveness of the past and have set the country on a clear path toward greater openness and less government interference, most significantly in the area of capital movements. Greater liberalization of the capital account entails both potential benefits and potential costs in the future. On the plus side, the fact that interest rates abroad are substantially lower than those at home suggests that Korean firms will be able to lower their costs of production and thus enhance their international competitiveness as a result of freeing up the capital account. On the minus side, the inflow of foreign funds may make the achievement of macroeconomic stability more difficult by restricting the autonomy of domestic policymakers although the scope of this problem will depend on the extent to which opening up does indeed produce a capital inflow. In any case, it is probably true that given the size and heavy external dependence of Korea's economy and the worldwide trend toward globalization and borderlessness, it is inevitable that sooner or later Korea will have to free up its capital account, and the commitments it has made in order to join OECD will help to ensure that this will occur sooner rather than later.

### III. Macroeconomic Issues in Korea's Capital Account Liberalization

In this section, we examine the various issues associated with Korea's plans to open up its capital account, discussed in II. We first look at the pre-conditions for capital account liberalization and the extent to which Korea satisfies those pre-conditions. We then examine the potential consequences of capital account liberalization on the Korean economy at both a quantitative level and a qualitative level.

## 1. Pre-conditions for capital account liberalization

Broadly speaking, there are two main pre-conditions which a country must meet if it is to successfully free up its capital account [see Mathieson and Rojas-Suarez(1993)]. First, the country's fiscal position must be more or less in balance. A large budget deficit requiring money creation and the inflation tax will encourage domestic residents to move their funds abroad. Since freeing up the capital account will facilitate such capital flight, it follows that an open capital account and fiscal imbalances are mutually inconsistent. Furthermore, even if the government finances its deficits by borrowing rather than printing money, an ever-growing stock of debt will raise doubts about its creditworthiness. Second, the domestic financial system must not be saddled with excessive regulation and/or a high proportion of non-performing loans or bad debts. The reason is that a financial system consisting of weak players who are not capable of competing internationally is likely to experience a severe crisis when the capital account is liberalized. To the extent possible, the government must take appropriate measures to shore up the domestic financial system before it has to face the rigors of international competition.

In terms of the above key criteria, the evidence on whether Korea is fully ready for capital account liberalization is ambiguous. More precisely, Korea largely satisfies the first criterion, fiscal balance and macroeconomic stability, but at the same time, falls far short of meeting the second criterion, an efficient financial system which can hold its own with foreign competitors.

At present, Korea does not suffer from any critical macroeconomic imbalance. While its current account deficit is sizeable and shows no signs of shrinking, it is not large enough to raise long-term concerns in the international financial markets. More significantly, the government budget remains more or less in balance even if we

account for hidden, quasi-fiscal expenditures. There are thus no reasons to expect that a more open capital account would lead to an exodus of domestic capital.

On the other hand, as noted earlier, the Korean financial system has long suffered from stifling “guidance” by the government, with adverse consequences on the development of strong and competent management. A prime example of such interference is the large number of government-mandated policy loans which have depressed the system’s profitability. It would not be an exaggeration to say that the financial system is an instrument of industrial policy more than anything else. Furthermore, some major banks are alleged to have a sizeable number of non-performing loans in their portfolios. The inevitable conclusion is that Korean financial institutions are less than ready to go head-to-head with their foreign counterparts.

In light of the above, the gradualist and cautious approach to capital account liberalization which is evident in Korea’s commitments to OECD seems appropriate. Korea currently satisfies only one of the two main pre-conditions for such liberalization although it is imperative that both be largely satisfied before any complete dismantling of capital controls can be contemplated. Any further opening up will have to wait until the domestic financial system improves its competitiveness.

## 2. Potential consequences of capital account liberalization

### i. Quantitative assessment: Korea Development Institute report (1996)

In a recent report, the Korea Development Institute (KDI) has run simulations on the effects of capital inflows using a macroeconomic model of Korea. KDI distinguishes between two alternative scenarios based on the reaction of the monetary authorities to the inflow of foreign capital. The first scenario is one of flexible exchange rates so that the inflow shows up entirely as an appreciation of the domestic currency while the second scenario is one of fixed exchange rates so that the inflow shows up entirely as

an increase in the monetary base and the money supply. In both cases, KDI assumes US\$10.5 billion of net long-term inflows and US\$5 billion of net short-term inflows in 1996-97, US\$14.5 billion of net long-term inflows and US\$5 billion of net short-term inflows in 1998-99 and zero net inflows from 2000 and on. Tables 2 and 3 below show the results of the simulations.

	1996	1997	1998	1999	2000	2001	2002	2003
GDP	0.90	2.69	4.51	4.89	3.37	1.03	-1.14	-2.57
CPI	-0.01	-0.02	0.12	0.53	1.15	1.73	1.99	1.86
Investment	0.75	2.85	5.47	6.97	5.94	3.13	-0.04	-2.52
Consumption	1.46	3.85	6.16	6.52	4.76	2.31	0.09	-1.40
Nominal interest rate	-0.55	-1.35	-1.43	-0.80	0.36	0.75	0.53	-0.03
Real interest rate	-0.35	-0.80	-0.82	-0.48	0.09	0.24	0.11	-0.13
Real exports	-0.00	-0.01	-0.07	-0.26	-0.64	-1.19	-1.81	-2.35
Real imports	0.37	1.76	3.68	5.21	5.12	3.61	1.46	-0.59
M2	4.27	9.00	12.56	10.80	6.51	3.16	1.08	0.13
Trade balance	-0.55	-2.79	-6.24	-9.48	-10.20	-8.60	-5.52	-2.18
Real effective exchange rate	0.01	0.02	-0.12	-0.53	-1.14	-1.70	-1.95	-1.83

unit: %

Table 2: The macroeconomic effects of capital inflows under fixed exchange rates

	1996	1997	1998	1999	2000	2001	2002	2003
GDP	-0.22	-1.14	-2.15	-2.48	-1.63	-0.28	0.77	1.31
CPI	-0.29	-1.50	-3.08	-4.23	-4.12	-3.24	-2.32	-1.57
Investment	-0.07	-0.74	-1.96	-2.87	-2.58	-1.16	0.41	1.46
Consumption	0.04	0.04	-0.00	0.09	0.40	0.87	1.22	1.34
Nominal interest rate	-0.08	-0.69	-1.59	-2.13	-1.81	-0.90	-0.17	0.24
Real interest rate	-0.02	-0.28	-0.66	-0.81	-0.58	-0.16	0.12	0.23
Real exports	-0.05	-0.44	-1.23	-2.08	-2.45	-2.10	-1.35	-0.59
Real imports	0.68	2.25	2.46	1.22	-1.04	-1.72	-0.97	-0.03
Nominal exchange rate	-1.88	-5.07	-7.20	-6.84	-4.29	-2.41	-1.40	-0.72
Trade balance	-0.87	-3.38	-4.76	-4.36	-1.71	-0.49	-1.09	-1.93
Real effective exchange rate	-1.60	-3.63	-4.25	-2.72	-0.17	0.86	0.94	0.86

unit: %

Table 3: The macroeconomic effects of capital inflows under flexible exchange rates

The KDI simulations shows that the main difference between the macroeconomic effects of capital inflows under the two different regimes is that whereas high growth and price instability characterize the adjustment process under a fixed exchange rate system, the adjustment process under a flexible exchange rate system entails low growth and price stability. Under either system, the nominal interest rate will fall, the real effective exchange rate will appreciate and the trade balance will deteriorate. That is, regardless of whether the impact of capital inflows is felt through changes in the money supply or the nominal exchange rate, we can expect Korea to experience larger trade deficits for an extended period of time.

#### ii. Qualitative assessment

The exchange rate regime currently in place in Korea contains elements of both a fixed exchange rate regime and a flexible exchange rate regime. In most developing countries, the exchange rate policy is geared toward protecting external competitiveness and in this connection, policymakers pay close attention to and attempt to influence movements of the real effective exchange rate [see Aghevli et al. (1991) and Kwon (1995)]. This has also been the case in Korea. Over the last decade, however, the market mechanism has come to play an increasingly bigger role in the determination of exchange rates in Korea. In the spectrum of exchange rate regimes between a completely fixed system and a completely flexible system, Korea probably still lies closer to the former but it is making gradual progress toward the latter. Therefore, in Korea we can expect the impact of the capital inflows anticipated to follow from capital account liberalization to be absorbed largely by movements in the money supply rather than the nominal exchange rate.

As Fischer and Reisen (1993) correctly note, the exchange rate is not only an asset price but also a relative price affecting the goods market and thus external

competitiveness, domestic output and inflation. In particular, the powerful effect of the real effective exchange rate on external competitiveness has rendered this an index of paramount importance among policymakers. The real effective exchange rate is affected by the nominal exchange rate as well as by the domestic price level. The governments of many developing countries consciously target the real effective exchange rate and East Asia has enjoyed a good deal of success from doing so [see Corden (1990)]. As the KDI simulation results discussed earlier show, capital inflows associated with financial opening up will result in an appreciation of the real effective exchange rate regardless of whether the exchange rate system is fixed or flexible. The only difference is in the adjustment process, under flexible rates the inflows will lead to appreciation of the nominal exchange rate while under fixed rates they will bring about increases in the domestic money supply and hence the domestic price level.

Korea has been heavily dependent on foreign trade during its development process. This fact, combined with a widespread if misguided economic nationalism of viewing exports as beneficial and imports as harmful, means that the policymakers as well as the general public pay a lot of attention to the current account balance in general and trade balance in particular. In fact, in Korea the greatest concern about capital account liberalization has always been the prospect of exchange rate appreciation and the consequent damage on external competitiveness. Due to the nature of its exchange rate regime, the anticipated appreciation of the real effective exchange rate in Korea would be due more to an increase in money supply than to appreciation of the nominal exchange rate. Korea's trade deficit and current account deficit reached all-time highs in 1995 and they are expected to grow even further in 1996. Be that as it may, two factors mitigate the significance of this situation. First, relative to the size of the Korean economy as a whole, the deficits are nowhere large enough to be considered

unsustainable. Second, the trade deficit reflects a surge in imports of capital goods rather than over-consumption so there are fewer grounds for long-term pessimism.

We can expect the adverse consequences of exchange rate appreciation to be somewhat tempered by the reduction in the cost of imports and hence inflation and interest rates. Much more significantly, we must weigh this short- to medium-term loss in the form of reduced external competitiveness against the long-term gain in the form of higher rates of economic growth. The Korean economy is currently at an ambiguous stage where it is in danger of being sandwiched between fast-growing Southeast Asia and China on one hand and the developed countries on the other. While it lost its wage competitiveness quite some time ago, it has yet to complete the transition toward capital-intensive production techniques and higher labor productivity. Capital account liberalization will be of invaluable help if Korea is to successfully complete this transition since it would enable Korean firms to accelerate their imports of capital goods by giving them unrestricted access to the less expensive funds available in overseas financial markets. Thus, the inflow of capital from abroad can serve as the lubricant for Korea's much-needed industrial restructuring process.

The overall picture which emerges in our qualitative assessment of the consequences of opening up Korea's capital account is one of a trade-off between greater external deficits in the short to medium run against enhanced productivity and higher growth rates in the long run. While it is ultimately up to Korean policymakers to determine the magnitude and speed of financial liberalization in accordance with their perception of this trade-off, we strongly feel that the long-term considerations are by far the more relevant ones. Korea risks being left in the fast and furious world of international competition unless it frees up its capital account as soon as possible. As noted earlier, this depends on how soon the players in the Korean financial system can compete

effectively with their foreign counterparts, and therefore, the government should intensify its efforts in this area with a greater sense of urgency. The Korean government's commitment to the OECD liberalization package represents a promising beginning but only a beginning in the hopefully rapid journey toward full liberalization.

In addition, it is not at all clear if capital controls would be effective even if the Korean government decides to retain them in the future. Increasing globalization, evident in ever-growing trade links and expansion of multinational corporations, leads to greater financial integration, which may weaken the effectiveness of capital controls [see, for example, Fischer and Reisen (1993)]. Empirical studies by Haque and Montiel (1990 and 1991), Haque, Lahiri and Montiel (1990) and Faruquee (1991) show that in the 1980s capital mobility grew significantly even in developing countries which had extensive capital controls.

#### IV. Policy Options

As we have seen, capital account liberalization and the capital inflows it induces raise genuine concerns about inflation, appreciation of the real effective exchange rate, loss of external competitiveness and worsening of the current account balance. Furthermore, capital inflows may adversely affect the stability of the domestic financial system. Policymakers can implement a number of measures in order to address those and other possible concerns. The precise nature and timing of the measures depend on whether the capital inflows are long-term or short-term, the availability and flexibility of policy instruments, the state of domestic financial markets, the prevailing policy environment and the credibility and reputation of the policymakers [see Khan and Reinhart (1995)]. In this section, we examine the various policy measures which the Korean policymakers may use to counteract the undesirable potential side-effects of financial liberalization.

## 1. Fiscal policy

As discussed earlier, the budgetary position of the Korean government is roughly in balance, which means that the capital inflows which are anticipated to follow the post-OECD liberalization of capital movements will be due to factors other than financing a fiscal deficit. Barring some cataclysmic event, such as a prohibitively expensive reunification with North Korea, we expect the Korean government to stick to a course of fiscal responsibility. Therefore, since lack of fiscal discipline is unlikely to be the fundamental cause of the capital inflows, Korean policymakers cannot use fiscal tightening to attack the problem at its roots for the simple reason that lack of fiscal discipline is unlikely to be the fundamental cause of the capital inflows in Korea's case. However, fiscal restraint will help to restrain aggregate demand and thus the inflationary pressures stemming from the capital inflows. Another benefit of a tighter fiscal stance in terms of moderating the impact of capital inflows is that it would help to moderate the flows themselves by lowering the interest rate.

According to Calvo, Leiderman and Reinhart (1994), the financial liberalization experiences of several developing countries indicates that fiscal restraint usually takes the form of reduced spending by the government sector on non-traded goods and services. Such reduction has a direct impact on aggregate demand and is usually not offset by higher private-sector demand. By contrast, raising taxes will have an indirect, smaller impact on aggregate demand because part of the higher revenues will have come from private sector resources which would have been saved rather than consumed.

Cutting back government expenditures is universally politically sensitive issue which is more often than not met by public backlashes and opposition. Korea is no exception in this regard. Also, because Korean governments have almost always exercised fiscal

responsibility and the government sector is relatively small and the budget currently in balance, there is only limited room for maneuver in this regard. In other words, even apart from political difficulties, there is very little “fat”. In addition, a significant proportion of government expenditures goes toward national defense, which is virtually untouchable in light of the considerable military threat from North Korea. Another difficulty associated with cutting back government expenditures in Korea is that the government continues to play the dominant role in investments in social overhead capital and infrastructure. If the government decides to use fiscal policy in spite of the above problems, it should attempt to set clear priorities among the competing expenditure categories and, to the extent possible improve its efficiency, so that it can manage with fewer resources.

## 2. Sterilization

Strictly speaking, sterilization refers to the exchange of government bonds for foreign exchange. Sterilized intervention reflects the attempts of policymakers to restrain the monetary effects of the capital inflows associated with financial liberalization. The primary reason that governments want to contain the growth of the money supply is their concern about the overheating of the economy and the inflationary pressures this entails. Such intervention is normally temporary and relaxed if the inflows persist for some time. In broader terms, sterilization includes not only the exchange of domestic securities for foreign currencies but also any other monetary measure which has the effect of cushioning the domestic financial system against increases in liquidity due to the capital inflows. Examples include raising reserve requirements, limiting access to the central bank’s rediscounting facilities and direct credit controls. However, as is the case with the conduct of monetary policy in general, open market operations involving

the sale of government securities are the most desirable instrument for carrying out sterilization since they are by far the most precise, flexible and predictable.

As Schadler, Carkovic, Bennett and Kahn (1993) note, even sterilization involving open market operations entails three types of potential costs. First, to the extent that there are differences between the interest on domestic bonds and return on foreign reserves, open market operations create quasi-fiscal costs. Second, the sale of domestic bonds puts an upward pressure on domestic interest rates, which is what led to the capital flows in the first place. Third, when capital flows continue for some time, sustaining open market operations which channel them into purchases of government bonds deprives the economy of the benefits of such inflows such as greater domestic investment and higher economic growth.

Nevertheless it remains true that open market operations are preferable to other means of sterilization. Unfortunately, in Korea the market for government securities is not very well-developed and subject to extensive government interference. The most liquid government paper is monetary stabilization bonds(MSBs). While the issues of MSBs are large enough and their maturities are varied enough for them to be an effective instrument of open market operations, in practice the Bank of Korea has traditionally managed their sales and set their interest rate at below market rates. The government needs to deregulate and open up the markets for MSBs and other government securities if it hopes to use open market operations effectively for sterilizing capital inflows. Encouraging the participation of foreign investors will also help add to the breadth and depth of those markets.

### 3. Exchange rate policy

We noted earlier that capital inflows lead to greater liquidity under a fixed exchange regime and nominal exchange rate appreciation under a flexible exchange rate regime.

Khan and Reinhart (1995) correctly point out that allowing the nominal exchange rate to appreciate carries three advantages. First and most significantly, it prevents the expansion of the domestic money supply and emergence of inflationary pressures. Second, it reduces the prices of imports and thereby help reduce inflationary pressures. Third, the uncertainty introduced by exchange rate fluctuations can discourage the more speculative types of capital inflows. On the other hand, nominal exchange rate appreciation would lead to immediate appreciation of the real exchange rate as well and thus harm the external competitiveness of the economy. Grobar (1993) notes that there may be negative effects on tradable goods sectors even if the appreciation does not persist.

The width of Korea's nominal exchange rate band is currently 4.5%. That is, the Korean government targets the exchange rate to be within 2.25% of some desired level in either direction. In order to realize the benefits of greater nominal exchange rate flexibility described above, the government would do well to consider gradually expanding the band up to a width of perhaps 20%, as was done in Chile in 1992 [for a discussion of the Chilean experience, refer to Helpman, Leiderman and Bufman (1994)]. It is worth remembering that rigidly targeting the nominal exchange rate in the face of large capital inflows can only lead to a serious misalignment and a costly adjustment process. In particular, Korean policymakers would be well-advised to review their long-held bias toward competitive exchange rates. Finally, accelerating the development of markets for derivatives which hedge against exchange rate uncertainty will help cushion the negative effects of real exchange rate appreciation on external competitiveness. This would help domestic firms better cope with the additional business risks that greater nominal exchange rate flexibility entails. At the present,

however, such markets are not well developed in Korea, suggesting the need for a more active policy.

## V. Conclusion

In Korea, concerns about financial sector liberalization and an open capital account have always have always centered much more on the potentially destabilizing effects of capital inflows rather than on capital flight. Relatively sound macroeconomic policies and an abundance of investment opportunities have meant that capital flight will never be a serious problem as it is in many other developing countries. While some of the anxieties about the inflow of foreign capital are based on sound economic reasoning and well founded, it nevertheless remains true that misguided economic nationalism and a general aversion to foreign ownership of domestic factors of production go a long way towards explaining the Korean policymakers' bias against an open capital account. These psychological barriers to financial liberalization still remain in place although economic realities are lessening their impact.

One such reality is the growing perception that the Korean manufacturing sector must complete its re-structuring away from labor-intensive production techniques toward more capital-intensive ones. Opening up the capital account will greatly facilitate this process by giving Korean firms access to the less costly funds available in international financial markets, funds which they can use to purchase the capital goods they need for their much-needed re-structuring. Viewed in this light, financial liberalization is not only significant in terms of its effects on the financial sector but could make the critical difference whether the Korean economy as a whole can successfully escape being sandwiched between the developed economies and the rapidly growing economies of Southeast Asia and China. The short- to medium-term

loss of external competitiveness due to liberalization is but a small price to pay once we consider this broader picture of restructuring and international competitiveness.

In any case, even if Korean policymakers were to attempt to retain capital controls in the future, it is doubtful that they would be successful in the face of increasing financial integration due to the dramatic expansion of trade links and multinational business activity. This doubt is particularly justified for the Korean economy, which has a heavy external dependence in the real sector. Furthermore, there are a number of macroeconomic policy instruments and measures available to the Korean policymakers to the extent that they have genuine concerns about the capital inflows although, as we have already seen, various institutional and other obstacles can sometimes restrict the effective use of such instruments and measures.

The financial liberalization program Korea committed itself to during its negotiations with OECD requires policy changes for liberalizing capital movements as well as opening up financial sector industries to greater foreign participation. While some may feel let down by the cautious, timid and gradual nature of the program, it nevertheless does set Korea on a clear, well-defined and credible path toward greater openness and less regulation in the financial sector. As such, it constitutes a clear break from the past and a first step toward breaking down the psychological barriers which stand in the way of a more open capital account. The program probably also represents greater understanding among the policymakers and the public of the beneficial effect of capital inflows on the restructuring of the economy toward more capital-intensive methods of production and higher labor productivity. We must also remember that, in addition to psychological barriers, the relatively backward state of Korea's financial sector and the inability of its financial institutions to compete internationally as of yet still constrain

the speed and magnitude of its policy reforms in very real, as opposed to psychological, ways.

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