WHERE IS THE EXPORT VEHICLE HEADING?: Solving the Trade Deficit Problem

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The Past

For decades, Korean economic development rested on the so-called "unbalanced growth" strategy, which mainly means that Korea was able to ride on a fast growth vehicle by concentrating its underdeveloped resources on a few industries with the greatest industrial linkage effects. The heavy and petrochemical industries are considered to fall in that category of industries that help reduce costs and induce employment in other linked industries. Under a quasi-command system Korea took another strategy for economic development, the so-called "export-drive" strategy, that attempts to curb import demand while scale economies and other industrial factors to boost the efficiencies of the export industries are engineered through governmental coordination. This led to the domestic markets being isolated from the rest of the world, while creating cumulative dissatisfaction among the workers/consumers. One would expect that such strategies would face an impasse sooner or later in a globalized world.

Last year the Korean current account deficit was estimated to have reached $23 billion, or 4.7 percent of its GDP, which was incidentally the second largest in the world following that of the United States. There are rumors of a possible, if not very probable, exchange-rate crash that could invite massive unemployment in the manufacturing sector. The hotly debated and very political issues of labor standards and union rights are unsettling the nation and were reviewed by the OECD Executive Committee as problematic. Now seems to be the most probable time to take the nearest exit to explore a different route. But which route?

According to a government report, exports edged up 3.8 percent from 1995 to $129.7 billion, while imports soared 11.2 percent to $150.2 billion last year. The record high trade deficit was caused more by the sluggish exports than the import hike. The slowing export growth was caused by two main factors. First, the weak Japanese yen improved the competitiveness of Japanese products, in particular automobiles, shipbuilding, and petrochemical products, which are primary exports of Korea. Second, the slowdown in global demand for and the ensuing price fall of semiconductors caused the export of semiconductors, which accounted for 17.7% of total Korean exports in 1995, to decrease rather than increase from $22.1 billion in 1995 to $17.86 billion in 1996 (expected), a fall of 19.8%.

Even though the prices of the yen and semiconductors might or might not bounce back in the future, in any case the economy does not look very healthy, depending critically on a few fluctuating prices. But that seems to have been the price we had to pay for the past growth strategies. When Korea faced escalating competition from China and Southeast Asia with cheaper labor, Korean conglomerates began to invest heavily, often into more capital-intensive industries. However, they still rely on imports of capital goods, materials and components to keep the export vehicle running without many domestic linked industries and small and medium-sized enterprises blossoming abreast. Therefore, it seems that after all, the strategies were executed to an extreme degree. Too much of a good strategy turned out to be really bad, which we have to live with presently. This is a structural reason for the increasing trade deficit of 1990s.

As we look toward the so-called age of global competition and absolute advantages, Korea needs to have either advanced technology, know-how, or efficient enterprises, since we apparently do not have cheap labor. Korean companies seem to have failed to spend enough on research and development. Instead they built more factories to achieve economies of scale, which has long been considered as the sure and one-dimensional way to boost economic growth. Now we realize that the past growth strategies have even blocked our way of fostering research and technological and entrepreneurial networks essential for the future. Professor R. Dornbush of MIT pointed out that Japan has the problem of bureaucratic government and the bureaucratic businesses, which seems to apply also to Korea, except that Korea does not have the comparable technology of Japan. Let us assume that Korea is learning a hard lesson during this cold winter of 1997, and seeks the right exit to take.

Letting the Exchange Rate Go

Turning to a shorter-term relief for the trade deficit problem, solutions range from micro-level solutions such as diversifying export items and curbing factor costs to macro-level solutions such as financial reforms, restructuring the government, and amending competition laws, among others. Last year the government launched a campaign to lower production costs and boost industrial efficiency and tried other micro-level solutions, but such measures alone would not solve the national competitiveness problem fundamentally since the past strategies of quasi-command economy have been taking us in the wrong direction. Economists, businesses and the government, at least in principle, support the view that large-scale deregulatory reforms are in order. If that is too much to accept, we could take the first step toward that direction by letting the exchange rate go. Again Professor R. Dornbush suggested a medium-term solution--i.e., the Bank of Korea should allow the won to depreciate 10% more against the dollar. This might to some extent solve the trade deficit problem by encouraging exports, but there is the other side of coin. The burdens of capital goods imports and foreign borrowing will grow with the currency depreciation. Since the BOK would have to worry about the foreign debt burdens of Korean firms and the hikes in the ensuing import prices of materials and capital goods, it is not clear whether that is a viable option for the BOK. A sad twist to this question is that regardless of the desirability of the non-sterilization policy, it might simply become unable to support the exchange rate at the current rate due to the continuing trade deficit. Then the trade deficit pressure will make the BOK surrender to the free market spirit of letting the market decide on the rate. This could very well be, in the absence of the national competitiveness, an unhappy scenario for the nation depending on the outcome of the floating exchang rates.

Financial Reform

The current discussion on financial reform are being headed by the newly created Presidential Commission on Financial Reform, which is debating whether the reform should take the form of a big bang or a gradual liberalization in which interest rates are deregulated first and then the financial markets are opened to foreign firms. Once it is liberalized in either way, regardless of the ownership of such financial services, it will dramatically change the corporate picture of the nation, as the management of all

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