Structural Change in the Effects of the Exchange Rate on Output in Korea

<SUMMARY>

This paper compares the effects of exchange rate shocks on output in Korea between the two periods from 1970 to 1985 and from 1986 to 2001. Theoretically, it is posited that the effects of real depreciation shocks on output may change from positive to negative as the economy transits from a late industrialization phase to an economic liberalization phase. It is contended that the main reason for this lies in the negative effects of real depreciation on investment and the success or failure of institutions in internalizing the demand spillovers, especially those from export expansion.

Empirical analysis is carried out, relying on a vector error correction model comprised of such variables as real exports, real investments, real output, broad money, and the real won-dollar exchange rate. It is shown that, in the former stage of economic development, real depreciation *contributed* to economic growth in Korea by helping industries to export and realize economies of scale in investment. This was facilitated by a *dirigiste* system which internalized demand spillovers. However, in the phase during which most industries came to mature *while the economy began to be more liberal and open, the negative effects of real depreciation* on investment arising from the increased costs of importing and debt servicing outweighed its positive effects from export expansion. This change was partly because the spillovers from export expansion to investments had weakened due to a mismatch between social capabilities and the new institutions. Hence, real depreciation in this period contributed to a dampening of output growth.

Key word: exchange rate, investment, growth