1. Recent Developments

Growth

Increased industrial output and exports since the second quarter lead to the expectation that the economic downturn may be bottoming out.

Thanks to the steady expansion of export volume and the sustained high rate of chemical/heavy industry plant operation, the second quarter of 1997 witnessed a 9.7% growth in industrial production, thereby leading to speculation that the protracted poor economic performance was likely to bottom out shortly.

Of particular note, dollar-denoted exports, which had continued to decline since the third quarter of 1996, began to increase in the second quarter and registered over 15% growth in the third quarter from a year earlier.

Export shipments in terms of volume expanded 10.8% in the first quarter from a year ago. The growth rate was still lower than the 12.4% growth rate on average for 1996, but rose further to 21.6% in the second quarter and over 27% in the months of June and July this year.

Economic recovery delayed due to lagging domestic demand and inventory readjustment
Regardless of the recovery in exports, growth in domestic demand still lagged below the level of a year earlier. Its growth rate was 2.0% in the first quarter, 4.8% in the second quarter and 3.1% in July versus the 6.4% average growth for the whole of last year.
Influenced by concerted efforts to reduce inventories, the inventory growth rate declined from the 20.9% peak in June 1996 to 9.7% in July this year. Nevertheless, such major industrial items as semiconductor machinery and equipment, electric machinery and oil refinery equipment still maintain an inventory growth rate of around 30%.
The leading composite index, which forecasts economic performance six-to-seven months in the future, has risen steadily since last March. However, other economic indicators have pointed in the opposite direction. In particular, domestic-demand-related indicators remain sluggish, thereby dimming hopes for an early economic recovery.

The leading composite index rose for five consecutive months from March; but the coincident composite index has been unable to indicate that the economic downturn is about to bottom out. The cycle of the coincident composite index, which indicates the current economic level, has been declining since last April and marked 99.7 in July.

These levels are still higher than those marked when economic recessions hit bottom in the past.

This stems from the fact that indicators of domestic consumption and investment still remain

on a downhill trend, although production and shipments centered around exports have been growing steadily albeit on a limited scale.
In the first half of this year retail/wholesale and shipments of consumer goods rose only 3.5% and 0.9%, respectively, reflecting stunted domestic demand.

Despite favorable turn in certain indices, practical economic confidence has withered.

Due to stunted substantial income growth and increased concern about the economy stemming from the protracted downturn, household consumption growth rapidly declined from 6.5% in the last quarter of 1996 to 4.4% in the second quarter of this year. Growth in construction and facility investment also declined due to increased inventories and increased number of unsold apartment units.

Industrial production marked a growth rate of 8.4% in the first half of this year versus the 8.5% of a year earlier, but the disparity between the chemical/heavy industry sector and light industry has become all the more conspicuous.

Spearheaded by the recovery of semiconductors, vehicles, portable computers, and iron and steel products, the chemical/heavy industry sector marked a 12.2% growth in the first half of this year over the same period of last year, thereby topping the 11.6% growth registered in the whole of 1996 over 1995.
Light industry, on the other hand, witnessed a negative growth of 5.7% in the first half of this year versus the minus 2.5% growth marked a year earlier. The overall performance was influenced chiefly by negative growth rates of 8.5% for textile goods, 28.8% for garments, and 11.7% for footwear.

In July, industrial production marked 7.9% growth, with the production of automobiles registering negative growth rates of 5.4% from a year earlier and 16.1% from the previous month.

Private Consumption

Since the second quarter of this year, the area of the private consumption index centered around durable consumer goods has improved, but overall domestic demand has remained at a lower level than the previous year.

Retail/wholesale transactions in the second quarter marked a 4.1% growth, a slight improvement from the first quarter, influenced by increased sales of POL (petroleum, oil and lubricants), garments and office equipment. But the 3.5% growth in the first half and the 4.9% growth in July from a year earlier are still far below the 6.9% and 6.7% growth marked in 1996 over 1995.

In the second quarter and in July the shipments of domestic consumer goods witnessed growth rates of 3.1% and 4.9%, respectively, which represent a favorable turn from the negative growth of 1.4% in the first quarter, thanks to increased growth rates in durable consumer goods of 16.2% in the second quarter and 15.9% in July from a year earlier. This resulted from discounted sales of automobiles and the launch of new model mobile telephone systems.

Shipments of nondurable consumer goods continued to witness negative growth rates of 2.8% in the first quarter, 4.4% in the second quarter and 1.1% in July.

Government consumption expenditures, which saw a 7.1% growth in 1996 due to increased personnel and commodity expenditures, declined to 4.6% in the first quarter and 6.1% in the second quarter. The slowdown in the growth of government consumption expenditures is likely to continue in the third quarter and thereafter due to a retrenched government budget to cope with an anticipated decrease in government revenues.

Investments

Due primarily to the protracted economic slowdown and over 9% expansion in production capacity, the facility-related investment indices continued to decline or remain low even into the third quarter of this year.

Facility investment in the public and non-manufacturing industrial sectors marked relatively higher growth, while that in the manufacturing industry decreased. This resulted in a markedly low level of machinery procurement orders in the first half of this year.

During the second quarter of this year, machinery shipments witnessed 26% growth while imports grew at a negative 12.2% rate, standing testimony to the fact that machinery imports were confined to the repair or renovation of established facilities.

Whereas production capacity rose 9.4% in the second half and 9.6% in July of this year due chiefly to increased imports of facilities in 1995 and 1996, industrial output rose just 9.7% and 7.9% during the same periods, respectively, thereby reducing the average operating rate of plant capacity to below 80% (78.8% in July).

In the second quarter of this year, with increased orders for privately-induced infrastructure projects and private housing projects, the construction-related investment indices turned favorable; however, the trend was reversed in the third quarter of this year.

Construction investment, which witnessed a 6.3% growth in 1996 despite lagging building construction, experienced a continued slump in growth in the first half of this year due to a continued slowdown in housing and other construction projects, although investment in social overhead capital projects saw a continued increase.

During the second quarter of this year, the construction permit area saw an increase except for industrial plants, but even this trend was reversed in the month of July. The construction investment indices are expected to decline in the third quarter of this year, reflecting their rapid expansion in the third quarter of last year.

Foreign Trade & Balance of Payments

The first quarter of this year witnessed the largest quarterly current account deficit on record of $7.8 billion. In the second quarter, however, exports turned favorable and imports declined; thus the trade deficit declined to $600 million and the current account deficit was reduced to $3.5 billion.

The growth rate trends of increased exports and decreased imports in the second quarter continued in the months of July and August, thereby improving the trade balance. The trade shortfall is expected to continue to decrease.

On the other hand, invisible trade including unrequited transfers in the second quarter and July still topped the level of last year, thereby remaining a major factor in the current account deficit.

The overall balance, which represents the combined sum of long-term and short-term capital transactions plus the current account balance, turned to a surplus in the month of March this year and has since been favorable. Thus, the shortfall in the current account was reduced to less than $800 million by the end of July this year.

In the month of June, the trade sector witnessed a surplus for the first time since December 1994, but this was reversed once again in the months of July and August.

In the months of July and August exports rose 19.7% and 14.9%, respectively, while imports decreased 0.6% and 11.9%, respectively.

Influenced by decreased facility investment and retrenched consumption expenditures, the month of April saw decreased imports, except for crude oil, and since May overall imports have continued to decline from the same month of last year.

This has resulted from decreased international market prices of grain and crude oil since early in 1997 coupled with withered domestic consumption and facility investment. In the month of July, imports dipped as much as 23.4% from a year earlier and on top of that domestic consumption dropped 8.9% from a year ago.

During the month of August, arrivals of export L/Cs turned for the better. However, negative growth rates were recorded for such major items as automobiles (-29.4%), electric and electronic products (-19.1%), iron and steel products (-19.1%), and iron and steel (-12.0%).

Prices

Influenced by the poor economic situation and stabilized supply of primary industrial products, consumer prices and producer prices rose just 4.0% and 2.7%, respectively, as of the end of August this year, thereby maintaining their stable trends since May last year.

Thanks to stabilized international market prices of raw materials, including crude oil, along with stabilized prices of domestic agricultural and fishery products due to bumper crops, consumer prices remain stable in the third quarter, despite increased charges for some public utility services.

In August, the prices of some agricultural, livestock and fishery products rose somewhat; but the levels of increases in industrial products, increased public utility charges in the third quarter and private service charges were no higher than those of 1996.

Money & Banking

Short- and long-term market rates began to rise in March and hit 12.5% (debenture yield) in early May but have since remained stable at around 11-12%, except for the period market rates rose during the financial crisis of Kia Motors. The stable trend of market rates despite the collapse of some conglomerates is believed to be the result of the following factors.

Decreased capital demand of enterprises resulting from decreased facility and construction investments and blunted inventories.

Flexible money supply policy by monetary authorities. Despite the withered economy and decreased demand for capital in general, the month of April saw a 20.9% growth in the average balance of total money supply and around 18% on a year-to-year growth is being maintained.

In the wake of Hanbo動 financial crisis, applications for the issuance of enterprise bills and debentures have increased sharply, reflecting efforts of enterprises to raise short-term funds and thus prepare for uneasy prospects for capital.

The general stabilization of market rates notwithstanding, the rate of dishonored bills remains high along with the relatively wide fluctuation in market rates Ñ signs that capital market and tight credit factors still remain uncertain.

First, tight credit factors remain extant in the aftermath of the increased number of major enterprises that have gone belly up and the 肌ccord for prevention of bankruptcyÓ being applicable only to major enterprises.

Second, enterprisesÕ demand for capital has been decreasing, but there has emerged a temporary demand for capital which has been touched off by concern on the part of enterprises that they might fall victim to vicious rumors that their financial condition is poor contrary to the fact that they are enjoying a surplus.

Third, the ratio of firms unable to float debentures (being permitted by the authorities concerned), due to the refusal of payment guarantee agencies to cooperate as a result of the bankruptcy of major enterprises, increased from 4.4% in January to 7.9% in March, 11.7% in May, and 17.1% in July.

Fourth, although some enterprises have considerable surplus, the gap between enterprises has been expanding, due chiefly to the inactive role of banking institutions and the withered capital market.

Money supply indicators show that money supply growth has been blunted since the second quarter. Nonetheless, movements between accounts and the current economic phase indicate that the money supply has been relatively elastic. The fact that M2 alone has risen thus far this year has resulted from the transfer of funds between accounts in the wake of the implementation of the MMDA (liberal withdrawal account linked to market rate) system.

The current capital market status Ñ bipolarized capital situation, tight credit phase, etc. Ñ reduces the significance of the money supply-related indices as indications of money supply. Rather it may be said that the dishonored bill indicators and the rate of failure to float debentures better reflect the current capital market situation.

In July the ratio of dishonored bills to total bills issued in terms of value in Seoul stood at 0.23%, the highest rate since 1982. But this indicator has dipped to 0.19% since August. The ratio of failure to float debentures by enterprises that are approved to do so due to deterioration of the capital market has increased sharply.

2. Outlook for 1997/1998

Growth

GDP, which marked a 7.1% growth in 1996 over 1995, is likely to witness 6.0% growth in 1997 and 6.4% growth in 1998 when the economic downturn is likely to hit bottom and to begin a gradual upturn.

The possibility of economic recovery has improved as exports turned for the better since the second half of this year and the readjustment of inventories also made progress in the third quarter. However, influenced by the increased unemployment rate, withered household expenditures and negative investment attitude of enterprises due to the protracted business slump, it is likely that facility investment and domestic demand, including consumption, will remain sluggish.

Furthermore, the withered economic confidence will remain unchanged for the time being, inasmuch as the bankruptcy of Hanbo, Kia and other major enterprises and the expanding bipolarization of the capital situation are expected to adversely influence production and export activities even after the second quarter of the year.

The unemployment rate, which hit 3.4% last March, has declined to just 2.1% (2.3% after seasonal adjustment), despite the increased number of economically active population. This has resulted from a continued decrease in the employment in primary and secondary industries, while employment in the construction and other service sectors increased. In fact, the share of employment in the service sectors rose from 65.8% in 1996 to 67.3% in August. The rapid expansion of employment in the service sector is emerging as a cause of serious concern.

In the first half of this year, wages based on payment dropped 2-3 percenttage points from a year earlier and the nominal increase in wages through labor-management negotiations was around 3% or half the level of 1996.

It is likely that 1998 may witness gradual recovery in the growth of exports and fixed investment. Still annual growth in 1998 may not be more than 6.4%, and may remain below the potential growth rate.

Exports in terms of volume expanded from 14.5% last year to 14.8% in the first quarter and 24.9% in the second quarter on a year-to-year basis. However, with domestic demand still in the doldrums, it is rather difficult to expect an epoch-like upturn in the economy through increased exports alone.

Exports, which have turned for the better since the second quarter of this year, may mark a double-digit growth in the second half of the year to register an overall 8.0% growth in 1997 over 1996. Such expansion in exports has resulted not so much from increased unit value than expanded volume. Therefore, it may facilitate readjustment of inventories but will little contribute to enhanced productivity. (Export volume may grow 16.5% this year Ñ a small increase from 1996 Ñ but the unit value index of exports is likely to decline by around 14.5%.)

Since last March economic indices have generally improved. The coincident composite index, industrial output index, operating ratio, and electric power demand index have marked increases. At the same time, labor input, import, and nondurable consumer goods indices witnessed downturns.

In the case of the leading composite index, arrivals of export L/Cs and imports of raw materials for export goods remained sluggish along with machinery procurement orders related to facility investment and the unemployment rate.

In 1997, no final demand sector other than exports is likely to recover. In particular, facility investment and private consumption have declined conspicuously since the second half of 1996. Even into the third quarter of this year, the plant operating rate and inventories are expected to continue to undergo readjustment. Therefore, technical confirmation of the economic downturn動 bottom is likely to be possible sometime in the last quarter of this year. The anticipated recovery of exports stems from the expected positive factors of the depreciation of the won since last year, continued economic growth in advanced countries and international market recovery for such major items as petrochemicals, iron and steel products, and semiconductors.

Readjustment in facility investment is expected to be completed to a certain extent over a period of two years, from the last quarter of 1995 to the last quarter of 1997. The inventory sector, too, is expected to hit bottom in the third quarter of this year and mark a 3.7% growth in 1998.

In 1996, construction investment saw a growth rate of just 6.3%, less than originally anticipated, due to lagging construction of buildings. It has turned for the better from the second quarter of 1997 and is now expected to moderately grow by 1.0% in 1997 and 3.3% in 1998.

This is because the anticipated upturn in light of past construction business cycles is being delayed. In the housing construction sector, for example, its leading composite index indicated recovery from after the second quarter of this year in conjunction with eased restrictions on housing construction. However, its expansion may hit a snag due to the rise in the number of unsold apartment units since last May.
Public sector construction investment is likely to grow after the second half of this year in the wake of the placement of construction orders. In the case of construction investment in commercial buildings, gradual expansion is expected after the second quarter of this year.

The facility investment sector, which entered a contraction period in the second half of 1996, marked a year-to-year growth of 15.8% in 1995 and 8.2% in 1996. In 1997, the investment confidence of enterprises has further withered in the second half and it is likely that 1997 may witness a negative growth in the sector of around 2.5% over 1996. In 1998, however, when the facility investment cycle is to begin turning up after completing readjustment of inventories and plant operation rates, a moderate growth rate of 3% is expected.

Prices

During the second half of 1997, it is likely that pressure on domestic demand will be eased due to the protracted economic depression, while international commodity prices will continue to be stable. Thus, consumer prices are expected to rise around 4.3% in 1997.

In 1998 when the economy is expected to begin turning around, consumer prices will be up around 4.5% Ñ somewhat lower than 1996 but slightly higher than 1997.

Domestic manufacturing industry wages, which remained at around one-half of the level of OECD nations in 1996, have since been increasing rapidly Ñ at a rate of 3-5 times greater than that of advanced nations. In view of this, pressure for higher wages is likely to mount in 1998, thereby adversely affecting prices.

Balance of Payments

Trade Balance

The first quarter of this year witnessed a trade shortfall of $5.6 billion. However, 1997 is likely to see a trade deficit of no more than $8 billion for the year, thanks to increasing exports and stunted growth in imports. In 1998, the trade deficit will be down further to around $2.35 billion inasmuch as the import growth rate will lag far behind export growth rate.

This outlook stems from the forecast that while exports of such major items as semiconductors and other electronic products, iron and steel products, petrochemicals, and automobiles are expected to continue to expand, growth in imports will remain sluggish as it is unlikely that domestic demand will fully recover in 1998.

Exports for 1998 are expected to witness a 9.7% growth over 1997 to $152 billion, thanks to the depreciation of the won and increased export volume of major products that will more than offset the decreased unit prices of exports.

Externally, the yen remains weak at a level of 120 yen per dollar, while the legal tenders of Southeast Asian nations have plummeted. Internally, increased bankruptcies of major enterprises and the protracted financial crisis at Kia Motors have tended to adversely influence even the foreign exchange market and the won-dollar exchange rate is now being maintained at 915 won per dollar. It would seem possible to further depreciate the won.

However, in 1998 when the external and internal difficulties are likely to ease, it may be expected that the yen and the won will slightly appreciate to the levels of 115 yen and 900 won per dollar.

During 1998, imports are likely to grow 6.9% versus the anticipated export growth of 9.7%, inasmuch as domestic demand growth will be no more than 5% and facility investment growth may not top the level of 1996.

Current Account

In contrast to the decreasing trade shortfall, the invisible trade and unrequited transfer balance is likely to continue to increase, from $10.47 billion in 1997 to $10.69 billion in 1998. Thus, the deficit in the current account is expected to hit $113.9 billion in 1998, or more than 2% of GDP.

The unfavorable offshore travel balance, which accounts for one-third of the invisible trade shortfall, has been increasing inasmuch foreign visitors are spending less though their number has been increasing, while Korean overseas travelersÕ per capita spending has been increasing.
In addition, deficits related to payments of royalties, trade goods transportation, etc. are expected to increase further for the time being.

Interest Rate &
Exchange Rates

Interest Rates

In September, the market interest rate again rose above the 12% level. However, the rate is likely to be stabilized at around last year動 level of 11.9% in the last quarter of this year, influenced by enterprisesÕ subdued capital demand, continued blunted demand for investment due to the protracted economic downturn, and stabilized consumer prices at the level of last year.

Although there exist factors that are apt to push market interest rates up after the second half of this year, such as uncertainty in the capital market and projected elimination of the accord for prevention of bankruptcies of major enterprises, the blunted demand for capital due to withered investment confidence is likely to pull down market rates to a certain extent.

If exports increase, visible signs of economic recovery occur, prices rise rapidly under the pressure of accumulated factors or a less flexible money supply policy is adopted, 1998 will see once again mounting pressure on market rates, and the interest rates would surpass the 12% level.

Exchange Rates

The won-dollar exchange rate, which began appreciating last April, once again has reversed its trend due to depreciation of the yen and the currencies of Southeast Asia. However, if the capital market is stabilized and the current account shortfall is reduced, the end of 1997 is likely to witness appreciation of the won to 910 won per dollar and further to 900 won per dollar by the end of 1998.

Due to the mounting deficit in the current account and the strong dollar in the third quarter of this year, the won has appreciated to 915 won per dollar.

1998 is likely to see a slight appreciation of the won influenced by continued increase in exports and upturn of the domestic economy, which will help induce an increased inflow of foreign capital.

In the short-term, however, the won is likely to continue to slide due to the slowed economic recovery of Japan and the weakening currencies of Southeast Asia.

Korea動 foreign exchange holdings, which had continued to increase since April, declined in August due to the central bank動 release of foreign exchange reserves to curtail the sharp depreciation of the won and increased withdrawal of foreign capital invested in the stock exchange. The foreign exchange reserves of Taiwan and Singapore are $85 billion and $72 billion, respectively, while the IMF says the optimum level of foreign exchange reserves of a country is a sum equivalent to an amount enough to cover its imports for three months. In Korea動 case, that sum is around $36 billion.

The balance of foreign exchange deposits by Korean residents, which used to increase in parallel with increased overall foreign exchange holdings, began to decline since last July.

Summary

Having witnessed economic growth rates of 6-7% in the first half of the economic downturn that lasted four quarters since the second half of 1995 and 5-6% in the second half or since the second half of 1996, Korea動 economy is expected to begin an economic upturn cycle in 1998 and mark an economic growth rate of over 6% for the year.

In the latest economic downturn cycle, which was influenced by a combination of economic cycle factors and the industrial structure of Korea, the government did not resort to a positive macroeconomic policy to uplift domestic demand. As a result, the uncertainty of the domestic capital market has been protracted and the economy has been experiencing an economic contraction lasting nine to 10 quarters since the last quarter of 1995. Nevertheless, the economic downturn is likely to bottom out in the last quarter of 1997, thanks to increasing exports since the second quarter of this year. Anticipated annual economic growth rates are 6.0% in 1997 (versus 7.1% in 1996) and around 6.4% in 1998.

Affected by the rapid decline in imports, the current deficit shortfall is expected to decrease to $15 billion in 1997 and $12 billion in 1998, and the consumer price index is likely to drop below the level of 1996.

Inasmuch as the won has depreciated for the last two years or since the last quarter of 1995 and there is an indication that the value of the won is closely linked to the weakening yen, it is probable that exports would continue to expand in the second half of 1997. On the other hand, while facility investment remains blunted and imports decline rapidly influenced by the depreciation of the won, the deficit in the foreign trade sector has decreased rapidly.

In the export sector, however, the uncertainty over the currencies in Southeast Asia, which is likely to be protracted despite efforts of the IMF to the contrary, may adversely affect Korea動 exports, as the region has emerged as the largest market for Korean products, replacing the United States. In fact, the region has now become the major source of Korea動 trade surplus.

Meanwhile, the imminent advent of an economic upturn cycle notwithstanding, the investment confidence of enterprises remains frozen and this may lead to untimely, inadequate facility investments, extended economic downturn and delayed restructuring of industries.

In short, while Korea動 economy is about to enter an economic upturn cycle in 1998, it needs to minimize such adverse factors responsible for low-production efficiency and low economic growth and continue efforts to reduce the current account deficit. In medium- and long-term measures, Korea needs to upgrade various economic variables to those of advanced nations in the process of integrating the domestic economy with world economies not only in terms of prices but the capital market as well. It must also minimize industrial bipolarization and continue efforts to effectively restructure domestic industries.

3. Environments & Foci of Macroeconomic Policies

Macroeconomic Environments

Recent macroeconomic indicators forecast an economic recovery in the not too distant future, easing signs of continued poor economic performance.

Meanwhile, exports have turned for the better, inventories are declining, while shipments are increasing Ñ indications that the economic downturn is about to bottom out.

Nonetheless, the deterioration of terms of trade and still depressed domestic demand are causing the public to remain uneasy about the protracted economic conditions. The growth in domestic demand has stayed at a depressed level thus far.

The slump in domestic demand has resulted from an unfavorable employment situation and stunted wage hikes. However, measures adopted since last year to reduce the growing deficit in the current account also tended to wither domestic consumption propensity.
Furthermore, the economic downturn this time is being protracted more than in the past because of the continued stringent credit system. Korea動 economic cycle has been marked by 33 months (average) of economic expansion and 17 months (average) of economic downturn. The current economic contraction phase, which began in the last quarter of 1995, has already exceeded two years and yet its termination has not been confirmed.

And the current economic slump is marked by two vital factors: decreased production growth and risks of economic activities. As an aftermath of the bankruptcies of major enterprises, business firms in general have serious misgivings about their prospects, while workers are faced with an uncertain future because of possible bankruptcies or downsizing of their enterprises.

As indicated in the diagram on the previous page, the bankruptcy rate of enterprises has risen to 25%, far higher than the 17% marked in 1980, previously the worst year for bankruptcies.

The unemployment rate, which was stabilized at around 2% since the second half of 1980, recently rose to 3%, reflecting increasing uncertainty of employment.

Influenced chiefly by such uncertainty and risks, household consumption and enterprise investment confidence remain withered. Consequently, the BSI (business survey index), which indicates the business perceptions of domestic entrepreneurs, has dropped to the lowest level since 1980. In anticipation of a protracted economic downturn, the BSI has been declining since 1996.
In conclusion, the problems of the current economic cycle are not simple inasmuch as the decreased total industrial output has been compounded by uncertainty and risks of economic activities. In particular, the frequent occurrence of bankruptcies of major enterprises has led to uncertainty of financial institutions that, in return, reduced the credibility of Korean banking institutions in international financial markets Ñ a fact that may well lead to financial catastrophe.

It is indeed quite serious to contemplate that the decreasing credibility of domestic financial institutions will make it rather difficult for them to induce credits from foreign banking institutions which in turn will cause further depreciation of the won Ñ factors which will further boost the instability of domestic capital and foreign exchange markets.

Macroeconomic Policy Issues

1. The government should consistently implement policies designed to stabilize prices and the capital market.

The most important issue at hand is how to prevent the current troubles of the real sector from touching off a financial catastrophe. The government should urgently adopt measures to ease the concern of domestic capital market participants over possible financial panic.

It is a difficult proposition to check financial panic only with an adequate supply of money. Recently the monetary authorities resorted to a flexible monetary supply policy by raising M2 to 19% in August, but it is impossible to resolve credit panic only through an expanded money supply. It should not be overlooked that the current financial crisis resulted not so much from an inadequate money supply as from the mounting uncertainty over the outlook for the money supply that has prompted financial institutions to avoid loans, thereby blocking the smooth flow of capital.

The government recently took measures to release special loans to Korea First Bank and merchant banks in a move to subdue fears of a financial crisis and to check the declining credibility of domestic financial institutions. But it appears that these measures were taken too late. Therefore, it was necessary for the government to declare that it will guarantee reimbursement of foreign credits induced by domestic financial institutions in order to enhance credibility of the domestic capital market. Especially, efforts must continue to be made to publicize exact information on the domestic economy for overseas participants in the domestic capital and foreign exchange markets.

Inasmuch as the reduced application of macroeconomic policy is responsible in part for the current economic depression, the government should maintain stability in its implementation of economic measures.

When it became apparent that Korea failed to make a softlanding in the second half of last year, the government concluded that the potential growth rate of the economy had decreased and came to implement a macroeconomic system on a reduced basis. However, there are indications that it was too premature to have concluded that the potential economic growth rate had declined to the 6% level.

It cannot be overlooked that such a miscalculation led the government to create a social atmosphere stimulating decreased consumer demand. This being the case, it is necessary for the government to gradually stimulate consumer demand in order to reverse the domestic demand slump.

In consideration of the fact that the scale of the economy has been expanded to a considerable extent while the weight of the export sector has been gradually declining, it must be noted that an overall economic recovery is rather difficult without recovery of domestic demand. (The share of exports to GNP dropped from 36% in the 1980s to 30% in the 1990s.)

The government plan of reducing outlays for social infrastructure by 2,000 billion won under the pretext of the government setting an example by reducing expenditures needs to be reconsidered. This is because it will not only further prolong the current economic downturn but will also delay nourishing the long-term growth potential of the economy.

2. The government should gain an accurate perception of the principle of market economy.

There is an acute need for the government to clarify in no uncertain words its principle and position concerning the recent series of bankruptcies and temporary rescue measures for cash-strapped major enterprises.

The government authorities concerned have been making it clear that enterprises themselves must be held responsible for their financial troubles and that the government will not interfere so as to uphold the principle of market economy.

However, it must be noted that, while the long-term perception of the government that the principle of market economy should be upheld is not without justification, it should not be literally applied in finding solutions to short-term recovery measures, inasmuch as the economy is being macroeconomically depressed while microeconomically restructured by the government, which says it would uphold the principle of market economy.

Furthermore, the government has failed to strictly uphold its principle of market economy by interfering in some cases of financially-strapped enterprises, thereby incurring distrust of government policies. There are indications, in fact, that the government failed to maintain its policies insofar as its measures concerning the 記ankruptcy rescue accordÓ are concerned as well as in the disposition of financial troubles of certain enterprises.

What is more desirable, if the government is determined to firmly establish market economy and carry on with microeconomic restructuring, is that the government create an environment and a system conducive to spontaneous participation of enterprises instead of obliging them to blindly follow its policies.

What is even more important is for the government to remove/ease a number of restrictions to facilitate the function of economic principles in the market economy. In order to facilitate restructuring of enterprises, it is also necessary to ameliorate restrictions related to employment. In addition, the merger and acquisition (M&A) market needs to be activated, in order to facilitate industrial restructuring.

Recent Economic Policies & Measures

(Jun. 26-Sep. 18, 1997)
September 18

Ministry of Finance & Economy announced salient points of its budget bill for 1998.

September 5
Bank of Korea announced special loans to merchant banks to help ease their financial difficulties.

Ministry of Finance & Economy announced relief measures for Korea First Bank and merchant banks.

September 1

Office of Small Business Administration said a bill insurance system will be implemented from September 1, 1997.

August 28

Ministry of Finance & Economy implemented measures to further liberalize foreign-trade related capital.

August 27
Ministry of Finance & Economy sponsored a public hearing in the National Assembly on plans to enact laws concerning guarantee of secrets on real-name financial transactions and on the prevention of money laundering.

August 13
Ministry of Trade, Industry & Energy appealed to the WTO on the refusal of the United States to withdraw antidumping duties on Korean DRAM chips.

August 11
Office of Small Business Administration announced amendments to the Special Measures Law for Small Business.

July 25

Ministry of Finance & Economy approved plans of securities firms to handle commercial papers and of merchant banks to handle negotiable bill transactions.

July 11

Ministry of Finance and Economy ameliorated its government budget management system.

June 28
Ministry of Finance & Economy raised foreignersÕ investment ceilings on stock index futures and option transactions.

June 26
Ministry of Trade, Industry and Energy announced its plan to revise the Substitute Energy Development Law. The ministry also said a total of 14 items would be removed from the list of items for diversification of import sources (to check imports from Japan in order to ease the growing trade deficit with Japan) from July 1997.