1. Recent Developments

Business Conditions

Recently, a number of economic indexes have started to show a moderating trend in the domestic economic downturn.

The leading index and the cycle of coincident index have continued to climb since last April and September, respectively.

Since last August, the rate of decline in industrial production has begun to slow, while the average operation ratio has been rising.
The indexes related to equipment investments, however, still remain at low levels, but the rates of their decline have decreased since the second quarter of last year.

Exports fell last year from May to October. However, thanks to increased exports of semiconductors and automobiles, exports marked a 1.5 percent growth in November. The trade account surplus thus marked increases of $3.2 billion in October and $3.7 billion in November, thereby raising the aggregate for the first 11 months of the year to $35.9 billion.

Nonetheless, it is still far too premature to confirm that Korea's economy in general is headed on a upswing. The indexes related to domestic demand still remain on a steep downward path.

Furthermore, the rate of decline of inventories is accelerating. This indicates that the process of readjustment of inventories is far from completed.

Prices

During the October-November period, the consumer price index and producer price index rose 7.8 percent and 11.3 percent year to year, respectively. These are indications that the price growth rates, which peaked in February, have continued to slow into the last quarter of the year.
The sustained downward trend in prices has been attributed to stabilized international market prices for crude oil and other raw materials, a stable won-dollar exchange rate and the deep slump in domestic demand.

Money, Banking & Exchange Rate

The tight money supply environment has eased and the interest rate in the domestic capital market has been on the decline.

Due to money movements between financial products, the growth rate of M2 has climbed, while that of MCT has declined.

Annual interest rates for both short and long-term loans have dropped to single-digit figures.
The Bank of Korea's open market operating interest rate (based on short-term RPs) dropped to below 7 percent, which in turn brought down the interest rates of short-term loans including call loans and CPs to 6~8 percent.

Annual interest rates on such long-term bonds as national bonds and debentures also dipped to 7~8 percent, following the recent interest rate lowering in the U.S. and other industrialized countries. A stable foreign exchange market has also contributed.

Thanks to the sustained surplus in Korea's current account and increased foreign exchange holdings, the highest level in history, the value of the won has been strengthening steadily.

The fact that the yen rose to the 110 yen per dollar level and the popular expectation that the value of the won will further appreciate have no doubt contributed to increasing selloffs of dollars by domestic enterprises, which in turn has led to the won appreciating in the short term.

2. Outlook for 1999

Economic Growth and Employment

The year 1998 is likely to witness the lowest growth rate, estimated at minus 5.9 percent over 1997, in the economic history of Korea. However, by the second half of 1999, the nation is expected to escape from the negative growth and post 0.2 percent growth.

The negative growth rate is likely to be around 5.8 percent in the last quarter of 1998, due chiefly to growing exports and a slowdown in the decline of domestic demand. Nonetheless, it is still premature to predict that the economy is about to bottom out, inasmuch as the quarter-to-quarter change of GDP has continued to fall.

The pace of contraction in domestic demand has notably eased, but the decreasing rate of inventories remains high, which indicates that one can hardly expect rapid growth in industrial production in the first half of 1999.

Influenced by the smooth implementation of industrial restructuring plans in major sectors amidst stunted industrial activities, Korea's unemployment rate is likely to increase in the first half of 1999 to around 9 percent.

The tangible effects of enterprise restructuring efforts are expected to manifest in the first half of 1999. It is expected that Korea's unemployment rate will hit its peak in the first half of 1999 and slowly decline thereafter. In particular, following next March when new college graduates are expected to be seeking their first job opportunities, the number of unemployed is likely to top two million.

Even if financial restructuring efforts are completed in the second half of 1998, the slump in the real economic sector induced by lagging exports, continued downturn in domestic demand and increased unemployment is unlikely to be reversed conspicuously in 1999. Consequently, the prevailing attitude of financial institutions to restrict loans is expected to continue for a considerable period.

In the final demand sector, 1998 witnessed a continued slide in each sector, but 1999 will be marked by a slowdown in the decline in each sector. Some sectors will even begin to grow in the second half of 1999. Nonetheless, on an annual basis, the final demand sector excluding the inventories is likely to either maintain the 1998 level or decline further. Thus, full-scale economic recovery spearheaded by recovery in domestic demand will not be possible until after the year 2000.

Exports are expected to grow 1.4 percent in 1999 over 1998. The decreasing trend in the international market prices of raw materials is expected to level out, while the won will likely continue to appreciate. This will lead to minimal cutbacks in the unit prices of export goods. As a result, Korea's annual growth in exports in terms of volume will drop from about 16 percent in 1998 to 4 percent in 1999. The unfavorable effects touched off by the Asian currency crisis will continue to linger in 1999. This will be further complicated by growing signs of China's economic slump, an economic downturn in Latin America, and an economic slowdown in the United States.

In the consumption sector, consumption demand is expected to revive somewhat after the third quarter of 1999, inasmuch as real estate and other asset markets are expected to improve from the third quarter of 1998, despite the decline in real wages and unstable employment prospects.

In the equipment investment sector, prospects for domestic and overseas demand are still uncertain, while efforts to reform the financial structures of enterprises will be concentrated in 1999. Thus, negative growth in equipment investment is expected to last throughout the year. A recent investment plan survey conducted by the Federation of Korean Industries indicated that equipment investment by enterprises will fall by 16 percent in 1999 from their equipment investment target for 1998, which was revised in the second half of 1998. In the case of Korea's five major business groups (conglomerates), it will be rather difficult for them to boost equipment investment in view of their cash flow prospects, which are tight due to their effors to reduce their debt-to-equity ratios to 200 percent by the end of 1999.

Investments in construction, which dropped sharply in the last quarter of 1998, are likely to continue the downward trend in the first half of 1999, despite increased government investment in social overhead capital and other public projects. It is likely that overall construction investment will mark a decline of some 13.6 percent in the first half of 1999, but the slowdown in the second half of the year is expected to ease to around 6.5 percent.

Prices

The growth rate of consumer prices peaked in the first quarter of 1998 and has since been declining. As a result, the consumer price index is expected to register an increase of 2.0 percent for the whole of 1999.

In 1999, fluctuations in the foreign exchange rate will be minimized, international market prices of raw materials will remain stable along with wages, and the total domestic demand sector excluding inventory, will likely continue to decline. In the end, the overall pressure for price increases will remain at a low level. The average won-dollar exchange rate in 1999 will remain stable at around 1,150-1,250 won per dollar.

GDP excluding increased inventories will maintain a downward path, raising concerns that sluggish domestic demand will exert deflationary pressure.

Exports & Imports

The surplus in the current account, which is estimated to reach $40.5 billion in 1998, is expected to be $32 billion in 1999 -- a level still considered high.

In spite of the anticipated increase in the payment of interest on foreign borrowings, the surplus in the current account will remain at a high level, thanks to an anticipated surplus of $36 billion in the foreign trade sector. The ratio of the current account balance to GDP is expected to decline somewhat, from 13 percent in 1998 to around 10 percent in 1999. The foreign trade sector is forecast to achieve a surplus of $36 billion in 1999, a decrease of about $6 billion from 1998.

Imports are likely to grow 8.4 percent this year, affected by needs for equipment investment and recovery of consumption demand in the second half. At the same time, exports are expected to grow no more than 1.4 percent due to stunted overseas demand and increasing international trade frictions.

Unlike the surplus in the balance of international trade in commodities, the unfavorable balance of trade in the services and other sectors is expected to further increase in 1999 to around $4 billion, influenced by increased payment of interest on borrowed funds that will result in an unfavorable balance in the investment sector.

Interest Rates & Exchange Rate

The prevailing capital market rate, which dropped to the 8-percent level (based on the yield of three-year debentures) in December 1998, is expected to slide further in the first half of 1999. This means that domestic interest rates will remain lower than those in the international market for the first half of 1999.

The government has been expanding the total money supply since last September. However inflationary pressure from total demand continues to weaken due to the anemic demand.

The government has remained intent on stabilizing interest rates on short-term loans at the 5-percent level and market interest rates (based on enterprise debentures) at around 7 percent.

In the foreign exchange market, the value of the won has been rising, stimulated by continued appreciation of the yen. The won-yen exchange rate has generally stabilized at around 1,000 won per 100 yen.

Market interest rates, including the rate on short-term loans, are expected to be stable, if not lowered somewhat, for the time being, provided that the current stability of the foreign exchange market remains intact. It is desirable for the monetary authorities to ease mounting pressure for appreciation of the won by lowering interest rates rather than by direct intervention in the foreign exchange market. So long as the exchange rate and interest rates remain stable, an increasing inflow of foreign capital will be assured for a considerable period.

The won-dollar exchange rate is likely to be maintained at 1,200 won per dollar through the end of 1998. In 1999, the rate is expected to approach the real effective exchange rate level.

Our institute estimates the current real effective exchange rate at 1,120 won per dollar. However, in the event that restructuring of financial and other industries is delayed, the surplus in the current account is radically decreased, and/or overseas economic conditions deteriorate, influx of foreign capital will be reversed and the won will depreciate. On the other hand, in the event that the that Korea's financial credibility is restored, the ceilings on foreignersÕ ownership of shares are eliminated, the bond market is opened to foreign competition, and the financial crunch of the domestic capital market is substantially eased, it will be possible for the won-dollar exchange rate to attain the real effective exchange rate level.

3. Macroeconomic Enviroments & Policies

Macroeconomic Environments

A. Favorable Turn of Macroeconomic Environments

We have come to witness the emergence of the so-called new three lows -- low interest rates, low (depreciated) dollar and low crude oil prices.

The U.S. federal funds rate has been lowered three times since September 30 of last year by a total of 0.75 percentage point. Other major economic powers also joined the U.S. drive to reduce interest rates. The yen, which had dropped to the 140-yen-per-dollar level, has recently recovered to the level of 110 yen per dollar. Influenced by increased oil output of the organization of oil producing and exporting countries and the slowdown in world demand for oil due to a worldwide business recession, the international market price of crude oil has dropped to less than $10 per barrel.

The government needs to make best use of the current favorable economic environment in order to expedite Korea뭩 economic recovery from the crisis.

B. Acceleration of Big Deals and Restructuring of Major Enterprises

The long-pending efforts to restructure the top five business conglomerates came to a fruition on December 7 this year when leaders of government and business circles held a joint, informal meeting to iron out the framework for the restructuring projects. Nonetheless, it is rather difficult to predict how the restructuring process will proceed in the course of concrete negotiations.

It can be said that an overall framework for restructuring the five conglomerates has been adopted. However when it comes to issues involving swapping of business lines, evaluation of assets and debts necessary to swapping businesses, downsizing work forces, etc., serious bottlenecks might eventually emerge and may present serious problems.

Furthermore, in doubt is the anticipated effects, including synergy effects, of swapping business lines.

In terms of streamlining manufacturing and sales efforts of such items as semiconductors and automobiles, such swapping of business lines may yield favorable effects such as elimination of excessive investment in a specific business line, consolidation of manpower, and other factors which will help reduce business outlays. However, it is probable that business restructuring in favor of a specific line of business for specialization will tend to encourage monopolies.

The business restructuring framework also involves the potential of reviving a serious credit crunch, inasmuch as the restructuring financial institutions may not hesitate to call due their loans from insolvent affiliates of the business groups that have been worked out or squeezed out of business.

C. Horizontal Development of Economic Indexes

Various economic indicators concerned with economic growth, industrial production, and consumption have recovered from serious setbacks suffered in the wake of the so-called IMF era recently. However, what is disturbing to note is that the indicators are tracing horizontal lines as time goes on.

The economic growth rate in the third quarter of last year registered minus 6.8 percent (the same level as the second quarter of 1998). Industrial production marked a 0.1 percent growth in September, but this turned to a minus 8.0 percent growth in October. The wholesale and retail trend recorded negative growth of 11.9 percent in September and experienced negative growth of 13.6 percent in October.

With respect to the pattern of economic recovery, there have been varying views, ranging from V-type and U-type to L-type patterns. However, in view of the serious economic crisis we experienced early last year, it appears that neither a V-type nor U-type pattern will match the conditions.

Macroeconomic Policy Issues

A. Augmentation of Export Promotion Policy to Exploit Favorable Turn of Economic Environments

It is urgent that we make the best use of the current favorable turn of the economic environments marked by the so-called "new three lows."

Furthermore we must now further promote exports by utilizing Korea웹 enhanced export competitiveness on the world market gained through depreciation of the won.

Due to the possibility of our trading partnersÕ economic conditions worsening at any time, we must act now to ensure that the maximum benifits can be gained. If we don 뭡, we may lose a golden opportunity to quickly recover our economic vitality.

B. Prompt Adoption of Domestic Demand Stimulation Measures

If we take into account that our export growth rates so far were negative despite our recovered export competitiveness due to the depreciation of the won, it is evident that sustaining continued growth in exports is not an easy proposition.

Furthermore, we should not overlook the possibility of the world economy taking a steep downward turn in 1999, which would also reduce world demand for our exports.

When we take into consideration such an economic possibility, it is evident that we cannot solely rely on exports for recovering our economic vitality. This means that we need to exert more efforts to boost domestic demand. It is thus necessary for us to promote demand and job opportunities through positive implementation of social overhead capital projects. In particular, the rapid drop in household consumption in the wake of the IMF-era has withered our overall domestic demand for over a year. This being the case, it is urgent that we restore healthy household demand. The prevailing social climate in which savings are considered the best means to bolster the national economy and ultimate social development should be tempered in favor of stimulating sound and rational consumption.

C. Industrial Restructuring and Economic Recovery

There have been warnings that the current economic policy emphasizing industrial restructuring ahead of economic recovery has been responsible for prolonging the economic recession. Those who hold the view that industrial restructuring should precede economic recovery say that eliminating insolvent/marginal enterprises is necessary for the reason that withdrawal of the current stringent monetary policy without removing such enterprises would only prolong the current economic crisis.

However, it should be noted that the liquidation of nonperforming debentures, increasing capital through flotation of shares/debentures on the stock exchange, and similar measures are all fundamentally linked to the overall economic conditions, recovery of assets and stock markets, etc.

Therefore, such unilateral assertion that efforts for economic recovery only tend to further delay industrial restructuring needs to be re-assessed.

When thus viewed, it becomes apparent that in order to expedite industrial restructuring, it would be more effective to focus on microeconomic policies rather than macroeconomic policies. Therefore, it is obvious that only through such microeconomic policies as enhancement of the competitiveness of the domestic commodity market by opening the market to foreign competition as well as removal of market regulatory measures, augmentation of free capital market selection options by allowing free establishment of interest rates, and ensuring management transparency of financial institutions through reformed board of directors and auditor systems will it be possible to ensure the sustained effectiveness of industrial restructuring.

In particular, efforts for restructuring and normalization of financial institutions need to be expedited in order to restore sound economic activities.

Simultaneously, whenever there are signs indicating a substantial upturn in real estate and other assets, monetary liquidity needs to be adjusted flexibly.