Recent Developments

Korea's economy, which plummeted to minus 5.3 percent growth in the first half of this year from a year ago due to a drastic weakening of domestic demand, has continued its downward slide in the second half of this year.

During the months of July and August, the economy witnessed a sustained downturn in terms of all significant economic indices, including industrial production (down 12.4 percent from the same period last year), wholesale/retail trade, domestic orders for machinery, and domestic construction orders received. Also the protracted and sharp contraction in the domestic economy boosted the unemployment rate in the months of July and August to 7.5 percent. The worsening slump in the consumption sector in the two-month period following the first half of this year resulted from a further withering of consumption sentiment induced by a series of adverse factors including extended slumps in the stock and real estate markets, growing unemployment due to industrial restructuring that has curtailed household purchasing power, uncertain outlook for employment as corporate restructuring continues to proceed, concerns about international capital markets and rumors related to the possibility of another foreign exchange crisis. On the other hand, a slight improvement in the investment index resulted from expanded investment by the public sector, although private sector investment remained depressed due to the tight liquidity situation and negative mind-set of corporate management in general.

Influenced by the fact that sharply decreasing imports have continued to contribute to an overall trade surplus, the foreign trade sector also yielded a favorable balance in the third quarter, raising the aggregate surplus during the first nine months of this year to US$28.9 billion. However, a slowing growth rate for exports at the start of the second half of this year lowered the average monthly surplus from US$3.7 billion in the second quarter to US$3.1 billion in the third quarter.

Major factors responsible for the declining exports include shrinking import demand from the Asian region, depreciation of currency values in countries competing against Korea on the global market, downward pressure on export prices due to intensified competition worldwide, and stringent bank lending in the wake of the IMF-bailout regime.

By sector, exports of light industrial products remained sluggish, while chemical/heavy industrial products which showed signs of recovery in the first half of this year suffered a sharp downturn in the third quarter.

By region, exports to Japan, China, and ASEAN countries further deteriorated, while those to the United States and Central/South America, which were relatively favorable in the first half of this year, also weakened in the second half.

During the months of July and August, the current account marked a surplus of US$5.9 billion thanks to the contraction in imports, thereby raising the aggregate surplus during the first eight months of this year to US$27.5 billion versus a US$11.6 billion deficit for the same period of last year. This figure thus represents a substantial US$39.1 billion improvement in Korea's current account balance during this period.

The third quarter of this year witnessed increases of 8.0 percent in consumer prices and 13.4 percent in producer prices (year-on-year basis), indicating that their sharp growth has continued to slow from the peak marked in February.

The blunted growth in prices, notwithstanding price hikes for agricultural products brought on by serious damage related to extensive nationwide flooding this past summer, has resulted from stabilized prices for manufactured goods and service charges, curtailed by the acute slump in domestic demand.

With the opening of the second half of this year, domestic interest rates began to show signs of instability over concerns about the debt moratorium declared by Russia, however, rates stabilized shortly thereafter. Stimulated by a reduction in RP rates by the Bank of Korea on September 30, the interest rates for call loans and debentures likewise declined.

As a result of sustained current account surpluses, inflow of foreign currency proceeds from the disposition of enterprises, and increased foreign exchange reserves, the domestic foreign exchange market stabilized at around 1,200 won per US dollar. Following the declaration of the debt moratorium by Russia, however, exchange rates have been fluctuating around the 1,380 won per dollar level, reflecting uncertainties in global capital markets.

Outlook
Growth

Korea's GDP, which marked a minus growth rate of 3.9 percent in the first quarter of this year and an even worse negative growth rate of 6.6 percent in the second quarter, showed no signs of improvement in the second half of this year due to deteriorating exports and domestic demand. This year is thus likely to witness a GDP growth rate of minus 6.5 percent.

Exports that mitigated a further slide in GDP growth earlier in the year began to decline from May, and in the absence of any favorable indications the second half is likely to see a further setback.

Prospects for Korea's exports remain gloomy due to the lingering aftermath of the Asian financial crisis, blunted economic growth in China, signs of economic downturn in South America, and indications of economic slowdown in the United States.

The government announced a package of financial measures to facilitate exports and imports in the third quarter. Nonetheless, it will require some time before the new financial measures are translated into action by financial institutions.

The domestic demand sector as well is likely to remain a conspicuous factor impeding economic recovery, although it is expected that the extremely sharp decline will slow following the last quarter of this year.

Household expenditures have been rapidly shrinking due to decreased income from assets, increased unemployment, and reduced nominal wages Ñ all of which have served to encourage precautionary savings so as to help weather the ongoing hardships.

Enterprises plan to reduce facility investments by over 50 percent from a year earlier. This leads to the forecast that this year is likely to see a negative investment growth rate of around 47 percent from 1997.

Even if restructuring of the financial sector is completed by the end of this year, financial institutions will continue to assume a 豈efensive postureÓ insofar as extending loans to enterprises is concerned. That is unless the current trend of increasing unemployment and bankruptcies is not reversed by the end of 1999. This being the case, unless drastic policy reform is implemented to help ease the supply of credit, the domestic economy is likely to sustain a minus 1.3 percent growth in 1999. (Scenario A)

On the other hand, if and when the current stringent credit flow is significantly eased through the promotion of macroeconomic policy stressing expanded credit availability, it will be possible to attain a positive 1.2 percent growth in GDP in 1999. (Scenario B)

In the event that the government's outlays in 1998-1999 are expanded to correspond to a deficit to GDP ratio of 5 percent (Scenario C), the year 1999 is likely to witness considerably more positive GDP growth of 2.2 percent as well as nominal GDP growth of 6.8 percent.

The domestic demand sector is expected to rapidly deteriorate due to sharp declines in household expenditures and investments by enterprises as well as relatively restricted fiscal expenditures.

Prices

Although the growth rate for consumer prices has been gradually declining from the peak seen in the first quarter of this year, the consumer price index is expected to record an increase of 7.8 percent this year, influenced by the won's depreciation, thus experiencing its second highest inflation rate since 1991, which marked the beginning of Korea's 記ubbleÓ economy.

Inflationary pressure has been eased since the second quarter of this year, influenced by such factors as the continued slump in domestic demand, relatively stable international market prices for energy and raw materials, and stringent money supply in the first half of this year.

The year 1999 is expected to witness a relatively low rate of consumer price growth of around 2 to 3 percent, due to stable foreign exchange rates, sustained stability in wages and international market prices of raw materials, and continued weakness in overall demand.

Foreign Trade

Foreign trade marked a deficit of US$3.8 billion in 1997. However, it turned into a surplus of some US$21.3 billion in the first half of this year, while a surplus of US$19 billion is expected in the second half, raising the annual surplus to around US$40 billion for this year, due mainly to the sharp decline in imports outpacing the lesser decrease in exports.

The downturn in imports, centered around consumer and capital goods, is likely to continue due to the protracted business slump, withered consumption and negative investment outlook. Thus the second half of this year may see an import contraction of around 35 percent from a year earlier.

Exports in the second half of this year may see a decrease of around 5 percent, unless dramatic measures are effectively implemented. This is due to the fact that the benefit of the won's depreciation has been halved due to the depreciation of the currencies of competitor countries, not to mention the continued slump in exports to Japan and markets in Southeast Asia.

In sharp contrast to the favorable balance in direct foreign trade, the deficit in the unrequited transfers and services sector is expected to continue in 1998 to around US$1 billion. The balance of invisible trade is likely to be improved somewhat over 1997 inasmuch as the anticipated growth in overseas investment deficit is expected to be partially offset by improvement in the tourism account.

Interest Rates

Domestic capital market rates soared to 18-20 percent per annum in the first quarter of this year, influenced by the stringent monetary policy implemented at the beginning of the year. With the stabilization of the foreign exchange market in the second quarter, market interest rates gradually trended lower.

It is likely that market rates (based on yields of debentures) will be maintained at around 12 to 13 percent following the second quarter, unless the stability of the foreign exchange market is shaken. It is possible that market rates will further decline, depending upon the trend of foreign exchange rates.

Exchange Rate

Since last March, the foreign exchange market turned into a buyersÕ market with the exchange rate stabilizing at a level of 1,300 won per dollar. Influenced by the yen's appreciation and coupled with uncertainty in the international capital markets since the beginning of the third quarter, the won-dollar exchange rate moved downward. However, the value of the won is still somewhat undervalued in light of the potential for the current account to continue to sustain surplus results while commodity prices remain stable.

As for the short-term outlook, international investorsÕ evaluation of the results of domestic industrial restructuring and progress of labor-management relations will hold the key to the successful inducement of foreign investment. This will them primarily influence the direction of the won-dollar exchange rate, more so than outright accumulation of foreign exchange holdings.

Policy Issues

Monetary Policy

In order to normalize the functions of banks which have been virtually non-existent due to their concerns over satisfying the BIS capital adequacy ratio as well as the need to restructure themselves, it is necessary for the central bank to assume a more positive role.

In view that commercial banks have drastically reduced lending due to the stringent money supply, it is necessary to utilize the remaining portion of reserve funds effectively for a certain period so as to enable the cash-strapped commercial banks to expand their overall lending activities.

This will enable the commercial banks to access additional liquidity and thereby help to revive fundamental intermediary functions of discounting trade bills and other commercial bills.

As of the end of August, reserve funds amounted to 18.6 trillion won or 6.8 trillion won short of the 25.4 trillion won targeted by the end of September, in accordance with an agreement with the IMF. Thus, there is room to improve liquidity.

In the event that the current macroeconomic environment is maintained (Scenario A), this year's GDP will likely record a minus 6.5 percent growth from last year (minus 7.5 percent in the second half of this year) and attain a negative growth of 1.3 percent in 1999.

When and if the supply of reserve funds is to be expanded to the level agreed with the IMF (Scenario B2), Korea's economic growth is likely to register a minus 5.9 percent this year and a positive 1.2 percent in 1999.

However, if a credit crunch persists despite an expanded money supply (Scenario B1), negative growth rates of 6.3 percent this year and 0.8 percent in 1999 are anticipated.

In order to normalize the current distorted flow of funds marked by circulation of capital only among financial institutions (to conform to Scenario B2), it is necessary to further reduce the interest rates of RPs and currency stabilization bonds.

In addition, if the government stimulates commercial banks to set interest rate spreads spontaneously, the banks will not hesitate to resume lending to industrial enterprises not affiliated with the top five business groups.

Fiscal Policy

It is estimated that some 100 trillion won will be needed to cope effectively with banking sector restructuring and unemployment issues. To this end, issuance of national bonds would be more favorable than any other means.

If national bonds are issued at market determined interest rates at this time when general misgivings about the safety of bank deposits are mounting, it would be possible to absorb more funds than normally anticipated.

Nonetheless, it will be rather difficult to dispose of 100 trillion won worth of national bonds on the domestic capital market; thus it will likely be necessary for the central bank to underwrite a major portion of the bonds.

On top of Scenario B2, if the government expands its expenditures during 1998-1999 up to 5 percent of GDP (Scenario C), it is expected that the year 1999 will witness a real GDP growth rate of 2.2 percent or a nominal GDP growth rate of 6.8 percent.

Re-establishment of Priorities for Industrial Restructuring

Now is the time to focus on industrial restructuring based on microeconomic policies.
There is a limit to resorting to macroeconomic policy for the purposes of promoting industrial restructuring as this is likely to create adverse side effects such as high levels of retrenchment.

Furthermore, the current economic downturn does not merely represent a typical economic cyclical downturn but rather poses a threat to the very industrial foundation. The ongoing industrial restructuring should not be a demise of marginal enterprises but it should represent overall microeconomic industrial restructuring.

Restructuring will only be effective when the following microeconomic measures are taken: the liberalization of markets and the easing of restrictive measures, the decontrol of market interest rates, and ensuring transparency of enterprise management by augmenting the roles of boards of directors and auditors.

Inasmuch as the credit crunch impedes efforts for boosting exports and renovation of the financial structure of enterprises, policy priority needs to be focused on the recovery of exports through which improvement of enterprisesÕ financial condition will be effectively promoted.

Amidst the serious credit crunch, the government has been pursuing two conflicting policies simultaneously: one for enhancement of international competitiveness and the other for renovation of industrial structure and improvement of managerial transparency.

In order to quickly restructure the enterprises (e.g. a sharp reduction in their debt/equity ratios), it is necessary to bolster cash flow, particularly through expanded exports.

A certain segment of the government seems to fear that efforts to promote exports would delay the restructuring of enterprisesÕ financial structure. However it should be noted that measures to boost exports do not conflict with efforts to restructure enterprises inasmuch as the enhancement of export capability depends on improvement of the financial structure of enterprises. In the end, improvement of cash flow through expanded exports will tend to stimulate improvement of corporate financial structure.

Positive Export Promotion Measures

Trade financing needs to be extended to major enterprises and general trading companies as well as small- and medium-size exporters.

Trade financing for major enterprises was suspended in February 1988, when foreign trade yielded notable surpluses and domestic businesses became favorable. Presently, however, all enterprises have been experiencing unprecedented business slump on top of mounting pressure for restructuring.

The government has been assuming the position that trade financing for major enterprises runs counter to the WTO accord on trade subsidies. However, it is meaningless to argue that trade financing should be banned or otherwise restricted for the big five or top 30 business groups at this time when the very foundation of Korea's exports is being seriously jeopardized.

The maturity of loans made to affiliates of 64 major enterprises needs to be extended.

Except for insolvent enterprises, the maturity of loans which come due by the end of this year needs to be extended by one year.

The following two measures need to be implemented to enable small- and medium-size enterprises to secure trade financing.

Certificates of purchase approvals issued by major enterprises to small- and medium-size enterprises should also be included in the list of instruments that enable trade financing guarantees from credit guarantee agencies.

The trade financing rules of the Bank of Korea should be revised to include certificates of purchase approvals issued by major enterprises to small- and medium-size enterprises among the instruments eligible for credit guarantees.

Systematic amelioration to facilitate export credit guarantees is needed

The rules of the Export Insurance Corp. need to be revised to eliminate the provisions requiring guarantors and blanket promissory notes. Risks related to export credit need to be minimized by effective screening by the Export Insurance Corp. and expanded government contribution to the Export Insurance Fund.

Increased government contribution to the Export Insurance Fund is necessary

The 200 billion won earmarked by the government for contribution to the Export Insurance Fund in the second half of this year needs to be increased to one trillion won.

As of the end of June 1998, the Export Insurance Fund of the Export Insurance Corp. stood at just 627.6 billion won, while outstanding export insurance policies amounted to 17 times the available funds - an indication of the seriously vulnerable nature of the fund.