Recent Developments

Amidst sustained growth of domestic demand and exports, business indicators including production, consumption, investment and average operating ratio have shown a steady upward trend. Rapid production expansion has curtailed the rate of decline in inventory levels as compared to the same period of a year ago, while since May, in fact, inventory levels have started to show signs of increase. In addition, since various business indicators began to turn positive in August of last year, the improvement in August of this year was somewhat below that of the previous month of July.

As industrial activity indicators continue to record favorable results, composite indices related to current and future business conditions are showing positive trends as well.

Employment in July and August increased as compared to the same period of last year, while growth however has slowed on a monthly basis since March. Of significance, in line with the reduction in employment opportunities, the economically active population has been on the decline, resulting in a corresponding downward trend in the unemployment rate.

Since May, exports have recorded a steady growth, which is projected to continue into the second half of the year. On the other hand, import expansion has sharply outpaced export growth, thus narrowing the gap between exports and imports noticeably, on a customs clearance basis.

In line with the downward trend of trade surplus results, the current account surplus fell significantly to US$1.41 billion in August from US$2.8 billion in the previous month. And in spite of a continued inflow of foreign direct investment, the capital balance has remained in the red since June, due to repayment of Korea? IMF loan as well as the outflow of foreign funds from the stock market.

Since March of this year, prices have shown overall stability, and ever a downward movement in some cases. Hownver, the recent hike in international crude oil prices and surging prices for various agro-fishery products due to recent bad weather have caused price levels to move upward in August and September.

In the third quarter, the Daewoo Group? debt crisis contributed to considerable instability in the financial sector. Consequently, in an effort to cope with this situation, the Bank of Korea has sought to maintain a flexible money supply policy, even if money supply growth moved up to the upper limits of the desired range.

During the third quarter, deposits of investment trust companies fell off significantly, resulting in their diminished capacity to absorb further CP and corporate bonds, which led to a decline in direct financing by domestic businesses. However, with an abundance of bank loans readily available, corporate liquidity has actually been quite favorable on the balance. On the other hand, call loan rates have been under upward pressure due to growing demand for funds.

Call loan rates remained relatively stable around the 4.75% level during the third quarter thanks to the Bank of Korea? flexible RP operations and adequate liquidity conditions overall. However, long-term interest rates have continued to move upward since mid-September as investment trust companies have engaged in heavy selling of corporate bonds to mobilize funds for anticipated customer withdrawals. With the establishment of a special fund for stabilizing the corporate bond market on September 21, interest rates have shown some downward movement.

The Korean won has weakened somewhat as a result of the Daewoo financial crisis, combined with an outflow of foreign funds from the domestic stock market in anticipation of relatively stronger economic growth in Europe and Japan.

Outlook for 1999 & 2000

In 1998, the Korean economy recorded annual growth of minus 5.8%. However, from the first quarter of 1999 positive growth was achieved and reached 9.8% in the second quarter, rebounding to pre-crisis growth rate levels. In the second half of the year, private consumption is expected to maintain a 9% or so growth, along with overall economic growth of about 8%, thanks to robust exports and investment. As such, the annual growth rate for all of 1999 is forecast at around 8%. As for the labor sector, the number of employed workers has exceeded the 20-million mark since the second quarter, while the unemployment rate has steadily subsided from a peak of 8.7% recorded in February, due to a more rapid than expected recovery and concerted government efforts.

Next year, despite the absence of 1998? dismal economic results for year-on-year growth comparisons, continued positive growth trends are still projected, with a stable annual growth rate estimated at 6.4%. By sector, private consumption and wages are expected to continue moving upward while unemployment further subsides amidst more positive consumer sentiments due to reduced anxiety over the consequences of business restructuring. Under such circumstances, private consumption growth is forecast to exceed economic growth in 1999 and 2000. Moreover, in response to strong demand recovery at home and abroad, facility investment is likewise anticipated to surge some 24.9% this year and another 12.9% in 2000. Construction suffered a significant 10.8% contraction in the first half, however, the sector is predicted to get back on track to positive growth in the fourth quarter, in line with the overall economic pick-up.

In terms of exports, rising semiconductor prices and the yen? current strength will help to boost the competitiveness of Korean products, although the Asian region has still not fully recovered from its financial crisis, thus curtailing export growth to 6.0% for this year and 8.1% in 2000.

In contrast, import growth will be sharply higher at 25.1% in 1999 and 20.3% in 2000, due in large part to the drastic 36.6% decline in 1998.

Accordingly, the trade balance surplus will continue to narrow over time.

Meanwhile, last year? sharply reduced deficit in the non-trade balance (net services, investment income and transfers) has again resumed an expanding trend. In 1998, the non-trade deficit amounted to US$1.07 billion, however, this figure is forecast to reach US$5.05 billion in 1999 and US$6.06 billion in 2000. As such, the record current account surplus of US$40.6 billion recorded in 1998 will decline to some US$21.8 billion this year and US$9.2 billion in 2000, due to steady import growth and widening non-trade deficit.

As previously mentioned, real economic indicators including production, consumption, investment, and exports have rebounded sharply, although signs of instability have emerged related to prices and the financial sector. Over the near term, the won-dollar exchange rate is expected to remain within a narrow range of 1.170 to 1,210, which should not impact price levels in 1999. However, the recent run-up in crude oil prices and indications of rising price trends in terms of various raw materials, in addition to steadily increasing wage levels and higher public utility rates, will combine to push prices upward, with consumer prices up by 2.5% in the second half of 1999 compared to 1998, and a projected 4% in 2000.

As for interest rates, the government? market stabilization measures have been effective overall. However, price uncertainty, fund withdrawals from investment trust companies, and an expanded corporate bond supply will exert considerable upward pressure on long-term interest rates. In particular, with the maturity dates of bonds being so heavily concentrated in the last quarter, the likelihood of a sharp jump in long-term interest rates seems inevitable, if only temporarily.

In the fourth quarter, various financial institutions and businesses are planning early repayment of medium and long-term loans to foreign creditors, while monetary authorities are seeking to build up foreign currency reserves in September and October, which is likely to weaken the Korean won versus the U.S. dollar. Meanwhile, the Japanese yen? exceptional strength should provide a boost for Korea? trade competitiveness, while positive effects of recent corporate restructuring efforts should begin to show tangible results. Thus, an adequate supply of dollars will be available through next year.

Policy Issues & Recommendations

On the back of the government? low interest rate policy that has been in place since the second half of 1998, the real economy has recovered considerably more rapidly than expected, although recent price hikes in crude oil and other raw materials have created concerns about price instability. Now is a good time to carefully review existing policies, in light of current and projected circumstances. Of note, the Daewoo financial crisis has led to huge displacements of funds within the financial sector, while bond market activity has stalled, causing interest rates to move upward. Due to the need to stabilize the financial sector, the government was compelled to maintain its low interest rate policy.

Still, government measures-such as maintaining call rates at around 4.75%, calling on investment trust companies to curtail their sale of corporate bonds, and having banks expand their purchase of corporate bonds and offer fixed deposit rates?ave served to disrupt the normal flow of funds, thus distorting the financial market. As such, the interest yield curve has steepened noticeably, with the differential between short-term and long-term interest rates reaching 5.7% (corporate bond rates vs. call rate) and 4.6% (government bond rates vs. call rate), the highest levels since 1991, indicating the likelihood of higher interest rates ahead.

Of note, the risk premium, as measured by the difference between corporate and government bond rates, has remained within the normal range of the past several years. However, uncertainty related to even the top-tier business groups is significantly higher today, meaning that these circumstances have apparently not been properly reflected in the bond market. Likewise, the bond and money markets are not functioning normally due to the heavy flow of funds into commercial banks, which are not being circulated into the bond market and other short-term financial markets.

As such, the government? efforts to ensure a smooth functioning and stable financial market are not being realized. Over the long term, market stability can best be achieved through expanded adoption of autonomous market principles, as opposed to frequent government intervention. With a more normal flow of funds, resources will be naturally allocated on a rational basis.

Moreover, with consumption growth trends likely to surpass overall economic growth, the abundance of liquidity needed to effectuate a low interest policy will result in more costly efforts to deter inflation in the future. Since the IMF era, the Korean economy has opened widely to the global economy, therefore it is important for the exchange rate policy to be market-oriented first and foremost. For example, the government? move to advance the payoff of its IMF loan installments and the private sector? early repayment of foreign debts will serve to deprecitate the won? value. However, it would be more desirable to allow the won? value to fluctuate in response to the trade balance performance.

Under an open global economic order, it will be necessary to emphasize policy priorities rather than macroeconomic targets, while it will be almost impossible to attain both price stability and stable international balance of payments at the same time by closely coordinating various domestic sectors. In light of the mutual dependence between Korea? economy and the world economy, adapting to rapid change has in fact become a way of life.

Who are we ?
Korea Economic Research Institute (KERI), a private economic research institute, was founded on April 1, 1981. Its purpose is to contribute to the growth and development of the national economy through "the building of an efficient free-market economy system and the nurturing of healthy corporate growth." Our scholars are conducting integrated research on both the entirety of the Korean economy and the long- and short-term prospects for corporate growth. We are vigorously working towards becoming a world-class think tank. The founding concept and basic philosophy of our research institute is 'Free Market, Free Enterprise, Free Competition.'

KERI consists of five research departments which conduct efficient, practical research on the Korean economy: the Macroeconomic Studies, the Financial Studies, the Industrial Studies, the Center for Regulation Studies and the Center for Economic Growth & Development Studies. To assist the research departments, we have four support departments: the Administration, the Public Relations, the Information & Computer Services and the Research Coordination.

Introducing the individual research departments, the Macroeconomic Studies conducts research on the macroeconomic level and on relevant policy trends, and provides forecasts on domestic and international economic activity. Its research also includes both development of policy alternatives for monetary and financial policy concerning corporate activity, and the improvement of related laws and systems. The quarterly journal 'KERI Economic Outlook & Policy predicts trends and suggests short- and long-term prospects for the Korean economy. The publication of the 'KERI Economic Quarterly' in English will contribute to an understanding of the Korean economy's place in the world in this age of globalization.

The Financial Studies conducts research though a systematic approach to the areas of finance and taxation. It develops and presents policy alternatives for reform in these areas.

The Industrial Studies focuses on two main fields of research. The first is industrial policy, including policies on big business and technical development. The second is in areas related to corporations, such as corporate restructuring, under the open economy system. The Industrial Studies is continuing the publication of its 'Free' series in order to expand awareness of the free-market economy.

The Center for Regulation Studies concentrates on research and policy proposals both to enhance the autonomy and creativity of private corporate activity and to resolve inconveniences in everyday life. Its ultimate goal is to support the creation of a true free-market economy. Presently, we are working to evaluate government policies appropriate to the openness and democracy of our time. Pursuing this goal, we publish the Regulation Studies series of reports. Our research focuses on areas related to privatization, antitrust policy and land, entry and price regulations.

The Center for Economic Growth & Development Studies concentrates on the study of economic growth and social institutions, east asian economic growth models, innovations and capital accumulation, total factor productivity (TFP), endogenous growth and sustainable development, human capital and education, technology transfer and diffusion, and economic integration. It also aims to provide policy recommendations on current topics related to strategies for the development of the Korean economy.