

# Recent Economic Developments

## Economic Growth

GDP growth in the second quarter of this year reached 9.6% on a yearly basis thanks to a substantial increase in facility investment and the strong pace of export growth.

Facility investment grew 41.3% in the second quarter keyed by significant expansion in the investment in the machinery sector.

At the same time, exports grew 22.9% led by heavy and chemical industry products.

However, the pace of economic growth has gradually slowed down. The seasonally adjusted quarter on quarter GDP growth for the second quarter of this year was a low 1.1%. This continued the slowdown from a peak in the second quarter of last year.

## Production

Production and shipment, despite the slowdown in domestic demand, continued to increase as a result of strong export performance.

With a steady increase in semiconductor and computer exports, production grew 19.3% in July 24.1% in August. Shipments also rose along with production. At the same time, inventories grew 14.7% in July and 14.2% in August.

The average operation ratio for the manufacturing sector, which had fallen in the second quarter to 76.3% due to the general elections and labor strikes in the auto sector, continued its rebound in August to reach 82.1%. Strong exports were mainly responsible for the increase.

## Consumption

Affected by the adjustment phase of the business expansion cycle, the growth in consumption indicators slowed substantially in the second quarter.

While sales at large discount and department stores rose, automobile sales and wholesale sector sales fell, weakening the rising trend in wholesale and retail sales.

Consumer goods shipments slowed in July and August as demand declined markedly for mobile phones and durable goods.

## **Investment**

Facility investment-related indicators including facility investment estimates are still on a steady rise. Domestic machinery shipments and machinery imports continued to grow at the same rate as in the first half. Facility investment estimates, particularly in areas of industrial machinery, computers and communications equipment increased by 30% in July~August.

Domestic machinery orders, the leading indicator of facility investment, remained strong despite a slowdown in the public sector. The increase in private sector investment has been led by the shipbuilding, transportation and telecommunications sectors.

Construction investment, despite a slowdown in the rate of shrinkage, remained depressed.

## **Employment**

Affected by slowing down of economic activities, the employment situation is beginning to show signs of a retreat.

The August unemployment rate was 3.7%, 0.1 percentage points higher than in July, reversing the declining trend marked since January 2000. The seasonally adjusted unemployment rate was 4.1%, also reversing to an upward trend for the first time in 19 months.

## **Exports and Imports**

Exports, which grew at a 25% rate in the first half of the year, continued robust 27.3% during the July-September period. The rise in the growth was due to the recovering global economy and unit price increases for major export items.

Imports also rose during the third quarter, reaching 35% growth due mainly to high oil prices. However, recently the import growth rate is beginning to show signs of a slowdown due to the slowing domestic economy.

## **Prices**

Domestic prices, which were relatively stable in the first half of this year, began to rise starting in June due to the high oil prices, higher public utility rates such as bus fares and medical insurance premiums, and increasing agro-fishery product prices due to the effect of summer typhoons.

## **Interest Rates**

With the Hyundai “liquidity” crisis solved to a large extent and the government’s policy steps to stabilize the capital markets, interest rate volatility subsided. However, in the second half of the year interest rates have begun to rise again due to the domestic stock market crash in mid September, which was ignited by foreigners’ selling spree of semiconductor equities with the spreading of an uncertain market sentiment. Government and corporate bond yield rates have returned to 8% and 9% level, respectively since mid-September.

## **Exchange Rate**

The won/U.S. dollar exchange rate remained stable during the June-August period due to a balanced supply-demand situation. Since the early part of June, the rate remained in a narrow range at around 1,100 won.

But at the end of August, a foreign sales rally and stock market instability sent the rate to rise up to 1,130. The rate however began to stabilize once again around the 1,100 level as public funds committed to stabilize financial markets reached 4 trillion won and officials made a strong commitment to finalize financial and corporate sector restructuring by early 2001.

# Economic Outlook 2000/2001

## Economic Growth

Owing to the recent increase in raw material prices, especially crude oil, the economic slowdown will likely become evident starting in the fourth quarter. Furthermore, the government's determination to conclude restructuring by the end of this year may create a credit bottleneck that could adversely affect the real economy.

Accordingly, the GDP growth rate for the second half of 2000 is projected at the 6% level and to fall further to 4.6% in the first quarter of next year. After the second quarter of 2001, high oil prices are expected to moderate and the effect of corporate and financial sector restructuring is expected to begin to pay off. Therefore, the economic growth is expected to rebound to 5.3% per annum in 2001.

Furthermore, the improved economic condition of Korea's main trading partners will provide a boost to the domestic economy. The economies in the U.S. and Europe are expected to remain stable while Japan continues to exhibit signs of recovery with advances in its IT sector and increasing private investment.

## Prices

Beginning from the fourth quarter of this year, consumer prices are expected to rise. The CPI for 2000 is projected to grow 2.4%, while it is estimated to increase 3.8% next year due to oil related product price increases and hikes in public utility and service

rates.

Moreover, the wage increase rate is expected to remain at the 10% level observed since 1999, reflecting improved labor market conditions putting upward pressure on prices. Therefore, inflation is expected to rise mainly due to increases in production factor costs.

With the aggregate demand likely to weaken it would be difficult for monetary authorities to fight inflation aggressively.

## **Balance of Payments**

This year's commodity trade and current account surplus are projected to be US\$12 billion and US\$7 billion respectively. However, next year the import growth rate is expected to exceed the export growth rate, therefore reducing the current account surplus. The current account surplus for 2001 is projected to be US\$1.35 billion.

## **Interest Rates**

By the end of 2000, long-term interest rates are projected to stand at 9.6% and to grow up to 10% in the first half of 2001 before declining again thereafter.

The factors that will raise interest rates next year are high oil prices, wage increases, corporations' capital mobilization efforts with the easing of the credit crunch. On the other hand, a decline in GDP growth, facility investment and the possibility of the exit of non-competitive corporations with the completion of corporate restructuring will work against the increase in interest rates.

The demand for capital in the second half of 2001 will not increase significantly due to the expected economic slump and thus the interest rates in the second half will likely decline.

## **Exchange Rate**

The exchange rate at the end of this year is expected to be 1,100 won to the U.S. dollar. During the first half of 2001, the value of won is projected to depreciate slightly

to 1,125 won before rising again thereafter.

Domestically, the decline in the scale of the balance of payments surplus and the slowdown in foreign capital inflow will work to depreciate the Korean currency. Externally there will be upward pressure on the won due to the economic recovery in Japan and the yen's rise.

During the year 2001, the most important factor for exchange rates will be foreign capital inflow in connection with the domestic stock market recovery. But similar to year 2000, the won should reach its peak in the second quarter and return to the 1,100 level by the end of the year.

## Policy Issues

**Countermeasures Against External Shocks, Including Oil Prices**

External shocks such as rising oil price and falling semiconductor prices presents a challenge to policymakers at the moment. It is necessary to minimize the negative effects of such shocks on the real economy by alleviating the shocks through exchange rate adjustments and domestic price changes.

Oil price increases will likely exert strong pressure on domestic prices, thus leading to a cost-push inflation. In light of these prospects, it might be desirable to lower growth rate and other macroeconomic target.

If high oil price trend continue for a considerable amount of period, the government could consider lowering energy tax as a buffering measure. However, since it is a change in a relative price, domestic energy prices should reflect higher costs.

Such non-price policies at restriction on car use may be considered, yet enforcement of such policies could be costly, thus blunting their effectiveness as a result.

## **Policy Recommendations Concerning Restructuring**

External factors are negatively affecting the economy. Moreover, the internal restructuring process is also exerting pressure on the domestic economic situation.

If restructuring of financial and corporate sectors is delayed, uncertainties in these sectors will increase and will likely prolong the current credit crunch. This will, in turn, shrink the real economy. Therefore, the goal should be to achieve rapid progress based on sound economic principles.

The merger and acquisition of financial institutions should be based on clear guidelines in order to have the desired beneficial effects. A government-led banking sector reorganization is unnecessary. The financial holding company concept has the danger of exacerbating financial problems.

Financial restructuring in the short-term may have contractionary effects. Measures should be implemented by the Bank of Korea, which has control over liquidity, if should there be a severe credit crunch.

Furthermore, we can adopt a lesson from Japanese policy in connection to their long-term economic stagnation. The financial policy employed by the Japanese government has lacked consistency in three areas - economic stimulation, restructuring and the use of public funds. Subsequently, it gave rise to the lingering economic stagnation, delayed restructuring, reduced tax revenues and has led to budgetary

problems.

In consideration of the fact that a delay in restructuring of the financial market would cause concern to spread, it is imperative that government gain credibility. Restructuring policies should aim at drawing a clear distinction between business fit to survive and those that have little chance. Weeding out "losers" will reduce uncertainty in assessing & creditworthiness of firms, which will help to ease credit crunch. In addition, special attention should be paid to transparent application of public rescue funds.

In connection with restructuring policy, market exit of poorly performing financial institutions should be considered. If government intervention is based on the exit principle, moral hazard problems can be prevented and self-help efforts will intensify at surviving financial institutions.

## Commentary

### How to Ease Restructuring Fatigue

For the past two and a half years, encouraged by globalization and the concept of the survival of the fittest, the Korean government has imposed strong instructions to financial and manufacturing firms to undergo structural adjustments. Korea's financial sector has known to lag behind the major financial leaders, with the industrial sector still struggling to achieve the levels of advanced nations. However, from these observations, it cannot but be the case that many financial and manufacturing industries have suffered from tensions and fatigue from structural adjustments. It is therefore questionable whether the tensions regarding structural adjustments are tolerable without a proper solution to the adjustment fatigue.

In my awkward, as a first step to resolve some of the fatigue from structural adjustments, we need to detach ourselves from the hastiness and impatience toward becoming an advanced country. A new economy is not created simply by satisfying a list of priorities constructed from a set of economic objectives in a certain amount of time. Economic phenomenon unlike natural phenomenon is influenced by many variables, and has been described as "organized complexity". Moreover, because the success or failure of an economy results from our own judgement and activities, it is not easy to become familiar with economic phenomena. Also, it is not easy to design its functions nor achieve prosperity by enforcing some deliberation about economics. In other words, economics can not be managed through instructions or revolutions. In this respect, the failure of command economics was already foreseeable, and the current fatigue from the recent structural adjustment efforts was also expected.

It is not always the case that the best society survives in the world of liberal economy. That is, in terms of economics, it is not entirely true that only the best firms survive. Despite the law of the survival of the fittest, economic theory teaches us that even in a limitless economy a firm may survive with little profits. Following the same logic, Korea's economy may as well survive despite the various problems that it faces.

It is about time that we move away from the current structural adjustments and the haste advancement mentality that were born under the recent crisis. We can only try and reduce structural adjustment fatigue by properly understanding the various laws and institutional changes that have been introduced and the consequent impatience of financial and corporate firms that have undergone severe structural adjustment.

In order to solve adjustment fatigue, it is necessary to localize government policy on structural adjustments. The competitive market for capital is like picking the winner from a marathon. Thus, market competition is necessarily to decide and rank the winners and losers. Even if Korea's economy may be relegated to a second or third class economy, it does not mean that all firms. That is, there will be a spectrum of good and bad firms. However, market structural adjustment pressure obviously should be more concentrated on weak financial and manufacturing industries. Even if there may be cases where the government leading the way, this principle must be upheld for the sake of effective market competition.

Suppose there are 18 banks in our economy. Then, there will be a ranking from the best to the worst in terms of competitiveness. Then the government should not emphasize that all banks should undergo structural adjustments, but should allow for enough freedom for banks to follow their own independent paths. Only with those banks that perform extremely poorly should suitable market measures and structural adjustments be pursued according to strict principles. The beauty of market competition lies in the fact that it not only determines the least competitive firm but also allows for the voluntary adjustments of other banks. This is also the case for industrial structural adjustment. Despite that there remains many unresolved economic problems and that with respect to advanced countries like Korea may appear to be third class, there is definitely place for the market to decide the competitiveness of firms. As such, it is not necessary to tie up well-performing firms together with problematic firms under the name of structural adjustments. A policy allowing for the exit of firms that are genuinely problematic, given a strict standard should help market competition. In this manner, whether it is financial or manufacturing firms, localizing policy on a particular sector or group of firms should allow not only for voluntary structural adjustments but minimize the adjustment fatigue as well.

Ruling a large country is not unlike cooking a small fish, and as such is much akin to the Taoism thought. Turning things round a little too often will not leave the fish intact.