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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 that conduct efficient, practical research on the Korean economy: Macroeconomic Studies, Financial Studies, 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: Administration, Public Relations, Information & Computer Services and Research Coordination.

The Macroeconomic Studies department conducts research at 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 forecasts trends and suggests short- and long-term prospects for the Korean economy. The publication of the 'Korea Economic Outlook' in English will contribute to an understanding of the Korean economy's place in the world in this age of globalization.

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

The Industrial Studies department 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 an open economc system. The Industrial Studies department 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, land and entry/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.

I. Recent Developments

Production and consumption indicators have continued their upward march this year. However, the rally seems to have cooled down with growth rates decreasing month by month.

During the first quarter, production and shipments in Korean industries increased 23.4% and 25.1% respectively year-on-year, a slight decline from their growth peaks of 28.9% and 31% in the fourth quarter of last year.
In addition, domestic wholesale and retail sales during the January-March period increased 14.5%, which also represents a steady decline from the height of 17.6% in the third quarter of 1999.

Meanwhile, facility investment indicators remained strong while construction activity began to show signs of recovery with an increase in domestic construction orders and average construction permit area.

The employment situation also has steadily improved. Since the second quarter of 1999, the number of employed persons has increased and the seasonally adjusted unemployment rate has shown a generally downward trend.
Furthermore, the percentage of regular employees relative to part-time employees has stabilized after a long period of decline.

Exports grew 30.1% year-on-year in the first quarter powered by increased demand from advanced countries, the economic recovery in developing countries, export price increases for major export products and the strength of the Japanese yen.

However, the strong expansion of exports was more than negated by skyrocketing import growth. Imports shot up 51.8% during the first quarter over the same period last year. Import growth recieved a boost from domestic demand expansion due to the economic recovery and higher raw material prices including oil.
Accordingly, the first quarter trade surplus reached only US$550 million compared with US$4.69 billion in the same period last year. The April trade balance remained positive at US$230 million.

Consumer prices, which increased for three consecutive months due to the rise in crude oil prices and seasonal factors, reversed course in April and declined slightly. Prices stabilized due to the growth in imports, special sales at large discount stores, a steady won/US$ exchange rate and the expansion of e-commerce.

Long-term interest rates, which had exhibited an unstable tendency due to the spread of uncertainty about the Daewoo Group? liquidity situation, stabilized in the first quarter following the smooth resolution of the debt repurchase issue in February. The corporate bond yield moved back and forth around the 10% mark while the government bond yield followed the same pattern around the 9% mark.

Interest rate stability benefited from the relief of uncertainty in the financial market, the adequate availability of funds, corporations lower demand for capital and the government? determination to maintain stable interest rates.

Outlook for 2000/2001

The Korean economy, after scoring 13.0% growth in the fourth quarter last year, is estimated to have achieved around 12% growth during the first quarter this year. This momentum is likely to continue in the first half of this year due to the expansion of exports, increased facility investments and stability in private expenditures.

During the second half of 2000, the pace of private consumption and exports is likely to slow down and affect the pace of economic growth.

For the year, economic growth is projected at around 8% compared with 10.7% last year.

With the increase in private sector demand for durable and non-durable goods and services, expenditures are expected to exceed the rate of economic growth. The private sector consumption psychology is likely to remain constant as wages increase and unemployment decreases.

An asset market recovery is likely as fears subside over the effects of corporate restructuring adjustments.

Construction activity, which was off 10.4% last year, reversed course to achieve 1.2% growth in the first quarter and a continued expansion of facility investments is expected to support the upward trend for the year. However, with the constraint in the public sector budget, construction growth will likely be led by an increase in private housing demand.

Despite the won appreciation trend, exports are expected to climb by 14% this year aided by the global economic recovery, strong demand for Korea? major export items, recovery in Southeast Asia and China? projected 7.4% expansion in GDP.

Prices, which increased mainly due to the rising cost of crude oil in the fourth quarter of last year, are expected to stabilize in the first half of this year. However, consumer inflation is forecast at 2.2% year-on-year.

During the year, the won is projected to increase by 5% in value and international raw material prices are expected to stabilize. However, wage increases are forecast to be higher than in the past two to three years. In the second half of this year, total demand is expected to rise, putting upward pressure on prices.

The foreign exchange rate, which affects domestic foreign exchange reserves, averaged 1,400 won to the U.S. dollar in 1998, 1,180 won in 1999 and is projected to range between 1,100 and 1,050 won to the dollar this year.

Surpluses in commodity trade and the current account in 2000 are expected to be halved from the 1999 results to approximately US$10 billion and US$14 billion, respectively.

The international balance of payments surplus is also projected to decline due to increased imports in line with production activity and final demand in most sectors recovering to pre-financial crisis levels.

Accordingly, the current account share of GDP is forecast to fall to 2.3% this year from 6.1% in 1999 and 12.8% in 1998.

Exports in 2000 are expected to achieve 14% growth, which is slow compared with increases of 16% and 21.4% in the third and fourth quarters of 1999, respectively.

Imports this year are projected to increase by around 30% versus growth of 40% during the second half of 1999 and 50% in the first quarter of 2000.
During the second quarter of this year, the call loan interest rate is likely to climb gradually with the variable factor being whether or not monetary authorities will raise short-term interest rates. However, even if the authorities increase short-term rates, changes in the call rate would be restricted due to sufficient liquidity in financial institutions and capital market stability. In the second half of 2000, monetary authorities are expected to implement a tighter monetary policy, providing room for an increase in the call rate over the long-term.

There is a possibility that long-term interest rates in the second quarter of this year will decline due to an expansion of the secondary financial sector and sluggish demand for capital by corporations as a result of the improved debenture demand and supply situation. However it is noteworthy that banks are moving to sell stocks and bonds to clear their liabilities with the expiration of money trusts, which they began to sell in April 1999. This situation may disturb the long-term interest rate structure temporarily. At the same time, the unrest over post-election price increases and full-fledged financial restructuring is considered a long-term interest rate push factor on a gradual basis. However the rise should be restricted, especially in terms of upward scale, due to the government? firm committment to a stable interest rate policy and sufficient liquidity held by financial institutions.
According to KERI projections, the real foreign exchange rate is expected to stabilize this year although it has shown a continuous downward movement since 1999. As of March 31, the real foreign exchange rate was 1,108.30 per U.S. dollar. This rate is lower than the real effective exchange rate of 1,174.17.

With the declining trade surplus, the foreign exchange rate may be determined by an intervention of monetary authorities and the extent of foreign purchases on the stock market.

This year the government projected inward foreign direct investment to reach US$16 billion. But it has already topped US$8 billion in the first quarter. This will create pressure for a further won appreciation.

However, pulling the Korean won in the other direction is the decline in the current account, the bond flotation for foreign exchange stabilization funds and monetary authorities drive for the early redemption of foreign debts.

Considering these two opposing factors, the foreign exchange rate is expected to decline gradually to 1,080 won to the dollar by the end of the year.
Policy Issues & SuggestionsMacroeconomy

A. Assessment of the Current Economic Situation

1) Reaching the Peak of the Current Economic Boom

It appears that Korea has reached the peak of its current economic boom with 13% growth in the fourth quarter of 1999 and 12.8% growth in the fourth quarter of this year. However, from the second quarter of 2000 the pace of growth is likely to ease considerably along with declines in production, shipment and consumption growth rates. After the second quarter, the economic growth rate is expected to settle at around 6%.

2) No Imminent Rise in Inflation Although Cost Push Factors Exist

Last year, the more than 10% growth rate created stronger pressure in the demand sector. However, there was no evidence of an increase in prices due to a demand push.

During the first quarter of this year, consumer prices increased 1.5% while producer prices rose 2.2%, both much lower than the first quarter average of 5.9% during the 1990~1999 period.

The low inflation rate is a factor of the won? appreciation; the improvement in the distribution sector, including the rise of e-commerce and large-size discount store expansion; flexibility in the labor market; reinforcement of rational consumer behavior; and market mechanism improvements in line with market liberalization.

However, the supply side factors on the price front, including higher prices for crude oil and ferrous and non-ferrous metals, remain strong due to conditions in the global economy. Crude oil prices are expected in the US$21-25 per barrel range this year.

Since the second half of 1999, nominal wages have increased 5% over the previous year. Upward pressure on wages still exists and is expected to have a push effect on prices this year.

Last year, financing costs for enterprises declined as they mobilized funds via rights offerings and enjoyed lower interest rates. But considering the future capital market and the potential for tighter monetary policy, push factors exist for corporate financing costs this year.

3) Current Economic Boom Centered Around the So-called New Economy

Economic activity, including production, employment and business performance, is up sharply led by information technology, digitalization and the Internet. Manpower and capital are moving to the new economy sector based on the growth of tech stocks on the KOSDAQ and stock options.

4) Stock Market Adjustment Continues

The stock market was able to post stable growth last year. However massive rights offerings by corporations to reduce debts have worsened the situation, forcing an adjustment for four consecutive months. Furthermore, with the echo effect dominating international stock markets, the recent stagnation of the U.S. markets is directly reflected in the domestic market.

B. Future Policy Tasks

1) Switch to a Tight Monetary Policy not Urgent.

With a high growth rate of 12-13%, there is some concern about overheating, but the forecast is for slower growth in the second half of the year. Belt tightening is not required in overall demand management at this juncture.

On the other hand, it is necessary to increase the efficiency of monetary policy to reduce the gap between long-term and short- term interest rates. Therefore, it is desirable to raise short-term interest rates with a view to easing expectations.

Although there is no need for a tightening of monetary policy at this time, the real economy and liquidity must be carefully monitored so that quick action may be taken if necessary.

2) Mapping Out and Promulgations

In connection with the second round of financial sector restructuring that is to take place this year, the government should clarify and make public its plans to eliminate uncertainty and instability. It is necessary that the government publish a detailed timetable for financial restructuring in terms of the target institutions and deadlines to relieve the uncertainty in the market.

Moreover, with the injection of public funds there exists potential for moral hazard associated with a government-led drive for financial institution reform. This should be eliminated by focusing in the main on private sector led initiatives and market economic principles.

3) Preventing a Return to a High-Cost Structure

There are signs that the economy could return to the high-cost structure of the past due to higher international raw material prices, increased wage pressure and growing financing costs. At this early stage, it is necessary to develop countermeasures for this situation.

The medium and long-term principle to address this concern is flexibility in the labor market and an emphasis on market economic mechanisms in order to raise economic efficiency. Moreover, a restructuring of the economic infrastructure is required in order to absorb the cost push factors and improve productivity.

On a short-term basis, a tax rate cutback is considered appropriate in order to combat rising price pressures. M2 and the inflation index also should be monitored closely to address any indication of an upward price spiral.

Public sector innovation and reform as well as corporate restructuring should be continued. In this context, friction between labor and management could damage the economy. Therefore this situation should be managed wisely through an open dialogue involving labor, management and the government.

4) Expansion of Stock Management Base and Stabilization

The stock market has contributed significantly to invigorating the economy during the recovery from the financial crisis of 1997. Now, steps are needed to stabilize the slumping market. However, a more stable demand base should be established instead of turning to government intervention.

The long-running U.S. business boom may be coming to an end just as Asian economies like Japan and Korea are on the verge of recovering from their recession. With this change in the global economic environment, it is necessary to stabilize investment trends and eliminate uncertainty for investors.

Reform of the Financial Sector

A. Present Situation

The government-led financial reform introduced at the outset of the foreign exchange crisis restored investor confidence. However, in responding to the Daewoo liquidity problem, the government? main policy goal was to ease short-term market uncertainty.

Government-led action has delayed the full establishment of market principles and increased the potential for moral hazard. Moreover, its policies put too much emphasis on individual objectives such as their focus on attaining BIS capital adequacy standards. This policy direction is insufficient to improve the competitiveness of financial institutions and to help them adapt to the new environment. In short, the statistical objective-based reform has halved the effect of the reform effort.

Blessed with the rapid recovery of the macroeconomic sector, financial soundness was attained rather quickly. However, financial sector competitiveness has actually declined due to the bipolarization of the lending market. The imbalanced focus on the venture and high-tech sector has led to vulnerability and risk for financial institutions.

B. Tasks Ahead

The goal of the second round of financial reform should be the re-establishment of a market-based environment on a mid and long-term basis. The reform should focus on how each financial institution can establish a sound financial structure.

In any case, financial structural reform is unavoidable considering the extreme changes in the international market environment such as mega bank mergers and acquisitions and reductions in deposit protection mechanisms.

However, considering the state of the present domestic market situation, restructuring purely led by market forces can not be achieved easily. For example, such restructuring has to contend with labor issues and the difficulty of voluntary M&As among domestic financial institutions due to their unstable financial condition.

The sell-off of domestic banks and financial institutions has not been as successful as desired due to complications in the political situation and financial conditions.

The government should be constrained in mobilizing public funds to restructure the industry in order to avoid the return of governmental influence over the financial sector.

Accordingly to save the financial industry and minimize the public burden, the government should explain clearly the need to inject public funds. Restructuring should be completed based on this principle.

Reform of the Corporate Governance Structure
A. Present Situation

In terms of the system, the government? corporate governance structure reform effort was successful. The government? approach focused on management transparency, the function of boards of directors and shareholder rights and responsibilities. Based on these objectives, the Commercial, Stock Market, Fair Trade and other laws were revised.

During 1998 and 1999, remarkable reform progress was achieved due to the strong leadership of the government and the pressure of the economic crisis.

B. Policy Tasks Ahead

The new regulations and rules should be implemented with consistency and fairness in order to improve the corporate governance structure. Currently, reform of business practices and culture is lagging behind the changes in the official system. Translating the new laws and regulations into actual practice will take time.

Thus far regulatory reform has focused on the system of laws. Now, instead of new systems, it is necessary to establish a climate conducive to the improvement of improper practices and to incorporate the changes into business operating systems.

From a long-term perspective, corporate governance structure reform should aim to harmonize management responsibility and efficiency. The ultimate goal is to enhance corporate value via various reforms.

The realization of full shareholder rights is the proper basic direction. However, it is as yet premature to implement drastic changes such as class action lawsuits. In short, the management objective of Korean enterprises is to harmonize shareholder value and corporate growth. It is unavoidable to change the current ownership model to benefit all shareholders.

With this backdrop, management reform should enhance shareholder value through practical steps including improved investor relations, the addition of outside members to boards of directors, enhanced corporate transparency and expanded shareholder rights.

Standing in the way of full implementation of such a system, however, is the fact that Korean enterprises are different from corporations in advanced countries in terms of ownership structure, labor- management culture, etc. The U.S. and European models of shareholder value may create friction among these various interests. This requires a more realistic and practical approach.

Therefore a division of roles to carry out reform is needed among the government, the market and enterprises themselves. This is the right time for the government to establish principles and minimize intervention. The remaining tasks should be assumed by market functions and the enterprises concerned.

It is a fact that the domestic market economy is incomplete. But it is not for the government to find an alternative to the market. Rather, it should establish the proper environment to normalize market functions.

It is noteworthy that the Korean market economy is improving with the increase in foreign investment and the growing emphasis on shareholder rights.
The problem of corporate governance structure reform also should be viewed in the context of the various related economic organizations. It is necessary to reform not only the corporate governance structure, but also public organizations, including institutional investors, financial institutions, public funds such as pension funds, and non-profit organizations that should audit corporate performance. To ensure real reform, all of these public elements should be reformed in the existing system.

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