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#### 1. Recent Developments

The Korean economy, which witnessed a minus 3.8 percent growth in the first quarter of this year, seems to be headed for even worse conditions in the second quarter, influenced by deteriorating external economic environmental factors including the economic and political unrest in Indonesia, the continued slide in the value of the Japanese yen and the possibility of the devaluation of the Chinese yuan.

Industrial production in April and May decreased as much as 10.8 percent from a year earlier and the indexes for domestic consumption and investment including wholesale and retail trade, domestic machinery orders and domestic construction orders all nose-dived, thereby further accelerating the economic downturn.

The marked decrease in consumption has continued with a sharp fall in the prices of real estate and wages, raising concerns about the possible outbreak of a second round of the foreign exchange crisis and uncertain prospects for industrial and financial restructuring that has extremely weakened consumer sentiment. Unemployment also rose rapidly to 6.9 percent in May after hovering in the 2 to 3 percent range until early this year.

Investment has contracted 23 percent (year-on-year) in the first quarter. The current indicators continue to be weak.

During the months of May and June, export growth reversed markedly. But influenced by a sustained sharp cutback in imports due to the protracted slump in domestic demand, the second quarter saw a surplus in foreign trade of US\$11.6 billion, thereby raising the aggregate of the trade surplus in the first half to US\$20 billion.

Exports in the second quarter declined by 0.7 percent from a year ago, resulting from a stunted Asian market, decreased export unit prices, and the depreciation of the yen that tended to offset the effect of the weak won.

By sector, exports of chemical/heavy industrial products were relatively favorable, while those of light industrial products remained in a slump. By region, exports to the United States, Europe and other advanced countries were favorable in addition to Russia, India, the Middle East, Central and South America and Africa. On the other hand, exports to Japan (which has been experiencing weak domestic demand) and Southeast Asian nations (which have been suffering from foreign exchange crises) were unfavorable.

In April and May, the current account saw a surplus of US\$8.1 billion thanks to a

large surplus in the foreign trade sector. This performance brought the total surplus in the first five months of this year to US\$18.8 billion or an increase of US\$28.7 billion from the same period last year that witnessed an accumulated deficit of US\$9.9 billion.

Commodity prices have continued to decline since February. This slow but steady decline is attributed to two factors: firstly, stabilization of the exchange rate brought about lower prices for petroleum and manufactured goods, and secondly the accelerated drop in domestic demand reflecting the severe economic downturn.

The domestic financial market in mid-May wavered somewhat due to the uncertain Indonesian situation and labor unrest that pushed up call rates and debenture rates. But it recovered normalcy in late May.

The foreign exchange market saw the won-dollar exchange rate shoot up from the 1,300 won level in April to 1,400 won in May due to the continued depreciation of the yen, shaky labor market and concern about the imminent industrial restructuring. These negative factors more than offset the effects of the sustained surplus in the current account and increase of foreign investment raised through the sales of enterprises and equities.

## 2. Outlook

### Economic Environments

The negative economic growth seen in the first quarter is expected to continue in the second quarter.

Externally, demand in Southeast Asian countries has been declining in the aftermath of the region's foreign exchange currency crisis. On top of this, the economies of Japan and advanced countries have been showing signs of softening to the detriment of Korea's export outlook.

Recently, in addition to the depreciation of the yen, the currencies of Taiwan and Singapore have depreciated while the possibility of the yuan's depreciation still looms large. All in all, the depreciating currencies of our competitor countries on the world market have eroded the effect of the depreciation of the won late last year.

Domestically, aggregate demand has seriously weakened due to a series of adverse factors including the protracted liquidity crunch, inadequate export financing, delayed normalization of the financial system, decreased income and the sharp fall in real

estate prices.

## Growth

Due to continued credit retrenchment resulting from a stringent fiscal policy and the restructuring of the banking sector since the introduction of the IMF bailout program, Korea's GDP witnessed growth of minus 3.8 percent in the first quarter. We expect the growth rate will continue its fall to -4.9 percent in the second quarter of this year. In the second half of the year, GDP growth will be affected by the degree of normalization in the banking sector. All in all, GDP this year will record a negative growth of 4.0-5.7 percent.

Korea's exports this year may witness 3.6 percent growth (versus the 1997 growth of 6.6 percent) due to a deterioration of export conditions including the fall in export unit prices and blunted demand in Southeast Asian countries experiencing foreign exchange crises. Furthermore, unless the stringent credit conditions are eased in the second half of this year, 1998 may well witness export growth of less than 1 percent.

The consumption sector may see a minus 10 percent growth this year as a rapid decline in consumer purchasing power is inevitable due to the protracted economic downturn, decreased wages, expanding unemployment and sharp declines in real estate and stock prices.

It is probable that the equipment investment sector will witness a minus 37.5 percent growth this year, due to a series of unfavorable factors including deterioration in enterprise profitability, uncertain business outlook, and industrial restructuring to shed large liabilities so as to restore financially viable enterprise standards.

The construction investment sector, too, is expected to register a minus growth of around 12 percent this year in view of the unfavorable outlook including a trimmed government budget for social overhead capital projects which will reduce investments in engineering and construction projects, difficulties in raising funds due to the protracted business slump, and increased prices of construction supplies.

In the case of the financial sector restructuring carrying over to the second half of this year and should such adverse economic effects as increased enterprise bankruptcies and high unemployment last into 1999, it is likely that next year will witness economic growth of minus 4 percent. If this is the case, it may take over five years before the potential economic growth rate is restored.

On the other hand, if industrial restructuring is completed this year and the surplus in

the current account is expanded thanks to concentrated efforts for export promotion, the Korean economy will enter a substantial growth phase in the last quarter of this year. In this case, around 2 percent growth would be possible in 1999 and would serve to trace a stable economic growth path thereafter.

## Prices

The growth rate in consumer prices is easing somewhat since the first quarter of this year. Nonetheless, it will hit 8 percent on average this year—the highest rate since 1991 when the economic bubble began expanding.

Inflationary pressure is expected to ease somewhat in the second half of this year in view of the decreased pressure on demand induced by the extended slump in domestic demand, stable prices of energy and industrial raw materials in the world market and sustained stringent monetary policy in line with the government accord with the IMF.

However, inflation is likely to pick up once again if the won is further depreciated. Furthermore, the government plans to raise public utility rates which will inevitably affect various prices in the private sector.

## Foreign Trade

The foreign trade sector, which saw a deficit of \$9.8 billion last year, is likely to witness a surplus of over \$40 billion in 1998 thanks chiefly to a sharp drop in imports.

Korea's imports this year are likely to register a decrease of about 27 percent over last year due to the continued economic slump and sharply lower demand for consumption and investment.

Unless drastic measures are implemented to boost exports, it will be rather difficult to anticipate marked growth in exports this year in view of the fact that the effect of the sharp depreciation of the won late last year has been almost halved with the subsequent depreciation of the currencies of Korea's competitor-nations in emerging countries and Japan. In particular, exports to Japan and Southeast Asian countries, which have been experiencing economic difficulties, are likely to be stunted this year.

The income account is expected to see an increased deficit resulting from increased payments of interest. However, the service and current transfer account are expected

to register a surplus thanks to increased tourism income and remittances from Korean residents abroad.

The current account is expected to register a surplus of over \$40 billion this year thanks to the sharp growth in exports.

### Interest Rates & Exchange Rate

The interest rate in the capital market is likely to decline to around 15 percent per annum by the end of this year inasmuch as the current trend of slow but steady decline is likely to be sustained in the second half of this year.

The capital market interest rate is expected to be maintained at around 14–15 percent in the third quarter and thereafter, unless the stability of the foreign exchange rate is seriously threatened. Additional decline in interest rate in the late second half of this year is possible if the current trend of slow but steady appreciation of the won against the U.S. dollar is sustained.

The won–dollar exchange rate appears to have stabilized at the 1,400 won per dollar level since last April with the easing of foreign exchange shortages. There is, however, the possibility of further appreciation of the won in view of the level of the effective exchange rate that is higher than current values.

Based on an evaluation of the won's purchasing power, the equilibrium rate as of the end of last May was 1,200 won per dollar. However, its approach towards the equilibrium level may not be possible until after 1999. The inflow of foreign capital has been slow and is expected to remain slow due to the delayed inducement of adequate foreign capital resulting from delayed restructuring of financial and other sectors, and uncertain prospects for a sustained surplus in the current account.

## 3. Policy Issues

### Macroeconomic Sector

Under the current situation in which the foreign exchange market has remained stable for a while, the high interest rate and stringent monetary policies appear to have weakened the basic industrial base through increased bankruptcies and withered facility investment. Therefore, taking prompt measures to ease the stringent monetary policy

and high interest rates must be seriously considered.

Some of the foreign exchange reserves should be used to help facilitate enterprise restructuring, as well as to ease financial difficulties currently being experienced by Korean exporters.

In order to resolve the foreign exchange crisis and unemployment issues, it is necessary to raise the operating rate of manufacturing industrial plants through expanded exports. As such, expansion in foreign trade financing is urgently needed.

### Financial Sector

What is most critical to the restructuring of the financial sector is the restructuring of banks which have the leading role in the improvement of the financial services system.

Even prior to the complete restructuring of the financial sector, it is necessary to encourage bank mergers to promote the emergence of major viable banks and thus expand banks' credit supply capabilities which will help expedite restructuring of enterprises.

Along with the liquidation of nonviable enterprises, debt restructuring of the remaining banks needs to be carried out promptly so as to prevent enterprise bankruptcies resulting from a temporary liquidity crunch.

In addition, efforts must be made to terminate government-managed financing and to establish a responsible management system for banks. Those financial institutions requiring government support should be restricted to those that merge with viable financial institutions.

### Enterprise Restructuring Policy

The Government should clearly define industries to be restructured in accordance with the free market principle so as to pave the way for the maintenance of a consistent restructuring policy.

In order to facilitate M&As and the division and/or sale of enterprises, measures more inducive than those adopted in February 1998 for promotion of enterprise restructuring are required, including preferential tax measures and simplification of restructuring procedures.

Flexible application of fair trade measures is necessary to the establishment of holding companies.

#### Labor Sector

In laying off employees, it is necessary to avoid ambiguous terms such as "for managerial reasons," "endeavor to avoid layoffs," "layoff criteria" and "honest negotiations with the labor union." Instead, clear-cut words and sentences should be used to avoid any unnecessary friction between labor and management over the interpretation of any labor-management agreement.

In the case of re-distribution of workers or a labor unemployment system, operations should be left to the free market mechanism. The functions of an employment agency should be expanded to include vocational brokerage, furnishing of vocational information, and vocational training so as to foster such a firm's growth as an overall manpower service company.

Instead of the passive approach that sees the government coping with layoff problems caused by the need to downsize operations by merely protecting the unemployed, the government should create an environment in which enterprises will gain vitality to engage freely in production activities so that they do not only maintain their current manpower but create demand for extra manpower.

The government and enterprise management need to encourage sharing of restructuring pains among all parties concerned including labor, management, government and political circles, true to the spirit of the grand accord worked out by their representatives early this year.

#### Fiscal & Public Sector

The government should promote flexible amelioration of its public budget structure through simplification of fiscal operations, enhanced transparency, and effective management of local governments' fiscal operation.

The current recession could turn into a long-term economic slump due to problems in the banking sector and increased unemployment stemming from restructuring of enterprises. It is necessary to suspend the principle of a balanced government budget for the time being and consider a deficit budget system over a limited period.

The government should also expedite the privatization of the Korea Tobacco &

Ginseng Corp. and other public enterprises. And their sale should be open to foreign investors as well as domestic firms.

#### External Sector

In order to enhance the credit rating of Korea as well as to stabilize the foreign exchange rate, the expansion of foreign exchange holdings through increased exports and inducement of increased foreign investment is urgently required.

The government has to remove uncertainty about the Korean economy by making its labor-market related policies transparent and in conformity with the free market principle, including consolidation and restructuring of non-viable financial institutions and layoffs of employees.

From the surplus foreign exchange reserves, \$5 billion should be initially earmarked for financing exports and imports. This sum should be raised to \$10 billion, if and when the surplus of foreign exchange reserves so warrants.

In order to ensure the smooth importation of raw materials needed for the manufacture of export goods, it is necessary to secure as much capital as possible from the EXIM Bank and other agencies to finance exports to foreign countries. A credit of \$1 billion has already been secured from the Export & Import Bank of Japan for subloans to end users of raw materials to be used for the manufacture of export goods.