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Contents

Recent Developments 5
Outlook 2000/2001 9
Policy Recommendations 12
Commentary: Recent Credit
Crunch-A Crisis Foretold
Appendix
Economic Statistics 16

I. Recent Developments

The Korean economy, which was feared to be in danger of overheating at the beginning of the year, now has begun to show signs of gradual stability. While still maintaining strong growth, real economic indicators production, consumption and facility investment ?ave shown signs of slowing down. The leading index and the cycle of coincident composite index point to downward trends ahead.

During April and May, production and shipment grew 18.5% and 17.5% respectively but were off their respective peaks of 28.9% and 31.0% recorded in the fourth quarter of last year.

The wholesale and retail index in the April-May period rose 13.0%, down from its peak of 17.6% registered in the third quarter of last year.

Investment in the computer and communications equipment sector remains strong. However, overall investment has decreased slightly.
Employment has continued to improve since the second quarter of 1999. The seasonally adjusted unemployment rate has moved downward throughout the first half of this year reflecting the gradual improvement in the job market. The previous trend of a decline in regular workers and increase in part-time workers has begun to reverse with the easing of the employment structure.

Exports in May and June rose 21.0% and 28.0%, respectively owing to increased unit prices for semiconductors and steel products as well as increased shipments of semiconductors, automobiles and computers to advanced countries.

The import growth rate, helped by a drop in crude oil prices and eased domestic demand, declined from 40.5% in May to 29.2% in June.

As a result, the trade account surplus of US$500 million in the first quarter grew to US$3.85 billion in the second quarter of the year. However, the growth rate of imports is still outpacing the growth rate of exports. The trade surplus of the first half of this year, US$4.35 billion, is

less than half of last year? surplus of US$11.67 billion for the same period.

During the April-May period, consumer prices remained stable thanks to a drop in food prices due to favorable weather. However the CPI rose 0.5% in June due to the resurgence of international oil prices.

The second phase of financial restructuring, Saehan group? need to enter the workout program and Hyundai? problems led to a somewhat unstable financial market. Yet the stock market inched its way hack to the 800 point level and interest rates showed a slight downward tendency. A large scale outflow of funds from investment trust companies since March continues to depress the corporate debenture market. Conservative corporate lending practices by banks, who are concerned about further financial restructuring, caused a capital shortage for firms.

II. Outlook 2000/2001

We expect the Korean economy to reach its peak in the first half of this year, and the pace of growth to slow in the second half.

However, exports will remain stable, supported by a rlatively favorable external economic condition (an economic soft landing in the United States and a continued global economic rebound). Despite the instability in the domestic capital market, the slowdown will be moderate. Accordingly, this year? GDP growth rate is expected to be 8.5%, down from the 10.7% registered in 1999.

Nonetheless, this soft landing scenario contains a few downside elements. Government-led financial restructuring, without the application of the principle of loss sharing, is creating lower confidence in the market on a long-term basis. As a result, the mony supply in the second half may shrink, throwing cold water on the soft landing projections. Many enterprises entered the year with ambitious investment programs but have postponed them until the second half. This is due not to high interest rate levels but to a scarcity of capital. Accordingly, unless there is an increase in capital availability in the second half of the year, facility investment expansion would be limited. By year end, 55 investment tax credit measures are set to expire. Unless extended, these will negative affect for investment. As demonstrated in the recent trade friction with China, trade disputes with major trading partners can quickly result in a contraction of the trade surplus.

In 2001 GDP is expected to grow around 6%. Next year, fiscal expenditures will be maintained at roughly the same level as this year under the country tight fiscal policy. Nonetheless, an early policy switch to a tightering of the financial and monetary sector is not likely to happen unless real signs of inflation emerge. Large-scale asset income growth is not expected. However, a stable, upward household consumption trend will continue based on higher employment and wage increases.

Construction investment is expected to perk up in the second half and corporate facility investment is likely to remain robust in the last six months of this year and into 2001. Therefore, the investment sector is expected to represent a larger shart of GDP growth.

Despite a stronger Korean won, export growth is expected to continue to exceed the economic growth rate due to the global economic recovery and increases in the unit prices of key export

items. In particular, Southeast Asian countries continue their recovery from the economic crisis, and China? economy is on a stable growth track as it prepares to join the WTO by year? end. This provides a favorable export market for Korean companies.

Consumer prices during the second half are expected to rise 2.0% due to higher public utility rates and price increases for energy-related products. This would result in a 2% increase for all of 2000. Consumer prices are projected to rise about 3.0% in the first half of 2001. Total consumption pressure does not warrant significant price increases. However, strong wage increases since last year herald that there will be some upward pressure on total demand in the second half, consequently putting pressure on prices. Moreover, as real income increases, service demand growth is expected to become a factor in domestic prices.

For 2000, the trade account and current account surplus will fall to about one-half of their level last year at US$12.2 billion and US$8.0 billion respectively. Next year, import growth will outpace export growth. As a result, the current account surplus will continue to decline. The recent gradual appreciation of the won will affect the export growth rate starting in the second half of this year.

With restructuring accelerating in the second half of the year, financial institutions will adopt a more conservative capital management policy. Thus large short-term interest rate increases are unlikely. Unless the government comes out with a sweeping financial market policy package, uncertainty in the financial market will continue to linger. Long-term interest rates will inch up in the second half when the demand for capital by corporations to redeem debentures increases.
The won/US$ exchange rate is expected to fall slightly to 1,100 won to the dollar at years end. One to the current account surplus and new direct and indirect foreign investment inflow, there will be increased pressure for a stronger won. However there is always the possibility that the government will intervene to prevent any sharp rise in the won? value, so that any increase in the future will likely be gradual.

III. Policy Recommendations

Maintaining Current Macroeconomic Policy Direction

As the economy grew at a double digit rate early in the year, there was concern about overheating. However, that concern has eased recently. In particular, with the second half growth rate slowing down, a shift to a tight fiscal policy is not required. It is desirable to maintain the current direction. To maintain the current account surplus, it has been suggested that a rise in interest rates was needed. However, as second half economic growth will slow, thus also slowing import growth, the necessity of an interest rate hike to defend the current account has waned. Meanwhile, due to a high level of uncertainty linked to financial restructuring, a flexible monetary policy is required.

It is desirable for the government to move to a balanced fiscal policy as soon as possible. However, its implemention should be flexible considering the automatic stabilization effect of the fiscal sector in case the macro-economic situation deteriorates because off among others a tight money-market and the aggravation of overseas conditions. It is important to quickly inject capital to restructure financial institutes. This is necessary so as not to miss opportunities and to pre-empt a potential aggravation of the macro-economy.

Reconsideration of the Principle of Financial Restructuring and Macroeconomic Measures

Government intervention in the financial market until now was aimed at rescuing insolvent financial institution. It should shift to the ?rinciple of market exit based on a clear formula. The previous method of government intervention in financial market restructuring led vulnerable financial institutions to expect the injection of public funds instead of concentrating on self-rescue efforts and real change. In injecting public funds, it is important that the principle of thorough self-responsibility be implemented. Such principle is necessary to avoid the occurence of moral hazard problems in connection with restructuring. Accordingly, when the government, under the principle of market exit, intervenes market, it is expected to intensify the self-rescue efforts on the part of vulnerable institutions.

If financial markets seize due to the change of principle and method of restructuring, the central bank should actively play the role of leader of last resort.

Anti-inflation Policy Package

In 2000, upward pressure on prices has not been evident. However, there exsit such uncertain factors as higher international raw material prices, wage increases, an inflation mentality and plentiful short-term liquidity. Meanwhile, there is still potential for the continuation of economic expansion and a consequent shrinkage of surplus supply capacity.

As a result, an immediate anti-inflation policy is unnecessary. However, contingency plans should be in place to respond swiftly to signs of an outbreak of inflation.

IV. Commentary: Recent Credit Crunch-A Crisis Foretold

The level of anxiety in financial markets rose sharply in June as some analysts and the financial press warned of the possibility of severe consequences from the domino-like widespread business failures of a few firms owing to the lack of funds. Extraordinary government action taken in early July confirmed that such worries were indeed legitimate. Repeating the steps taken last October, the government orchestrated the formation of a financial market stabilization fund of about 10 trillion won, contributed by banks, whose main task was to purchase second tier investment grade corporate bonds and thus provide some breathing room for businesses with funding problems.

Almost identical measures aimed at stabilizing bond market turmoil precipitated by the failure of the Daewoo group were taken last October. At that time, there was a surge in trust account cancellations by customers who were spooked by the potential fallout from the Daewoo debacle.

Faced with such a rising demand, Investment Trust Companies (ITCs), the main repository of government as well as corporate bonds, had to dump their bond holdings, thus putting tremendous pressure on the bond market. All long-term interest rates rose sharply, mirroring falling bond prices. Worried that these developments might critically impact the Korean economy, recovering from the recent wrenching contraction of 1998, the government took the extraordinary step of forming special funds to stabilize the financial markets. Given the size of the Daewoo group and the potential adverse repercussions of its failure, the actions taken by the government last October were understandable. However, observing a repetition of the same actions in July this year, one cannot help but wonder whether this is going to be a recurring theme. Some commentators seem to think so. Two considerations appear important in determining whether financial markets will remain stable in the near future.

First, June? credit crunch was a predictable event. The origins date back to late 1998, when the determination to lower the leverage ratio of the top 5 business groups was riding high. One measure implemented to reduce financial institutions exposure to a small number of large businesses was to limit the share of financial institutions holdings of commercial papers (CP) and corporate bonds (CB) of firms belonging to a single business group to below 10 to 15% of the total CB holdings. As a direct consequence of this measure, the share of the top five business groups firms in the issuance market fell from 87% in August 1998 to 35% in December 1998. In their place, firms with lower credit ratings increased their supply of CBs. For example, the proportion of CBs with a rating of BB+ or lower to total newly issued unsecured bonds rose from 4.1% in August to 42.9% in December of 1998. ITCs appeared to have voraciously absorbed much of these to boost the rates of return on various trust products they aggressively marketed to investors. Many individual investors with extra funds that they previously held in bank accounts as well as stock converged onto trust products that promised high yields. The resulting scarcity of better credit-rated papers, however, did not increase the credit risk spread between high and low grade CBs. In retrospect, the overall appetite for risky CBs seemed to have gone unchecked by both market participants and financial regulators. Despite the fact that large businesses effectively stopped issuing new CBs, the overall volume of CBs rose during that period. Rather, the trend was viewed in a positive light as firms that had previously no access to the corporate bond market now could issue them. These CBs had maturities of 2 to 3 years, the bulk of them coming due this year.

The first factor could have had a neutral effect on the financial market had those firms that issued CBs remained profitable and generated enough cash reserve since 1998. Apparently, this was not the case for some of these businesses. Despite a favorable macroeconomic environment of robust growth and low interest rates that prevailed since late 1998, some businesses failed to generate enough cash flow to meet their financial obligations. Especially with Daewoo? failure in mid-1999, investors became quite concerned about the credit risk of securities held by ITCs. Regarding the government? intervention of last October, one could be led to believe that the benefits outweighed the costs since those measures seemed have brought stability in financial markets. However, the problem lies in the fact that this was not a one-time extraordinary occurrence as evidenced by the adoption of more or less the same measures this year. This time it was a medium-sized business group? failure that kick-started the chain of events. Perhaps it is inevitable that a few of the businesses that issued CBs in 1998 fail to meet their obligations when their papers come due. If the government becomes obsessively concerned about any business failure and tries to prevent it by any means, the recent governmental intervention could

lead to a recurring pattern. Risky investment offers a high return for a reason. Investors going after high returns by buying risky papers should not be surprised or protected when some of those bets turn out to be unfavorable.

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