KOREAN ECONOMIC POLICY PERSPECTIVES FOR 1996

Three Main Focal Points of Economic Policy

Economic policies for the 1996 would focus on a soft landing. More and more are becoming convinced that the domestic economy recovering since the beginning of 1993, finally peaked in the 3rd quarter of 1995, is now showing signs of gradual decline. However, even if the domestic economy declines, as long as the level of potential growth is maintained, then employment will not be affected much, and no special policy measures will be needed.

The next area to focus on is the increased market opening entailed in the OECD membership and whether or not the various industrial sectors have made sufficient preparations. The opening which began in early 1990 has resulted in a hastening of the weeding-out process of businesses which have gradually reached the limits of their economic competitiveness. It looks like the bipolarization caused by the clear gap in growth rates between leading and underdeveloped industries may spread from the manufacturing sector into the financial service sectors. Therefore, it will be important to examine how to maintain competitiveness in industrial sectors undergoing rapid restructuring due to high labor costs, and also how to minimize the social costs resulting from the increasing number of obsolete industries.

The third major policy concern is seeing if the Korean economy can continue to function smoothly in the midst of such uncertain internal and external conditions. Domestically, the political scene is extremely unstable, which has had a very negative impact on consumption and investment. Internationally, the economy is undergoing unprecedented change to the degree that some are calling this a 'Nervous '90s.' For example, we are witnessing: frequent localized or regional conflicts; a slowdown in the advanced countries' domestic economic activity; the emerging need to reorganize the international monetary system; the intermittent, yet still damaging trade disputes, and the lessening of national governments' ability to protect their domestic economy with the advent of the WTO era, among other things.

The Uncertain Economic Situation

Before looking into these three policy areas, we must first examine the current economic situation. The domestic economy, after having posted an extremely high growth rate of 9.9% in the 3rd quarter of 1995, has begun to gradually lose some of its vitality. It is predicted that the growth rate beginning the 4th quarter will be in the 7% range. This is a result of the slowdowns in total consumption, exports and facility investment.

Economic slowdown is occurring in a wide range of sectors. In the case of exports, November's total letters of credit, a leading economic indicator of exports 3 months in advance, was lower than a gear ago for the first time this happened this year. This is deeply related to the fact that export conditions are worsening, since the major exports markets such as the U.S., Japan and China are all experiencing slowdowns. Moreover, the markets for a large number of the major export items are already mature and other developing nations are rapidly catching up.

In the case of investment, a Ministry of Finance and Economy survey showed that for 1996, the eight major business groups were planning to increase their investment by only 10% or so, down from the 20%-30% increases of last year. This is because with the exception of a few rapid growth industries, most of their facility investment has been completed. In addition, with expectations of the domestic economy declining in the aftermath of the slush fund scandal, consumers are acting cautious, which is causing a reduction in domestic demand.

It is also becoming less and less likely that the strong yen, which contributed greatly to the increase in exports, will recur. The recovery of the Japanese economy is taking longer than expected. Even though the Japanese Government has increased its already massive public outlays, these seem to have had little effect. While the trade balance between the U.S. and Japan is starting to lessen, it does not seem that a major reduction in the U.S.-Japan interest rate differential will be in store.

The Possibility of a Hard-Landing

The major factors which will cause the decline in the domestic economy in 1996 are the lower rates of export growth and investment increases. The drop in export growth is a result of a combination of the weakening yen and the stronger won, and the worsening market conditions caused by the decreased economic activity in major export markets such as the U.S., Japan, and China. This slowdown in export growth has led to a decrease in the need for further investment.

How vigorous Korea's economic growth will be is directly linked to its exports. Without even mentioning the findings of the IMD's *World Competitiveness Report,* suffice it to say that our country's economic competitiveness has, at best, stayed at a standstill for the last several years. The financial service sectors remain underdeveloped, while export intermediate goods and capital facilities are still largely foreign dependent. The labor market is still too rigid and there has been little improvement in the foreign exchange rate system on which export competitiveness is so largely dependent. If the overall competitiveness cannot be improved, then a decrease in exports will cause a corresponding decrease in investment, which will then initiate a domino effect within the overall economy.

Under these circumstances, if the economy undergoes a hard-landing, then what will be the reasons? If the present political uncertainty including the after-effects of the slush fund scandal continues into the April '96 general elections and labor-management negotiations, then the resulting loss of public confidence will bring about a sharp decrease in investment and consumption. During past downturns, the domestic economy was propped up by the spending of income saved during more prosperous periods, but this lagging consumption effect may not occur this time due to the public uncertainty over the political climate.

Limitations on Policy Implementation

Of course, there will be limitations on the Government's implementation of its economic policies. First of all, since price instability is expected during the economic downturn in 1996, it will be difficult for the Adminstration to pursue economic expansionary measures. If price instability cannot be controlled, then we may be faced with stagflation. There are many reasons for price instability: the 1996 general elections and the subsequent 1997 presidential elections, the weakening of the central government's ability to control prices due to the implementation of local autonomy, the resulting gradual rise in public utility costs to actual levels, rapid increases in freight costs, and others.

Second, it is likely that the number of small and medium-sized businesses going bankrupt will increase. With the continuing economic bi-polarization and the shrinking of the private loan market, the primary source of funding for small and medium-sized businesses, due to political instability, even the healthiest of businesses will experience financial difficulties, and the number of bankruptcies is bound to increase. Since an increase in the number of bankruptcies will cause confusion in the financial markets, the Government will probably implement fiscal relief measures, which will further limit its ability to control prices.

Third, with the increased opening of the capital markets and the additional inflow of foreign capital which will ensue, regulating the monetary system will become more difficult, and the value of the won is likely to rise. For example, with the raising of the stock investment ceiling for foreigners, the flow in and out of speculative hot money will increase. And if the foreign exchange rate system remains rigid, the supply of domestic credit will rapidly fluctuate, which can cause agitation in the financial markets. At the same time, the exchange rate will see a reactionary rise, and the won may become highly evaluated, which will make the exchange rate difficult to predict. This will lead to lifelessness in export activity and an increase in losses of foreign exchange transactions.

Key Policy Areas

It is expected that in 1996, the Government's economic policies will center around guiding the Korean economy into a soft-landing. While keeping an eye on factors which may cause disturbances in the financial markets, the Government will probably aim to keep the monetary supply flexible. In addition, as has already been shown in the 1996 government budget, policy emphasis will be placed on expanding SOC(social overhead capital).

If such is the case, then the Government needs to examine the following things in executing its policies. First of all, while there are some limitations as was previously stated, it must harmonize its individual policies if they are to succeed. For example, it must execute its policies of boosting domestic economic activity and controlling prices, which basically run contrary to each other, in a balanced manner.

Second, the continued domestic economic activity caused by active domestic consumption which normally accompanies an economic downturn cannot be counted upon this time. Accordingly, it is essential that strong export growth be maintained to the maximum possible extent. Toward that end, the won must not be allowed to become overly strong so that it will not hurt our exports' competitiveness. It will be difficult to do this by directly intervening in the foreign exchange markets. Therefore, other, more roundabout, methods such as trying to increase the domestic savings rate or increasing the outflow of capital overseas must be sought.

Third, deregulation is needed, or in other words, the market mechanisms need to be allowed to function properly. Since the economic environment is rapidly changing and the policy options of governments have become reduced under the WTO regime, then each individual economic entity must be forced to depend upon its own ability to adapt if it is to survive. A massive reduction of administrative regulations is needed so that businesses can foster their ability to respond and adapt in this age of free competition.

Fourth, support measures for businesses which are reaching the limits of their industrial restructuring need to be considered. Programs to help businesses in obsolete sectors to switch industries or to retrain workers or similar programs need to be developed.

And finally, the local administrations need to show restraint in their public spending. In competing with each other over the degree of their financial independence, the local governments have been vigorously pursuing various development plans, which may lead to real estate price inflation and overall price increases. This needs to be avoided. VIP

Soon-Won Chung
Senior Research Director
the Hyundai Research Institute