SIGNS OF ECONOMIC RECOVERY?

by Il-Young Cheon

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Where does the Korean economy stand now? When will the Korean economy recover? Recently, there has been debate about when the current business cycle of the Korean economy will bottom out. Some are predicting that the economy will reach the bottom in the second or third quarter of this year. Others are saying that the signs of economic recovery will appear later than expected; in other words, they feel that the Korean economy will reach bottom early next year.

The Pessimistic Outlook

According to the pessimistic outlook, there are many gloomy aspects. First, investments will not pick up significantly this year because many companies in major sectors are done with a full round of expansions of their facilities. Second, inventories have piled up to the extent that the production should be cut. Third, private consumption, which accounted for about half of GDP in 1996, has also been slowing down considerably. GDP growth this year will be well below consensus estimates, which range between 5.5~6.0 percent. The primary reason for this extremely pessimistic view is that the Bank of Korea has little choice but maintain its tight monetary policy. Other pessimists are raising concern about "a Korean complex depression" similar to what happened in Japan. The recent bankruptcies of several big business groups and companies and rumors of others have put strain on the financial market, causing financially weak companies to either sell off their assets or go into bankruptcy themselves. This auctioning of real-estate, both by companies and by financial institutions who obtained real-estate as collateral from insolvent companies, can cause an over-supply in the real-estate market, which could lead to a crash in the real-estate prices, called the deflation of assets. If the price of real estate were to fall rapidly, the health of financial institutions and companies with such pledged real estate would become even worse, which could make the whole financial system unstable and negatively affect other economic sectors. Thus, a crash in the price of real estate could delay the economic recovery.

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The Optimistic Outlook

On the other hand,, there are many optimistic aspects. Since 1970s, the Korean economy has experienced five cycles in total, which averaged 50 months in length. More specifically, expansions lasted 33 months on average while contractions lasted 17 months. Most assume that the current sixth cycle began in either October 1995 or February 1996, depending on whom you ask. This means that the present contraction will end in April or, at the latest, in August, if history should repeat itself. Leading indicators as a whole, which normally reach bottom 7 to 8 months before the economy does, also suggest a similar conclusion. They hit bottom two months ago, which implies the economy will probably bottom out soon. Moreover, economic indicators have been getting better from April this year. Consumer prices, including personal service charges, have begun to show signs of stability, having grown by only 2.2 percent in the first four months of this year, the lowest growth level over the same period since 1989's 1.7 percent. In addition, the nation's foreign exchange holdings have risen for the first time this year. The foreign exchange holdings as of the end of April this year totaled $29.83 billion, up $680 million from the $29.15 billion reported a month before. The rise was prompted by the fact that exports began rising in April while the demand for import slowed down. On a customs-cleared basis, the April trade deficit was $1.5 billion, off $350 million from $1.85 billion recorded in March this year. The foreign exchange holdings are expected to grow further now that the current account deficit is predicted to decrease and the inflows of foreign capital such as foreigners' securities investment money will expand considerably. The Speculative demand for foreign currencies decreased in the domestic financial market following the government's March 31 raising of the foreigners' stock ownership ceiling from 20 percent to 23 percent. Also responsible for the increase in the nation's foreign exchange holdings was the abrupt decrease in the projected demand for foreign currencies in view of the stabilized won-dollar rates.

The Seasonality of the Trade Deficit

Any recovery of the Korean economy, which is heavily dependent on exports,

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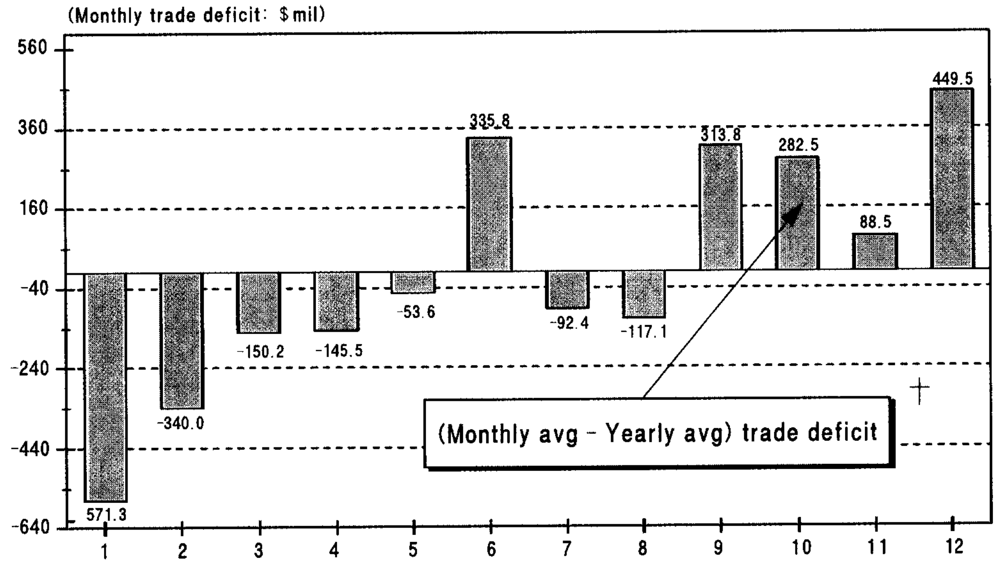
〈Figure 1〉 The Seasonality of the Trade Deficit



* Trade deficit data are monthly averages (on a customs-cleared basis) from 79.1 - 97.4.

† Bar data is composed of the difference of each monthly average of balance of payments and the yearly average of balance of payments

should first be embodied by an improvement in the balance of payments (the increase of exports). Looking at the seasonality of the balance of payments shows that the Korean economy is expected to recover from June. <Figure 1> shows that the first-half's trade dedicit is worse, while the second-half's is better. With the latest surge of the Japanese yen and signs of an export recovery here, the Korean economy appears to be gradually turning around. Mainly thanks to rising exports, Korea's trade deficit narrowed from $2.2 billion in March to $1.5 billion in April.

"The nation's trade deficit has continued to narrow since the outset of this year."

This seasonal pattern is expected to continue in Korea in 1997. Exports began showing signs of upward movements in April for the first time this year, while the nation's trade deficit showed signs of slower rises. On a customs-cleared basis, exports in April this year amounted to $11.378 billion, up 7.0 percent from a year earlier, while imports during the month reached $12.88 billion, up only 1.6 percent, thus leaving a trade deficit of $1.50 billion. This was the first export expansion since last December, and the monthly export growth rate outpaced the import growth rate in April for the first time in 10 months since last June when exports grew by 0.5 percent against the 0.9 percent decrease in imports. Moreover, the nation's trade deficit has continued to narrow since the outset of this year. Responsible for the favorable export performances in April were the recent export price recovery of semiconductor chips and the brisk export shipments of automobiles, iron-steel products, petrochemicals and textiles. The exports of semiconductor chips in the first 20 days of April showed a fall of 14.2 percent from a year earlier, but the decrease rate was lower than the 36.9-44.2 percent declines reported during the first three months of this year. In April alone, increases were seen in the exports of auto components (up 254 percent from a year ago), vessels (up 136.1 percent), oil products (up 34.9 percent), industrial electronics (up 28.9 percent) and iron-steel products (up 24.7 percent). Exports of heavy-chemical products posted an average increase of 11.4 percent in April.

Strong-yen shock

The Korean economic recovery is expected to be helped by the rising yen. The U.S. dollar slid to another four-month low against the yen in the Tokyo foreign-exchange market toward the end of the month, with the yen-dollar rate standing at 116.34 yen per greenback as of May 30. The Korean won, which is largely pegged to the U.S. currency, has also depreciated 5 percent against the yen so far this year. The won-yen exchange rate stood at 742.50 won per 100 yen as of May 30. The latest surge of the Japanese yen in international currency markets may give a temporary boost to Korea's sagging exports, but it remains to be seen if this will lead to a full recovery. The yen's strength will likely continue for the time being, but after that the rate will move either up or down depending on Japan's economic situation.

"The strong yen pushes up the dollar-denominated export prices of Japanese goods higher than those of Korean products in foreign markets."

Immediate beneficiaries of the strong yen are the Korean exporters of auto, ship, steel, electronic and petrochemical products, which are in direct competition with their Japanese counterparts in international markets. The strong yen pushes up the dollar-denominated export prices of Japanese goods higher than those of Korean products in foreign markets. While domestic general trading companies are carefully weighing the effects of the yen's movement on export prospects, officials at major trade organizations say that it is too early to tell about the recovery of export competitiveness. Between April 1995 and January 1997, during which the yen maintained its weakness, Japanese exporters slashed their foreign shipment prices by 17.1 percent. In comparison, the Korean firms lowered their export prices by 7.8 percent during the same period. Despite the yen's rebound, the Japanese companies are still maintaining their low-price policies, while pushing ahead with brisk plant relocation and globalized parts supply system. This indicates that the Japanese exporters are ready to weather another spell of strong-yen. The Korean economy cannot escape from the 'weak-yen shock' unless the Japanese currency surges above the 110 yen per dollar mark and stays there at least for three months or more. However, the strong yen is expected to make imports increase. In the case of Korea, because of its dependence on imports for capital goods and machinery, as exports increase, so will imports. Therefore, the improvement in the balance of payments will be offset by the increase in imports. <Figure 2> illustrates that the growth rate of exports and imports increases rapidly at the 110 yen level. However, the growth rate of imports is higher than that of exports, to the point where the improvement in the gap between the growth rate of export and import is offset perfectly.

Looking at a number of economic indicators, especially the strong yen shock, the economy will recover and the pace of the recovery may be faster than expected. However, the trade deficit in April is still $1.5 bil, and Korea still has a record trade deficit in terms of absolute number. Fortunately, the growth rate of export is 7% more than that of import (1.6%). If the strong yen shock continues, then the growth rate is expected to increase rapidly. VIP

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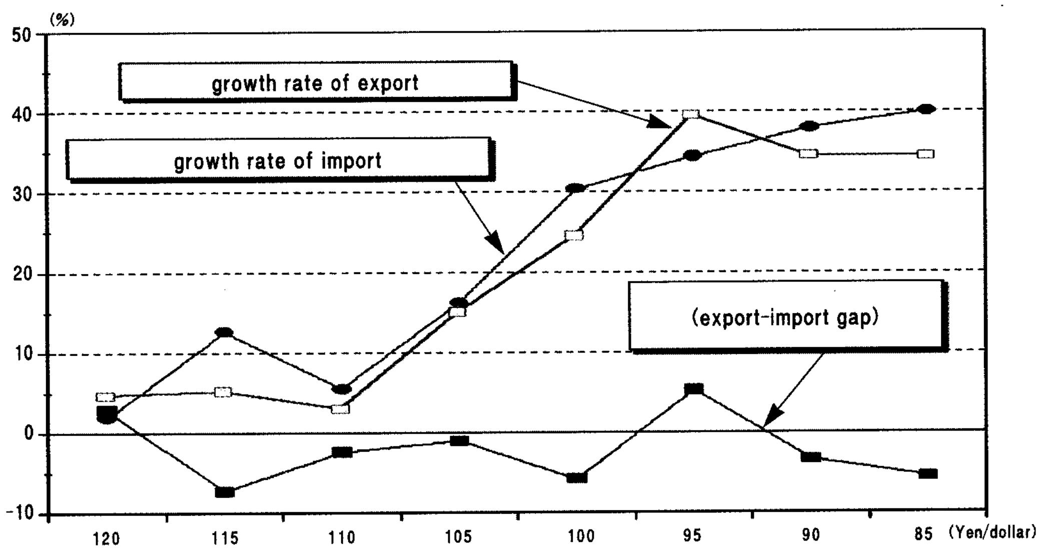
〈Figure 2〉 The Growth Rate of Export and Import By Level of Yen/Dollar



* Data is the growth rate of exports and imports compared to the same month last year on a customs-cleared basis from 79.1 - 97.4