KOREAN ECONOMY IN A PROLONGED SLUMP

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Possibility of L-shape Long-Term Depression

When will the Korean economy recover from the current long slump? Unfortunately, it is difficult to say whether Korean economy has already hit bottom or not. The cyclical component of the coincident composite index dropped 0.9 percentage points in June from May, which shows the economic situation is growing worse. The year-on-year figure of the leading composite index was down 3.5 percent in June. This has shown negative figures since January this year, casting a dark cloud over the prospects for the country's early economic recovery. The depression is expected to continue for the time being.

Household consumption is declining sharply because of the rapid increase in unemployment and also wage cuts. In the background, there is also a negative wealth effect caused by asset (stock and real estate) deflation and high interest rates. The uncertainty surrounding the Korean business environment due to corporate restructuring and the credit crunch have deprived firms of the demand and the credit supply necessary for facility investment.

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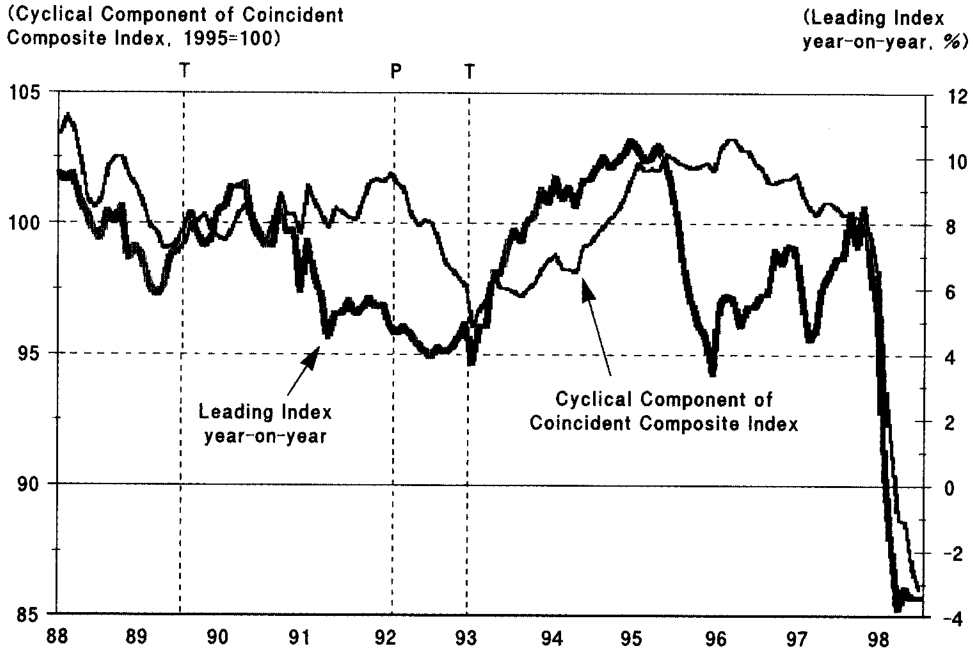
〈Figure 1〉 The Trend of the Korean Business Cycle



Therefore, investment is declining sharply as well. There are worries that the growth potential of the Korean economy might be weakened.

Domestic demand is shrinking even more severely than expected. If exports grow rapidly, the period of economic crisis can be shortened since export play an important role in Korea's economic growth. However, to make matters worse, exports have been decreasing during the past 3 months compared to the same period last year. Overseas factors such as the shrinking Asian markets and the depreciation of the yen have exerted a harmful influence on the growth of exports. In addition, the trade financing system has been paralyzed in the process of restructuring and the value of won has risen recently. Thus, a decrease in exports could not be avoided.

The rapidly slowing exports coupled with cooling domestic demand continue to hurt industrial activity severely. The growth rate has been negative for six months in a row since January, when output growth turned to negative 10.8 percent from a 3.0 percent gain in December. In particular, industrial output fell 13.3 percent year-to-year in June, its largest drop since 1952. Manufacturing plants operated at 66.5 percent of capacity in June, compared with 66.7 percent in May and 80.3 percent in June of 1997. Unemployment has soared, reaching 7 percent in June and raising concerns of social unrest. Some people worry the country's industrial base is on the brink of collapse under the speedy restructuring and the fiscal and financial retrenchment that the IMF has been imposing over the last seven months.

At a glance, the financial markets seems to be working well. The interest rates have declined with the relatively stabilized exchange rate. However, liquidity is circulating only among sound financial institutions and the big five business groups. The usable foreign currency reserves have reached 40 billion dollars, and the exchange rate has also fallen down to around 1,300 won per dollar. The falling exchange rate is contributing to the rapid decrease in exports, which will probably lead to the erosion of the base of economic growth. While the depressed domestic demand caused by restructuring is unavoidable, the credit crunch and the won's appreciation, which have been brought about by restructuring as well, are making the economic slump longer and weakening the economic growth potential.

The Third Quarterly Policy Review: A Turning Point?

In late July, the IMF came to recognize the severity of the current Korean economic depression. During the IMF's third quarterly review of Korea's economic policy, the two sides agreed to cut the target for GDP growth to -4 percent in 1998 from -1 percent. Also, according to the new letter of intent, the fiscal deficit will be expanded to 4 percent of this year's GDP. The deficit will be used to boost Korea's social safety net and support economic activity. The deficit target is higher than what was agreed upon in the second quarterly review with the IMF in May. The increase in the deficit will be primarily financed by the market issuance of government bonds. To provide adequate scope for a further gradual reduction in interest rates, Korea will maintain a flexible monetary policy and continue lowering call rates, the government said in its letter of intent. The flexible monetary policy will also be used to ease cash crunches that may arise from ongoing corporate restructuring efforts.

With the IMF's support, Korean government must expand fiscal expenditures and money supply to reboot economic activities. Restructuring without policies to support economic

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