AGAINST OUTSIDE SHOCKS

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After the currency crisis late last year, several economic indicators in Korea have shown some signs of recovery: interest rates have begun to fall and the domestic currency has stabilized against the U.S. dollar. The Korean government says that financial and corporate restructuring are proceeding consistently. However, the road to recovery is not a simple one which can be ensured by domestic efforts alone. In fact, Korea is an export-oriented economy which has a relatively small domestic sector, like other Asian nations, and is heavily dependent on the foreign sector. In this sense, the external factors are more important in curing the distressed economy. Unfortunately, the current international environment is not very favorable to the Korean economy, as well as to most of the other troubled Asian nations.

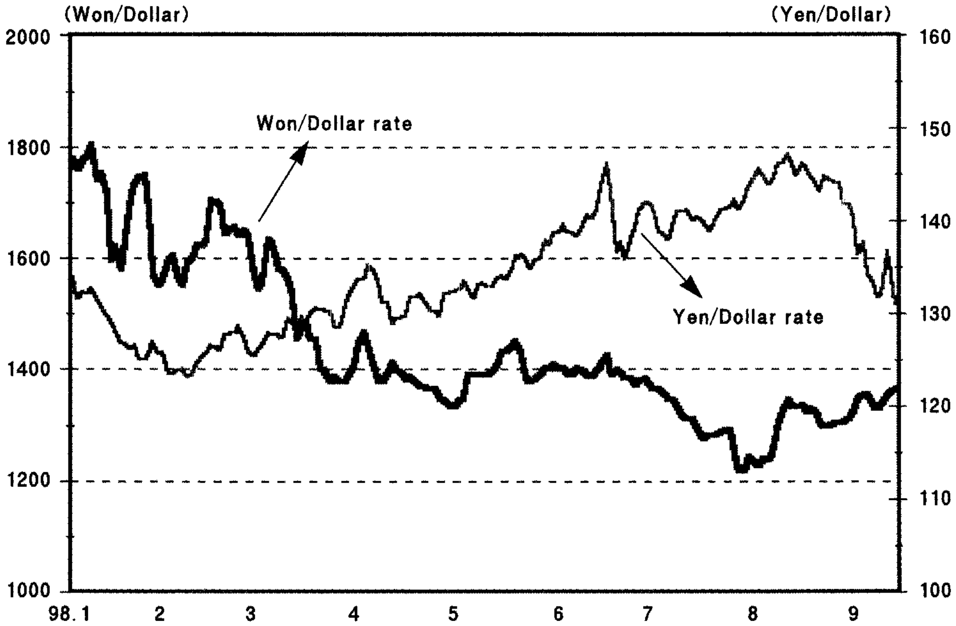
Repercussion from Russia and Other Regions

The financial turmoil in emerging markets is spreading all over the world. As the Asian economies deteriorate further, the other emerging markets are also losing the confidence of international investors. The demand for cross-product trade, especially raw materials, has dropped due to the lower demand of Asian economies. This, in turn, has deteriorated the economies of Russia and Latin America, which has resulted in the default situation in Russia and the Peso devaluation in Colombia. International capital, as a result, is shifting away from most emerging markets. The emerging markets will face a severe recession because of this "repercussion effect." This is a crucial negative factor for the Korean economy,

〈Table 1〉 Japan's Share as Export Market For Asian Countries (1997)

China	17.4 %
Hong Kong	5.0 %
Korea	10.8 %
Taiwan	9.6 %
Indonesia	23.3 %
Malaysia	12.6 %
The Philippines	16.6 %
Singapore	7.4 %
Thailand	15.0 %

〈Figure 1〉 Won/dollar and Yen/dollar Exchange Rate Trends



which desperately needs foreign direct investment and portfolio investment in order to restructure the domestic economic system, not to mention stable exports to emerging markets.

Japan: Big Responsibility, No Response

Japan's economic woes are dampening hopes for Asia's export turnaround. Moreover, its economic recovery took yet another hit with the release of Japan's GDP stattistics. It shows three consecutive quarters of GDP contraction : in the second quarter of 1998, at -3.3% on an annualized basis. With the recent 25 basis point cut in interest rates which is unlikely to pull the economy out of the liquidity trap, Japanese officials are now mulling over further policy options to turn things around. The pessimism surrounding the Japanese economy does not bode well for Asia, given that Japan is a major export market for other Asian countries. Indeed, trade surpluses appear to have peaked out in Korea. The narrowing of the trade surplus, even as exports decline, will be exacerbated by imports of raw and intermediate inputs in coming months.

On the other hand, movements of Japanese yen are the key to Asian currencies, especially the Korean won. Asian currencies encountered renewed selling pressure as the Japanese situation continued to further depress investor sentiments toward the region. Moreover, the Korean economy remains closely intertwined with Japan's via substantial cross-border flows in trade, investments and bank loans. For now, movements in the Japanese yen will continue to have a direct impact upon the Korean won.

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Chinese Economy Holding the Line

Although there is no immediate threat that the Hong Kong dollar peg will succumb to speculative pressure, the ongoing troubles in Japan that reinforce and prolong the yen weakness will extract a heavy economic toll on the Hong Kong economy. Likewise, China will most likely avoid a devaluation of the yuan for the time being, but it is possible that the authorities may gradually allow it to weaken, a move almost certain to create serious volatility throughout emerging markets globally.

In August, China's export growth continued to slow, although it showed a trade surplus of $31.3 billion on the first eight months of this year. In this period, China's exports rose 5.5% to $118.6 billion, significantly down from a record growth of 21% in 1997. If the trade balance deteriorates further, the pressure on the depreciation of the yuan increases.

Korea's Policy Options

The policy agendas which face Korean policy-makers can be categorized into two groups. One is blocking or minimizing outside shocks or spillovers by keeping a sufficient cushion of foreign exchange reserves. The Korean government has made full use of a relatively stabilized Korean won and tried to prevent further recession of the domestic economy by easing the money supply. However, the risk of another crisis remains : a continued deterioration in emerging markets will ultimately spill over into weaker regional currencies, thereby derailing Asia's incipient efforts to stabilize their economies. The best way to prevent this is to pile up enough foreign exchange reserves. It would be desirable for Korean monetary authority to increase its foreign reserves far over the current $40 billion level to around $70 billion by the end of this year. In the event that the expansion of foreign reserves is prohibitively hard, and at the same time, a possible large-scale capital outflow is foreseen in the near future, one can consider a policy which is suggested by Paul Krugman — that is, a kind of capital control, which is already being implemented in Malaysia. If internal fundamentals and external conditions continue to deteriorate, a forced tide change in Korea's liberal policy of unrestricted capital mobility could be on policy-makers' minds.

The other is to boost Korea's sovereign credibility in the international markets. Judging at least from recent trends, however, market spreads (the risk premium paid on sovereign bonds) have apparently risen high enough already. As indicated in the abrupt increase in the spreads for Korean "Exchange Rate Stabilization Bonds (ESB)," Korean policy-makers should note that sovereign credibility can often free-fall in the middle of crisis while improving of it really takes time and toil. In the case of Korea, strict enforcement of the current reform policy surely is the only solution to this problem. VIP

〈Table 2〉 Spreads on Korea's ESB
(Basis Points over U.S. Treasury Bonds Rate)

Aug. 14	Aug. 21	Aug. 28	Sept. 4	Sept. 11
535	638	935	963	923

* Source: Bloomberg