

WHEN WILL THE ECONOMY "RECOVER"?

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Bottom Is Around the Corner

"The leading composite index . . . rose in October. . . . Industrial data for October showed improvements as well."

It seems that the Korean economy will hit bottom in the near future. The leading composite index, which shows the state of the economy several months ahead, rose 0.7% in October year-on-year. The improvement of this index continues from September, when this index dropped just 0.7%, improving from falls of 3.4% in July and 2.9% in August. The cyclical component of coincident composite index, which reflects the current economic situation, rose 1.0% points in October from September and 2.0% points in September from August, the first two consecutive months of increase.

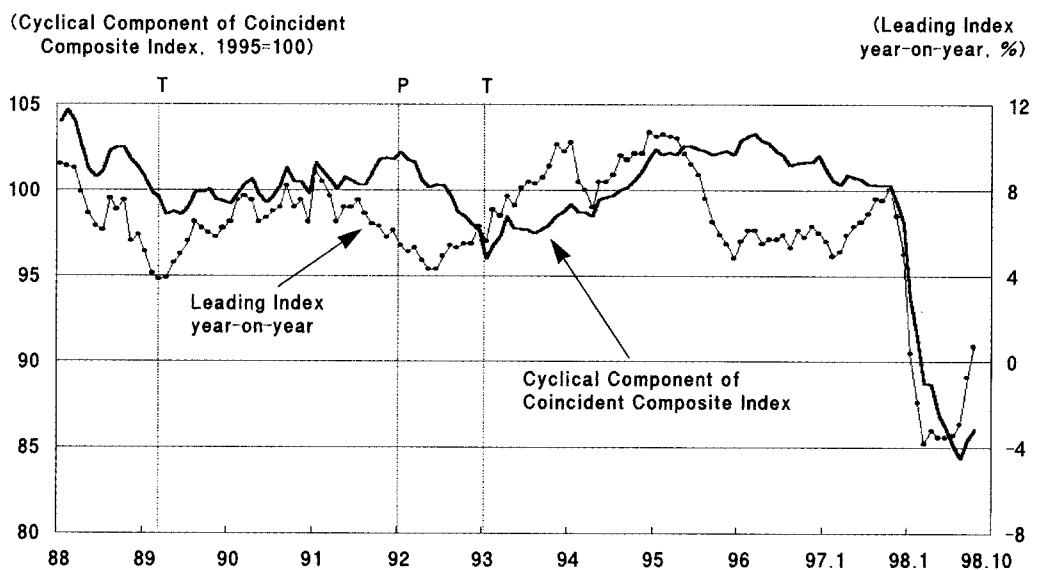
Industrial data for October showed improvements as well. The extent of decline in industri-

al production decreased compared to September. In August, industrial production dropped over 10% from a year ago, but just 6% in September and 4~5% in October. Manufacturing plants operated at over 65% capacity since September, a decent improvement from a record low of 62.9% in August.

Exports increased for the first time in six months in November, reaching \$12 billion, up 1.5%. In addition, the daily export volume in November of \$504 million was the highest in the second half of this year. Optimists would say that exports have already bottomed out and are now on their way up.

Another sign that the Korean economy is approaching its bottom is the GDP statistics. Gross domestic product in the third quarter

<Figure> The Trend of the Korean Business Cycle



declined less than expected: in the third quarter, GDP shrank just 6.8 percent. Compared to the 4th quarter last year when the foreign exchange crisis began the 4th quarter GDP statistics will definitely show a much lesser declining rate. Therefore, the GDP growth rate will bottom out in the third quarter. Since the GDP growth rate usually leads the business cycle by one to three quarters, the Korean economy will hit most likely bottom in the fourth quarter of 1998 at the earliest or the second quarter of 1999 at the latest.

#### *When Recovery Will Begin?*

The expectation that the Korean economy will hit bottom soon does not necessarily mean that it will be on the upturn right after that. The recent improvement of some indexes is mainly based on the production surge in automobile and semiconductor industries driven by growing exports. But the problem is that while exports show signs of recovery, domestic demand is still severely contracted. For example, consumption dropped sharply by 11.8 percent in the third quarter, with household spending plummeting by 12.1 percent in the aftermath of corporate and financial-sector restructuring. What matters is that the domestic demand will not recover in the near future. Wage reduction and increasing unemployment will continue next year. Since most firms are compelled to reduce debt and improve their short-term cashflows, investment is likely to be strongly restrained.

The recent recovery of exports seems to be supported by the improvement of overseas factors, in particular, the so-called new "three lows"—low dollar (high yen), low interest rates, and low commodity prices. However, this "three lows" situation is not expected to last for a long time. Expecting the yen to remain con-

tinuously strong is probably wrong as the yen's appreciation against the U.S. dollar did not result from improvements in Japan's economic fundamentals.

If domestic demand does not reverse its contraction and if the recovery of exports is just temporary, the overall recovery in the Korean economy could be delayed even after the bottom. A pessimistic scenario, which is referred to as an L-shaped or a W-shaped business cycle, might be realized if the government's stimulus package has little effect in boosting domestic demand or if financial and corporate reform do not show a tangible improvement as expected.

#### *Conditions for the Recovery*

Recently, the domestic financial markets have been showing signs of improvement. This trend is influenced by the improving global economic situation, the spread of optimistic views overseas about Korea's economic outlook, and signs of Korea's economic recovery reflected in several indicators. The composite price index of the stock market rose over the 500-point level, which was the first time since March.

It is noteworthy that the speed of improvement in the financial markets is much faster than in the real economy. If domestic demand stays in a deep contraction for a long time and the increasing trend of exports cannot be maintained, the recovery of the Korean economy will be delayed and recent developments in domestic financial markets will turn out to be mere bubbles. At that time, another wave of turmoil in the domestic financial markets could occur. Therefore, the government's stimulus policy package and restructuring are essential to build upon the recent recovery trends. VIP

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