KOREA'S MACROECONOMY IN 1998 AND THE 1999 POLICY ISSUES

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Background of 1998's Macroeconomic Policy

During 1998, the Korean Government's main economic policy agenda, in accordance with the IMF guidelines, was to eradicate the causes of the foreign exchange crisis. Korea's industries possess a unique structure in which an increase in exports often leads to more import demand; thus high economic growth, especially when propelled by exports, has often resulted in massive current account deficits. The first priority in the 1998 policy agenda, therefore, was to suppress the growth rate down to a level where Korea's current account would remain balanced. In addition to the excessive current account deficits, bad loans and imprudent offshore borrowings by Korean financial institutions have been pointed out as other major causes of the liquidity shortage in the fall of 1997. These malignant practices, which were partly rooted in a "moral hazard" psychology as well, can only be cured by the overall restructuring of Korea's banking industry and corporate sector.

In order to meet these needs, Korea's economic policy in 1998 was focused on two basic agendas. The first is concerned with the macroeconomic policy stance: to limit the money supply and fiscal spending and to keep interest rates high. The other dealt with the sector-specific reforms: to pursue restructuring in the banking industry, corporate sector, labor market, and public sector. In retrospect, while the restructuring processes in each sector so far, are being evaluated as fairly successful so far, even by some foreign observers, the macroeconomic policy stance at least during the first half of the year has been criticized as being inappropriate for the Korean economy's specific situation. Since the Korean economic crisis was triggered by a foreign currency shortage and not by excessive government budget deficits nor high inflation, the suddenly imposed tight monetary policy and the resulting high interest rates only choked the already debt-ridden businesses. In addition, the banking sector restructuring began with the new requirement that every bank should meet the 8% BIS (Bank for International Settlements) capital ratio standard within an extremely short period of time. Coupled with the tight monetary policy, this new standard naturally led to a full-scale credit crunch situation. For example, many banks refused to offer even conventional trade-related credit because this kind of credit temporarily lowers a bank's BIS ratio.

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Macroeconomic Environment in 1998

The IMF policy prescription, which has been the single most important factor determining the macroeconomic policy of the Korean government, gradually changed its stance. During the first half of 1998, the Korean macroeconomic environment stemmed from a stringent monetary and fiscal policy. According to the IMF's logic, this high interest rate and tight monetary policy should be continued until Korea's foreign currency market was stabilized. However, the high interest rates, tight monetary policy, and the abrupt imposition of the BIS ratio requirement on domestic banks led to a sudden and massive credit crunch in the domestic financial market. This, in turn, produced an explosive number of bankruptcies in the Korean economy. During the 1st quarter of this year, an average 3,000 firms went broke each month; the bankruptcy rate almost tripled compared to the previous year. The real hazard of this policy scheme lies in the fact that, at that time, the bankrupt firms were not necessarily badly debt-ridden firms. Most of them had quite solid financial structures but were suffering from tight cash flows. Many economists in Korea began to worry about the possibility of the meltdown of Korea's entire industrial base.

After the 1st quarter, the foreign currency market emerged from its worst and the won/dollar exchange rate stabilized, dropping from more than 1,500 won per dollar to the 1,300 won range. Reflecting this change, the IMF policy began to allow lower interest rates and also fiscal deficits. From the 1st quarter policy review between the IMF and the Korean government, it became possible to lower the inter-bank call rate and to extend government expenditures over revenues in order to facilitate the restructuring process. This gradual change continued until the 4th quarter policy review when they agreed to let the interest rate be determined in the market, not to care about the reserve base any more, and to allow a budget deficit of up to 5% of GDP in 1999.

Roughly speaking, the macroeconomic indicators followed this trend of policy changes. Interest rates (e.g., 3 year bond rate), which had once hit a 30% per annum level in the beginning of the year, has fallen and stayed in the 7% range entering December. The bankruptcy rate fell from the 1st quarter's 0.5%~1.0% range to the current 0.2% range. The facility utilization rate in manufacturing sector is rising close to 70% in the 3rd quarter from below 65% in the spring. Exports have shrunk compared to last year's statistics but are gaining momentum to revive. Judging from the movements of business cycle indices, many economists expect the Korean economy will hit bottom around March or April 1999.

The general macroeconomic environment perceived by firms or consumers, however, has hardly recovered. Even though the government has announced that the banking sector restructuring is over, the credit crunch situation has not completely disappeared from the financial market. Facing uncertainty and insufficient cash flows, firms are radically decreasing their facility investment more than 40% compared to 1997; thus the worries over the deterioration of future growth potential are growing. Mounting unemployment and the shrinking income level of households are other sources of distress. The unemployment rate has risen to the 8% level with more than 1.6 million unemployed. When the number of those discouraged to look for jobs (which is not usually included in the statistic) is added, the total real unemployed would be far more than 2 million. Unemployment and the decrease in real income are the reasons why consumers cannot regain confidence. Consequently, consumption expenditures decreased 10~15%, surpassing the decrease in income levels.

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How to Make Up the Missing Parts[1)]

The macroeconomic policies in 1998 were based on the two basic principles: they were

Editor's Note: In this December 1998 issue, only short term policy agendas are discussed. HRI is currently preparing a special January 1999 issue in which the longer-term policy issues will be covered. For the mid-term and long term policy agendas, please refer to the January 1999 issue.

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aimed at getting rid of the reasons that caused the crisis and supporting the restructuring in the overall economy. In retrospect, the resulting macroeconomic environment only partly fulfilled these ends. More importantly, other principles or policy goals are needed for the second year of the IMF era. This is because during 1999, the Korean economy should be completely free from the danger of a foreign currency shortage and possibly return to the normal growth path. Therefore, these new policy goals must be ways to recover from the crisis as soon as possible while pursuing the ongoing restructuring. In this sense, we can propose several policy agenda.

Among the 1999 policy agenda, the first priority should placed on boosting the Korean economy by using both expansionary monetary and fiscal policies. In fact, these stimulus measures were needed from early 1998. The IMF should have realized earlier that the Korean economy needs to be boosted not only to preserve the growth potential in the long run, but also to facilitate the reform or restructuring processes in the short run. With negligible inflation pressure on the economy, one could adopt an inflationary stance to properly evaluate and sell financial and non-financial corporate assets, which could lead to a reduction of debt burden. Also an expansionary fiscal policy could directly help laid-off (or unemployed) workers. This will facilitate labor market reform and thus enhance the labor market flexibility.

The second important policy issue is the foreign debt repayment and the stabilization of the foreign exchange market (or the won/dollar exchange rate) by accumulating enough foreign exchange reserves. In fact, because of worldwide awareness and the relative stability in the international capital market since the 3rd quarter of 1998, it is getting less plausible that the second wave of a foreign exchange shock will occur in the near future. But Korea's foreign exchange market is still in a vulnerable situation, with a daily average transaction volume of less than $2 billion. Therefore, outside shocks such as the Russian moratorium experienced this past August could severely hit the Korean exchange market again. Also nobody is sure whether the currently booming stock market will continue to expand or not. Currently, Korea's usable foreign exchange reserves are at the highest level in history. For the reasons mentioned above, however, Korean policy makers should increase the foreign exchange reserves even higher than the current level and provide enough cushion against the possible shocks both from inside and outside Korea.

The repayment of foreign debt, which seemingly contradicts accumulating the foreign currency reserves, is another important component of Korea's external economic policy agenda. As was recently announced, the Korean government decided not to seek a roll-over but to repay the $2.8 billion portion of the IMF bailout loan which was coming due. The "on-schedule" repayment of foreign debt will definitely enhance Korea's external sovereign credibility substantially and should be continued as long as the level of foreign exchange reserves allow. In this sense, it is necessary for the Korean government to elaborate, publicly announce, and follow its short and mid-term plan and schedule to repay the foreign debts. By the end of 1999, Korea will finish the regular policy review schedule with the IMF. This means that Korea may "graduate" from the IMF bailout program. In order to "graduate" from the IMF program in a true sense, not only do we need to possess the independent capability to repay our national debts but also to demonstrate to others our strong will to "graduate" and fully emerge from the crisis. VIP