WHAT THE IMPROVEMENT IN THE FINANCIAL MARKETS MEANS

by Chang-Kyun Chae
(e-mail: ckche@hri.co.kr)

Improvement in Financial Markets

Recently, the domestic financial markets have been showing signs of improvement. This trend is influenced by the spread of optimistic views overseas about Korea's economic outlook and signs of Korean economic recovery reflected in several macroeconomic indicators.

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In particular, optimistic views overseas about Korea's economic outlook seem to be the main factor bringing about the change in the financial indexes. Recently, Moody's Investors Service said that it would consider upgrading Korea's sovereign credit ratings, citing the nation's "vastly improved" external liquidity position. A team from Moody's is visiting Korea early before adjusting the credit ratings of Korea from the current non-investment grade to investment grade.

Also, the Organization for Economic Cooperation and Development (OECD) has evaluated Korea's recent restructuring process positively as well. In particular, the OECD praised Korea for channeling public funds, equivalent to 15 percent of gross domestic product, toward conducting a quick financial sector restructuring.

As views overseas about the Korean economy have become even more positive, foreign investments have increased greatly. Foreign investors have bought $4.71 billion worth of Korean securities so far this year, with more than 90 percent of it invested in listed Korean stocks. This foreign portfolio investment of $4.71 billion represents a surge of 336 percent from the $1.08 billion in 1997 and is the highest level since 1993, when the figure stood at $5.7 billion. At the same time, foreign direct investments has amounted to $8.85 billion, showing 8 straight months on the rise.

With the continued inflow of dollars thanks to the foreign investment and the current account surplus, the exchange rate has dropped under 1,200 won against the dollar. The domestic interest rates have fallen into the 8% level due to the Korean government's strong intention to lower interest rates, coupled with developed countries' simultaneous interest rate cuts. With the large inflow of foreign capital into Korea to buy stocks, the KOSPI composite stock price index rose over 550 points.

However, it should be noted that the speed of improvement in the financial markets is much faster than in the real economy. While it

〈Table 1〉 Major Financial Indexes

(End of Period)

	1997	1998	
		November	12.30
Exchange rate (won/$)	1,415.2	1,243.7	1,207.8
Interest rate (3 yr. Corporate Bond Yield, %)	12.98	9.25	8.00
KOSPI	376.3	451.88	562.46

is obvious that the bottom of the Korean economy is around the corner, when recovery will begin is still uncertain. If the recovery of the Korean economy is delayed, the recent developments in the financial sector might turn out to be mere bubbles.

Bottom Is Around the Corner

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 percent in October year-on-year. The symptom of improvement shown in this index began from September, when the index dropped just 0.7%, improving from falls of 3.4% in July and 2.9% in August.

Industrial data for October showed improvements as well. The extent of decline in industrial production decreased compared to September. Until August, industrial production had been dropping over 10% from a year ago. If some temporary and seasonal factors could be controlled, however, industrial production dropped just 6% in September and 4~5% in October year-on-year. Manufacturing plants have been operating 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. In addition, the average daily export volume in November of $504 million was the highest in second half of this year. Optimists would say that exports have bottomed out and are now on their way up.

Another sign that the economic recession is approaching its bottom is the GDP statistics. Gross domestic product in the third quarter declined less than expected, shrinking just 6.8 percent. Compared to the fourth quarter of 1997 when the foreign exchange crisis began, the fourth quarter GDP statistics in 1998 will definitely show a much lesser decline rate. Therefore, the GDP growth rate will have bottomed out in the third quarter. Since the GDP growth rate

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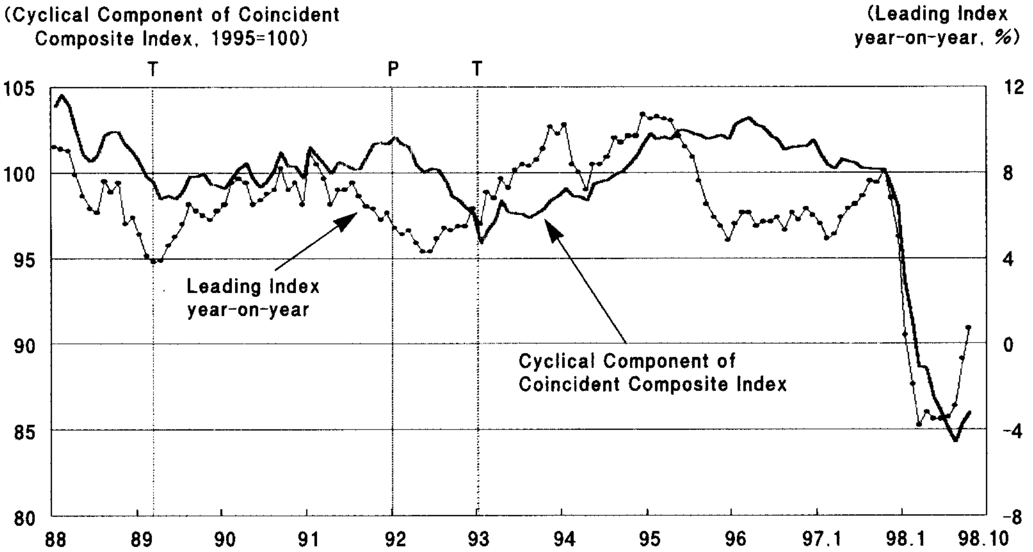
〈Figure 1〉 The Trend of the Korean Business Cycle



usually leads the business cycle by one to three quarters, the Korean economy will most likely hit bottom in the fourth quarter of 1998 at the earliest or the second quarter of 1999 at the latest.

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When the Recovery Will Begin Is Uncertain

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 production indexes is mainly based on the production surge in the automobile and semiconductor industries, driven by growing exports. But the problem is that while exports are showing signs of recovery, domestic demand is still severely contracted. For example, consumption dropped sharply by 11.8% in the third quarter, with household spending plummeting by 12.1% in the aftermath of corporate and financial-sector restructuring. Facility investment plunged by 46.3%, the eighth consecutive quarterly decline since the first quarter of last year.

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In other words, the key point is that domestic demand does not seem likely to recover in the near future. Wage reductions and increasing unemployment will continue next year, so consumption is not expected to increase greatly. Since most firms are compelled to reduce debts and improve their short-term cashflows, facility investment is likely to be strongly restrained.

The recent recovery of exports seems to be supported by the improvement of abroad factors, in particular, so called new "three lows"—a low dollar, low interest rates and low oil prices. However, this "three lows" is not expected to last for a long time. Expecting the yen to remain strong continuously is probably wrong as the yen appreciation against the U.S. dollar did not result from improvements in Japan's economic fundamentals.

If domestic demand does get out of its contraction and the recovery of exports proves to be just temporary, economic recovery could be delayed even after the bottom is hit. A pessimistic L-shape or W-shape scenario might be realized if the government's stimulus package has little effect in boosting domestic demand or if financial and corporate reform do not progress as expected. VIP

⟨ Figure 2⟩ Consumption, Investment and Production