

A SCENARIO FOR OVERCOMING THE CRISIS

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Benchmarking Other Countries' Experiences

In order to find the path to recovery out of the current crisis, it might be necessary to study other crisis-hit countries' experiences. In the early 1990s, Mexico and some Scandinavian countries, namely Sweden, Norway, and Finland, also went through financial and foreign currency crises. Even though the causes for the crises differed from one another, the recovery paths taken in these countries shed light on Korea's own struggle to overcome the current economic hardships. In fact, several common elements can be found in the government policies during the recovery processes. The governments in these countries maintained policies to induce foreign capital inflows and to keep the foreign exchange reserves high enough to avoid additional foreign exchange shocks. In addition, they pushed for restructuring in the financial and corporate sectors, focusing on reducing bad loans and spinning off not-so-competitive business lines.

Since there has been some trial and error in the recovery path, a couple of lessons can be learned from these experiences as well. In the case of Finland, implementation of an expansionary macroeconomic policy was delayed in the restructuring process. This resulted in an overall depression in asset prices, which in turn became a bottleneck to efficient restructuring in financial sector. Moreover, experts point out that unlike in Mexico, where the "social pact" campaign was quite successful in curbing high inflation, in Scandinavian cases the lack of a social consensus sometimes led to a delayed or an incomplete restructuring.

Reviewing these examples, we can propose three major common prerequisites for a successful recovery from an economic crisis:

- (1) Restructuring should lead the recovery. Above all, the bad loans in the financial sector must be first resolved so that other sectors' restructuring can progress without hindrance or delay. This applies to every case of the Scandinavian countries and Mexico.
- (2) Appropriate macroeconomic policies should accompany the restructuring. Expansionary monetary and fiscal policies are needed to facilitate the restructuring from certain stages. In the Scandinavian countries' examples, when this stimulus policy was implemented insufficiently or belatedly, the entire restructuring process accordingly became incomplete and delayed.
- (3) A social consensus is very important to the recovery path. The exact types of the consensus could differ from another, depending on the socio-cultural background in each country. It could be either an implicit and indirect consensus or a "social pact" in which labor, the government, and businesses agree upon the basic economic policy stances in a very specified manner. However, unless at least an implicit agreement is reached regarding the "pain-sharing" mechanism, it is very difficult to make progress on a smooth restructuring path. A social chasm or even worse, social unrest could lead to disastrous results in an economic crisis.

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Preconditions for Korea's Case

Korea cannot be an exception to the above prerequisites. Considering the exact causes for Korea's economic crisis and its industrial structure, however, several additional points should be addressed.

First, Korea's economic crisis directly stemmed from the foreign currency shortage, which was rooted in the mounting foreign debts. Fortunately, Korea was successful in rescheduling most of its short-term debts in early 1998. But much uncertainty still lies ahead. Southeast Asian countries are still suffering from crises. Russia's economic hardships are worsening and generating a "contagion effect" to other areas such as Latin America, particularly Brazil. The international financial market situation surrounding the Korean economy will not be so hospital or favorable as was in the cases of the Scandinavian countries or Mexico. Almost the only way for Korea to avoid possible future shocks is to pile up sufficient foreign currency reserves. Only when it has enough foreign currency reserves, will Korea be able to repay its foreign debts. The "on-schedule" or "earlier than schedule" repayment of foreign debts will help insulate the Korean economy from outside shocks by enhancing its external credibility. Therefore it is essential to elaborate, publicly announce, and adhere to the short-term and mid-term schedule to repay the foreign debts.

The second point regards industrial restructuring beyond the current corporate restructuring. Despite the fact that Korea possesses a solid manufacturing base, several problems have been pointed out as causes of the chronic current account deficits in the past. Korea's major industries consume too much energy compared to the value-added produced. They are also too dependent on the imports of capital

goods. Rising wage levels and high interest rates also dampened the overall level of competitiveness in major industries. Therefore, overcoming the current economic crisis in Korea must involve a process in which these malignant phenomena are properly addressed. In other words, Korean industries must be restructured in a way to enhance their value-added, their profitability, and their efficiency in every respect. A solution is the so-called "knowledge-based restructuring." A new industrial policy is needed to foster hi-tech and soft-touch industries and to integrate the newly developed knowledge or technology into the current manufacturing industries.

Hence, the preconditions for Korea's overcoming of the current crisis consist of the three lessons from the benchmarking of other countries' experiences and the two additional Korea-specific conditions just mentioned. They are (1) ongoing restructuring, (2) appropriate macroeconomic stimulus policy, (3) social consensus (cohesion or unity), (4) well-managed foreign debt structure, and (5) new industrial policy (industrial restructuring.)

Three Stages of Overcoming the Crisis

With these preconditions satisfied, the Korean economy will show a gradual but substantive improvement from 1999. Conceptually, the recovery process can be divided into 3 stages.

<Stage I (1998~1999): Completing the Restructuring>

By the end of 1999, the restructuring process should be completed in each sector of the Korean economy. In this stage, the financial indicators are expected to stabilize considerably. Sometime in the first half, production indicators will hit the trough of the business

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cycle. The exact timing of upturn will be dependent, however, on the degree of extension and effectiveness of the monetary and fiscal stimulus policies. The overall GDP growth rate in 1999 is going to be slightly over 0%, which is a symbolic recovery from the -5~-6% growth in 1998. Solid growth in exports and expansionary government expenditures will lead this apparent recovery. But consumption and facility investment will still remain stagnant. Restructuring in the banking sector and the corporate sector will entail substantial unemployment. Therefore, in spite of the growth rate rising by 5~6 percentage points, the unemployment rate will stay in the 8% range for a while.

<Stage II (2000~2002): Solidifying Competitiveness>

Helped by the completion of restructuring and the ensuing competitive edge in every area, the Korean economy should regain its growth potential from this stage. The new industrial policy and the social consensus will solidify this trend. Consumption and investment will recover to be the leading components

for economic growth. At the same time, the trade volumes of both exports and imports will expand. Financial indicators will reflect the state of the economy. The won/dollar exchange rate will approach the 1,000 won level while domestic interest rates continue to stay below 10%. With the restructuring process completed, a more flexible labor market will emerge. The new labor market will facilitate the smooth supply of labor while demand for new labor is to be stabilized. As a result, the unemployment rate will be soothed down to 5% level.

<Stage III (after 2003): Stable and Sustained Growth>

In this stage, the Korean economy will become an advanced one where a highly efficient market mechanism prevails and more value is produced for the same cost. Domestic demand from both consumption and investment, as well as exports, will lead the growth in a more balanced way. Per capita income will reach \$10,000 again in 2003. By this time, the economic crisis is over; stable and sustained growth is on its way. **VIP**

<Figure 1> A Scenario for Overcoming the Crisis

