BOTTOMING OUT NOT AS IMPORTANT AS ECONOMIC RECOVERY

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Showing Some Signs of Economic Recovery

It seems that the Korean economy will most likely have hit bottom in the 4th quarter of 1998 at the earliest or the 2nd quarter of 1999 at the latest. The coincident composite index, which reflects the current economic situation, has been rising since August 1998 and rose 0.7 percent in December from November.

The leading composite index also rose 1.9 percent in December from November, following a 2.3 percent month-to-month gain in November. This index has been rising since June 1998.

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Industrial output grew 4.7 percent in December 1998 from a year earlier, marking the sharpest gain since October 1997, when it rose 9.2 percent. December's output growth was a major swing from the 1.4 percent rise in November. Manufacturing plants operated at 70.5 percent of capacity in December, compared with 68.8 percent in November. This figure was the highest yet since Korea was bailed out by the International Monetary Fund in late 1997. The capacity utilization rate has been over 65% since September, a decent improvement from a record low of 62.9% in August.

The extent of decline in consumption and investment has decreased. On the consumption front, wholesale and retail sales, the main indicator of consumer sentiment, fell only 2.7 percent in December, slowing from a 8.4 percent contraction in November, as purchases of cars and oil fuels increased. In particular, the wholesale figure, which is directly linked to production edged up 0.2 percent, the first rise in 1998. Shipments of consumer goods for domestic demand shrank 12.6 percent, compared with a 19.3 percent decline in November. On the capital expansion side, local machinery orders, the main indicator of corporate capital spending, rose 0.8 percent year-to-year in December, also marking the first increase in 1998.

Exports have continued to register positive growth since November, rising a modest 3.7 percent from a year earlier in January. However, imports jumped 15.4 percent in January from the same month a year earlier, a major turnaround from drops of 28.9 percent in November and 14.9 percent in December. The rise in imports, the first monthly increase since October 1997, came as good news for the economy, in general, as the rise was driven mainly by a recovery in investments.

Still Too Early to Celebrate

The economy may have bottomed out, but it's too early to declare that the economy is turning up smoothly because the contraction of domestic demand might continue for the time being and the environment for exports is expected to worsen. Wage reductions and increasing unemployment will continue this year, so consumption is not expected to increase greatly. Investment is likely to be strongly restrained, since most firms are compelled to reduce their debt burdens and improve their short-term cash flows.

At the same time, the recent signs of economic recovery were mainly caused by the export recovery of certain items such as semiconductor. However, the overall export climate will not be so favorable for the following reasons.

First, global economic growth will slow down. We estimate that growth rate of the global economy in 1999 will be only 1.9%, which is much lower than that of 1998, mainly because of the slowdown of the U.S. economy and continuation of emerging markets' instability.

Second, the price competitiveness of export items might be weakened. The continued current account surplus, the inflow of foreign investment, and the upgrades of Korea's credit ratings are factors behind the won's appreciation, and the government's intervention may not be able to sufficiently prop up the dollar in face of these factors.

Third, the developed countries might raise the walls of protectionism. In particular, the U.S. decision to re-institute the Super 301 provision might darken the export outlook.

Given these difficulties in increasing exports, boosting domestic demand is important for the recovery of the Korean economy. Therefore, gevernment's macro policies should concentrate on revitalizing lackluster domestic demand.

Financial Market Shows Improvements

Recently, the domestic financial markets have also been showing signs of improvement. With the continued inflow of dollars thanks to foreign investment and the current account surplus, the exchange rate has dropped under 1,200 won against the dollar.

The domestic interest rates have stabilized at around 7~8% level due to the government's strong intention to lower interest rates.

With the large inflow of foreign capital into Korea to buy stocks and low interest rates, the KOSPI index is in the mid-500 point. range. The KOSPI even jumped up over 600 points in early January.

These trends are influenced by the spread of optimistic views overseas about Korea's economic outlook and signs of Korean economic recovery reflected in several macroeconomic indicators. There have been worries over the possible bubble phenomenon in financial sector, including the stock market. Ironically, however, the turmoil in the global financial markets, namely the recent financial crisis in Brazil, Russia and China, prevented Korean financial markets from becoming overheated.

Upgrade of Korea's Sovereign Credit Ratings

Fitch IBCA and Standard & Poors, leading international credit rating agencies, recently upgraded Korea's ratings to investment grade, while Moody's also said that they would consider upgrading Korea's sovereign credit ratings within a month. The restoration of an investment-grade rating reflects Korea's improved external position, and the progress in corporate and financial sector restructuring.

However, large amounts of foreign capital inflow are not expected in the short run, because corporate and financial restructuring is still in progress such that uncertainty in the investment environment has not been completely eliminated. Also, the credit ratings of most private corporations are still unchanged, which is restricting substantial foreign capital inflow.

In the long run, an increase in foreign capital inflow is expected with upgraded credit ratings of domestic corporations and financial institutions, narrower spreads on foreign currency denominated bonds, and improving foreign investors' view about the Korean economy. VIP

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