INVESTMENT AND EXPORTS: ELEMENTS OF SUSTAINABLE RECOVERY

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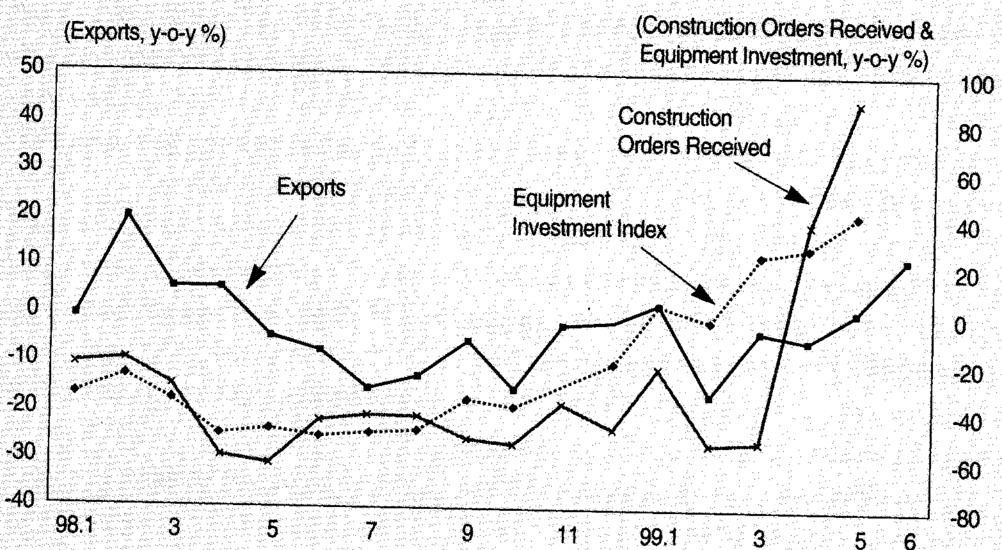
Industrial Activities Show Better Performance

The recovery of the domestic economy, which has been led by consumption so far, seems to have acquired another engine: investment. Wholesale and retail sales, the leading indicator of consumer trends, have been showing increases in the year-on-year 8% range since March 1999. However, the month-on-month increase fell in April and May, reining in the month-on-month rising trend since August 1998. At the same time, according to the National Statistical Office, the estimated indices of facility investment, domestic machinery orders and machinery imports rose by 43.4%, 40.5% and 15.0%, respectively. Domestic construction orders, moreover, climbed 39.3% in April and 89.6% in May.

Industrial production and exports showed solid growth in May. Export shipments went up by 28.3% and production surged 21.8% year-on-year. Accordingly, the capacity utilization rate for manufacturing went up from 74.1% in April to 76.5% in the following month.

Exports during June amounted to a record $12.98 billion, up 12.8% year-on-year. The reason for the sudden jump in exports is the improving conditions for trade abroad. Since the beginning of 1999, interest rates and wages have been showing stable downward trends and cost competitiveness has been regained somewhat. The U.S. economy continues to prosper, providing a large and open market for Korean exports. In addition, Asian markets including the Japanese market

Figure 1. Indicators for Exports, Equipment Investment, Construction Orders



are coming back to life and the European market is also showing partial signs of recovery.

Imports, on the other hand, soared 31.8% in June and the monthly volume passed $10 billion for the first time in 18 months. Despite this steep climb in imports, Korea still maintained a $2.77 billion surplus in the trade balance, thanks to the strong export performance.

Good Enough to Lead the Recovery?

However, it is difficult to say investment and exports are showing good enough performances to lead the recovery. The recent increase in corporate facility investment was induced by the necessity felt by some industries to maintain, repair, and add to their current facilities. Thus, the nature of investments made recently is distant from expanding production capacity. In particular, it should be noted that the high growth rate of corporate facility investment does not automatically mean that the absolute size of capital stock is growing. Instead, as is in the case of consumption, the high investment growth rate is largely due to a technical rebound to last year's extraordinary contraction. Moreover, due to the ongoing restructuring, companies do not realistically have enough financial resources to plan and to engage in facility investment.

In light of the drastic reduction of domestic consumption orders in April and May of 1998, it is not a surprise that orders showed a huge year-on-year increase starting two months ago. The absolute size of domestic construction orders still falls short of that of 1997. Orders received have a tendency to turn into construction investment only after a time gap of one or two quarters. Therefore, the current increase rate of orders will push up the increase in construction investment in the second half of 1999.

It is also debatable whether the increase in exports will carry on into the second half of the year. Whereas the won/dollar exchange rate is forecast to be pressured to fall, most advanced countries share a policy direction aiming to keep the yen weak. The won's relative strength against the yen is expected to worsen Korean exporters' competitiveness. Trade-related pressures on Korea and the possible devaluation of the Chinese yuan could also damage Korea's exports.

Importance of Full-Scale Recovery in Investment and Exports

Needless to say, there is a limit to an economic recovery without investment and exports turning upward. Lack of investment can weaken the growth potential. Also, frozen investment can turn inflationary concerns into reality. So far, increasing consumer demand has been met by raising the manufacturing operation rate. However, if the consumption rises faster than the operation rate does, then inflationary pressures will arise from unbalanced aggregate supply and aggregate demand.

If the abundant liquidity in the market these days is not mobilized for investment, then asset inflation could create a bubble in the economy. Searching for higher yields, the liquidity would flow to the stock market first and then to the real estate market. Furthermore, additional deregulation regarding real estate transactions may invoke speculation in the real estate market.

The government needs to implement some concrete and consistent policy measures to ensure that liquidity flows into facility investment and exports continue to grow. First, the liquidity in the stock market should be utilized to help firms smoothly increase their paid-in capital and minimize the burden of improving their financial structures. Second, the government should provide incentives to firms and financial institutions to purchase dollars in the foreign exchange market. For example, incentives to first pay back foreign currency-denominated debts should be provided. VIP