

## LESSON FROM PRE-CRISIS BOOM

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No one expected such a rapid recovery of the Korean economy, even as early as the beginning of 1999. However, the Korean economy's recent cyclical rebound reinforces the point that the economic growth is on the pace of recovery, based on increasing industrial production, consumption and investment. In particular, increase in exports is further accelerating the economy's recuperation from the second quarter of this year. Can we expect the Korean economy to enter a booming stage without any obstacles? With current economic conditions, Koreans may sit back and enjoy a smooth ride. However, admittedly, there are some risks. The Korean economy has a history of falling into a deep recession after the boom years of 1994 and 1995 on account of dropping growth rate and enormous trade deficits. Machinery & equipment investment and exports showed strong signs of prosperity in those two years. But the Korean economy was hit by the recession of 1996 and, unable to overcome it, eventually faced a foreign currency reserves crisis a year later. The booming period from 1994 to 1995 shares common phenomena with the first half of this year. Their similarities

lie in booming exports and increasing investments. Therefore, it is noteworthy to compare and analyze the two periods because history may tell us good and bad news in advance.

### *Resemblance to Previous Booming Period*

The two periods of booming economy – from 1994 to 1995 and 1999 – resemble each other in some aspects. First, both periods show fast rebounds against their respective recessions. In 1992 and 1993, the GDP growth rates were only 5.4% and 5.5% respectively, which were much lower than 9.2% in 1991. Though high growth rates in 1994 and 1995 were due to increases in exports and machinery & equipment investment, technical rebounds from the previous years' recession were not negligible. It seems that the year 1999 has been more influenced by the effect of technical rebound than the other period, since there are less growth facts in 1999 and the depression of 1998 was more severe.

Second, falling exchange rates and rising

**Table 1. Major Economic Indicators Since 1993**

	(y-o-y increasing rate, %)						
	93	94	95	96	97	98	99(f)
GDP	5.5	8.3	8.9	6.8	5.0	-5.8	7.1
Private Consumption	5.6	8.2	9.6	7.1	3.5	-9.6	7.2
Machinery & Equipment Investment	0.3	23.9	18.1	9.1	-8.7	-38.5	18.8
Construction Investment	9.7	3.7	8.0	6.1	2.3	-10.2	-8.0
Exports	7.3	16.8	30.3	3.7	5.0	-2.8	3.2
Imports	2.5	22.1	32.0	11.3	-3.8	-35.5	24.9

interest rates hampered the price competitiveness of export products during the two periods. The 3-year corporate bond rate was 12% in early 1994, but it rose to almost 16% in early 1995. In addition, even with the \$3.9 billion current account deficit, the won/dollar exchange rate continued to fall until the middle of 1995. This resulted in the huge current account deficit of \$8.5 billion in 1995.

Foreign exchange rates and interest rates in 1999 are showing trends similar to those in the booming period from 1994 and 1995. The Korean won has appreciated up to the 1,200 won/dollar level from 1,400 won (average) in 1998. The yield on 3-year corporate bond has currently jumped beyond 10% from 7.90% in February.

Third, the two periods post rapid import increases, which cause deterioration of current account surplus. Increasing imports worsened current account deficit in 1994 and 1995; they are eating away current account surplus in 1999. The main common reasons for import increases are expanded domestic demand for capital goods and raw materials and the won's appreciation in both periods.

In the background of these common features in both periods lies the unique industrial structure of the Korean economy.

Traditionally, the Korean economy's growth has been led by exports and facility investment rather than by domestic consumption. Due to the relative backwardness of the capital goods industry and Korean economy's heavy dependence on the manufacturing sector, however, growth in exports or in facility investment often result in massive imports of energy, raw materials and capital goods.

### What to Watch Out

It seems that the current economic growth is being driven by a sharp turnaround in exports and investment growth. This will lead the economy into a V-shape recovery. As happened in 1995, rise in the interest rates and drop in exchange rates may slow down the pace of economic recovery. The experience in 1994 and 1995 has proven how disastrous the misalignment between fundamentals and the actual economic indicators can be. That is to say, even when current account deficit was being widened in that period, the Korean won remained strong against the U.S. dollar not reflecting the fundamental economic situation. This misalignment was intensively debated among

Figure 1. Exchange Rate and Interest Rate 1993~1996

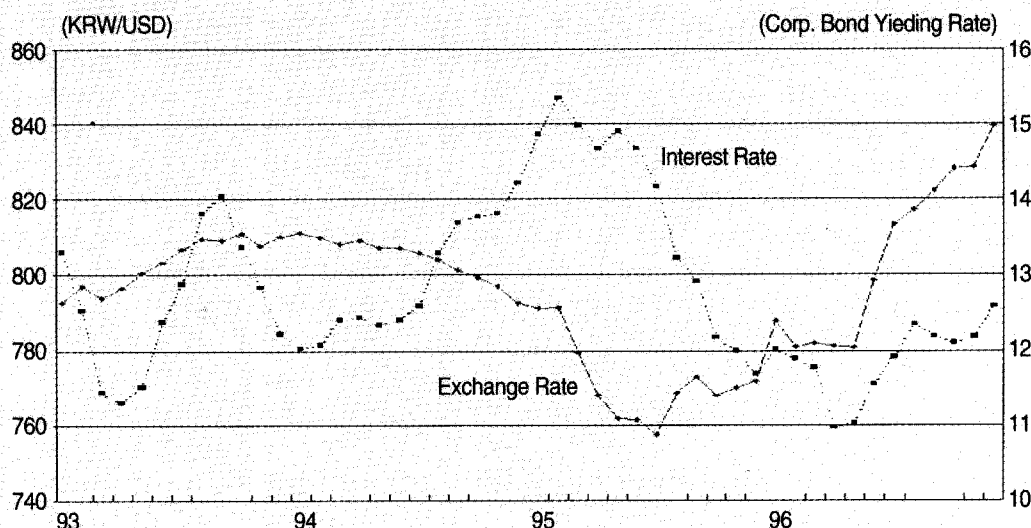
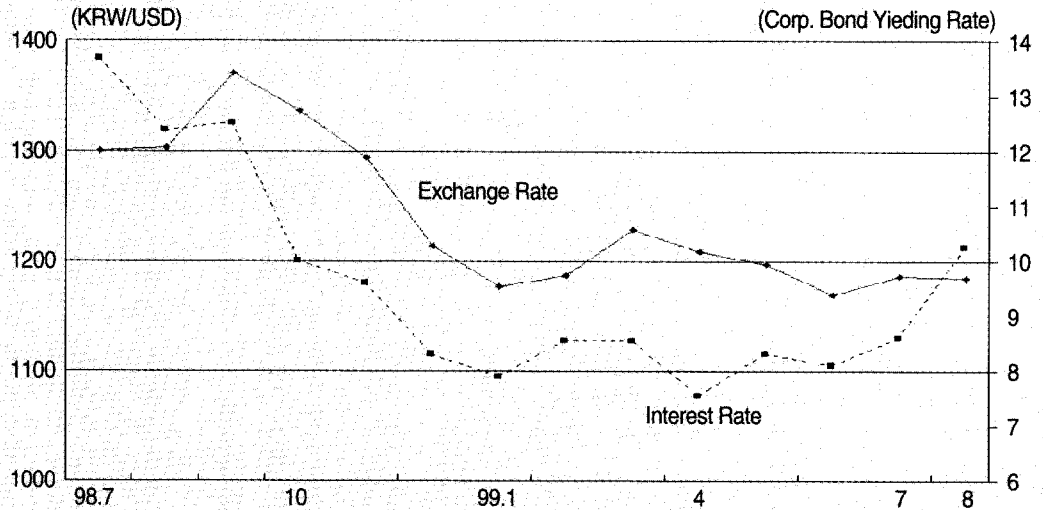


Figure 2. Exchange Rate and Interest Rate Since the 2nd Half of 1998



economists during the first half of 1997. Some economists at that time insisted that the exchange rate system be modified in a way to reflect the market situation. However, such an argument failed to be implemented in the actual policy-making, leaving the won/dollar rate below 900-won level.

As of this year, it is true that the recent fall in exchange rates is due to current account surplus. However, as the economy rebounds, the surplus will decrease as imports increase. If the present appreciation pressures for the Korean won continues even when the surplus shrinks, the economic growth will once again be hampered. The current rise in the interest rates, caused by financial market turmoils, can dampen the economy's recovery. If the period of higher interest rates and relatively appreciated exchange rates returns to Korea, the international price competitiveness of Korean exports will deteriorate and exports will slow down. The problem is that worsening export competitiveness imposes negative impact on the financial sector as well as on the real economy. Since it would hurt the corporate cash flow and thus discourage investors' expectation in the stock market on

the corporate earnings, stock market and financial market will directly reflect the alarming sign.

In this respect, it is undesirable that the government try to implement the stabilization policy to calm the economy. In 1994 and 1995, the government tried to slow down the economy by tightening the money supply, allowing the Korean won to be appreciated and constraining corporate equipment investment. However, the economy went into a deep depression after 1996. This teaches a lesson that excessive preemptive policy intervention may produce undesirable and risky consequences. Therefore, cautious determination of whether the current economy is overheated or not and well-planned implementation of the government policies are critical. Especially, the government should refrain from tight monetary policy because a relatively low level of inflation is expected this year and the economy still needs low interest rates and abundant liquidity in the stock market for the completion of restructuring, as well as for a full recovery. If not, the possibility of Korea experiencing a second economic decline cannot be ruled out. **VIP**