ECONOMIC RECOVERY'S DARK SIDE: DETERIORATION OF TRADE BALANCE

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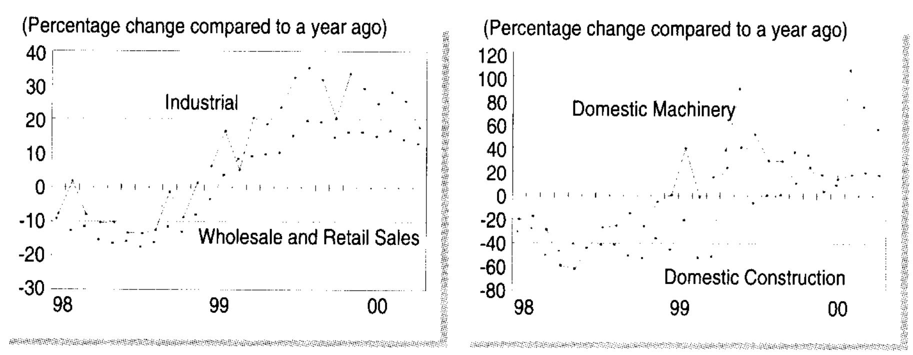
The Korean economy is still on its way to peak.

Most of the economic indicators announced by the National Statistical Office last month showed that the Korean economy is still on its way to peak. Industrial output in March increased 17.6 percent on a year-to-year basis. According to the National Statistical Office, the average operating rate of manufacturing plants was 79.4 percent, slightly higher than the 78.7 percent posted in February, due to increased production of assembled metal products and machinery equipment.

In addition to output, consumption indexes such as wholesale and retail sales and domestic shipment of consumption goods posted double-digit growth year on year. Although automobile sales slowed during the month, wholesale and retail sales increased 12.8 percent, buoyed by brisk sales at discount outlets and department stores.

Figure 1. Major Indicators of Industrial Activities



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Investment indexes showed even faster growth. Domestic machinery shipments soared 66.6 percent and machinery imports rose 57.5 percent in March. Since domestic machinery orders, the leading indicator of facility investment, increased 17.5 percent, we can expect further expansion in facility investment in the near future. Although construction investment is still depressed, it will take a favorable turn in the near future since domestic construction orders and construction permit areas have increased since the second half of 1999.

While many indicators showed favorable signs, other indicators showed that the Korean economy is nearly at the peak of its business cycle. Some seasonally adjusted indicators fell compared to the previous month. Output and wholesale and retail sales decreased 1.7 and 0.4 respectively during the month. Most importantly, the leading business index showed a negative trend for three consecutive months, which means the economy may reach its peak in six months considering past experiences.

Although the speed of economic growth is slowing down, the high economic growth rate seems to be continuing, at least in the first quarter. Owing to industrial growth, the seasonally adjusted unemployment rate, at 4.1%, was the lowest figure since January 1999.

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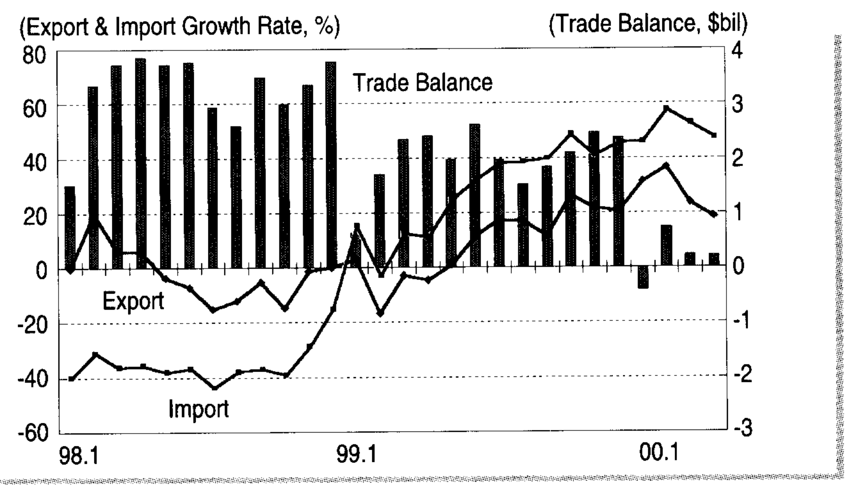
While the economic upturn brought some desirable results such as low employment and a high growth rate, it also caused several undesirable results, one of which was deterioration of the trade balance. Korea recorded a $225 million surplus in April, which was more than expected but less than one tenth of the surplus from the same period last year. The cumulative trade surplus so far in 2000 is $773 million, which is only 10.9% of the corresponding figure for last year. In the first four months of 1999, the trade surplus amounted to $7.086 billion. While the drastic downturn in the trade surplus was already expected, the speed of the current decrease was faster than expected.

Figure 2. Export, Import & Trade Balance



Our concern is that deterioration of the trade balance will have a bad influence on the Korean economy. Although balanced trade is desirable in the long run, Korea currently needs higher trade surpluses. The enormous trade surpluses of 1998 and 1999 played a very important role in replenishing Korea's foreign reserves and

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bolstering the country's external credibility, while contributing to a high growth and low inflation in 1999.

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If the steep decline of the trade surplus is prolonged under the current conditions, which forecast a slowdown in economic growth and a rise in the price level, it will bring Korea's macroeconomic problems into relief and hurt Korea's external credibility. In that case, domestic banks and firms will have difficulties raising offshore funds, foreign portfolio investment will leave the country, and finally the whole situation would precipitate nationwide economic instability. Particularly, the sharp decrease in the trade surplus along with the second financial restructuring including investment trust companies may lead to instability. Moreover, more foreign reserves are needed since foreign portfolio investments are flowing into the market in larger quantities, causing fluctuation in the domestic financial market. But it will be difficult to expand foreign reserves in the face of a declining trade surplus.

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It seems that a drastic decrease in the trade surplus is inevitable. The huge surpluses of the last two years owed to a sharp contraction in imports, rather than an increase of exports. At that time, many domestic firms and banks tried to secure foreign currency to avoid dishonor or default. Such efforts made the exchange rate skyrocket and the hike naturally contributed a great deal to the surplus. Moreover, a large number of firms, forecasting a deep recession, reduced or cancelled their facility investments, which slashed the import of capital goods dramatically. The decrease in consumption during that period stemmed from the exchange rate hike, lower income, and a consumer frugality campaign.

The factors which resulted in the sharp decrease of imports will no longer be effective when the economy recovers and the foreign exchange market stabilizes. Raw material and capital goods imports, which had been postponed during the last two years will rebound. As we cannot find any evidence that Korea's dependence on imported capital goods and raw material has decreased since 1998, it seems that the decline in the trade surplus will accelerate in the future. Considering these factors, one cannot rule out a trade deficit in 2001.

Continued growth will come of the cost of a smaller trade surplus.

Although the business upturn was somewhat sluggish during the last two months, the overall economy seems to be on an ascending phase owing to expanded investment, favorable export conditions, and a moderate increase in consumption. The investment sector in particular will lead economic growth this year considering the recent rises in the leading indexes of facility and construction investment. While the economy is expected to grow more than 8 percent owing to higher investment, the growth involves an undesirable phenomenon, namely a deterioration of the trade balance. VIP