Ⅳ. Korea Economic Focus

Are Things Turning Around in the Financial Sector?

Recent developments in Korea's financial situation suggest that things may be turning around. To begin with, foreign direct investment (FDI) seems to be on the rise. Newly reported FDI, which had been sharply declining through April on a year-on-year basis, turned around abruptly in May for several reasons. Korean firms' efforts to attract foreign capital by selling off business lines or equity seem to be paying off. Also, the won's substantial depreciation since the currency crisis combined with the huge drop in stock market prices has halved the current dollar value of Korean firms relative to September of last year. Furthermore, the institutional environment for foreign investors has improved considerably with the liberalization of capital movements, a reduction in taxes, land incentives, and other systematic support measures.

At the same time, the financial markets seem to be improving. Interest rates, particularly short-term rates like the repurchasing rate or call rate, are steadily falling, largely thanks to the monetary authorities' firm policy to lower interest rates which began in the 3rd quarter. Meanwhile, with interest rates falling, capital has been flowing into the reviving stock market, boosted by increased foreign buying. After dropping under 300 points at one point in September, the KOSPI index has now rebounded into the low 400-pt. range.

Another welcome development has been that the spreads (the yield in addition to a base rate such as LIBOR or U.S. Treasury bond rates) on Korea's foreign denominated bonds are steadily falling. The spreads on Korea's exchange rate stabilization bonds issued in New York in April, rose as high as 10% at the end of August, but now they have fallen back down to the 4% range, which implies a lower risk premium for Korea. Some superior firms with better financial structures or fewer bad loans have been able to return to the international capital markets.

Not Everything Is Rosy

Despite the positive appearances, the situation is still far from desirable. Even though foreign direct investment has been on a rising trend for the last since months, the total amount attracted in the first ten months of this year is still 5.3% less than the same amount last year. Furthermore, Korea's ratio of foreign direct investment to total fixed investment is still much lower than that of its major Asian competitors. Korea's ratio for 1992 to 1997 was a miniscule 0.93%, a fraction of Singapore's 25.37%, Malaysia's 18.07%, China's 12.97%, and even Taiwan's 3.52%.

In the financial markets, even though banks are starting to lend to some of the superior small- and medium-sized firms, firms' credit risks are still high and the credit crunch persists. Meanwhile, the gap between banks' lending and deposit rates has actually widened to 5.3%.

Furthermore, the recent drop in Korean bond spreads was more the result of the international financial markets' regaining their stability after the panic caused by the Russian debt moratorium. In other words, just as the sudden spike in yields in August was largely the result of problems in other emerging markets like Russia and Latin America as opposed specific developments in Korea, so is the subsequent drop. In reality, it will be hard to expect an upgrade in Korea's sovereign credibility by the major rating agencies such as S&P or Moody's until the first quarter of 1999 at the earliest. And even if this should happen, firms' ability to raise capital will be more affected by their own individual credit ratings, which will be largely determined by their financial structures.

All in all, the recent developments are a welcome indication that Korea's financial situation is improving, but it is still far too early to say that the problems are over.

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