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KOREA ECONOMICS

PRUNING THE CHAEBOL

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Pruning the chaebol

- The Korean economy is entering a second, painful phase of reform, during which much of the real economy should expand vigorously while the chaebol remain troubled, bankruptcies among small and medium-sized enterprisers (SMEs) continue to soar, the investment trust companies (ITCs) crumble and a new wave of bank problems occurs.
- The US$50-65bn Daewoo problem is huge but containable.
- President Kim Dae Jung is going after the other chaebol, with audits and arrests, but the big four will not collapse. Instead, they are likely to fragment over many years.
- The big issue is not the chaebol but the insolvent ITCs, which are key to the equity and fixed-income markets and must be restructured.
- Foreign banks are accustomed to special treatment, but huge Daewoo numbers make that politically difficult. US banks are keeping exposures flat, European ones are reducing theirs, and Japanese commercial banks are withdrawing.
- Kim Dae Jung is using up his political capital and could lose his parliamentary majority in the April 2000 elections. But an incoherent opposition will likely save him.
- Korea remains one of the world's most socialist economies and faces a long period of transition to the market.
- The principal drivers of economic growth are strongly rising domestic demand, high demand for semiconductors, and a relatively strong yen. Growth next year should be vigorous but at half of this year's rate — because of base effects, rising interest rates, more bankruptcies and more bank/ITC problems.
- The equity market will be weighed down by political uncertainty, ITC restructuring, pressure on the chaebol, and foreign fund withdrawals. Improving economic conditions and earnings will not outweigh these negatives. But the market averages, which will be bearish, will disguise the emergence of very big winners as well as very big losers.
- The fixed income market will be volatile, the yield curve steep, and the market troubled by inflation, political uncertainty and a weak currency.
- The risks to continued vigorous recovery are yen collapse, New York stock market collapse followed by US recession, unexpected problems in another chaebol, a decisive election loss by Kim Dae Jung, and North Korean collapse.

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Prelude: crisis and phase one reform

Korea is entering the second phase of reform. A successful first phase restored economic growth. Austerity restored the foreign exchange reserves. The government restructured the banks and some smaller companies while introducing some labour mobility. In the second phase, the major chaebol must be reformed and the investment trust companies must be restructured. This is likely to be a weird phase, in which leading parts of the real economy look set to soar while bankruptcies of SMEs multiply and ITC problems require a major public bail-out. Eventually Korea will have to restore and expand a market economy, replacing what is now, by force of circumstance, one of the world's most socialist economies. To see its trajectory clearly, we need to trace briefly where it has come from.

Korea's miracle was semi-socialist but disciplined by competition…

From 1961 to 1996 South Korea created one of the greatest economic miracles in human history, moving from the status of one of the world's poorest countries, with a per capita income that made Ghana look wealthy, to one of the world's most powerful industrial economies, with a per capita income of about US$10,000. It was even accepted into the OECD. This miracle was accomplished through a combination of strategies. The government carried out market-oriented reforms, but at the same time backed a small group of firms — around a dozen for most of the Park Chung Hee era — for special privileges. These chaebol were run by politically loyal but highly competent executives. Although privately owned, they were managed under tight government control. Every year, they negotiated their lines of business, production targets and export targets with the office of the country's president. The government approved not only the targets but also every import licence and the interest rate and amount of every loan. Korean banks were essentially automatic teller machines owned by the government, managed by the finance ministry, and serving the conglomerates.

They were socialist state enterprises with a difference. The least important difference was that they were privately owned. The most important was that for the most part they competed in the same business lines, creating hyper-competition within the limited Korean market. And the tariffs and other protection arrangements that insulated them from international competition were lowered relatively quickly by third-world standards, so they were gradually forced into global competition. Like the Japanese automobile and consumer electronics companies that had a similar experience, their hyper-competition spilled across the Pacific and engulfed the world. Hyper-competition at home and concessional finance were the secrets of global conquest. Koreans conquered global textile markets, developed one of the world's largest and most efficient steel mills, became a major global force in consumer electronics, and went on to create the world's largest shipbuilding and computer chip-making firms as well as some of the world's biggest construction firms.

…and by national security concerns

Behind this economic drive was a vital political agenda. At the time of independence, the partition of Korea left North Korea with most Korean industry. In the Korean War, the South was hampered by lack of industry and was initially overwhelmed by superior northern weaponry (supplied by the Soviet Union). The first Korean regime (to 1960) tried concentrating its resources on the military but just fell further behind the industrially superior North. The second (1960-61) tried democracy, but democracy in that era was overwhelmed by student demonstrations, labour unrest, communist propaganda, inflation and general instability. Then General Park Chung took over and bet everything on a drive for industrial superiority led by the chaebol. In addition to the discipline of the market, the chaebol had a more immediate discipline. General Park and his country stood at death's door. The North was superior and aggressive, and any southern waste of resources would lead to another Korean war and the enslavement of the people of the South. Hence the government was not interested in having profitable chaebol. It wanted big chaebol, huge conglomerates that would overshadow the North, employ the wretched southern population, raise living standards, and stabilise South Korea. Hence the government set nearly impossible growth targets for the chaebol, funded their plans generously, encouraged them to take great risks, and picked them up when they fell down. Well, it picked them up if they fell down taking approved risks to achieve government goals; if they collapsed from corruption or mismanagement, they were allowed to fail, and some did.

The strategy carried huge risks…

This semi-socialist strategy ran obvious risks. If the government-chaebol team invested massively in the wrong industries at the wrong time, disaster could strike. The availability of funds far in excess of what the market would have provided created an incentive for over-investment, and the government's national security emphasis created a strong bias toward heavy industry. Steel, ships, petrochemicals, autos, all the things connected with industrial prestige and the sinews of war, got funded. The services and unexciting smaller industries didn't, creating an unbalanced economy. Among the industries that was never encouraged to develop was banking. The concentration of over half the economy in five big chaebol, and of almost everything important in 30 chaebol, put the economy at risk if, for some reason, a very small group of management teams faltered.

The nationalism behind Korea's economic drive created another set of risks. South Korea was determined to own its industry, and so it financed the chaebol with bank loans and foreign loans while discouraging foreign direct investment. This created two problems. First, the chaebol carried huge levels of debt, typically around 400% of their equity. Second, Korea was inclined to tightly constrain foreign direct investment and long-term capital flows while it began to liberalise short-term capital flows.

…that came to fruition in 1980

In 1979-80, Korea experienced its first major crisis. Over-investment created massive inflation, overcapacity in key industries created a serious financial squeeze. These factors and discontent over Park Chung Hee's increasingly authoritarian management came together at the same time. An economy that had been growing in excess of 10% pa plunged into a recession that in 1980 cost it nearly 6% of GNP, just as the assassination of President Park (October 1979) created a political vacuum. But the Koreans managed to patch their system back together and restore an economic miracle that persisted for another 15 years. The patient had experienced his first heart attack, but the doctors were able to treat the symptoms and seemingly restore the patient to vigorous health.

Political change was handled smoothly…

South Korea outgrew its political model, which had imposed authoritarianism in return for economic growth and security against the North. It had imposed a ruthless regime on workers in return for job security and steadily rising incomes. Over time, diminishing fear of the North and the rise of an educated, middle-class society led to rejection of this model. In 1988 the shift to democracy gained overwhelming momentum, and by the early 1990s, Korean workers had formed disciplined, aggressive unions that, particularly under Kim Young Sam's regime, got both lifetime job security and wages of about twice what was sustainable by global competitors.

…but the economic transition was botched…

South Korea also outgrew its economic model. Overcapacity became omnipresent; to take just one example, Asia's capacity to produce automobiles became 38% larger than its ability to sell them. In a small market that already had half a dozen auto companies, Samsung decided to create yet another auto producer. Korea's excessive wages made its products increasingly uncompetitive and stimulated a vast shift of production offshore. The combination of over-investment, which ballooned imports, and uncompetitive exports, led to huge current account deficits. The debt of the major chaebol became larger than the foreign debt of most of the world's countries. Korea's ill-treatment of foreign direct investors limited long-term capital inflows but its liberalisation of short-term inflows encouraged an influx of "hot money." The nation's short-term foreign debt became half of its total debt, at a time when national foreign exchange reserves were limited. By 1996, corporate profitability, always weak, had essentially collapsed. The discipline of national security fears and intricate scrutiny of chaebol activities by the president had disappeared. The market discipline that would normally control the excesses of both labour and chaebol management was missing because of the government-dictated largesse of the banks.

In retrospect, all this ensured that a second heart attack would occur and that, when it did, it would be a massive one.

...creating the crisis of 1997

In 1997, the second of South Korea's systemic crises did occur. South Korea experienced a series of major bankruptcies, including seven of the top 30 chaebol. The reaction of bankers and portfolio investors quickly depleted all the country's foreign exchange reserves. The banks' previous largesse to the big chaebol led, via chaebol bankruptcies, to the collapse of the banks.

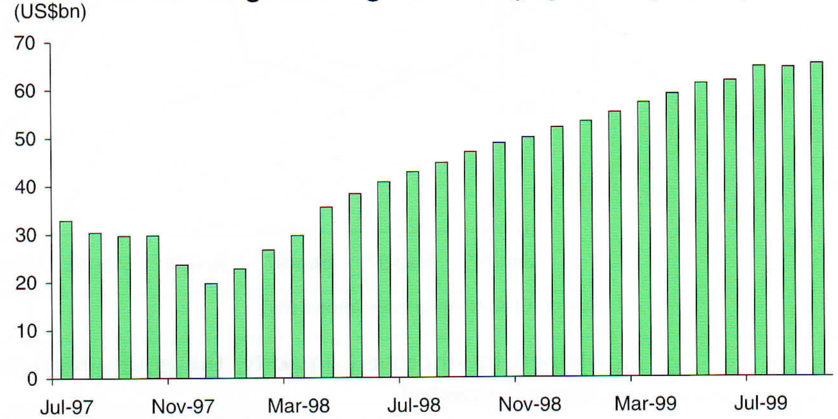
The systemic economic crisis of 1981 had been resolved through a heroic patching job that restored the old system. The systemic political crisis of the late 1980s had been resolved by a far-sighted, courageous change of the system. But the systemic crisis of 1997, no longer remediable through patching, was dealt with by denial. The hapless government of Kim Young Sam refused to acknowledge the scale of the problem, and indeed the foreign exchange crisis was addressed in time to avert catastrophic collapse only because a former government official, Kim Kiwhan, flew to Washington DC on his own account in December 1997 and spread the word that Korea was out of money. Nor was the rest of the world prepared to acknowledge the problem; the Kim Young Sam government's efforts to undertake minor, innocuous and totally inadequate labour law reforms attracted journalists and human-rights activists from all over the world to denounce the reforms themselves, as well as the way they were railroaded through the National Assembly, as an abuse of human rights.

Kim Dae Jung, the Fed, and the IMF stabilised Korea, against the odds

From that low point, the turnaround was dramatic. Kim Dae Jung, elected but not yet sworn in, took charge and committed Korea to a vigorous reform programme. The US Federal Reserve pressured US banks to roll over their loans to Korea (maintaining their total exposure, but with the flexibility to cut lines to one customer so long as new lines were opened to another Korean customer) and persuaded Japanese and European counterparts to do likewise. Only by this measure, a relief not granted to any other country, was total national financial collapse avoided. Korea was saved primarily by the Fed, and only secondarily by the IMF; this Fed help was a key pillar of rapid recovery. IMF officials lauded Korea as the IMF's best pupil. Even more importantly, Kim Dae Jung's strong stance restored the authority of a previously impotent government, a feat all the more impressive because the new president commanded only a minority position in the National Assembly and achieved his ability to govern at the cost of alliance with Kim Jong Pil, an almost lifelong personal opponent who had originally created, and was now supporting, many of the institutions that Kim Dae Jung was determined to transform.

The IMF imposed an austerity programme and a series of reforms that, at the cost of a severe but short recession, cut imports and restored the foreign exchange reserves.

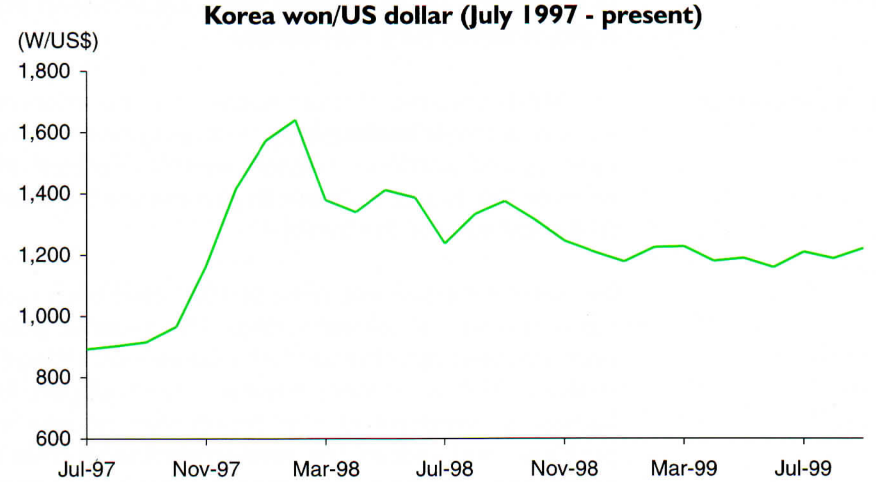
Korea foreign exchange reserves (July 1997 - present)



Source: CEIC, Nomura International (HK)

The currency and bond markets recovered.

Korea won/US dollar (July 1997 - present)



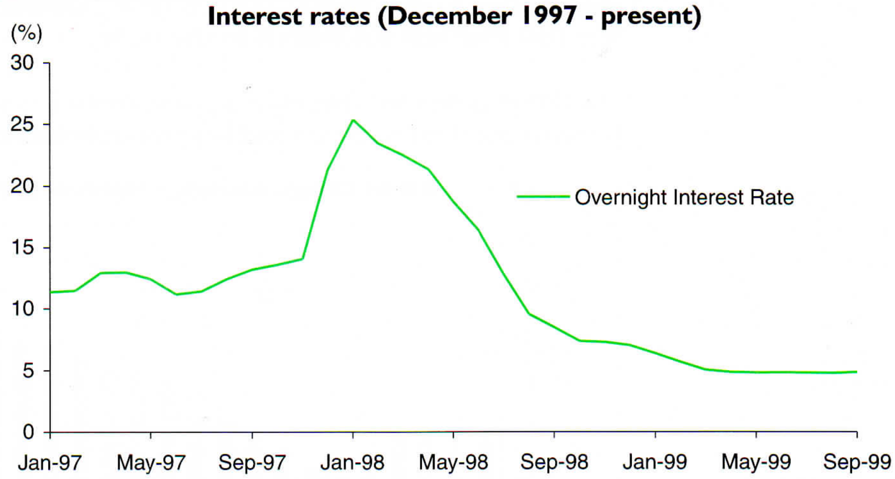
Source: CEIC, Nomura International (HK)

Korea 2008 sovereign, spread over US treasuries

Source: CEIC, Nomura International (HK)

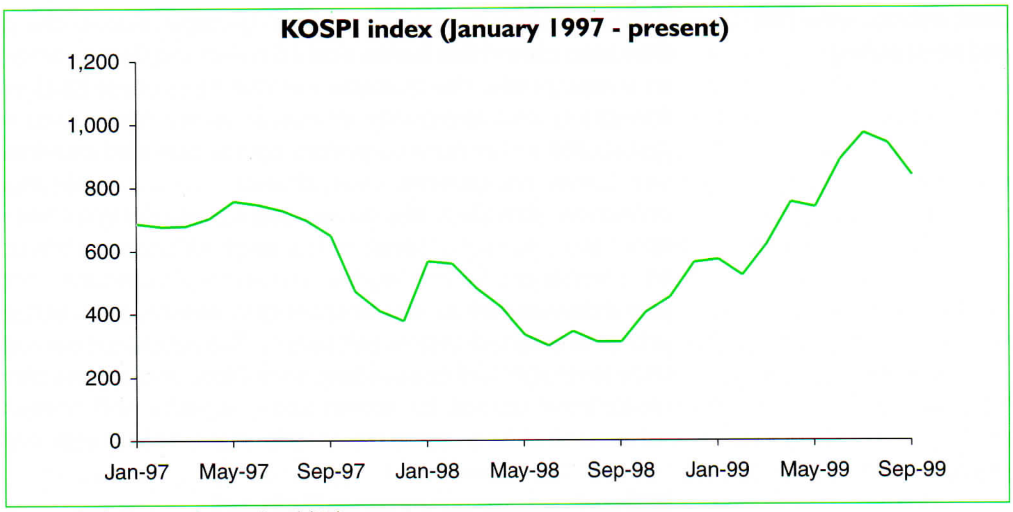
Interest rates came down sharply.

Interest rates (December 1997 - present)



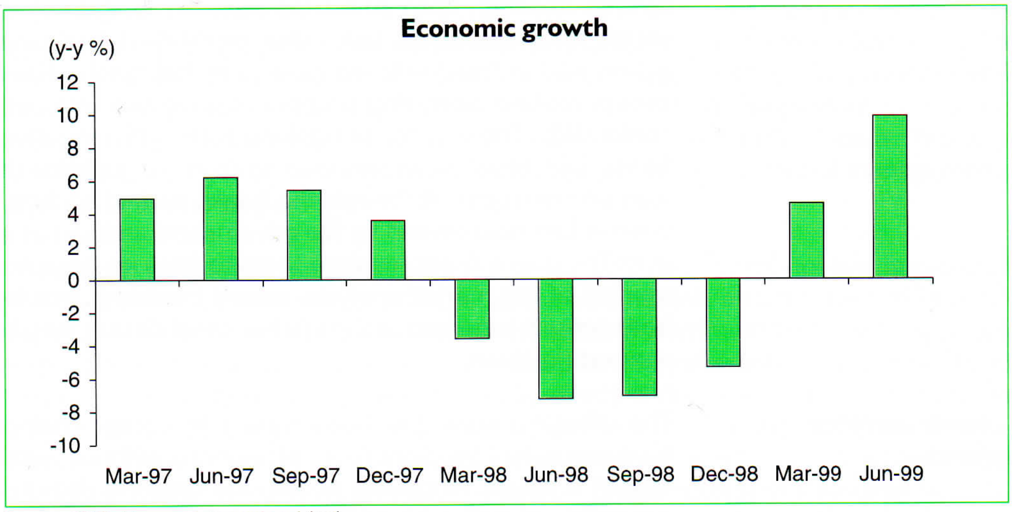
Source: CEIC, Nomura International (HK)

Helped by improved liquidity, the equity market followed the bond and currency markets upward.



Source: CEIC, Nomura International (HK)

Subsequently, economic growth recovered, reaching a frenetic 10% pa pace after mid-1999.



Source: CEIC, Nomura International (HK)

Eventually, even unemployment began to decline from peaks of nearly 9% to around 5% currently.

Source: CEIC, Nomura International (HK)

Bank reforms were fast and far-reaching

Korea's reform programmes were stronger than those of other Asian countries. Kim Dae Jung closed five banks and 16 merchant banks. After providing them with W5.5tn of public funds, the government put Korea First Bank and Seoul Bank up for sale to foreigners and eventually managed to sell Korea First to Newbridge Capital. It also put six life insurance companies up for sale and provided W1.5tn of capital to Korea Life. Banks' management was changed rapidly, while Japan and Thailand, with similar problems, dawdled. The government pumped W43.5tn into banks by March 1999 in order to recapitalise them. In the corporate sector, the government demanded a shift to internationally intelligible accounting standards and to consolidated accounts, and it demanded an end to cross-guarantees, by which strong members of a business group subsidised their weak sisters. The president demanded that the chaebol reduce their leverage and consolidate their lines of business. And the government pressured recalcitrant unions to accept some lay-offs and benefit reductions. All these were reforms that had appeared utterly impossible a year earlier.

What was accomplished

In addition to banks...

At the end of this period of implementing formerly impossible reforms, the worst banks and merchant banks had been put to sleep and the remaining banks had been roughly half recapitalised. (The remaining half of the process had been delayed by wishful thinking, both about the numbers and about the willingness of the private sector to complete the task.) One lonely bank had been sold to foreigners. Several others had entered into alliances with foreigners. The remaining banks were, as a group, making operating profits but were still very early in the process of learning credit skills. The essence of banking is the efficient allocation of capital, and Korean banks had never been required to learn or practise that process; it could not be learned overnight. Although the banks wished to function as modern banks, they were in fact now owned by the government and just as much in thrall to its wishes as ever. The government required them to prop up large numbers of illiquid (and, in the opinion of key market analysts, mostly insolvent) smaller companies. The banks also had so much exposure to the top five chaebol that they had no choice but to continue supporting them.

...labour accepted reforms...

The labour unions had been forced to accept that companies facing imminent bankruptcy had the right to lay off workers without waiting two years. But the unions fought a tough rearguard action. Kia workers demonstrated violently against the possibility of a foreign company buying in, and unions at insolvent banks tried to sabotage computers. On several occasions, unions threatened general strikes. But the public would not support the unions and Kim Dae Jung gradually wore them down, using a tripartite labour-government-corporate committee and a brilliant series of political compromises. The result was a dramatic increase in labour mobility, from nearly zero, but it left Korea with a relatively rigid labour force. At Hyundai Motors, a crucial turning point, the company was allowed to lay off workers although it was not facing imminent bankruptcy, but under government pressure it laid off far fewer employees than management believed necessary. Although companies were finding many ways to reduce wage costs and to lay off employees, and although the law confining lay-offs to companies facing imminent financial difficulties could be interpreted quite broadly, lay-offs remained difficult and buying workers out of their jobs remained expensive. So progress was impressive, but Korean labour remained far more rigid than, for instance, French labour.

...a social safety net was expanded...

To help the labour negotiations, the government-sponsored national insurance fund was expanded to cover about three-quarters of all workers, as opposed to one-quarter before the crisis. Any company with more than five employees had to participate.

...and smaller chaebol restructured

While the ranks of the big 30 chaebol were depleted, the Korean economy remained totally dominated by the big five — Samsung, Daewoo, Hyundai, LG, and SK. In fact, for most of the first 18 months of reform, foreign banks refused loans to most Korean companies outside the privileged top five, so their role in the economy expanded.

Under pressure to get their leverage down, each expanded its equity base by having members of its own group buy equity from each other, then acquired massive amounts of additional debt, in the process driving others out of the market and defeating this aspect of the president's reform in the eyes of anyone other than an accountant with blinkers. Similarly, the government pressed the chaebol into "big deals" that were consolidated by forcing pairs of them to swap business lines, but the big deals were few and worked badly. Daewoo was openly defiant in opposing any serious reduction of its scope of business, and Hyundai was more quietly truculent.

Reforms made Korea even more socialist

In the process of recapitalising the banks and using them to rescue a wide range of companies, a government ideologically devoted to the virtues of the market found itself in the uncomfortable position of having converted a relatively socialist economy, where the government controlled the banks and used them to exert leverage over the chaebol, to a substantially more socialist economy, in which the government owned most of the banking system and issued detailed instructions to the chaebol.

Transparency improved

The government did make progress in forcing Korean companies to become more transparent in their accounting and to shed some aspects of the pyramid financial structure on which the chaebol were built. It set end-1999 deadlines for the chaebol to produce internationally intelligible and consolidated accounts. According to bankers in Seoul, LG, SK, Samsung, POSCO and KEPCO are already providing internationally acceptable accounts, while Daewoo and Hyundai have lagged these leaders; such transformations in advance of the deadlines cover about half of the economy and indicate a major policy success. The government also forced the chaebol to stop the practice of having member companies cross-guarantee each others' loans. This was just the beginning of forcing the chaebol into more sustainable financial management, but it was a solid beginning.

Despite strong leadership, government was divided

The reform was slower and more partial than it might have been, not just because of the opposition of the chaebol and the labour unions, but also because of internal divisions within the Korean government. The entire government had been organised and staffed to serve the old system, whereby powerful ministries used the banks to reward and punish the chaebol and thereby directed the economy in semi-socialist detail. Most of the opposition was opposed to fundamental reform of this system, and Kim Dae Jung's coalition partner Kim Jong Pil was a founder and defender of the old system. Within the government, opposition to the president's programme was led by the bureaucrats of the powerful Ministry of Finance — as in Japan.

Reform was vigorous but partial

So the first phase of reform accomplished much. The speedy return to creditworthiness underlined the solid fundamental position of Korea's government finances and the value of Korea's accumulated technology and other assets. The speedy return to economic growth underlined the competitiveness of much of Korean industry and the value of having (in contrast to Thailand and Indonesia) a highly-educated work force. But the first phase of reform left even more to be accomplished. As the summer of 1999 dawned, there remained a powerful coalition of chaebol managers, labour leaders, opposition politicians, coalition allies and government ministries who believed that an eye to the requirements of the April 2000 National Assembly election would lead Kim Dae Jung to back off from his ambitious reform programme.

The Daewoo crisis: *déjà vu*

Thus it was that in the summer of 1999 the process seemed to begin all over again — although this time the foreign exchange/currency crisis was absent. This time, instead of a crisis brought on by the collapse of the smaller chaebol, it was precipitated by the second largest chaebol, Daewoo.

The great game

Reform opponents remained strong

Labour unions kept hoping the president could be forced to back off. Some of the chaebol were betting that Kim Dae Jung would weaken, that when the honeymoon year of 1998 was over and when the sense of crisis had dissipated he would become more pliable. In particular, they were betting that by the summer of 1999 he would have to focus on the politics of winning the April 2000 general election and would have to give them whatever they needed. As in the senior echelons of government, key chaebol leaders were convinced that the old system was best and that changing it would be a sell-out. Daewoo in particular was committed not to reduce its number of business lines, not to fire any workers, not to pull back its programme of overseas investments, and as in the past, to invest its way through the crisis and come roaring out the other side. Daewoo was reassured by the fact that its head, Kim Woochong, as head of the Federation of Korean Industries, had special access to the president, and that a former Daewoo executive held the key post of head of the Financial Supervisory Commission (FSC). Like Daewoo, but with less public flair, Hyundai held back from many of the reforms the president was demanding, while SK, LG and Samsung moved more quickly to pare their debt ratios and their organisation charts.

Kim Dae Jung forced labour to back down...

In the event, despite rising political pressures, Kim Dae Jung stuck to his reform programme. In April 1999, subway workers struck in what turned out to be the turning-point confrontation between labour and the government. Kim Dae Jung warned that if they didn't return to work they would lose their jobs, and they returned. Workers sought a student-labour alliance at Seoul National University. The president told the police to contain them but not hurt them, and eventually, lacking middle-class support, they backed down. Parallel actions were called off, and there have been no serious strikes since. While the decline of unemployment from its peak around the time of the subway strike has certainly contributed to the relative labour calm since then, the fundamental lesson of the failed student-labour alliance was that Korea is now a solidly middle-class society, and when the middle class believes reform is necessary and refuses to support them, radical labour and student activists cannot win. This does not mean that public sentiment could not change in the future. And it does not mean that foreign institutions can easily lay off staff; in general they still have to arrange lay-offs by paying large sums to provide "early retirement" to whole categories of workers, or give long-tenure workers two to three months' minimum pay for each year they have been employed by the firm.

...then addressed the Finance Ministry...

In the summer of 1999, Kim Dae Jung appointed a new finance minister who had a strong commitment to reform, thereby demonstrating that, even in the face of political difficulties, the president would not allow the government bureaucracies to block his reforms.

...and the most defiant chaebol crumbled

The government continued to pressure the chaebol to reform. The chaebol were instructed to bring their debt-to-equity ratios down to 200%. In August 1998, controls were put on commercial paper issuance to avoid circumvention of loan limits. Banks were prohibited from having more than 10% of their assets concentrated in a single chaebol. In October 1998, similar regulations were issued for bonds. The noose kept tightening. The president criticised Daewoo and Hyundai by name and forced them to come up with more detailed restructuring plans. They produced plans that on the surface complied, but were laughably unrealistic in the amounts of money that were to be raised and the speed with which they would shed subsidiaries. Ominously, Daewoo's Kim Woochong was deprived of the right to meet the president alone.

Daewoo became isolated

Daewoo became the only major chaebol unable to conduct rights issues in the stock market; investors were too nervous. The remaining option was asset sales, but Daewoo was determined not to narrow its range of business, and anyway Daewoo subsidiaries were at the lower end of the market, whereas Hyundai's were mostly at the upper end. On July 19, 1999, Daewoo had to declare that it was unable to pay debts coming due. Nonetheless, despite its difficulties, it went ahead with such investments as a US$100m auto project in India.

Daewoo tripled Korea's restructuring problem

Before Daewoo, there were 80 substantial companies in financial workouts totalling W30tn of debt. Daewoo declared that it had W60tn of debt. At the end of October it became clear that the actual debt was far more. Not only were the accounts not transparent, but significant financial chicanery may have occurred. For instance, according to research by Woodworth Holdings, Daewoo had lent vehicles to prospective customers for free trials of two to four weeks, but asked each to sign an IOU while they had the vehicles. Daewoo allegedly then took the IOUs to the banks for funding, as if the vehicles had been sold. Daewoo's debt was over twice the GDP of Vietnam and over four times the record European bankruptcy of the Chunnel. Suddenly the orderly process of ameliorating the financial crunch became disorderly, with the banks and ITCs potentially in serious trouble and individuals desperate to secure their money.

Ramifications of the Daewoo collapse

Daewoo's financial squeeze immediately imperilled its creditors, its suppliers, the liquidity of the bond market, and the supply of credit to Korea generally. The government arranged a rollover of Daewoo's debts, additional credit lines from Korean banks in return for additional collateral, and a takeover of control of the majority of Daewoo units by creditors. This maintained employment and production, and prevented a financial domino effect. When suppliers balked at continuing to provide supplies to Daewoo, the government arranged advance payments to suppliers. Daewoo promised to sell off key units by December in order to reduce its debts; most market participants believe a two- to three-year process is more likely than the agreed three to four months.

The investment trust companies (ITCs)

ITCs, already insolvent, nearly became illiquid

The Daewoo insolvency created a crisis for Korea's ITCs, finance companies that are both a crucial source of funds for Korean companies and the most important force in Korea's stock and bond markets. Daewoo bonds are believed to constitute some W20-30tn of the original total W250tn assets (including W189tn of bonds) of the ITCs. This burden threatened to render illiquid a sector that was already insolvent. In 1989 the Korean government had forced the ITCs to invest heavily in a declining stock market in order to prop it up. As a group they have never recovered from the losses incurred at that time and hence have negative capital, but by not realising the losses year after year they have stayed in business. Moreover, the ITCs had typically not maintained the integrity of their funds; they promised investors in a given fund a certain return, and if that fund didn't produce the needed revenue the managers just took the money from a different fund. The government did not enforce rules that would have ensured the integrity of funds. The Daewoo insolvency jeopardised the ITCs' ability to continue these shell games.

The Daewoo crisis prompted a run on the ITCs. Some W50tn were quickly withdrawn. To stem the run, in August the FSC forbade institutions to cash any Daewoo bonds and declared that individuals could only cash in their Daewoo bonds, or their funds that included Daewoo bonds, to the extent of 50% of the value. After 10 November, 1999, they will be able to cash 80% and after February 2000, 95% of the book value. Institutions remain forbidden to cash in any Daewoo bonds.

Liquidity in the bond market promptly dried up. Institutions that had guaranteed the bonds held by the ITCs refused to honour the guarantees. Seoul Guarantee Insurance

Company had guaranteed W130tn of bonds, including W15tn of Daewoo bonds, but had only W2tn of liquidity. So on 20 September, 1999, the government announced a bond market stabilisation programme whereby the banks would be required to put up W20tn to buy bonds and reduce market interest rates. Each bank was told by the government how much it should contribute. Since the government holds a controlling share of the banks, in addition to a Japanese-style ability to regulate them in detail, the banks have to comply. This programme is exactly the kind of financial manipulation that created the problems of the ITCs and the banks in the first place. Korean scholars note that the FSC, which decreed this programme, is led by an ex-Daewoo official of the old school and staffed primarily by anti-reform officials from the Finance Ministry.

The debt burden was shifted politically

This series of decisions needs to be understood partly in political terms. The government could minimise the financial costs of Daewoo's insolvency by bailing out Daewoo directly and then restructuring it, but the breakup of Daewoo is seen as economically and socially desirable and having the market be the primary driver of the restructuring is also desirable. The government does not want individuals to be hurt — bad for votes — so it provides a gradual escape hatch for them prior to the election, while prohibiting institutions from liquidating their ITC investments. Bailing out the ITCs directly is politically unpalatable, but the ITCs are insolvent in large part because of government pressures, and they are the key to both the health of the securities markets and the future funding of Korea's most important companies. Hence it is convenient to shift the problem to the banks; everyone acknowledges that the banks must ultimately be bailed out, so the problem becomes politically manageable when it is a banking problem.

The shift could damage the banks

The government believes that interest rates will decline and that the banks will ultimately make a profit on the W20tn of bonds they are in the process of acquiring. Market participants lean heavily to belief that interest rates are likely to rise and that the banks therefore may take a bath on the bonds.

The government had hoped to delay the restructuring of the ITCs until July 2000, after the April 2000 elections. However, the temporarily impeded runs on the ITCs are forcing the government to move up its timetable and to acknowledge that the ITCs will require the same kind of restructuring that the banks experienced in 1998. The process of saving the ITCs will involve flooding them with government-provided liquidity, but over the longer term will be a drain on the supply of funds and put upward pressure on interest rates. The sequencing of this process will probably be the single most important key to the behaviour of the Korean securities markets in 2000, and that sequencing is likely to be heavily influenced by the politics of the April 2000 election.

Of the three biggest trust companies, two are owned by banks, therefore by the government, so the government can manage their problems itself. The third, part of Hyundai, is being left on its own. Hyundai says the government is demanding that Hyundai guarantee its ITC, but that the government has no right to do so. While this argument was going on, the government charged the head of Hyundai Securities, who oversees the ITC, with manipulating the market in certain shares.

The foreign banks

Foreign banks are confronting the government

The foreign banks have taken significant losses from Korean merchant banks and from leasing companies. They feel ill-treated over Daewoo. They are excluded from the meetings to decide policy, they were not provided with a share of the additional collateral put up by Daewoo, and they were ordered in a cavalier fashion to roll over their loans. The government has since ameliorated some of these problems but the foreign banks still have not been allowed access to policy-setting meetings, ostensibly because their 10% share of Daewoo's total debt is insufficient to justify a place at the policy table. Such a stance is unusual in emerging countries and unacceptable to the foreign banks. On 25 October, local creditors agreed to share with foreign banks 10% of the additional collateral they had received for rolling over Daewoo's loans, thereby resolving one of the outstanding foreign-local disputes. But now the foreign banks are demanding much more.

The foreign banks argue that they supported the big five chaebol out of a belief in Korea Incorporated, that is, out of a feeling that the government would never allow a big-five chaebol to go under. The Korean government had provided no such assurances, and indeed had been distancing itself from implicit guarantees of chaebol debt for nearly two decades. But foreign lenders have always received superior treatment in Korea because the Korean government knew it needed the foreign banks. Even in the case of the huge Kia bankruptcy in 1998, most foreign lenders were allowed to get out and local institutions then had to take the losses. With Daewoo, Korea Inc. suddenly ceased to function. (This paralleled the GITIC bankruptcy in China, where the government suddenly decided it had to put an end to the moral hazard that was attracting billions of dollars of foreign money to Chinese companies that were using it for highly speculative purposes in so many cases that the financial stability of the whole country would eventually be threatened.)

The foreign bankers also argue that the handling of Daewoo has been so politicised that the outcome is simply not a market outcome and therefore they should be guaranteed some minimum payout, say 80%, of their exposure to Daewoo. For instance, Daewoo pays the foreign banks with promissory notes that are normally presented to local banks. As part of the local banks' workout of their Daewoo exposure, they are prohibited by the government from processing such notes.

The government can't give foreign banks too much…

The Korean government, on the other hand, could not politically survive giving the foreign banks too much special treatment, given the huge sums and publicity surrounding Daewoo. It had not provided any written or oral assurances that foreign banks would be bailed out in the event of a big-five chaebol problem, and it is unsympathetic to banks that deliberately lent to an institution which was known to be financially shaky. Letting the foreign banks succeed in their demand for guarantees on the Daewoo payout would continue the "moral hazard" that had been a substantial contributor to the Korean financial crisis in the first place. For this reason, and because the perception of IMF money making it possible for the Korean government to bail out a big competitor of US companies would create a huge political problem in Washington, the US government is supportive of the Korean government's refusal to guarantee Daewoo's foreign debt. And, crucially, Korea for the first time in its modern history can do without the largesse of the foreign banks for an extended period of time if it needs to do so. Government domestic debt is only 20% of GDP and, as noted earlier, Korea now has huge foreign exchange reserves. The government's commitments in connection with debt problems are estimated to be another 20% of GDP. The fiscal deficit projected for 2000 is 5% of GDP. Although the total obligations are growing uncomfortably fast, the government can continue on its current crisis-management course for years before its financial position becomes untenable.

…and doesn't need to

This is the crucial financial calculation behind the whole government policy toward Daewoo. Decades of sound domestic financial management have left Korean finances in a position to absorb the financial shock of Daewoo without risking a domino-like collapse of the rest of the economy. And the IMF's stringent prescriptions in 1998, frequently denounced as excessive, have left Korea with the foreign exchange reserves to weather a period of considerable alienation from the foreign banks.

Unhappy with the new rules of the game, the foreign banks have been gradually reducing their support of other Korean companies to express their frustration over the handling of the Daewoo debts and to reduce their exposure in case another big-five company gets into trouble. Foreign banking leaders indicate that the European banks are reducing their exposure, virtually all the Japanese commercial banks are downgrading their offices from branches to representative offices, and the Americans are keeping exposures flat — with customers whose growth has traditionally required rapidly rising loanbooks. According to interviews with foreign bankers, Hyundai has been the big company most affected, but it appears able to weather the storm.

The foreign banks will come back

As in China after the GITIC collapse, the foreign banks are likely to limit loans to Korea for several years, but under competitive pressure will undoubtedly return to take up any creditworthy opportunities after a historically short period of disaffection. Local offices of foreign banks tend to react extremely strongly to situations like GITIC and Daewoo (which has been handled much more honourably than GITIC), and head-office credit departments initially overreact to losses, but in the end the head-office business managers respect governments that do what they have to do in order to eliminate a moral hazard and clean up a mess.

Foreign direct investors

Quick sale of Daewoo companies to foreigners is critical — but hampered by nationalism

The key to resolution of the Daewoo problem is the strategy of quick sale of all but five of the 26 Daewoo group companies to outsiders, including foreigners. This is also critical to the resolution of many other smaller problems and to broad recapitalisation of Korean industry. But Korea has traditionally had very strong nationalistic attitudes toward foreign ownership of companies. Aside from Burma, Vietnam, Laos and Cambodia, South Korea has traditionally treated foreign direct investors worse than any other Asian country. Among those who run regional operations for multinational headquarters, China for instance is regarded as much more foreign-investor-friendly than South Korea. The foreign investor has in many cases been treated as a necessary but temporary evil, whose funding was to be used and whose technology was to be acquired, after which the foreigner was encouraged to depart. Many of these attitudes have persisted. Kia Motors workers demonstrated violently against the prospect of foreign acquisition of a large share of Kia. The government held an auction at which Ford was believed to be the high bidder, but then Kia was nonetheless awarded to Hyundai. As a result of such experiences, foreign investors have far less interest in acquiring Korean companies as going concerns. Negotiations will be longer, prices will be lower, and foreigners will be more interested in acquiring specific assets from Korean companies rather than in acquiring whole companies. This is the reverse of the situation in most of the rest of Asia, and will hinder Korea's efforts to sell Daewoo Motors and other companies quickly and for good prices.

Pursuit of the other chaebol

Hyundai is a target...

Following the collapse of Daewoo, the government went after the other chaebol. Foremost among its targets was Hyundai, which like Daewoo had lagged in getting its debt ratio down and in consolidating its range of business lines. Hitherto Hyundai had appeared to be in a favoured position. It was believed to have contributed heavily to Kim Dae Jung's political machine before the presidential election. It has been the principal vehicle of Kim Dae Jung's "Sunshine Policy" toward North Korea, organising tours in the North, donating a herd of cattle (twice), sending its basketball team and building a basketball hall, and targeting as much as US$900m for expenditure on the North. Hyundai is judged by analysts to be in much better shape than Daewoo, because it is a leader in key sectors, with the country's most successful automobile company, the world's largest semiconductor plant, highly regarded construction and shipbuilding units, and others. Moreover, the Hyundai group has already been divided among the sons of the founder and therefore is not attempting to persist as a unified group in the manner of Daewoo. And it had attempted to downsize, for instance trying to lay off workers at Hyundai Motor.

...despite its help to the government

Ironically, some of Hyundai's financial problems result from compliance with government requests. It took over the bankrupt Kia Motors. It sharply decreased the planned lay-offs at Hyundai Motors in order to placate a president fearful of the political ramifications. But none of this prevented the government from prosecuting the head of Hyundai's investment trust arm for allegedly manipulating the prices of certain shares. And then the government decreed that banks will have to reserve 30% against loans to any big company that has a debt-to-equity ratio over 200% after the beginning of next year. Since the other big chaebol (Samsung, LG, SK) have already met the 200% ceiling, and since Hyundai remains at well over 300%, this rule was an arrow aimed directly at the heart of Hyundai.

Although Hyundai is clearly a target, and although foreign banks may have been particularly hard on the group, analysts see little risk that Hyundai will collapse like Daewoo. Unlike Daewoo, Hyundai is highly profitable. Unlike Daewoo, Hyundai's assets are top of the market and easy to sell. Hyundai Motors is the best car firm in Korea, and both it and Kia are profitable. Hyundai Electronics is the world's largest producer of semiconductors. Although Hyundai has been adding equity by selling it to other pieces of Hyundai, that equity is highly marketable.

So is Samsung

Samsung also became a target. The editor of *Joong Ang Ilbo*, the Samsung-affiliated newspaper, was prosecuted for tax evasion, a charge that chilled the entire chaebol-owning class because it is believed that most of the principal owners and their families would be extremely vulnerable to such charges. Scholars and others interviewed about this noted that Samsung contributed to the wrong side in the past election and that *Joong Ang Ilbo* opposed Kim Dae Jung. The government also pressured Samsung Electric, the most profitable and highly regarded unit of the group, to provide guarantees for the debts of the insolvent Samsung Motors even though the entities are legally separate and have no cross-guarantees. There is a political argument for this, because Samsung Motors is headquartered in politically sensitive Pusan, Kim Young Sam's territory, and there is a moral logic, since the government had provided the Samsung group with generous financing, but the shareholders of Samsung Electric — a majority of whom are foreign — were not impressed with such logic.

More transparency and governance reforms

The government has put further pressure on the chaebol to become more transparent and publicly responsible by insisting that 50% of their directors must be outsiders. The companies protest that directors should reflect shareholdings, and they are adept at choosing friendly directors, but analysts believe that the mere presence of numerous outside directors nonetheless makes it much more difficult to conduct private, dubious financial transactions.

The chaebol are gradually fragmenting

The government does not have the legal tools to forcibly dismember the chaebol, but they are already being divided. Daewoo is being broken up by creditors. Hyundai is being distributed among the sons of the founder. Samsung has already spun off several units, including the *Joong Ang Ilbo* newspaper.

Now the government is systematically auditing units of each of the remaining big-four chaebol, looking for infringements that it knows it will find — and that everyone else in the market knows it will find. The rules of the game as practised have long differed from the rules of the game defined in the law books, and that difference gives the government enormous ability to harass the chaebol, change their behaviour, and start changing their structure at the margin.

Eventually, according to leading scholars and officials, a Korean government will introduce inheritance tax measures and inheritance tax enforcement that will gradually break up the highly concentrated family holdings, but it is considered politically premature to display such instruments on the operating table.

Meanwhile, the smaller chaebol are already being restructured by the market — a process that should be substantially increasing the efficiency with which Korean financial and human resources are deployed.

Bank reform

Banks are making limited progress in becoming real banks, but they are making some progress. There has been a great deal of downsizing, and employment by banks has declined by roughly one-quarter. The purchase of Korea First Bank by Newbridge Capital should introduce modern banking structures and practices to Korea for the first time. Other banks have formed limited foreign alliances, with Commerzbank, Goldman Sachs and ING Barings. Local rating agencies are becoming more professional. But attempts by Korean banks to hire foreign credit specialists have mostly failed. Financially strong institutions still usually pay the same interest rates as weak credits — or get only an advantage of perhaps 20 basis points (bp). Excess liquidity and weak analytic skills squeeze spreads down.

The government wants real banks…

In principle the government wants to end the old system whereby the banks simply served as ATMs for the government, but the banks feel comfortable taking orders from the bureaucrats, the government owns all the banks, and the government finds it convenient to instruct the banks forcefully — for instance, to order them to keep many SMEs afloat so as to minimise unemployment, to invest W20tn in bonds to be bought from the ITCs, and so forth. The government is so accustomed to banks being compliant that it was apparently quite surprised when the foreign banks, ordered to roll over their loans to Daewoo, refused to consent to the order.

...but they remain socialist…

Similarly, the government wants the banks to apply independent credit judgment and to spread the credit around, but what the banks know how to do is to lend to the big chaebol, and anyway the big chaebol are so indebted to the banks that the banks are forced to lend to them — within limits set by the government. This relationship is changing at the margin, but the changes have not yet fundamentally altered the way Korean banking is done.

The Korean system for regulating banks remains intricate. There are three layers of regulation — the Bank of Korea, the Ministry of Finance, and the FSC, heavily duplicating each other's authority. For instance, banks must report every foreign exchange transaction to all three, in different formats. For every letter of credit, they must provide 17 different pieces of information. As in Japan, this smothering regulation gives the authorities thorough control of what banks do.

…and weak

The banks, which were almost all in serious trouble in early 1998, now display capital adequacy ratios of 8-15% and many show operating profits. The big five commercial banks expect to complete their recapitalisation by the end of 1999. The banks enjoy high margins. Non-performing loans are only 17% of total loans, compared with 47% in Thailand, and 10% out of the 17% are paying interest. On the other hand, they carry Daewoo loans as performing assets and merely reserve 20% against them — a strange combination. Similarly, many other troubled companies apparently are being carried as performing loans.

Banks have a long journey ahead

So the Korean banking system remains socialist in ownership, in authority over basic banking policy and most of the largest banking decisions, and it remains in an intermediate phase of recovery. Compared with Japan over the past decade, Korean banking reform is moving at lightning speed. Compared with Thailand, Korea has been much more decisive in closing banks and changing banks' management, and its banks have nothing like Thailand's burden of non-performing loans, but it is still catching up with Thailand in terms of having real banks that have credit skills and make real credit decisions. The speed of change in Korea impresses, but the journey ahead is a long one.

Political sustainability

Kim Dae Jung's popularity has waned

The strength of Korea's reforms has depended very much on the personal commitment and political strength of Kim Dae Jung. During 1999 his popularity has declined from the 60-65% level to the 35-40% level. The labour unions have remained most consistently supportive, but they are disappointed that their erstwhile leader has twisted their arms to allow so many lay-offs, so much unemployment, and so many changes in their privileges. The chaebol understood, rightly, that Kim Dae Jung was their enemy in principle. The president's "Sunshine Policy" toward North Korea, having met only intransigence and threats from North Korea, has been losing credibility, and there is widespread fear that, by allowing the US to talk directly to North Korea, Kim Dae Jung has turned his proud country into an impotent bystander. There is widespread anger over a scandal in which a senior prosecutor's wife was found to have been given gifts amounting to more than a worker's annual salary, and the president was slow to act; this anger has been surprisingly strong although there is not even a hint of personal impropriety on the part of the president.

In addition, the president's imperious manner and the continuing hierarchy of Korean society have disappointed those democratic-minded people who may have had exaggerated expectations as to how quickly society could be changed. There are widespread complaints that in relations with his own party and with the National Assembly he simply doesn't recognise the constitutional division of power and doesn't consult those who elsewhere would be consulted. Everything comes from the top.

Ideological and policy contradictions confuse

Many intellectuals and businessmen are also troubled by the seeming contradictions of Kim Dae Jung's approach to economic management. He is intellectually committed to the market, but is actually running an economy that is very hierarchical and socialist. The president commands the chaebol to reform drastically but presses them not to lay people off. He tried to bring interest rates down by fiat in 1998. He has forced the banks to prop up a wide range of illiquid and insolvent SMEs. He pressured Daewoo's Kim Woochong into spending his personal fortune to prop up his company. Although he has demanded an end to cross-guarantees by chaebol companies, he has pressured Samsung Electric to pay some of the debts of the failed Samsung Motors. He is insisting that the principal chaebol appoint 50% outside directors. All these moves have a political and moral logic, but not the logic of a modern market economy.

Korean politics remains regional

Perhaps more fundamentally, Kim Dae Jung's government still commands a political base that is heavily a regional party based in his home area of south-western Korea, while the traditional political powerhouses of the country are centred in the south-east and south-central regions. He is perceived as having favoured officials from his home region rather than having built a truly national party or administration. (The same is true of every other political party, but the south-east is still a limited political base.) While the president has made an effort to diversify the senior positions that he personally appoints, lower down there has been what one authoritative individual called "a very vulgar direction of patronage to the Kwangju area". (Kwangju is Kim Dae Jung's home city.)

Kim Dae Jung has responded to his declining popularity on two levels: policy and political structure. On policy, the public opinion polls show that the public hates the chaebol and hates corruption, so he has attacked the chaebol and founded an anti-corruption commission.

An instant new political party?

On the structural level, the president has vowed to create a new political party that would both merge his existing party and his existing coalition partner under Kim Jong Pil, and bring in new blood to replace the tired old politicians who have in many cases been around for decades. He is also trying to change the election system away from single-member districts — because they often elect independents who are quickly co-opted by a government that can offer both strong incentives and the chilling threat of tax investigations. While the objectives are understandable, and in the case of the new blood, laudable, he risks pursuing contradictory objectives. He could lose his existing base of old politicians before consolidating a new base with new blood.

His coalition partner with whom he wants to merge, Kim Jong Pil, is in some ways the oldest politician of them all, running a party that is the ultimate collection of old politicians. The price of a real merger with Kim Jong Pil's party would probably be a major position for Kim Jong Pil and the resulting loss of the president's reformist image. Finally, the idea of a new party is very much a top-down idea without evident support percolating up from below.

The president is at risk

The bottom line is that Kim Dae Jung is at risk. He needs to keep the economy flying high, and he needs to create a successful new party structure in a remarkably short period of time.

What if the opposition wins?

The opposition would slow reform…

If the opposition wins, the basic tenets of reform would remain, but the tempo and determination would be different. The opposition lacks an ideological commitment to a modern market economy, and indeed the leader of the opposition has refused advice to emphasise that theme to foreigners. Kim Dae Jung is virtually alone as a top political leader in the strength of his view that a chaebol-dominated, state-managed economy is not only bad for growth but also bad for democracy.

There would also be a difference of emphasis. The current government is particularly sensitive to the demands of workers, farmers, and underdogs in general. Such groups are more likely to demand social spending, less likely to be concerned about taxes. The opposition is much more based on the middle class.

…and favour different interests

The opposition is also much more inclined to serve entrenched interests and go slow on opening the economy. Its leader didn't like opening Korea's goods market and capital markets so quickly, and he objects to foreigners being allowed to buy Korean assets at low prices. (Foreigners have not in fact bought much in Korea at low prices, and the criticism from foreigners is that Korean price demands have been unreasonable and that, as a result, only a limited number of deals have been done.)

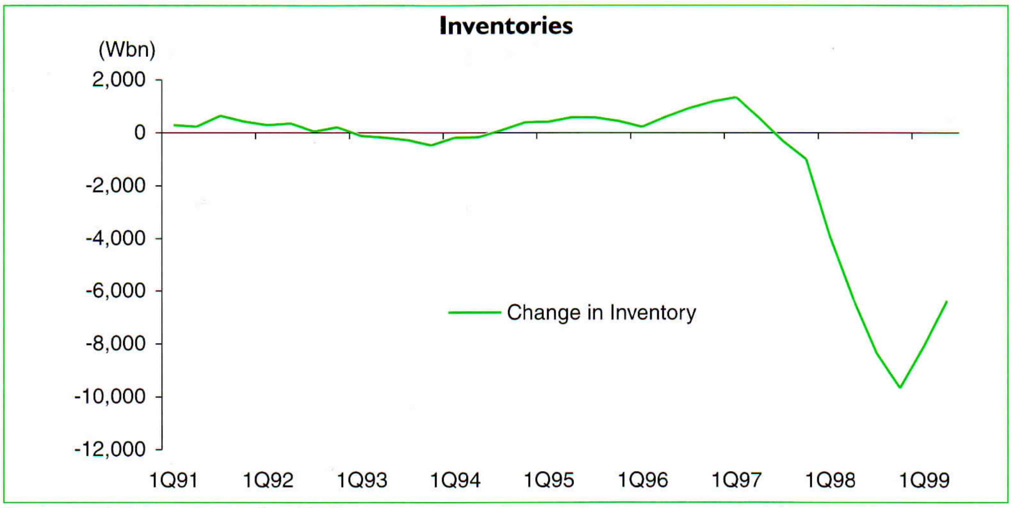
With an enemy like this, who needs friends?

Ultimately, Kim Dae Jung's strongest asset is the opposition, which has no ideology and no clear economic programme. The main idea of this opposition has been to oppose, and that offers little inspiration. But with the sense of economic crisis past, the election could hinge on regional divisions and that might well favour the opposition.

Economic prospects: short term

The Korean consumer has recovered...

The Korean recovery appears broad and sustainable. Many sectors are doing well, with semiconductors and cars standing out. Consumer spending may go up or down, but the Korean consumer has recovered. Consumer confidence is high, and the consumer balance sheet is in good shape. While widespread excess capacity persists and will keep facility investment from booming, inventories are low and companies will have to begin to invest in certain areas. The Asian and OECD markets are recovering, China could bounce back in a big way in the latter part of next year, and these developments should more than offset potential weakness in the US economy. The yen should stay relatively strong well into 2000, and the prospects for a relatively weak won should enhance Korean competitiveness.



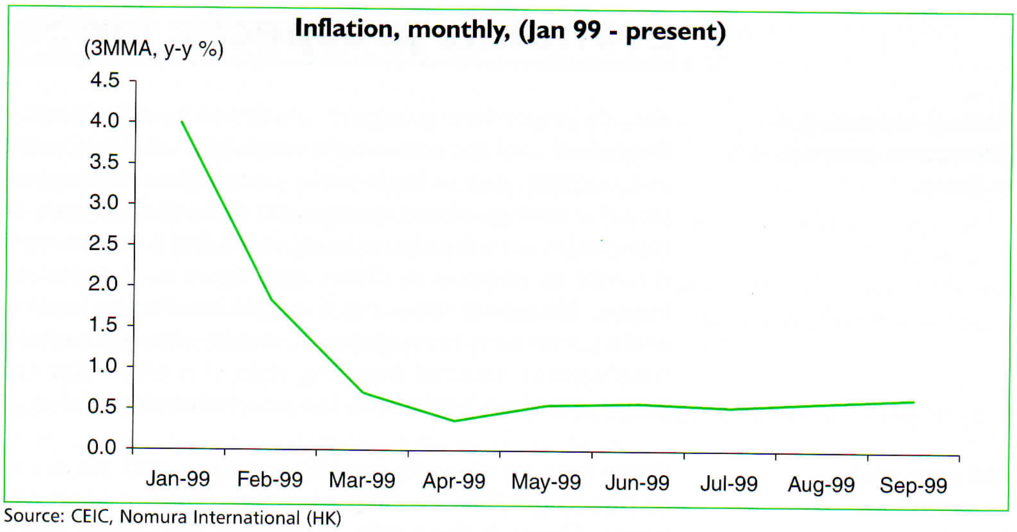
Source: CEIC, Nomura International (HK)

...but 2000 will not look as good as 1999

On the other hand, growth cannot possibly look as good in 2000 as it has in 1999, because 1999 was measured against an extraordinarily low base. Moreover, 1999 saw gains from won appreciation, from asset sales, and from labour cost reductions that in most cases will not be repeated. While the Korean consumer will not relapse into abject terror, consumption will rise more slowly because of rising interest rates, flat or possibly even increasing unemployment, and government investigations of anyone who buys a big foreign car or takes an overseas vacation. The semiconductor windfall will diminish as Taiwan restores full production and the Y2K boom ends. A number of key banks are likely to start addressing credit issues more courageously and tighten credit requirements.

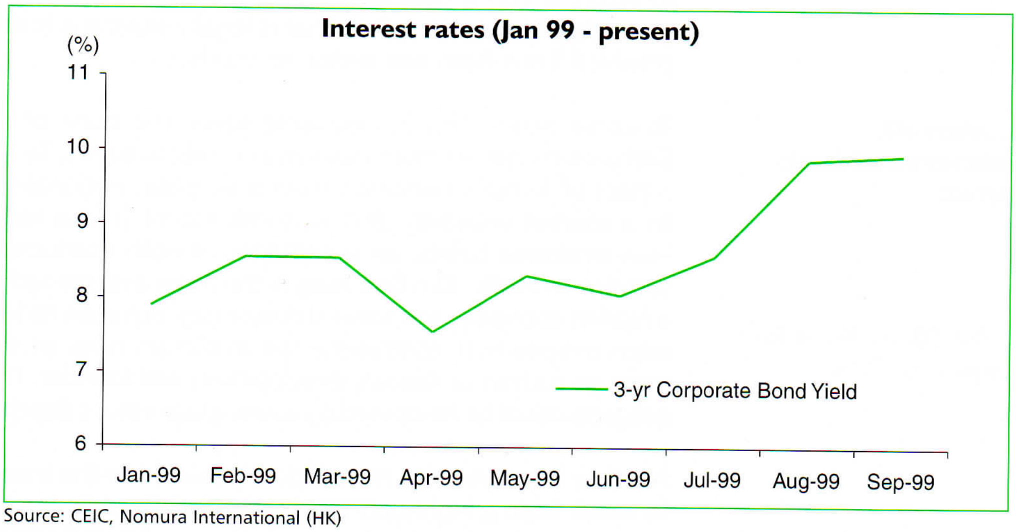
Success has its price

On balance, this is a big success. But success has its price, notably the risks of higher inflation and higher interest rates. Last year saw local deflation more than offset the import inflation that was caused by a devalued currency. This year has seen local inflation offset by the import deflation that resulted from an appreciating currency. Next year will see much stronger domestic inflationary pressures, combined with higher energy prices, higher commodity prices, and the possibility of a weakened won. The won would weaken because rising imports will curtail the huge current account surplus and because liquidity supplied to ITCs and banks could increase the supply of won. Korea's money supply has been rising at very rapid rates.



Source: CEIC, Nomura International (HK)

Inflation means higher interest rates. Also, since the bond market is in difficulty, companies have to raise money through bank loans and the banks will be in a position to raise rates.



Source: CEIC, Nomura International (HK)

Yield curve expected to steepen

Given the government's determination to keep rates low and its ability to control the short end of the yield curve, and given the longer-term pressures implied by rising government deficits, increasing requirements for the government to bail out banks and ITCs, and growing social welfare demands, the Korean yield curve should become steeper and steeper. This will benefit the banks but hurt the rest of the economy and create the temptation for a new round of maturity mismatch between corporate revenues and debt payments.

Risks

Korea's problems need decisive management

The risks to continued recovery are yen collapse, collapse of the New York stock market followed by US recession, unforeseen problems in another of the big chaebol, and political events that cripple Kim Dae Jung or bring to power a weak, non-reform-minded National Assembly that will not co-operate with the president. These risks are quickly stated but not to be quickly dismissed. The burden of our analysis is that Korea's problems are manageable but only with deft, decisive management.

Economic prospects: longer term

Korea is to Japan and Thailand as adrenalin is to Prozac

Korea's longer-term prospects are driven by a few basic considerations. It has a highly diversified, resilient economy with a highly educated workforce. Because it has invested in its people, and in large-scale, competitive management of its people, it does not face the ceilings of technology and scale that hamper Thailand and Indonesia. It has companies with decisive management and a government with decisive management. It is not as decisive as China, but Korea is to Japan or Thailand as adrenalin is to Prozac. Moreover, Korea has the additional advantage of being a middle-class society, and a particularly homogeneous middle-class society at that. This means that, despite a belligerent national debating style, it is often able to reach consensus on difficult issues and then implement the policies of its decisive government.

Still a socialist economy...

Korea remains a heavily socialist economy, and the essence of success will be gradual, or not so gradual, evolution toward a market economy. The government owns the banks. Through the banks, it controls the largest firms, with the entire core of the economy concentrated in a handful of the biggest and most vulnerable to bank and government pressures. It prevents companies, including a wide range of small and medium-sized companies as well as large ones, from going bankrupt. It prevents firms from laying off workers who are not needed. It dictates how many outside directors a firm should have. It dictates that the obligations of one firm should be guaranteed by another firm that is legally separate. It shifts the financial burdens of troubled firms from one sector to another.

...where old interventionist habits persist

To some extent this is inevitable given the scale of Korea's financial problems. Everywhere, governments take over troubled banks. To some extent it is an inevitable aspect of Korea's transition from a *dirigiste*, national-security-dominated economy to a market economy. But to some extent it also reflects the persistence of old interventionist habits, an acceptance of both Confucian moralistic thinking and of socialist controls. Kim Dae Jung is the most determined leader of the charge toward a market economy, and toward democracy, but even he frequently reverts to imperious interventions that contravene the minimum rules of the markets. The next leader must go further or Korea's development will founder. This is widely understood, but progress could be hampered by a new government dependent on elite interest groups.

Another imperative for Korea, closely related to the transition from socialism, will be to move from a highly personalised, capriciously interpreted patchwork of laws and practices on bankruptcy, to a more thoroughgoing rule of law. Currently the rules on NPLs, restructuring, and many other things change so fast, are reinterpreted so often, or are so extensively made up in the midst of crisis that banks and corporations cannot plan reliably. The use of esoteric regulatory powers and arbitrary pressures, for instance to nudge Samsung Electronics into guaranteeing some of the obligations of Samsung Motors, alienates investors of all kinds.

Asian countries have histories of responsible budget and foreign debt management

While high government deficits will persist for many years, due to government's obligation to bail out the banks, Korea's problem is much smaller than that of most developing countries. Korea's budget drag is caused by over-investment, whereas Brazil's is caused by persistent over-consumption. The Asian countries mostly have long histories of responsible budget and foreign debt management, and they can take a big hit, deal with it, and move on in a responsible fashion. Most Latin American and African countries have built combinations of voracious civil service, voracious military, voracious pressure groups, and budgetary opportunism that are much more difficult to correct. Japan has shown vividly how a once-lauded fiscal responsibility can slide into horrendous debt burdens, but that is because of a failure to reform over a decade that has no analogy in Korea or China.

The greatest growth will be in the service sectors

The gradual breakup of the chaebol will coincide with new kinds of growth for Korea. While there will continue to be a demand for huge companies to produce ships, cars and steel, the era is quickly passing when Korea will be able to base rapid growth on these 19th- and early 20th-century industries. That doesn't mean that heavy industry will vanish. Quite the opposite; in volume it will grow as opportunities in computer chips, telecommunications and others present themselves. But the greatest growth take-offs in the immediate future will be in the long-suppressed service sectors. Like China, Korea will experience an extended services boom as its lawyers and accountants and computer technicians catch up with its steel mills. The steel mills will increasingly find themselves in competition with a China whose costs are much lower and whose efficiency is improving.

North Korean instability

Just as predictably, at some time in the next five years South Korea will have to deal with the reality of a collapsed, unstable North Korea.

North and South Korea

Kim Dae Jung's hallmark "Sunshine Policy"...

Kim Dae Jung's "Sunshine Policy" toward North Korea has been one of the hallmarks of his tenure. He has opened the doors to talks and exchanges with the North, and has permitted direct talks between the US and North Korea — hitherto always a taboo. The theory is that a North crippled by famine, enticed by the opportunities of more trade and investment, and exposed to the enticements of more open polities, will start to come around in the way that China has.

...has met with North Korean truculence...

So far the North has responded with pure truculence. With foreign help, the famine is easing. The North has been willing to talk to the US and has achieved some lifting of sanctions. (US trade with North Korea is no longer absolutely barred, but in the absence of Normal Trade Relations status, previously called Most Favoured Nation status, it is still subject to the formidable Smoot-Hawley tariffs of the 1920s. It would for instance pay about ten times the tariff on toys exported to the US that China pays.) It has continued to develop nuclear-capable missiles and has used the threat of missile launches over Japan to extract economic concessions from the US.

North Korea has allowed South Korean tourists to visit severely restricted areas of the North, but at one point imprisoned a southern mother who argued with her northern tour guide about conditions in the South and suggested that he come see for himself. It has accepted cattle offered as a gift by Hyundai, has accepted limited investments from southern chaebol, and has offered to allow a Hyundai basketball team to play in the North while accepting a Hyundai offer to build a basketball hall in Pyongyang. But it has steadfastly refused to allow any citizens from the North to visit the South, and it continues to characterise the South Korean government as a puppet of the US and to place an absolute ban on any official conversations with that government.

...making it a political liability

In the long run, the Sunshine Policy is probably the policy most likely to achieve the South's goals of seducing the North into a more open economy and into contacts that will create wider awareness of the superiority of South Korea's system and thereby induce political change in the North. But in the meantime the North's intransigence has made the Sunshine Policy a political liability.

The North — short-term resilient, long-term hopeless

The hope that the North will gradually succumb to the inducements of the South and evolve peacefully into an economic partner and a participant in civilised political dialogue is the common foundation of South Korean, Chinese, Japanese and American hopes. It is likely a forlorn hope. The North Korean regime is short-term resilient, long-term hopeless. As awareness of the outside world increases, its people will be angry. This is not East Germany. Such regimes seldom collapse gradually.

Markets

While Korea will continue to enjoy relatively vigorous growth, with numbers moderated by a higher base than in 1999, the equity and bond markets will likely have a difficult year in 2000.

Higher inflation expected

Our economic analysis points to higher inflation. Import costs should rise both because commodity prices will likely rise in dollars and because the won will likely be weak against the dollar. High government deficits, high money growth, and the coming pressure for new facility investments all point towards higher inflation and therefore higher interest rates. Those interest rates in turn will hurt the equity and fixed-income markets. A wave of smaller bankruptcies means either a limited credit crunch, or the offsetting of a credit crunch by the release of inflation-enhancing liquidity into the economy.

Having said this, there is a frustrating difficulty in predicting the timing of events. The government will have to flood the market with liquidity in order to bail out the ITCs, or the banks with ITC paper, and that could raise market prices in the short run, before it leads to won depreciation, inflation and higher interest rates in the slightly longer run. It is probably a fair assumption that, as much as possible, the good times will be squeezed into the period before the April 2000 election and that bankruptcies, won weakness and inflation will as much as possible be deferred into the post-election period.

Window-dressing ahead of important election

The first quarter will probably see the benefits from politicians' window-dressing of the economy, but maximum uncertainty over the outcome of a very important election. The latter half of the year will probably see more growth benefits from corporate restructuring but more market problems from deferred corporate and governmental pain.

With the real-estate market starting to rise, and concern about future inflation, there could be some flow of money out of the market into real estate.

Main equity themes for 2000 likely to be digitalisation, telecommunications, cars and M&A

The principal equity market themes of 2000 are likely to be digitalisation, telecommunications and cars, along with international and domestic mergers and acquisitions as the log-jam of old conglomerate attitudes and unrealistic price expectations begins to break. Although it is probably too early to find large-scale secondary equity market investments that would exploit the take-off of the services sector, direct investment in Korean services may become a major trend. Cutting across all the sectoral trends in the market, with the diminished tendency of chaebol companies to help each other out, the overall market averages will undoubtedly disguise increasing divergence between big winners and big losers. Even within the context of a difficult market, the M&A wave and the identification of the winners should provide unusual opportunities.

Detailed economic forecasts

Kevin CHAN

Cyclical recovery or structural improvements?

Remarkable economic recovery...

The economic recovery in Korea has been remarkable. Following four consecutive quarters of recession, the economy has marched out of the economic slump with one of the sharpest v-shaped rebounds in the region. Not only did real GDP growth surge to 9.8% y-y in 2Q99, but it is also likely to accelerate to about 10-11% in 2H99. Such a strong economic recovery, achieved with low inflation, demands a close examination of the Korean economy. Have the reforms since the financial crisis successfully converted Korea into a structurally sound economy that will enjoy a long period of high growth and low inflation? Or has it been just a powerful cyclical recovery that has been accelerated by a strong yen and international commodity prices?

Cyclical recovery running out of stream

...looks more cyclical than structural

We are inclined to think that the strong economic recovery in Korea has been more due to cyclical improvements than structural ones. This is not to say that Korea has not achieved any progress in structural reforms in 1998-99. However, the pace of structural reforms has failed to catch up with economic growth. There is both qualitative and quantitative evidence that structural improvements have played a minor role in Korea's phenomenal comeback (refer to the relevant sections in this report for detail about structural reforms). Looking to 2000, inflation is predicted to rise by around 300bp, which, together with a falling current account surplus and the chaebol debt overhang, could put upward pressure on interest rates. The possibility of a wave of bankruptcy of SMEs could lead to a small-scale credit crunch and hurt employment and consumer confidence. A tighter monetary stance that is likely to follow should help restrain the growth in credit and hence the rate of economic expansion. Hence, we believe that real GDP growth is likely to slow from the 8.9% expected for this year to around 5.3%.

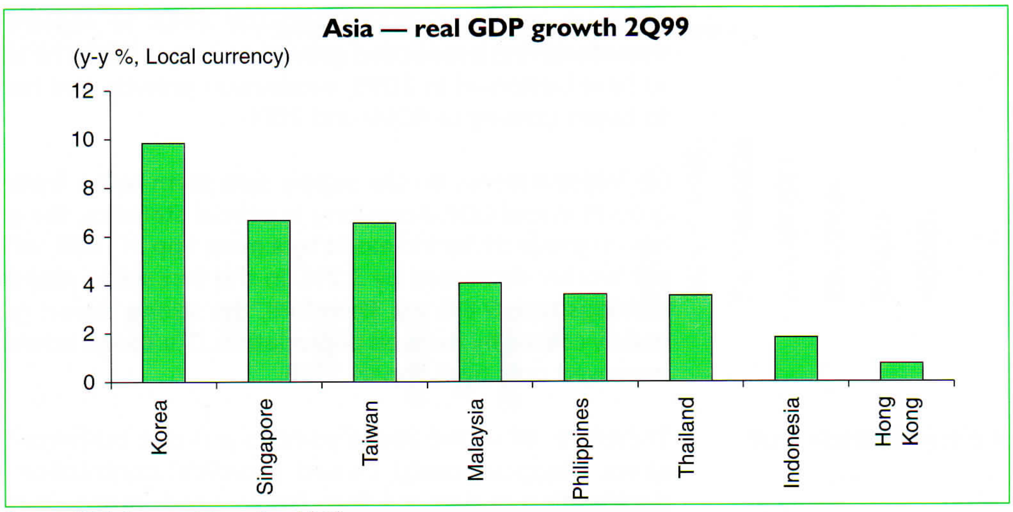
Chaebol reforms are the key

The rate of deceleration will depend on the progress of reforms in 2000

In fact, how fast real GDP growth will decelerate in 2000 will critically depend on the progress of structural reforms. While chaebol reforms are long-term positive for Korea, shorter-term economic performance may weaken as accelerating reforms produce job losses. Balancing all these factors, we believe that real GDP is likely to register respectable but slower growth of 5.3% in 2000. However, chances are that our forecast may need to be revised should the pace of chaebol reforms take off after the April election.

The powerful recovery

The performance of the economy, measured in terms of real GDP growth, appears to have outpaced most of the predictions made at the beginning of the year. Indeed, the 9.8% y-y real GDP growth in 2Q99 puts Korea at the top of the growth league in Asia.



Source: CEIC, Nomura International (HK)

What are the key drivers behind the recovery and can it be sustained?

However, what are the key driving forces behind the spectacular economic recovery? Can this kind of growth rate be sustained in 2000 without reviving inflation? Or will the inflationary pressure be substantial enough to force the Bank of Korea (BoK) to tighten monetary policy? How will rising interest rates affect liquidity in relation to the chaebol debt overhang and the health of SMEs? Even before we examine these issues in detail, there appears to be enough concern that the economic and market conditions facing Korea in 2000 are likely to be less promising than the impressive economic recovery enjoyed in 1999.

Evidence of a cyclical recovery

A brief recap of the economic performance in 1998 will provide insights into the drivers for economic growth for 1999 and 2000. The table on page 28 shows the result of a contribution analysis, which depicts individual demand component contributions to real GDP growth in terms of percentage points (pp).

In 1998, Korea's real GDP contracted by 5.8%. Our contribution analysis shows that the plunge in real domestic demand caused real GDP growth to decline by 12.5pp, with the decline in consumption causing real GDP growth to drop by 5.3pp and that of investments by 7.3pp. However, the growth in exports added 5.0pp to real GDP growth, which, together with the decline in imports, led to a 12.5pp increase in real GDP growth. So, adding all these together, the sum of domestic demand and external demand growth was zero in 1998. In other words, it can be said that there was hardly any recession in demand in 1998!

Contraction in real GDP due to inventory depletion

Hence, the contribution analysis shows that the entire contraction in real GDP in 1998 can be attributed to one factor — rapid depletion of inventories. Change in inventory, one of the most cyclical items in GDP, declined in the face of plunging domestic demand. The conclusions that follow from this analysis are clear:

(1) The foreign debt crisis resulted in sharp contraction in domestic demand in 1998. The chaebol were then forced to dump their inventory into the world market, while massively scaling back imports. This resulted in the record US$40.6bn (12.4% of GDP) current account surplus in 1998, which stabilised the foreign exchange market and helped ease the credit constraint of the heavily-indebted chaebol, and has fuelled the demand recovery in 1999.

(2) As liquidity improves, the need to dump inventory diminishes. A slower rate of inventory adjustments has helped to overstate the rate of economic recovery. In fact, of the 7.3pp increase in real GDP in 1H99, 5.1pp was attributed to a slower rate of inventory adjustments, while 4.0pp was credited to private consumption. Interestingly, despite the 14% increase in real exports of goods and services, net exports' contribution to real GDP growth was -1.3pp, with real imports jumping by 27.4%.

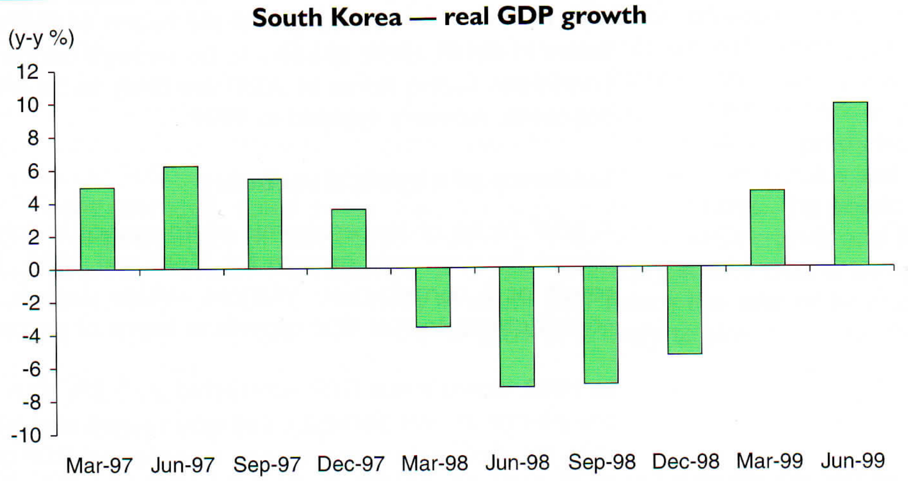
(3) Brisk export demand and the need to replenish inventory have caused manufacturing production growth to surge. With the decline in inventory appearing to have bottomed in 2Q99, production growth, and hence real GDP growth, is likely to begin slowing in 4Q99 and 2000.

(4) Improvements on the supply side seem to be limited, or have not matched the growth in real GDP. According to official statistics, the growth rate of manufacturing labour productivity increased by a mere 1pp in 1998, while average monthly earnings per worker decreased by 3.2%. In the first seven months of 1999, average monthly earnings rose 9.6% y-y. Therefore, the strong export growth in 1999 appears to be mainly caused by the won depreciation. Our rough estimate of investment productivity improved only by 0.5pp in 1998.

A classic business cycle

Therefore, all of the above point to a classic business cycle. An exogenous demand shock (financial crisis) caused a cyclical contraction in aggregate demand. The deceleration in demand then led to rapid improvements in external balances that helped to ease domestic liquidity and adjustments in inventory. As domestic demand has recovered, production has started to rise. To maintain sustainable economic expansion in the long run, it is vitally important that structural reforms be accelerated in order to enhance productivity growth.

South Korea — real GDP growth

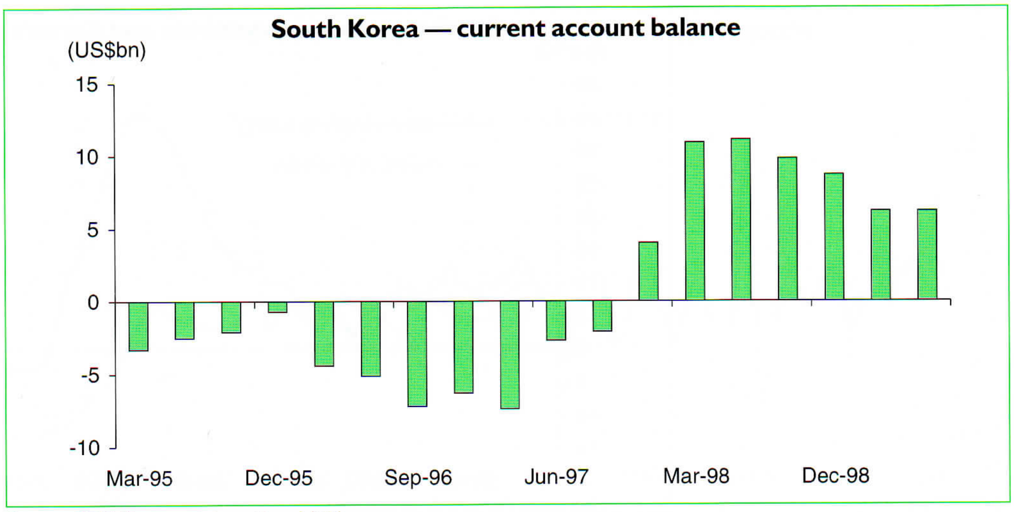


Source: CEIC, Nomura International (HK)

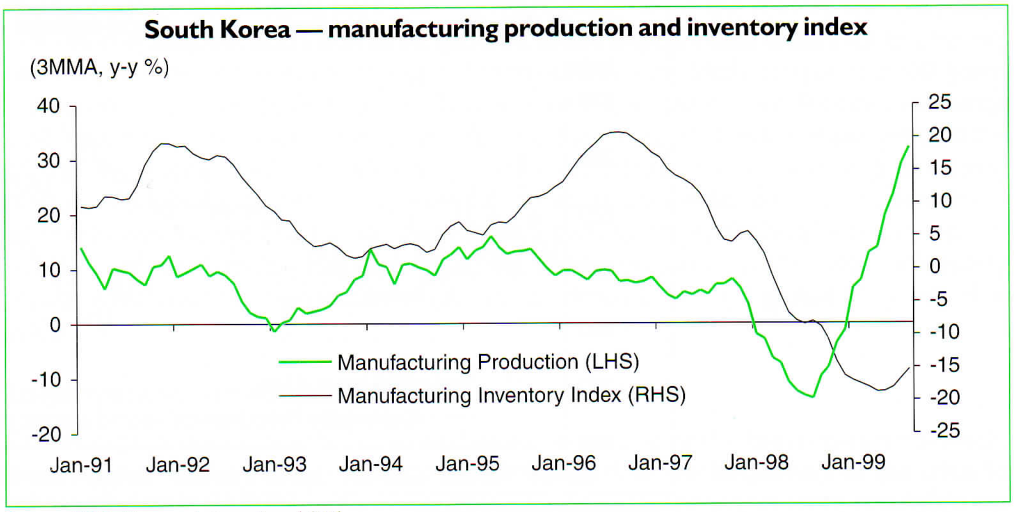
South Korea — contribution to real GDP growth (pp)

	Real GDP	Private consumpt.	Gov't	Invest-ments	Inven-tory	Exports	Imports	Residuals	Domestic demand	External demand
1Q96	7.1	4.5	0.7	2.1	-1.2	5.6	-5.0	0.4	7.3	0.6
2Q96	6.8	4.2	0.7	2.1	1.6	2.7	-4.2	-0.3	7.0	-1.4
3Q96	6.5	3.3	0.7	3.4	1.4	1.2	-3.5	0.0	7.4	-2.3
4Q96	6.7	3.6	1.1	3.0	0.3	4.1	-5.3	-0.1	7.7	-1.2
1Q97	4.9	2.7	0.2	0.3	0.7	3.6	-2.7	0.2	3.1	0.9
2Q97	6.2	2.4	0.2	0.8	-2.7	7.8	-2.6	0.2	3.5	5.2
3Q97	5.5	2.9	0.2	-1.4	-3.2	8.4	-1.8	0.2	1.8	6.6
4Q97	3.6	0.0	0.0	-2.7	-2.6	6.9	2.2	-0.1	-2.7	9.1
1Q98	-3.6	-5.8	0.1	-6.9	-9.3	8.8	9.8	-0.3	-12.6	18.6
2Q98	-7.2	-6.1	-0.1	-8.6	-6.4	4.9	8.9	0.1	-14.8	13.8
3Q98	-7.1	-5.7	-0.1	-7.7	-5.3	2.9	8.6	0.0	-13.4	11.6
4Q98	-5.3	-3.4	0.0	-5.9	-2.2	3.3	2.7	0.3	-9.4	6.0
1Q99	4.6	3.4	-0.2	-1.2	5.2	5.3	-7.4	-0.5	2.1	-2.1
2Q99	9.8	4.7	-0.3	1.5	5.0	7.2	-7.7	-0.6	5.9	-0.5

Source: CEIC, Nomura International (HK)



Source: CEIC, Nomura International (HK)



Source: CEIC, Nomura International (HK)

Outlook for individual demand components

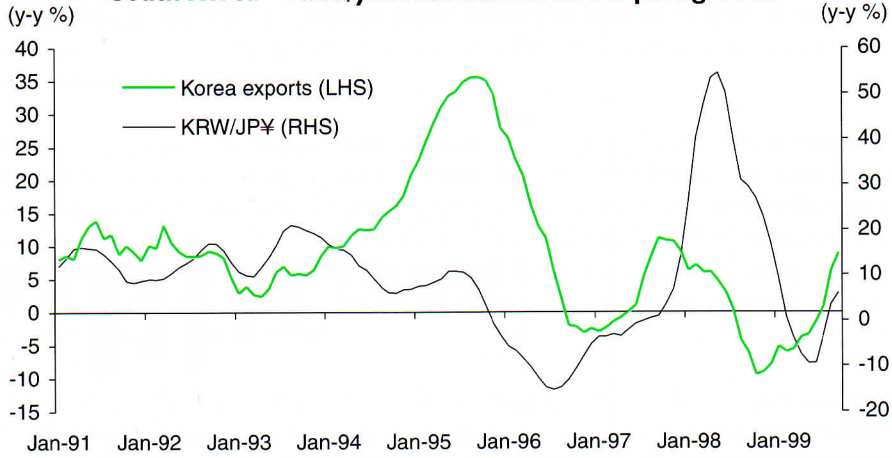
The yen and export growth

Korea tends to benefit from a strong yen

The yen has appreciated by 13.3% versus the won in the past 12 months and by almost a third since the financial crisis. Historically, Korea tends to benefit from a strong yen, given that it competes head-to-head with Japanese producers in IT equipment, lower-end consumer electronics and automobiles. Also, exports to Japan account for around 10% of total Korea's exports. Given our view that the yen is likely to stay strong in 2000, this should help to underpin satisfactory export growth in 2000.

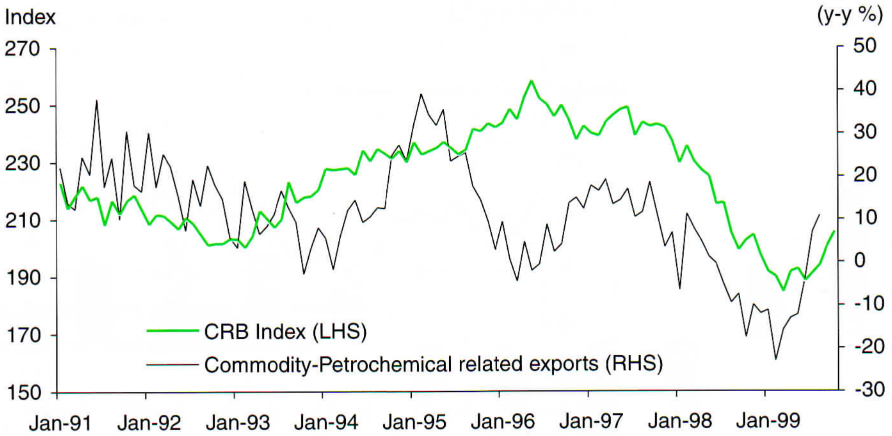
Moreover, with commodity/petrochemical-related and IT-related exports accounting for around a quarter and a third of the country's exports, respectively, the recovery in global commodity prices and strong PC sales in the US should also favour the exports sector.

South Korea — won/yen rate and Korea's export growth



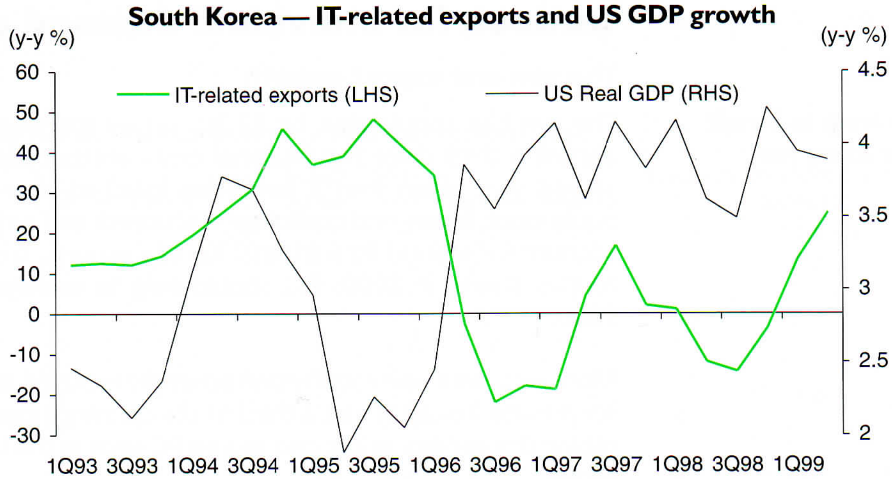
Source: CEIC, Nomura International (HK)

South Korea — commodity/petrochemical-related exports and CRB* index

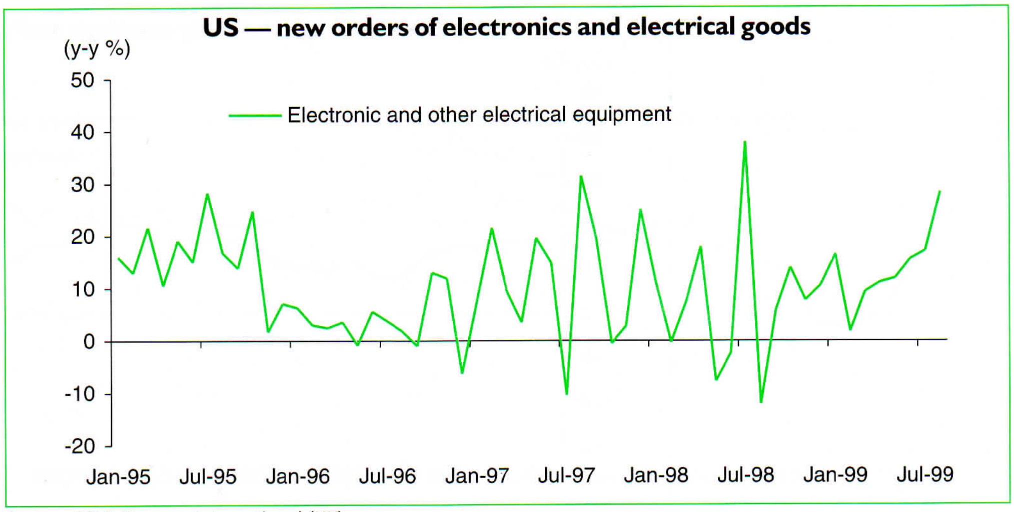


* Commodity Research Board
Source: CEIC, Nomura International (HK)

South Korea — IT-related exports and US GDP growth



Source: CEIC, Nomura International (HK)



Source: CEIC, Nomura International (HK)

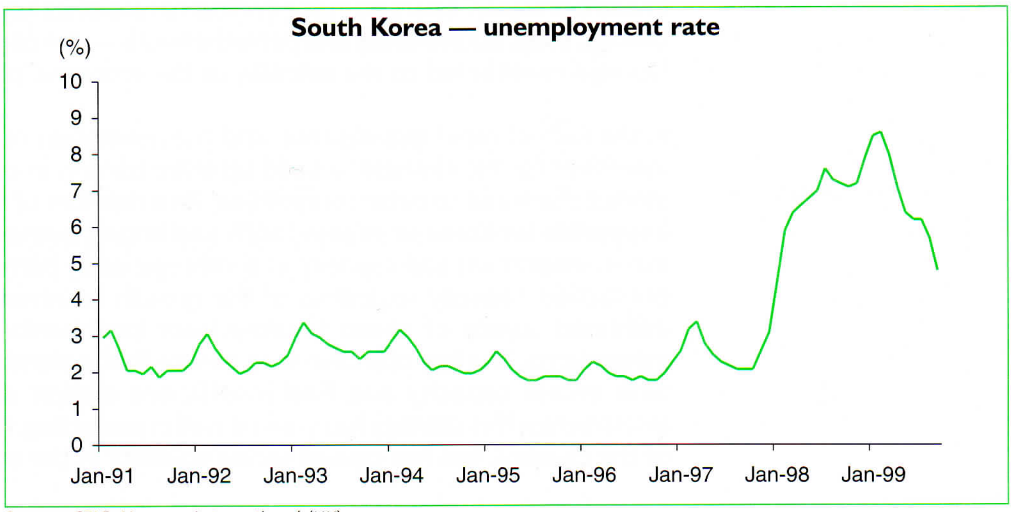
Key risk for exports is slowdown in US economic growth

The key risk for the exports sector is, like most countries in the region, the possibility of a sharp slowdown in US economic growth. While the US's new orders for electronics and electrical goods remain strong, US interest rates are likely to rise in 2000 given the recent warnings by Fed chairman Alan Greenspan. Also, recent profit warnings by IBM concerning the post-Y2K profit decline may suggest slower global demand for PC hardware in 2000. Finally, a quick resumption of Taiwanese producers' manufacturing capacity after the September earthquake could also cause a slowdown in new orders received by Korean DRAM producers. All in all, although Korean exports should continue to enjoy the benefits of the strong yen and rising global commodity prices, watch out for the possibility of sudden drops in US and global PC demand in 2000.

Employment and consumption

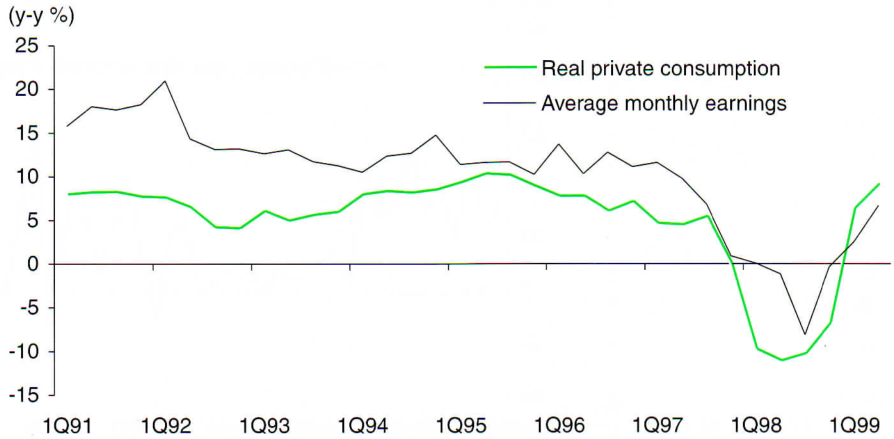
As mentioned earlier, private consumption has been one of the key drivers for growth. The nationwide unemployment rate rose from 2.1% at the beginning of the crisis to the cyclical peak of 8.6% in February 1999. Since then, the jobless rate has fallen for seven consecutive months to 4.8% — one of the lowest in the region. Manufacturing employment has increased by 8% since January 1999, while non-farm unemployment has fallen by 30%. As a result, average monthly earnings per worker swung into positive growth territory since February 1999 and have grown 9% y-y to date.

This sharp recovery in income has further boosted consumer confidence as the general economic environment improves. With brisk economic growth predicted in 2H99, wage settlements for 2000 should remain favourable for private consumption, especially for 1H00.



Source: CEIC, Nomura International (HK)

South Korea — average monthly earnings and private consumption



Source: CEIC, Nomura International (HK)

Employment and income growth will depend on post-election structural reforms

However, the pace of employment and income growth in 2H00 is less certain and depends critically on the pace of structural reforms following the April 2000 election. If President Kim is to push hard for chaebol reforms after the election and/or monetary policy is to be tightened as inflation rises and the chaebol debt overhang worsens, the pace of job growth should slow. Ironically, the slower the pace of the reforms, the better the prospects for short-term employment growth, although it also means higher systemic risk for the economy. Therefore, we may need to revise our forecast once more details about the reforms become available.

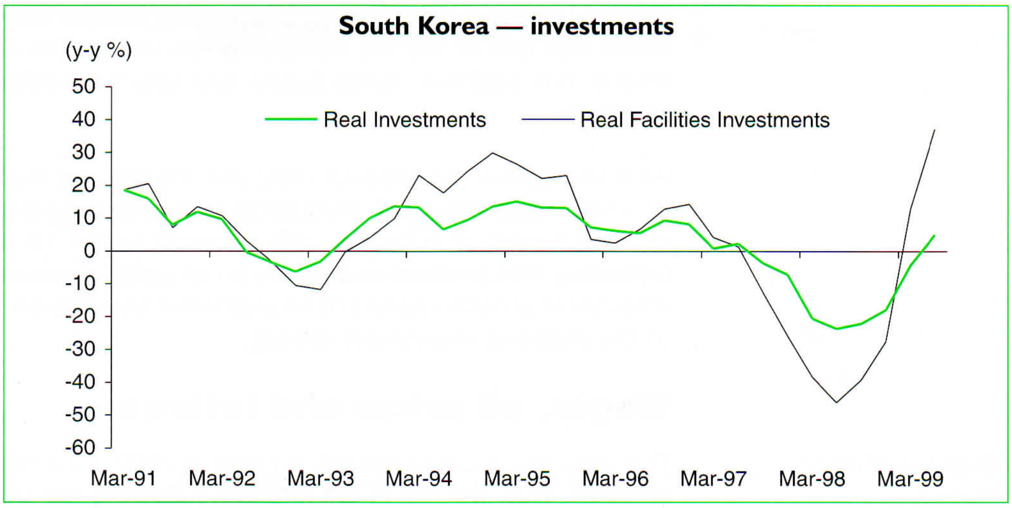
The other uncertainty affecting consumers is the likelihood of a wave of bankruptcy among SMEs, which is likely to have a knock-on effect on liquidity, employment and consumption growth. As inflation rises, local interest rates have to increase. Local banks' participation in the Daewoo bail-out and the pull-back from international banks in response to the Daewoo debt problem should further tighten the availability of credit, possibly in 2H00. This is likely to exert additional pressure on the financial markets and nearly insolvent ITCs. The consequent credit crunch, though it may be small in scale, could have a serious negative impact on the SMEs given their limited access to funds and relatively weak balance sheets.

Facilities investment

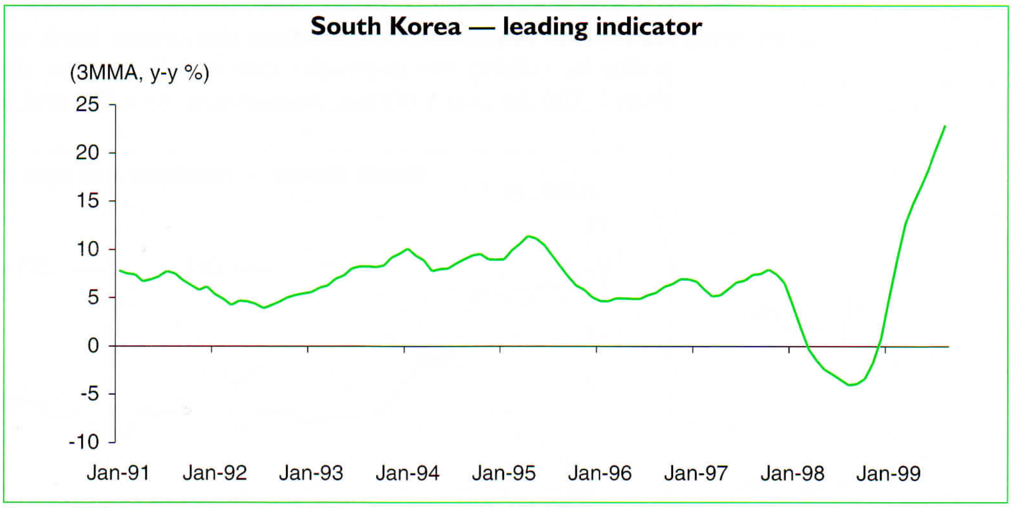
Korea is renowned for its boom-bust investment cycle

Facilities investment posted strong 37.2% y-y growth in 2Q99 — the second consecutive year-on-year increase since the financial crisis. Judging from the 25-year high of 23.6% y-y growth in the composite leading indicator in August 1999, strong export growth and a very low year-on-year base, facility investment growth is likely to continue rising in the next few quarters. Korea is renowned for its boom-bust investment cycle. Apart from the cyclical nature of its key industrial sectors — such as DRAMs, steel, automobiles and petrochemicals — the oligopolistic industrial structure has also contributed to the volatility of the economic performance.

In the face of rapid globalisation and the promotion of free trade, there are strong incentives for the chaebol to build up entry barriers in order to protect their existing market share and to deter competition. As a member of the WTO, it would be almost impossible for Korea to impose tariffs and import quotas. Therefore, the chaebol use excess investment and capacity as a strategic entry barrier by continuing to invest in production capacity regardless of the growth in international demand. An almost unlimited supply of cheap funding from local banks has helped to finance the investments. The key objective is to ensure that potential market entrants are faced with excess capacity and find insufficient market share to justify their initial investments. This strategy has worked well in protecting the dominant market position of the chaebol, but has caused excess volatility in the economy.



Source: CEIC, Nomura International (HK)



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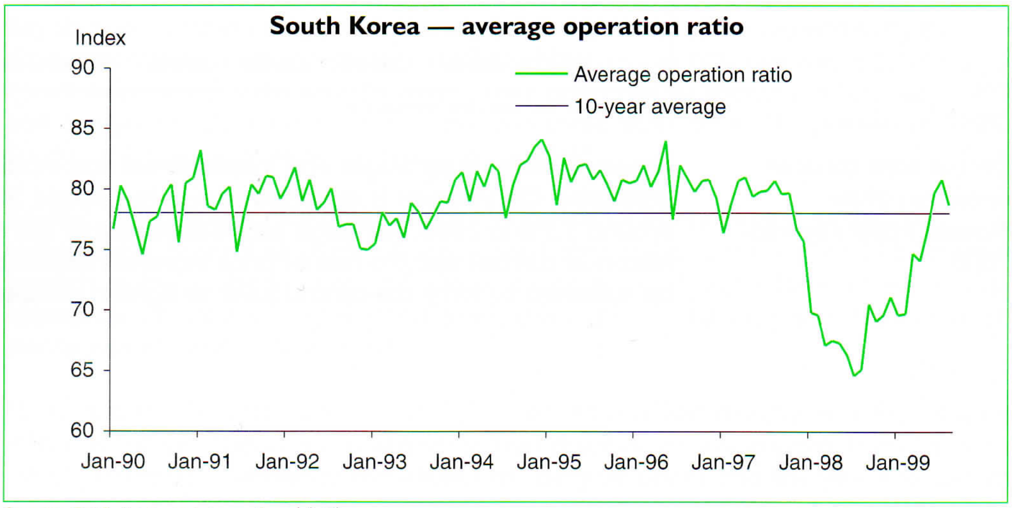


Source: CEIC, Nomura International (HK)

This kind of investment strategy and lending practice created a bubble in the economy, which was one of the key underlying reasons for the financial crisis in 1997-98. To resolve this problem, deregulation and structural reforms of the chaebol have to accelerate.

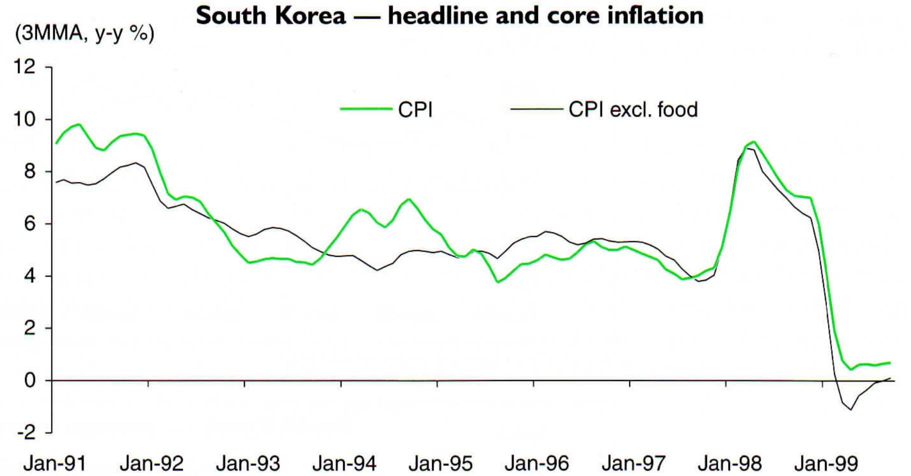
How much have the financial crisis and the reforms that followed changed this kind of investment practice? Anecdotal evidence suggests only a little. The average operation ratio of industries only returned to the 10-year average level in August, indicating that production capacity is not under pressure. The resurgence of facilities investment growth appears to be premature and may be indicative of the continuation of the excessive investment strategy.

Wages, oil prices and inflation

Major risk of rising inflation

The other major economic risk in Korea in 2000 is the fairly strong possibility of rising inflation. True, the rise in CPI inflation following the sharp depreciation of the won was short-lived. Both headline CPI and core inflation peaked in 1Q98 and have averaged 0.7% and -0.4% y-y so far in 1999. Limited inflationary pressures and an improved balance of payments have enabled the central bank to maintain a loose monetary policy by cutting the overnight rate and three-year corporate bond yield by more than 1,700 bp and 1,000bp, respectively, to 4.8% and 9.9%.

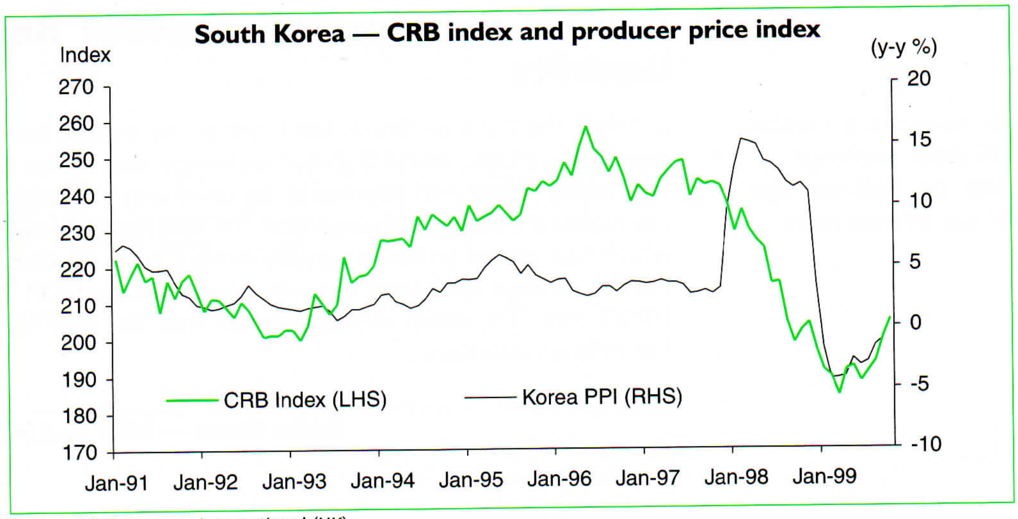
South Korea — headline and core inflation



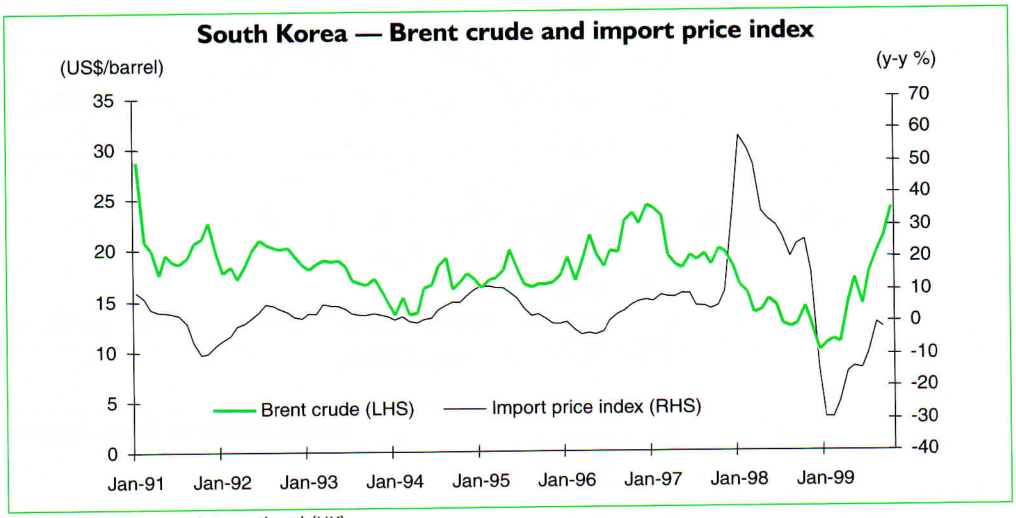
Source: CEIC, Nomura International (HK)

Central bank could be forced to tighten monetary policy by mid-2000

However, with rising wages and international commodity prices, crude oil prices in particular, CPI inflation is expected to rise by around 300bp from 0.8% in 1999 to around 3.7% in 2000. Although an inflation rate of less than 4% is not alarming in a historical context and the rate of price increases should be manageable, it is likely to be sufficient to force the central bank to tighten monetary policy by mid-2000.



Source: CEIC, Nomura International (HK)



Source: CEIC, Nomura International (HK)

External inflationary pressures and nationwide wage increases expected

Key sources of inflationary pressure are expected to be external, supported by double-digit nationwide wage increases (as reflected by average monthly earnings). First, as concluded above, wage growth swung back into positive territory in February 1999 and the year-to-date increase in wages has more than offset the decline in 1998. Further increases in wages are expected for 2000.

Crude oil prices should have a large impact...

Second, Korea is one of the biggest net importers of crude oil and petroleum in the region, with imports of crude oil and related products accounting for 17% of total imports in 1998. The doubling of international crude oil prices should have a large impact on the cost of imports and production costs in Korea, particularly in steel, transportation and energy prices.

...combined with yen appreciation

Third, around 18% of Korea's imports come from Japan directly and the lagging effect of the yen appreciation would suggest more expensive imports from Japan in 2000. Therefore, combining the impact of rising oil prices and the yen, the cost of more than 30% of Korea's imports could rise in 2000.

Rise in inflation should be manageable

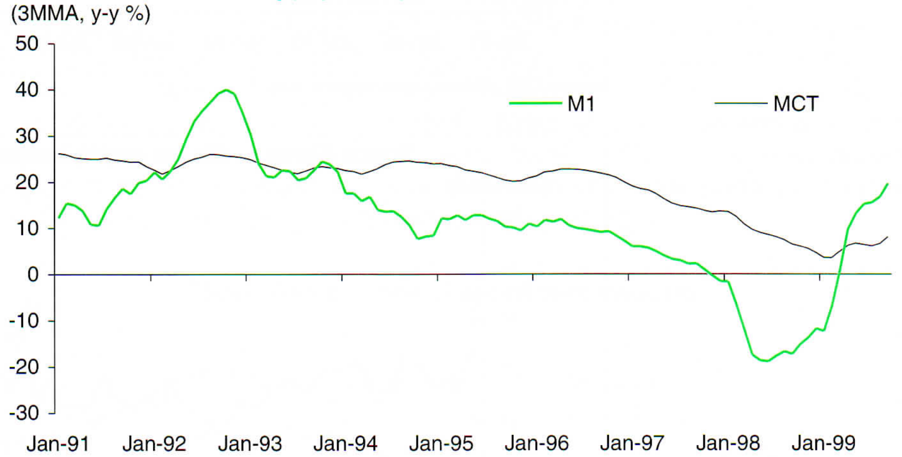
In sum, with average capacity utilisation only returning to the historical norm, we believe that the rise in CPI inflation should be manageable. Should the yen and/or global commodity prices rise further in 2000, negative surprises on the inflation front could lead to tighter-than-expected monetary policy in 2H00.

Central bank policy, chaebol debt overhang and liquidity

By maintaining a stable US dollar exchange rate, the BoK was able to cut interest rates

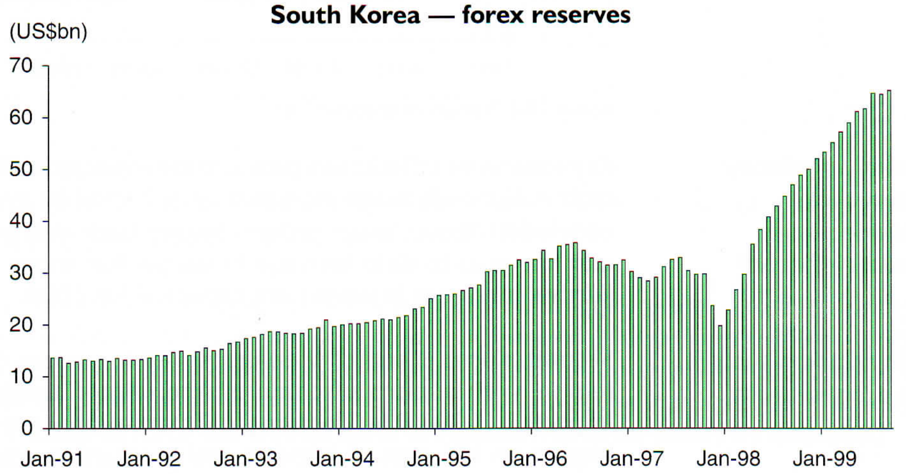
In 1999, the Bank of Korea, like most of the central banks in the region, has tried to maintain a stable won/US dollar exchange rate in the face of yen appreciation and improving balance of payments. By sterilising the balance of payments surplus and maintaining a stable exchange rate, the BoK has been able to cut interest rates sharply, which has helped to fuel an equity market boom and economic recovery. As a result, Korea's foreign exchange reserves have risen by US$13bn since December 1998 to US$65.1bn. The sharp increase shows that the BoK has been mopping up most of the inflows into Korea.

South Korea — MCT and M1



Source: CEIC, Nomura International (HK)

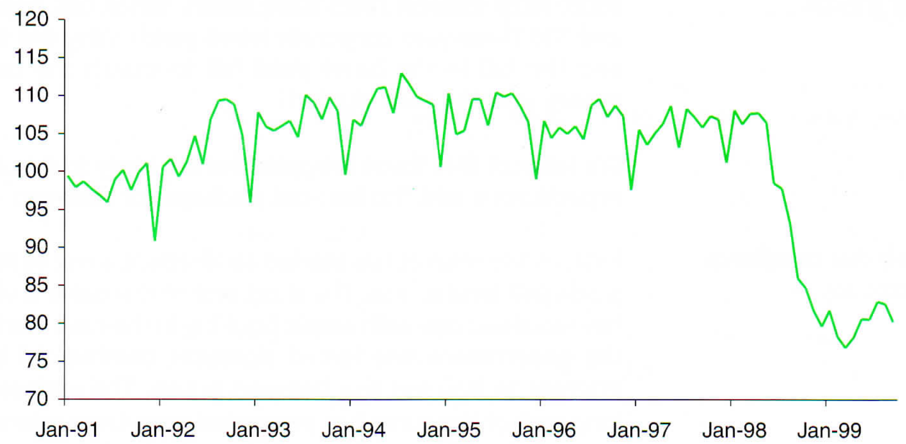
South Korea — forex reserves



Source: CEIC, Nomura International (HK)

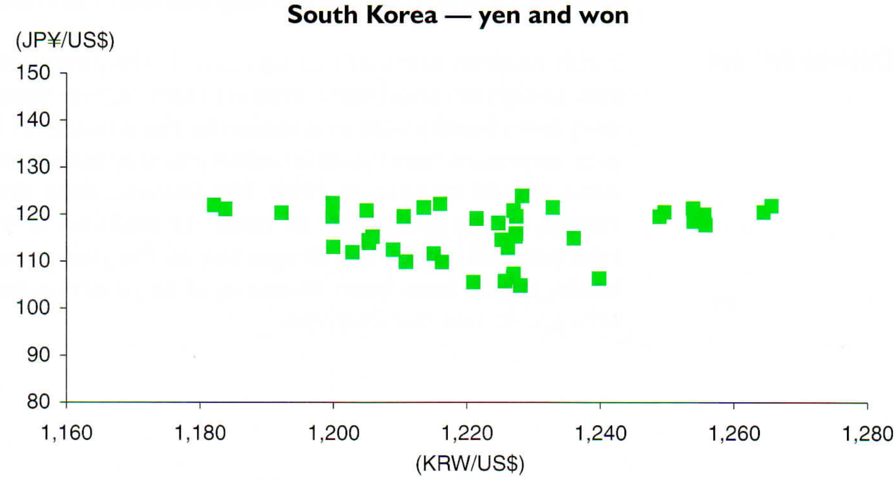
A simple regression of the won/US dollar exchange rate and the yen/US dollar exchange rate using weekly data from the beginning of this year yields a r-2 of 0.05, indicating that the won/US dollar has been almost perfectly insensitive to the yen's sharp appreciation so far this year. However, given the close trade relations between the two economies, the insensitivity appears unjustifiable without specific targeting by the BoK. Since Korea's trade surplus should improve with an appreciating yen, the won/US dollar rate should also rise to reflect the improvement in balance of payments.

South Korea — loan-to-deposit ratio



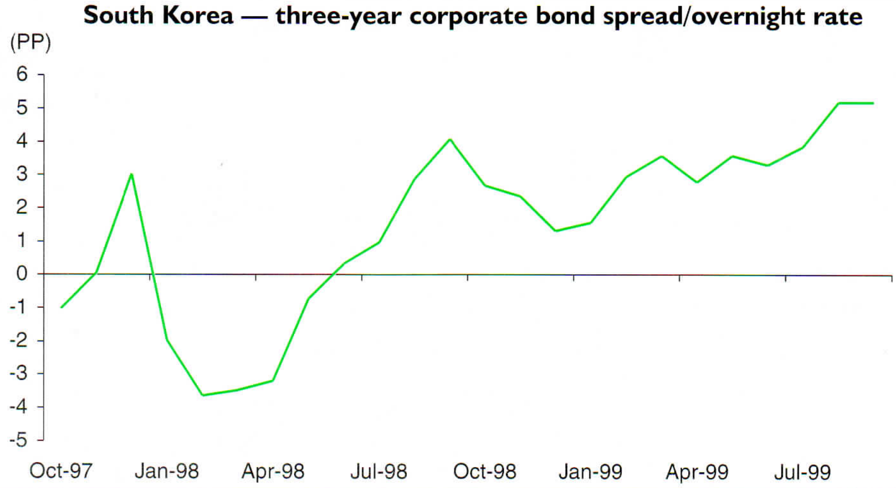
Source: CEIC, Nomura International (HK)

South Korea — yen and won



Source: CEIC, Nomura International (HK)

South Korea — three-year corporate bond spread/overnight rate



Source: CEIC, Nomura International (HK)

Broad money supply growth not excessive

The sterilisation policy of the BoK, selling won in the open market, has fuelled the increase in M1, which rose 20% y-y in August. However, although broad money MCT (M2, including trust accounts) growth accelerated from 3.7% in January 1999 to 8.4% in August, the growth does not appear excessive since it is in line with the nominal economic growth rate.

Irregularities in money supply growth...

So, following the BoK's sterilisation policy, narrow money growth has surged and short-term interest rates have fallen. What has happened to broad money growth and the three-year corporate bond yield? Why did the acceleration in broad money and the fall in the bond yield fail to match the respective movements of narrow money and the cash market?

We suspect that these irregularities are likely to be caused by two factors — inflation expectations and the bail-out package for Daewoo.

...likely due to inflation expectations...

First, as the market has started to discount a rise in inflation in 2000, long-term bond yields will tend to rise. The short end of the curve is virtually set by the BoK and hence has remained low with ample liquidity in the cash market (M1). Second, more plausibly, the government has forced domestic commercial banks to purchase bonds in an attempt to bail out the Daewoo group. The increase in the supply of bonds at the long end of the curve has prevented long-term interest rates from falling at the same pace as short-term rates and has restrained the expansion of broad money growth. Furthermore, uncertainties concerning Daewoo and other chaebol suggest rising systemic risks in Korea, which may also have contributed to the rise in the bond yield.

...and Daewoo bail-out

If this analysis turns out to be correct, the eventual rise in inflation could force the BoK to tighten short-term interest rates, which should also put upward pressure on long-term bond yields in addition to the increase in bond supply and risk. The three-year corporate bond yield is unlikely to stay below the critical 10% level and the yield curve should steepen in 2000. The Daewoo debt problems could have an important impact on the availability of credit. In addition to the pull-back of credit lines from international banks, the steepening of the yield curve is not good news for the local banks, which have been encouraged to purchase bonds at 9.0% interest rates in an attempt to bail out Daewoo.

Economic data and forecasts

South Korea

National account	1993	1994	1995	1996	1997	1998	1999F	2000F
Real GDP (% chg y-y)	5.5	8.3	8.9	6.8	5.0	-5.8	8.9	6.0
Private consumption (% chg y-y)	5.6	8.2	9.6	7.1	3.5	-9.6	7.7	5.9
Household consumption (y-y %)	5.7	8.3	9.7	7.1	3.5	-9.8	7.8	6.0
Private investment (% chg y-y)	6.3	10.7	11.9	7.3	-2.2	-21.1	3.4	7.6
Construction (y-y %)	9.7	3.7	8.0	6.1	2.3	-10.2	-8.0	5.0
Facility investments (y-y %)	0.3	23.9	18.1	9.1	-8.7	-38.5	30.0	12.0
Government expenditure (% chg y-y)	4.6	1.9	0.8	8.2	1.5	-0.1	-2.0	1.0
Industrial production (% chg y-y)	4.3	10.9	12.0	8.7	5.3	-7.3	16.0	8.0
Unemployment rate (%)	2.6	2.2	1.9	2.3	3.1	7.8	4.9	3.9
Nominal GDP (US$bn)	346	403	490	519	471	328	411	458
GDP per capita (US$)	10,553	12,107	14,436	15,009	13,423	9,227	11,376	12,501
Prices								
CPI (% chg y-y)	4.8	6.3	4.5	4.9	4.4	7.5	0.8	3.7
Wage rates (% chg y-y)	12.2	12.7	11.2	11.9	7.0	-2.5	9.0	13.0
External balance								
Exports (US$, y-y %)	7.3	16.8	30.3	3.7	5.0	-2.8	6.2	8.0
Imports (US$, y-y %)	2.5	22.1	32.0	11.3	-3.8	-35.5	27.4	13.0
Trade balance (US$bn)	-1.6	-6.3	-10.1	-20.6	-8.5	39.0	21.7	17.5
Current account balance (US$bn)	1.0	-3.9	-8.5	-23.0	-8.2	40.6	26.5	20.2
Current account balance (% of GDP)	0.3	-1.0	-1.7	-4.4	-1.7	12.4	6.5	4.4
Interest & exchange rates								
Money supply MCT (% chg y-y)	22.4	24.4	23.0	17.4	11.5	4.5	9.7	11.3
Three-year corporate bond yield (%)	12.2	14.2	11.7	12.6	24.3	8.3	10.0	11.0
Won per US$ (year-end)	808	789	775	844	1,415	1,208	1,210	1,300
Won per US$ (annual average)	803	802	770	807	962	1,369	1,200	1,250
Foreign exchange reserves (ex gold, US$bn)	19.7	25.0	31.9	32.4	19.7	52.0	67.0	72.0

Source: Korean Department of Statistics publications, Nomura International (HK)

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