

ASIA RESEARCH

South Korea



**Bankers Trust
Research**

South Korea's Economy and Inter-Korean Relations

**One of the Asian miracle
economies.**

**Military confrontation with
the North unlikely.**

- South Korea's average annual GNP growth rate has exceeded 8% for the last three decades.
- The ongoing economic restructuring has increased the international competitiveness of many capital-intensive and technology-intensive industries.
- Despite strained inter-Korean relations due to the nuclear inspection issue, military confrontation between the two sides is unlikely.
- Sudden collapse of North Korea is a risk, but economic exchange between the two-Koreas can help alleviate the difficulties in the North and reduce this risk.
- The equity market has risen dramatically, but remains inexpensive and attractive.

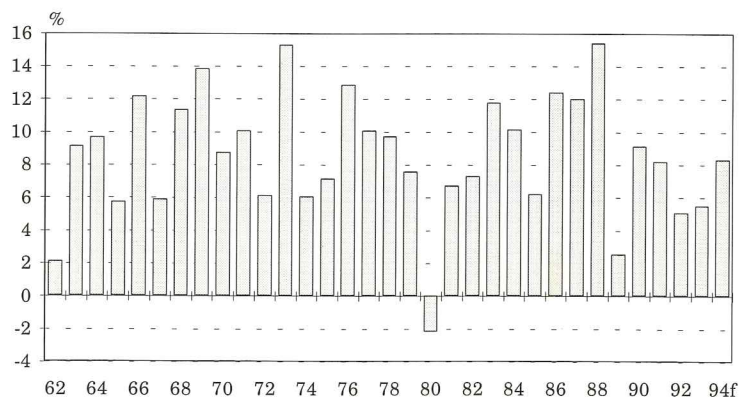
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Real GDP Growth: South Korea



Source: Datastream

Table 1. South Korea: Economic and Stock Market Statistics

ECONOMIC INDICATORS	1989	1990	1991	1992	1993	1994f	1995f
GDP (current prices, US\$ billion)	212.97	244.04	283.88	296.84	318.67	366.00	424.00
Per Capita GDP (current price, US\$)	5,025	5,693	6,561	6,799	7,234	8,234	9,454
Real GDP Growth Rate %	6.4	9.5	9.1	5.1	5.6	8.4	8.0
Growth of Total Consumption %	10.4	10.1	9.3	6.8	5.3	7.0	8.2
Growth of Fixed Capital Investment %	15.9	25.9	12.6	-0.8	3.6	9.9	9.5
Growth of Exports %	-4.1	4.2	11.8	11.0	11.2	13.4	12.3
Growth of Imports %	16.3	14.3	19.2	5.1	6.7	20.1	11.0
Balance of Payments (US\$, million):							
Trade Balance	4,598	-2,004	-6,980	-2,146	1860	-1,800	-2,000
Merchandise Exports (fob)	61,409	63,124	69,582	75,169	80,810	92,640	102,950
Merchandise Imports (fob)	-56,811	-65,127	-76,561	-77,315	-78,950	-94,140	-104,950
Current Account Balance	5,056	-2,179	-8,726	-4,528	384	-3,400	-4,400
Overall Balance	2,453	-274	-3,741	4,898	6,542	8,000	8,200
CPI Inflation Rate %	5.1	9.5	9.6	4.5	5.8	6.5	6.0
Unemployment Rate %	2.6	2.4	2.3	2.4	2.8	2.4	2.3
Interest Rates:							
Yields on Corporate Bond % (3 years)	15.2	16.5	18.9	16.2	12.6	13.2	14.5
Lending Rate % (up to one year)	11.3	10.0	10.0	10.0	8.6	8.5	8.5
Money Growth Rate (M2) %	18.4	21.2	18.6	18.4	18.6	15.6	15.0
Exchange Rate (end of period, W/\$)	680	716	759	788	808	790	770
Foreign Exchange Reserves (US\$, million)	15,214	14,793	13,701	17,121	20,228	21,680	21,880
Months of Total Imports	2.6	2.2	1.8	2.1	2.5	2.4	2.4
Total External Debt as % of GDP	15.9	15.8	16.3	17.4	16.9	15.9	15.5
Total Debt Service as % of Exports	11.7	11.4	7.8	7.9	8.5	6.7	6.0
Central Government Budget Deficit (-) or Surplus as % GDP	0.3	0.4	-0.8	0.3	0.3	-0.6	-0.3
KOREA STOCK MARKET							
Korea Composite Stock Index (year end)	909.7	696.1	610.9	678.4	866.2	1075.0 ¹	--
Market Cap (US\$, million)	140	110	96	107	139	189	--
Market Cap as % of GNP	66.8	46.5	32.1	35.6	44.2	51.6	--
Listed Companies	626	669	686	688	693	695	--
P/E Ratio (Year End)	13.9	12.8	11.2	10.9	12.7	16.7	--
Weighted Dividend Yields	1.2%	1.5%	1.8%	1.9%	1.4%	1.3%	--

Source: The Bank of Korea, International Financial Statistics, Bankers Trust Research

¹ This figure is for Dec. 6, 1994.

Overview

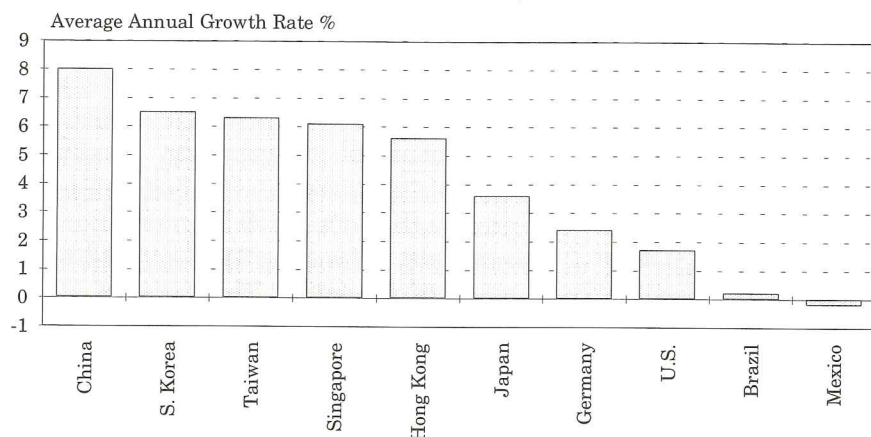
South Korea has a population of 44 million and a territory of 38,345 square miles. Ethnically and culturally, it is one of the most homogenous societies in the world. It was almost entirely an agrarian economy before the Japanese colonization in 1910. The liberation from Japanese colonial rule in 1945 was marred by the partition of Korea into two parts, North and South. The Korean War from 1950 to 1953 destroyed almost two-thirds of the nation's productive capacity, and killed almost 1 million civilians. The war ended by maintaining the partition of the Republic of Korea (south) and the Democratic People's Republic of Korea (north).

One of the Asian miracle economies

South Korea's Economy

South Korea is one of the "four dragons" in Asia that have achieved miraculous economic growth for over three decades. In the early 1950s, South Korea was one of the poorest agrarian countries in Asia. Since the launching of the First Five-Year Economic Plan in 1962, South Korea's economy has grown at an average GNP growth rate exceeding 8% over the last 32 years. In 1993, South Korea recorded a per capita GNP of US\$7,234 and a total GNP of US\$320 billion, ranking it the twelfth largest economy in the world. Its per capita GNP growth rate over the period from 1980 to 1993 was one of the highest in the world (Figure 1).

Figure 1. Average Annual Growth of Per Capita GNP, 1980-93



Source: *International Financial Statistics, International Institute of Finance*

The driving force behind this strong performance has been the successful adoption of an outward-looking development strategy

making exports the engine of growth--a strategy well suited to South Korea's conditions, i.e., insufficient natural resources, limited domestic market, and an abundant, well-educated, industrious work force.

Under economic restructuring

During the last decade, South Korea has been in the process of economic restructuring. In the 60s and 70s, South Korea's economic growth was built on labor-intensive, low value-added industries such as textiles and footwear. Since the mid-1980s, facing increasing competition from other emerging Asian economies, such as China and Southeast Asian countries, the nation has been under pressure to upgrade its economic structure by fostering high technology industries such as electronics, automobile, steel and shipbuilding. In 1993, heavy and chemical industries made up 71.5% of the total manufacturing sector, and light industries 28.5%.

Currently, South Korea's consumer electronics, semiconductor, automobile, steel and shipbuilding industries are globally competitive. In 1993, South Korea's share in the world consumer electronic industry reached 15%, making it the second largest producer in the world. Its share in the world semiconductor market was 17.8%, and share of the critical DRAM chips market reached 23.5%. In 1993, South Korea became the largest shipbuilder in the world for the first time, surpassing Japan in new orders. It is the sixth largest steel maker, the eighth largest chemical producer, and the sixteenth automobile producer.

Currently, South Korea's economy faces the following main challenges:

Current investment on R&D too little

(1) **Improving the technological level of its industries.** During the 60s and 70s, in the rush to industrialization, the nation's focus was entirely on quantitative growth in production. This created a "quick-fix" mentality and an imbalance between quantitative growth and qualitative improvement. In early 1990s, many South Korean products were seen as of poor quality and high price. R&D investment lagged economic growth. For example, The shipbuilding industry's R&D investment falls far short of Japan's. The ratio of R&D investment to total sales in South Korea's shipbuilding industry is less than 1%, while Japan's ratio exceeds 2%. In fact, South Korea's total R&D expenditure is less than that of General Motors or Mitsubishi.

In the past, South Korea's industries acquired advanced technology by borrowing from developed countries, via technology licensing and transfer. As its economy becomes increasingly a direct competitor of other advanced countries, it will have greater difficulty obtaining technology from these countries. Further

economic growth will increasingly depend on South Korea's own technological innovations.

The government seeks a new role

(2) Creating a new government-business relationship. The salient feature of the South Korean government-business relationship has been government's dominance of business. Before the 1980s, the government micro-managed most aspects of the South Korean economy. Since then, the South Korean economy has grown too large and too complex for the government to micro-manage. Recently, the government has tried to foster private initiative and creativity and to free the economy from constrictive government planning and intervention. The government reorganization plan, announced in December 3, 1994, and waiting for parliamentary approval, will down-size the government and merge the powerful Economic Planning Board (EPB) and the Ministry of Finance into the Finance and Economic Board. This "revolutionary" plan is a very encouraging sign that the government is determined to ease its control over the economy.

However, old habits die hard. Despite President Kim's strong push for reforms, government bureaucrats are so used to intervention that it is very hard for them to give up their grips on the economy. Many government bureaucrats are not sure as to what kind of economic role they should play in the future. On the other hand, the private sector is still very timid in dealing with the government. It will take a long time for healthier government-business relations to emerge.

Financial liberalization inevitable

(3) Financial reform. The development of the South Korean financial sector was heavily repressed throughout the rapid growth era. The government-led development in South Korea was implemented primarily through governmental control of the financial sector. The government was a major financier for businesses. In recent years, the government has realized the importance of financial liberalization, but the pace of actual liberalization has been painstakingly slow.

Since President Kim Young Sam came to power, reforms have gained momentum. In June 1993, the South Korean government presented a comprehensive plan to liberalize the financial sector and the capital markets, with a detailed time table for phased implementation in three steps during the period of 1993-1997.

The reason for the government's resolution to liberalize the financial sector is the external pressures it faces. One pressure is from the US and European countries. The other is competition for foreign capital from other Asian countries. South Korea's desire to become a member country of the OECD by 1997 also acts as a disciplinary device. However, although the South Korean

government is determined to overhaul its financial sector in a comprehensive manner, the pace of reform will continue to be slow because of the government's aversion to subjecting the domestic financial institutions to "excessive" foreign competition.

Economic Developments and Outlook

Growth gaining momentum

Economic Growth After two consecutive years of low GNP growth (5% in 1992 and 5.6% in 1993), the economy turned around in the fourth quarter of 1993 and showed strong growth in 1994. For the first half of this year, the annualized GNP growth rate was 8.5%.

...driven by investment and exports

The current economic expansion is driven by capital investment and strong exports. According to the latest government survey, facility investment by 200 large manufacturing and marketing firms grew at an annual rate of 53% from a year earlier. This increase in investment not only fuels the current economic growth, but also raises production capacity and productivity in the future by increasing and upgrading the capital stock.

The recent strong expansion in equipment investment seems to be attributable to increased business confidence and the improved export performance. Business confidence was low in 1992 and early 1993, due to political uncertainties associated with the presidential election. Business confidence has been boosted by President Kim Young-sam's strong commitment to economic recovery. In addition, the provision of special investment tax credit also stimulated equipment investment. Many firms revised the sizes and timing of their investments to take advantage of this special tax provision.

Led by increased spending on durable goods and leisure services, private consumption showed strong growth. Private consumption grew by 6.8% in the first quarter of 1994 over the same period a year ago, and 7.6% in the second quarter, compared to 5.7% in 1993. In contrast to private consumption, government consumption only increased 4.0% during the first half of 1994, reflecting the government's austerity program.

Aided by a strong yen, which made South Korean exports more competitive, exports increased by 13.6% for the first nine months of this year over the same period last year, compared to an 11.2% increase in 1993.

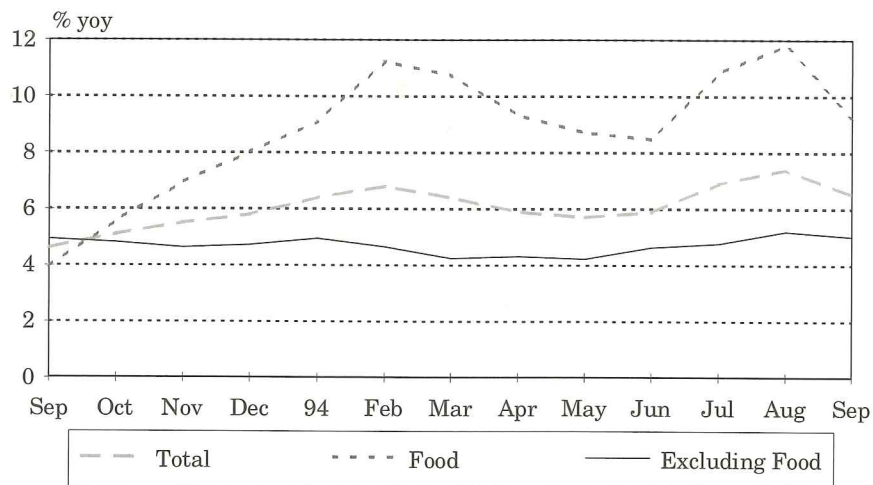
We expect domestic investment to grow at roughly the same rate in 1995 as this year's, i.e., about 10%. On one hand, investment in auto industry, electronic industry, and real estate will increase

due to strong export demand and strong business confidence. On the other hand, the expiration of the special investment tax credit at the end of 1994 will have negative impact on investment. Private consumption should grow faster next year, reflecting improved consumer confidence following this year's strong GNP growth. We expect private consumption to grow around 10% in 1995. Exports should continue to grow, but on a slower path due to the appreciation of the won. Overall, our forecasts for GNP growth rates are 8.4% in 1994, and 8.0% in 1995.

Higher than targeted inflation rate

Inflation and Money Supply Consumer price inflation in September was 6.6% yoy. The average CPI inflation in 1994 is expected to be 6.3%, over the government's target of 6%. However, we do not think the high inflation rate signals economic overheating. Higher inflation this year is mainly caused by the rise in the price of agricultural products due to bad weather. As the figure below shows, the CPI inflation rate, excluding food items, is actually not higher in 1994 than in 1993.

Figure 2. CPI Inflation Rate



Source: The Bank of Korea, Principal Economic Indicators

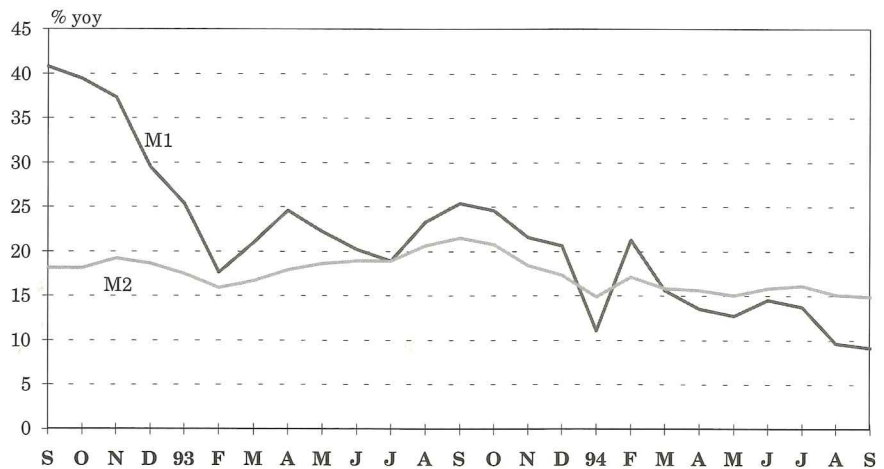
Next year, an increase in consumer spending, higher costs of imported raw materials due to a demand increase in international markets, and price increases for public utilities and services will increase inflationary pressure. However, the expected appreciation of the won and the increased market competition set off by market liberalization will mitigate these pressures.

Money supply tightened

Despite the fact that this year's excluding-food inflation rate is no higher than last year's, the monetary authority seems to be

concerned about economic overheating. The government has gradually tightened the money supply. M2 growth for the first nine months of this year was 15.6%, sharply down from 18.6% for 1993. Given the economic growth momentum, the government is likely to maintain the non-expansionary monetary policy in 1995 to curb inflationary pressures. The money supply (M2) growth target for 1995 is likely to be set within the range of 13-15%, which is 1-2% lower than this year's target. The central bank is likely to tighten the domestic credit supply in 1995 in order to offset the increase in liquidity following the increase in capital inflows.

Figure 3. Money Supply Growth Rate



Source: Institute of International Finance

Interest rates to rise

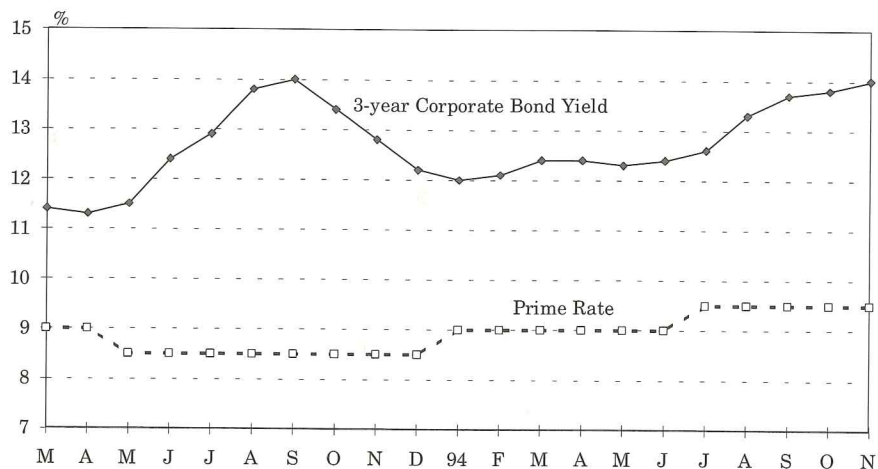
Interest Rates Due to the segregation of South Korea's domestic capital market from international markets, South Korea's interest rates are not closely correlated to those in the US or Europe. They are largely determined by demand for funds in the domestic market, as well as the money supply. Interest rates have increased since the beginning of this year due to (1) higher capital demands from small and medium-sized firms who generally do not have access to foreign capital, and (2) a tight monetary stance adopted by the Bank of Korea (BOK) to ease inflationary pressure.

In addition, higher foreign capital inflows contributed to the upward pressure on South Korean interest rates, because of the peculiar segmentation of South Korean financial market. Total money supply can be channeled into three sections: government, domestic private sector, and foreign capital. Given a fixed supply of money and assuming the amount of money in the government

sector is fixed, as money from overseas increases, i.e., more capital flows in, money available in the private sector decreases. The interest rates in domestic private sector will accordingly increase due to reduced supply in that sector. However, higher domestic interest rates do not necessarily mean higher capital costs. For large firms that have access to foreign capital, more foreign capital inflow means lower interest rates. But small and medium-sized firms are hurt by the high domestic interest rates. Overall, the average cost of capital is likely to decrease as more foreign capital flows in.

We expect long-term interest rates in 1995 to be higher than this year due to more foreign capital inflows and the BOK's tight monetary stance. The benchmark 3-year corporate bond yield is likely to reach 14.5% in 1995.

Figure 4. Interest Rates



Source: Bank of Korea, Bloomberg

Exchange rate The Won/US\$ exchange rate appreciated from W813 to a dollar in January to W793 in early December. This appreciation is mainly due to expected capital inflows after government's financial liberalization measures in the end of this year and during 1995. We expect the won to further appreciate during 1995. The won/US\$ exchange rate is likely to reach W765-W770 by the end of 1995.²

² For a detailed discussion of the South Korean won, please see Bankers Trust report: *Prospects for the South Korean Won*, December 10, 1994.

Trade balance to deteriorate

External balance The current account is expected to be back in deficit this year, as the surge in imports has been outpacing exports.

Exports posted growth of 13.6% in the first nine months, compared with 11.2% for the whole of 1993. Among the different sectors, exports of capital-intensive products, such as automobiles, machinery, and electronics, maintained high growth, while those of labor-intensive products showed slow progress. The good performance in exports is mainly due to the strong yen, which makes South Korean capital-intensive products more competitive relative to Japanese products.

Table 2. South Korea's Imports and Exports

	1987	1988	1989	1990	1991	1992	1993
Merchandise Exports (\$mm)	47,281	60,696	62,377	65,020	71,870	76,632	82,440
Export Composition % total:							
Textiles	23.3	22.2	23.1	21.4	20.5	19.6	19.3
Electronics	13.6	13.7	14.7	15.7	16.1	16.7	16.6
Export destination % total:							
U.S.	38.7	35.3	33.1	29.8	25.8	23.6	23.0
Japan	17.8	19.8	21.6	19.4	17.2	15.1	14.1
Exports as % GDP	35.9	34.8	29.3	26.6	25.3	25.8	25.9
Merchandise imports (\$mm)	41,020	5,1811	61,465	69,844	81,525	81,775	83,800
Import Composition % total:							
Capital goods	35.5	36.7	36.4	36.4	36.9	37.4	36.4
Food and consumer goods	9.6	9.5	10.0	9.6	9.9	10.5	10.4
Import origin % total:							
Japan	33.3	30.7	28.4	26.6	25.9	23.8	23.8
U.S.	21.4	24.6	25.9	24.3	23.2	22.4	21.4
Imports as % GDP	31.1	29.7	28.9	28.6	28.7	27.5	26.3

Source: *Institute of International Finance*

Imports grew even more rapidly, achieving a rate of 19.1% during the first nine months of this year. In particular, capital good imports surged as companies struggled to expand their production capacity to meet the increasing demand from abroad. For the year as a whole, the current account is expected to have a deficit of \$3.4 billion.

In 1995, two opposing forces will affect South Korea's exports. The recovery of the European economies and the continuing healthy economic growth in the U.S. and in Asia will keep

demand high for South Korean products. This year's massive investment on facilities will increase production capacity for exports. An appreciating yen will also boost South Korean exports.

On the other hand, a strong won will hurt the price competitiveness of many export sectors, especially the labor-intensive industries. We expect that in 1995 exports from capital-intensive industries will continue to grow faster than those of labor-intensive industries. Overall export growth will be around 12%.

Next year's imports should continue to increase rapidly but its annual growth rate should be lower, because this year's import surge. We expect capital good imports to grow at a lower rate, while imports of consumer goods will grow faster than this year. Overall, we expect the growth rate of imports to be at 17% in 1995.

In summary, we believe South Korea will continue to enjoy strong economic growth in 1995 and possibly 1996. Both consumption and investment will expand rapidly. Financial liberalization should attract large amount of foreign capital into the country and put upward interest rate and exchange rate. We expect the money supply continue to be tight, i.e., grow at 13-15%. GDP is expect to grow at 8%.

South Korea's Stock Market

South Korea's stock market has experienced a boom-bust cycle since mid-1980s. From late 1985 to the first quarter of 1989, the market experienced an unprecedented bull run, driven by double digit economic growth, sharply improved corporate earnings, and a large trade surplus. The Korea Composite Stock Index (KOSPI) rose from 150 in late 1985 to 1,007 by early 1989, and the market capitalization soared to W95 trillion (US\$135 bil), a 15-fold increase from 1985. Then, as the growth of the economy slowed down, the stock market began to weaken in the second quarter of 1989 due to a deteriorating trade balance, stiff currency appreciation, rapid wage hikes, labor unrest, mounting interest rates, excessive supply of new shares during 1988 and 1989, and real estate speculation. The KOSPI retreated more than 54% to 459 in August 1992.

Figure 5. KOSPI Index, 1985-94

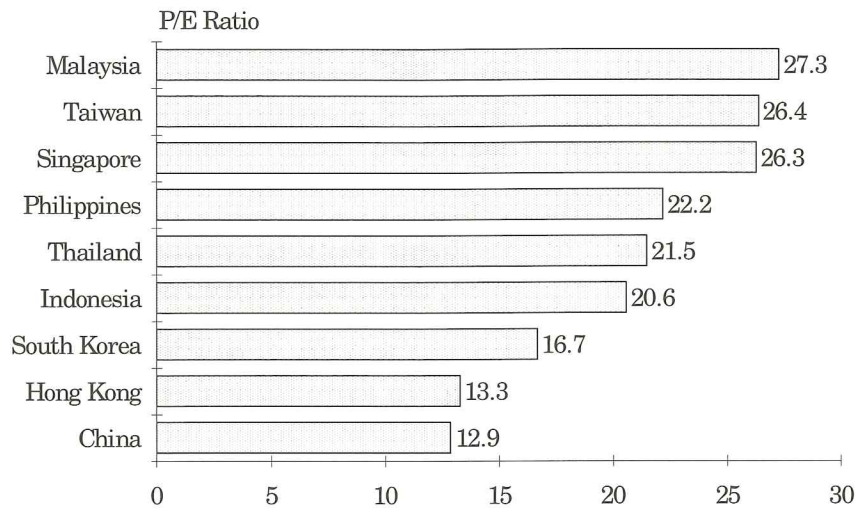


Source: Bloomberg

Since August 1993, the stock market has risen dramatically. KOSPI reached the historical high of 1138 in November 8, 1994. One reason for this bull run is market liberalization. Beginning in January 1992, the government has partially liberalized the stock market, allowing foreigners to own South Korean stocks up to a specified ceiling. The ceiling was first set to 10% in 1992 and was raised to 12% on December 1, 1994. This measure attracted a net foreign capital inflow over US\$10 billion. Another reason is the strong economic recovery since mid-1993, which improved corporate earnings.

Although the current KOSPI index is at historical highs, due to lift of ceilings on foreign ownership of Korean stocks, we believe the market is undervalued compared to other Asian markets. Its estimated market P/E ratio for 1994 is 16.7, much lower than all other major Asian markets except Hong Kong. In 1995, the listed companies are looking for much better earnings, especially for export oriented companies, thanks to strong yen and rapid export growth. In view of South Korea's sound political and social environment, comparatively high growth potential of the economy, advanced industry structure, and further markets liberalization in 1995, the stock market will continue its bull run over the next year.

Figure 6. Comparative PER



Source: Consensus estimates from *The Estimate Directory*

Inter-Korean Relations

Old enemies...

Since the Korean War from 1950-53, the two Koreas have been enemies. The South has been protected by the U.S. military while the communist north has allied with the former Soviet Union and China.

... with different records of growth

While the South has experienced rapid economic growth and rising international stature, the North's economy has lagged far behind, under a rigid Soviet-style regime. In 1992, South Korea's per capita GNP reached US\$6,749, while North Korea's was US\$943. Evidence shows that North Korea's economy has been shrinking for the last five years.

Contacts gradually increased

Since the early 1970s, the two sides have gradually increased contact on issues ranging from family reunification and inter-Korean reconciliation, to denuclearization of the Korean Peninsula. On September 4, 1990, the first South-North Prime Ministers' meeting was held in Seoul, which led to the signing of three important accords between the two sides on reconciliation, nonaggression, and denuclearization. Since 1992, the two sides have started preliminary meetings for a possible South-North Summit meeting.

Nuclear issue not a real threat

Recently, North Korea's refusal of nuclear site inspections by international monitors strained inter-Korean relations. But most South Koreans regard the roar over the nuclear inspection issue more as a plot by the north to extract economic aid from the West than as a real threat to South Korea's security. However, most

South Koreans welcome the recently signed nuclear accord as it will eventually help to improve North-South relations. The agreement lifted the threat of economic sanctions and a military strike against the North, giving Pyongyang the opportunity to solve the country's internal problems. There may soon be a further diplomatic crisis, however, if the new Republican-dominated U.S. Congress refuses to support the Clinton administration's deal with North Korea.

Economic contacts may lead to reunification

Economic contacts between the two Koreas already exist. Since 1988, Seoul has allowed indirect trade with the North. Each year South Korean firms buy almost \$200 million-worth of gold, zinc, fish and rice liquor from the North, shipping it via China or Hong Kong. In early November this year, South Korea announced that it would gradually lift its ban on economic exchanges with North Korea. This will further facilitate trade and investment in the North. Joint ventures with South Korean firms would help improve the economic situation in the North and pave the way for a peaceful reunification.

Military invasion by North unlikely

Although the possibility of a military invasion from North Korea can not be dismissed, it is unlikely. Since the end of the "cold war," there has been great change in the geopolitical mapping of the region. North Korea first lost the support of the Soviet Union. Then, as South Korea established diplomatic relation with China in the early 1990s, China has gradually distanced itself from the North, treating the two Koreas more or less equally. Currently, all the superpowers in the region, the United States, Japan, China, and Russia, unanimously support peaceful dialogue between the two countries. We believe that this positive external environment is very important for maintaining the stability of Korean peninsula.

Peaceful reunification: a realistic scenario

Another conceivable risk to South Korea's economic stability is a sudden collapse of the North Korean regime, and a flood of economic refugees from the north, similar to what happened in Germany. This would put a huge economic burden on the South since the per capita income in the South is several times that of the North. But this will not necessarily happen. A more realistic scenario is that the North gradually opens up its economy while maintaining political control, similar to what is happening in China. Under this scenario, the two Koreas will coexist for a considerable length of time while increasing their economic ties, eventually leading to a peaceful reunification.

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