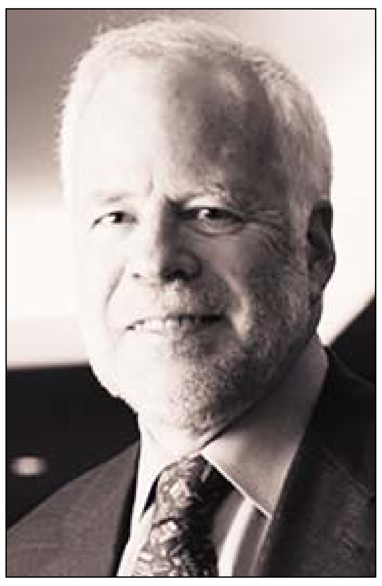
Korean Economy Stuck Between Two Whales

By Barry Eichengreen

George C. Pardee and Helen N. Pardee Professor of Economics and Political Science, University of California, Berkeley



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The Korean economy is a shrimp swimming amid two whales, the United States and China. Rather than being bashed by the whales' tails, Korea has always been able to navigate among these humongous creatures. Faced with a difficult situation, it has always been able to make something of it.

In 2008 the shrimp's task will be especially daunting, because the movements of the two whales will be especially violent. The United States is almost certainly headed for recession. While the Fed insists that the jury is still out, it has an incentive to hedge its bets and to avoid disturbing the markets. Independent economists, in contrast, can call it as we see it.

And what we see is increasingly depressing. Credit markets are not on the mend; to the contrary, every day brings news that the credit situation is worse than previously thought. Residential construction is at standstill, and commercial construction looks ready to join it. Ultimately the consumer will tell the tale. And here, early returns from retail stores counting on robust holiday sales are not encouraging. 2008 will almost certainly bring a weaker U.S. economy and an even weaker dollar.

China's situation could not be more different. Its economy continues roaring ahead. Extraordinarily high investment rates continue to fuel double-digit growth rates.

The authorities' steps to restrain this investment boom, limit the rise in property prices, and put a lid on the Shanghai and Shenzhen stock markets are notable only for their futility.

China's export industries continue to motor ahead. And as the dollar falls, the renminbi falls with it, further enhancing Chinese exporters' already admirable competitiveness. In turn this only encourages more frenzied speculation.

What should the shrimp do in this situation? Korea is in the fortunate position that it exports to both the U.S. and China. If the U.S. slows and China accelerates, it can export less to the first and more to the second.

Since China is more a purchaser of capital goods and the U.S. of consumer goods, this will be better for Korea's shipbuilding industry than its consumer-electronics industry.

But so it goes. Korean policy makers will want to worry more about strengthening trade and investment links with China and less about finalizing the Korea-U.S. FTA. But, again, there would be no grounds for a radical course correction.

While it is hard to imagine that 2008 could turn out better than this, it could turn out worse. Considerably worse would be if China joined the U.S. in recession. The two motors of the world economy would then fail at the same time. And countries like Korea would have no market to which to turn.

An interruption to Chinese growth is by no means certain, but there is a sense in which most economists are underestimating the risks. Worriers have been warning for years of dangerous imbalances in the Chinese economy.

China's high investment is admirable, but massive amounts of inefficient investment come back to haunt you — as Koreans will remember from their own experience in the 1990s. Labor shortages on the coast coexist with labor shortages in the interior. The Chinese economy remains excessively dependent on exports, including exports to a slowing United States.

Particularly worrisome is the country's financial position. China is experiencing massive property-market speculation. The stock market has lost all touch with reality. The banking system is a mess. No one knows exactly how much the banks have lent to real estate and stock market speculators, but the answer is certainly "too much."

The most alarming aspect is that the problem will only worsen. Since the renminbi continues to track the dollar, a lower dollar will mean more receipts for Chinese enterprises desperate for somewhere to park their funds.

There will be even more credit and liquidity chasing the same investments in real estate and the stock market.

Lower Fed interest rates will mean lower Chinese interest rates, where this is the last thing that the economy needs. Unless there is a radical change in China's exchange rate policy, which remains unlikely, the speculative mania will only heighten.

What goes up can, of course, come down. It is hard to say what the trigger might be, but history suggests that there will be one. The United States had a series of investment-led booms and crashes, followed by recessions, when it was a developing country in the 19th century. There is no reason why China should be different.

And a sharp decline in the Shanghai and Shenzhen stock markets could mean a sharp decline in Chinese growth. Property developers would pull in their horns.

Banks that had lent to real estate and stock market speculators would have to rebuild their balance sheets, and they would curtail their lending to industrial and commercial borrowers. With less domestic demand, Chinese firms would attempt to export more of what they produced. And the United States would be in no position to buy it.

For an economy like China presently growing a more than 10 percent, a sharp slowdown would mean that growth fell by half, to 5 or 6 percent, until the financial situation normalized. Five or 6 percent growth is not a recession for a typical economy, but it would be a very sharp change in circumstances for China and the world.

If 2008 is a year of U.S. recession, many economists will be able to say "I told you so." While the consequences for the world economy and the Korean economy will not be pretty, the pain will be tolerable.

But the real danger is that 2008 may also be a year of Chinese recession. For most economists this would be a surprise. And for the world economy and Korea, it would be a very painful situation.

High oil prices, U.S. subprime woes and slowing Chinese economy will combine to increase uncertainties for South Korean economy next year.

External Negatives Weigh on Economy

By Lee Hyo-sik

Staff Reporter

Major investment banks and economic research institutes at home and abroad are moving to revise down Korea's economic growth forecast next year as record high oil prices and other external negatives are increasingly driving the export-driven economy into a corner. The majority put the growth projection at somewhere between 4.5 percent and 5 percent, but they are set to cut the forecast to as low as 3.9 percent.

Concerns have been growing for quite some time over the rising international crude oil prices and a stronger won against the dollar. Analysts say high oil prices are making goods and services more expensive here, chipping away at corporate profits and reducing private consumption, while the strengthened won weakens the price competitiveness of Korean goods on overseas markets.

Also, the U.S. economic slowdown — as a result of the housing market slump on top of the high oil prices — will likely force American consumers to tighten their belts and buy fewer products from South Korea, they said. The Korean and global stock markets have recently been rattled by renewed concerns over the unabated U.S. subprime problems, making investors across the globe flee from stocks and other riskier assets.

Several international investment banks have begun sounding the alarm that the world's 13th largest economy could expand at a slower pace than previously expected in 2008 amid worsening external conditions.

Citing slowing exports and continued sluggish domestic consumption, Deutsche Bank recently forecast that the Korean economy will grow 3.9 percent in 2008, sharply lower than government's projection of 5 percent.

UBS also said the Bank of Korea (BOK)'s multiple interest rate hikes this year, designed to rein in rising inflationary pressure as a result of surging oil prices, will have a negative impact on the economy next year, putting the 2008 growth forecast at 4.1 percent.

"Korea's outbound shipments will slow in 2008 because of the U.S. economic slowdown in the wake of the housing market slump. Also, exports bound for China are likely to decline as the Chinese government's belt-tightening policies will negatively affect consumer spending," the Geneva-based investment bank said.

"U.S. subprime problems are making investors across the globe reduce stocks and other riskier assets.

With deteriorating external conditions, major local research institutes have also hinted at revising down the 2008 economic growth projection. Kim Chang-bae, senior researcher of the Korea Economic Research Institute (KERI), said the institute is considering cutting its growth forecast to below 5 percent. It earlier projected the economy will expand 5.1 percent from a year earlier, in line with Samsung Economic Research Institute (SERI) and LG Economic Research Institute (LGERI), which both put the next year's growth rate at 5 percent.

"We had previously expected domestic consumption to bounce back next year, the but high price of oil and other raw materials will likely keep private spending stagnant for the foreseeable future, failing to offset slowing exports," Kim said.

Also, LGERI economist Song Tae-Jung said if the U.S. gross domestic product (GDP) growth falls to below 1 percent next year, it could send the entire global economy into recession. "If such a scenario materializes, the Korean economy will not be able to expand more than 4 percent in 2008."

He said the government should closely monitor changes in the external environment, adding a host of outside factors will largely determine the fate of the Korean economy for the next few years.

Surging Oil Prices

The largest external risk facing the Korean economy is high prices of crude oil and other raw materials, which make products more expensive, worsen profitability of local companies and force local consumers to spend less.

"International oil prices have jumped sharply this year as demand from China and other developing countries rises, while the oil supply has remained unchanged across the globe. Also, the weak dollar and speculative forces have further pushed up prices," LGERI economist Song said.

He said crude prices are expected to increase at a faster pace next year on a weak dollar and speculative demand, on top of tight global supply, cautioning that if international oil prices surge above $100 per barrel, it will deal a blow to the economy.

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