

KERI

Economic Bulletin

October 2004 No.37 Quarterly

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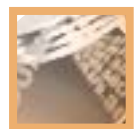
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Korea Economic Research Institute

What is KERI?

Korea Economic Research Institute (KERI), a private economic research institute, was founded on April 1, 1981. Its purpose is to contribute to the growth and development of the national economy through "the building of an efficient free-market economy system and the nurturing of healthy corporate growth." Our scholars are conducting integrated research on both the entirety of the Korean economy and the long- and short-term prospects for corporate growth. We are vigorously working towards becoming a world-class think tank. The founding concept and basic philosophy of our research institute is "Free Market, Free Enterprise, Free Competition."



The national economy in 2004 will likely record 5.0% GDP growth for the year, despite a slower growth in the second half forecast at 4.6% due to a slowdown in export growth and delayed recovery of domestic demand.

In the second half of 2004, a weak recovery of consumption and facility investment is expected, while the construction sector is expected to slow down sharply. Consumer prices are projected to register a 3.8% annual rate, with a 4% increase expected in the second half propelled by international oil price hikes.

Meanwhile, export growth is expected to decline in the second half of this year as external conditions turn less favorable. Risk factors are high oil prices, China's retrenchment policies and increases in US interest rates. The current account balance surplus is expected to record US\$23 billion for the year.

Economic growth for 2005 is forecast at 4.4%. Although a gradual recovery of domestic demand is expected with increased expansionary government policies, export growth is expected to decelerate, thus lowering the overall growth rate. Current account surplus is forecast to record only US\$10.3 billion for the year. Consumer prices are likely to rise at a 3.3% annual rate owing to the slowdown in economic growth, foreign exchange rate appreciation, and stabilizing international oil prices.

As for future policy tasks, a little less political bickering is called for. The very divisive current political strife on various issues including the abolition of the National Security Law, relocation of administrative capital, and investigation of historical issues is depressing broad business as well as consumer sentiments. A more stable political and social atmosphere appears to be a precondition for a sustainable economic revival. An expansionary macroeconomic stance should be maintained in both fiscal and monetary policies. In addition to budgetary stimulus, tax cuts should be considered as part of these measures. The efforts to establish healthy labor-management relations based on the rule of law should be redoubled.

Recent Developments

Together with the continuing slowdown in domestic demand, economic recovery has been held back due to sluggish export growth.

Poor progress in consumption demand has continued, registering a 0.6% decrease in wholesale and retail sales in July~August, following a 0.3% decrease in the second quarter of this year. Facility investment also displayed weak recovery in the midst of a construction investment decline.

Export growth, which had gradually slowed since April when it reached 46.6%, recorded 23.5% in September, which is lower than the monthly import growth of 25.2%.

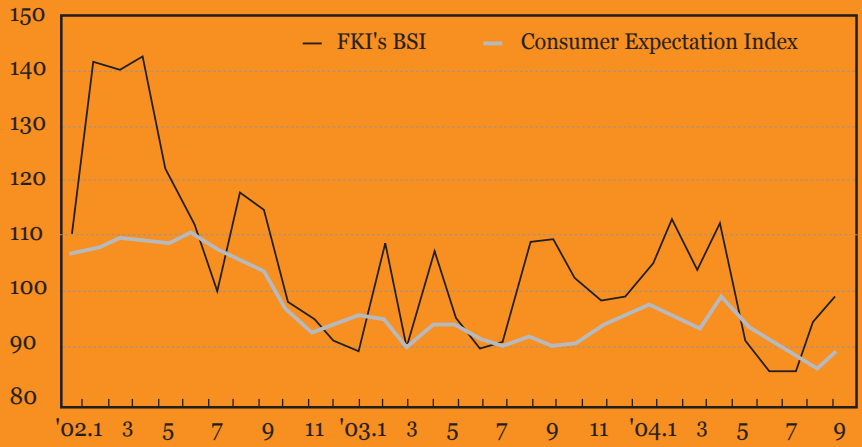
The Cycle of coincident composite index, indicating the health of the present economic trend, was below the standard value (100) for four consecutive months starting in May 2004.

Real Economy Trend (yoy%)

	2003						
	1/4	2/4	May	June	July	August	Sept.
Industrial Production	11.0	12.3	13.5	12.4	13.0	10.6	
Wholesale & Retail Sales	0.1	-0.3	-2.3	1.6	0.3	-1.5	
Facility Investment	-3.8	2.5	1.3	7.7	2.3	5.0	
Construction Investment	9.8	10.7	9.7	8.1	9.9	8.9	
Exports	37.7	38.8	41.9	38.0	36.2	28.8	23.5
Imports	19.3	32.5	32.3	38.1	23.2	33.2	25.2
Cycle of coincident composite index	100.1	99.6	99.7	98.9	98.1	97.1	

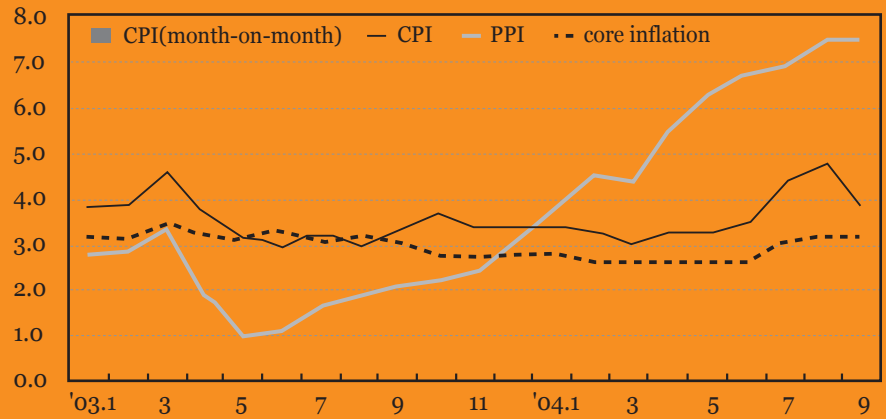
The BSI (Business Survey Index) of the Federation of Korean Industries (FKI) also recorded below the standard value (100) for five consecutive months since May, along with the continued fall in the consumer expectation index. The BSI is the result of a survey taken early each month by enterprises to obtain economic projection for the following month, and the consumer expectation index reflects consumer sentiment for six months ahead of month in which it is reported. Broadly speaking, we can expect a delay in the recovery of economic sentiment.

Trend of Major Economic Sentiment Indices



Affected by a sharp increase in international oil prices, producer prices and consumer prices rose 7% and 4%, respectively,

Price Trend (yoy%)



Sources: Bank of Korea (BOK), National Statistical Office (NSO)

Thanks to strong export performance and a large surplus in the commodity account balance, the current account for the January-August period this year recorded a US\$ 17.5 billion surplus.

Trend of Current Account Balance

(Unit: US\$100 million)

	2003				2004			
	1/4	2/4	July ~Aug.	Year	1/4	2/4	July ~Aug.	Jan. ~Aug.
Current Account	-15.2	24.3	16.5	123.2	61.5	70.4	43.3	175.1
Goods	12.4	57.6	37.5	221.6	86.1	104.1	60.3	250.5
Services	-23.0	-16.7	-20.0	-76.1	-18.8	-15.1	-18.6	-52.5
Income	2.6	-10.4	4.3	6.0	2.3	-11.6	3.0	-6.3
Current Transfers	-7.3	-6.2	-5.3	-28.2	-8.0	-7.1	-1.5	-16.6

Growth for Second Half '04 Projected at 4.6%

In the second half of this year, economic growth is projected at 4.6% given a number of unfavorable factors including export growth stagnation, and delayed domestic demand recovery. The full-year economic growth rate will likely be around 5.0%.

Export growth is expected to decline due to external risk factors such as the aftereffects of China's retrenchment policy, continued increase of U.S. interest rates in the second half, the possibility of terrorist attacks before the U.S. presidential election, and technical factors following the high export growth rate recorded in the second half of 2003.

Private consumption will remain on a slight recovery trend in line with a technical rebound in the second half of this year and considering recent poor consumption indices caused by a lack of significant improvement in employment and excessive household debt.

Facility investment is expected to post a 7%-level recovery in the second half due to positive preceding indicators including a rise in machinery orders, an increase in demand for facility investment, and improvement in financial conditions of manufacturing businesses. Construction investment however will likely continue its sharp downward trend for the time being largely influenced by the slowdown in economic conditions in the real estate following the government's reinforced housing and real estate restrictions.

Economic Growth for 2005 Forecast at 4.4%, Lower Than 2004

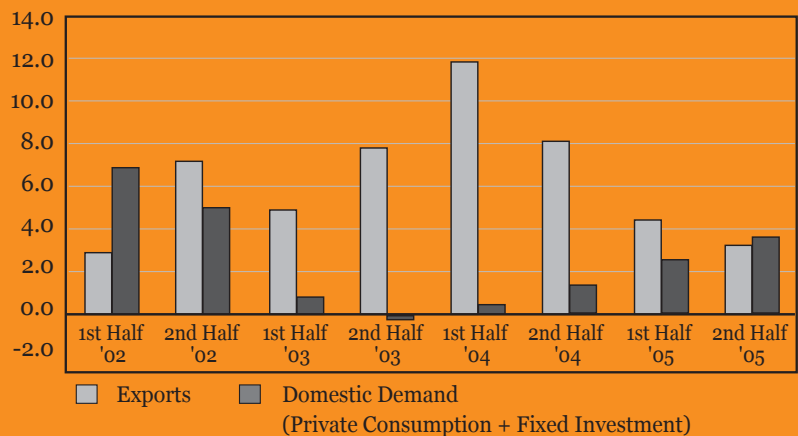
The economy is likely to grow 4.4% in 2005, slightly lower than in 2004, particularly recording low growth in the first half followed by higher growth in the second half.

With a slight decline expected in the global economy, export growth stagnation is expected to continue, while domestic demand is unlikely to recover significantly until after the first half of 2005. Consequently, economic growth for the first half of 2005 is expected to fall to a low of 4%.

In the second half of 2005, economic growth is forecast to rise near to 5%, with growth in domestic demand playing a leading role. Recovery in domestic demand is expected following the effects of the government's expansion of financial expenditures and tax reductions.

The overall shape of the possible future projection indicates that the contribution of exports to economic growth will decline on a gradual basis, while that of domestic demand (private consumption + fixed investment) will recover gradually.

Contribution of Domestic Demand and Exports to GDP Growth (%p)



Major Domestic and Overseas Risk Factors Related to Projection

Amongst important potential negative overseas factors related to projection are oil price instability, retrenchment of the Chinese economy, and continued U.S. interest rate increases.

High oil prices are already creating a heavy burden on domestic prices, with effects resulting in a worsening of corporate profitability and a fall in household disposable income. Although the sharp increase seems to have slowed recently, there is still the possibility that oil price problems will likely re-appear as instability in the Middle East persist.

It is widely believed that China's retrenchment will not lead to a hard-landing of its economy. Nevertheless, if symptoms of overheating such as price hikes and fixed investments increases appear again, China will most likely opt for broader and stronger retrenchment policies to cause a more rapid reduction in the growth of its economy.

Further increase in U.S. interest rates seems possible while avoiding an economic recession. However, on the international scene, the larger the increase in U.S. interest rates, the more the negative impact on the global economy.

Various domestic factors that could make consumption and investment recovery difficult include corporate management hardships, strong labor unions, business restrictions, and anti-entrepreneurial sentiment, as well as the possibility of continued political strife over issues related to the National Security Law, relocation of the administrative capital and investigation of historical issues.

Consumer Price Increase: 4% Level in the 2nd Half - Annual 3.3%

The combined impact of high-level increases in international oil and raw material prices, as well as the won-currency appreciation serving as the main domestic inflation pressure factor, consumer prices in the second half of 2004 is expected to soar about 4.3% resulting in an annual increase of 3.8%.

Import prices sharply rose by about 16% year on year in the July-August period this year. Subsequently, producer prices also rose to 7%, which will add pressure to consumer price increases with a time lag.

Prices in 2005 are expected to return to a comparatively stable trend, recording an annual rate of 3.3%. With a mild recovery in domestic demand coupled with a won-currency appreciation, inflationary pressure will not be as great, and could also benefit if international oil prices stabilize next year.

Current Account Balance: US\$23 Bil. in '04 and US\$10.3 Bil. in '05

With the gap between export growth and import growth narrowing in the second half of 2004, the current account is expected to record about a US\$9.8 billion surplus, which is smaller than the US\$13.2 billion surplus realized in the first half of the year.

In 2005, the scale of the current account balance surplus will likely register about US\$10.3 billion, less than the half that of 2004. Whereas the sluggish trend in export growth, which started in the second half of this year, is expected to continue next year, the decline in import growth will not be as great owing to a gradual recovery in domestic demand.

Long-Term Interest Rates to Continue Decline Until 1st Half of 2005

Based on the yield rate of 3-year-maturity corporate bonds, market interest rates in 2005 is expected to increase 4.2% in the first half and 4.8% in the second half, thereby registering an annual average of 4.5% for the year.

Due to export growth slowdown, mild domestic demand recovery, and continuation of geopolitical risks, improvement of investment sentiment will remain weak and with an additional decrease in the call interest rate, low-interest rates is expected to prevail.

However, a gradual domestic demand recovery over the course of 2005 should help raise interest rates in the second half.

Won-Dollar Exchange Rate to See a Slow Decline

The won-dollar exchange rate is projected to continue on its declining trend from this year's average of 1,155.1 won per U.S dollar to an annual average exchange rate for 2005 at 1,114.5 won per U.S dollar.

Influencing the won-dollar exchange rate are the narrowing difference between domestic and overseas interest rates and slowdown in export growth, as well as the inflow/outflow of foreigners' stock investment funds. However, a slow decline in the won-dollar exchange rate is likely owing to the current account surplus which is expected to continue in 2005.

Furthermore, due to expansion of U.S. budget and current account balance deficits, amongst other factors, there is strong possibility that the weakening trend of the U.S. dollar may continue in the near future. With expectations regarding an increase in U.S. economy's growth trend and U.S. policy interest rates, the dollar is unlikely to weaken significantly.

2004~2005 Economic Outlook

(Unit: Year-on-Year Change %)

	2003	2004				2005			
	Year	Q1	Q2	Q3	Q4	Year	1st half	2st half	Year
GDP	3.1	5.3	5.5	5.0	4.4	5.0	4.0	4.7	4.4
Private consumption	-1.4	-1.4	-0.7	0.7	1.7	0.1	3.1	4.6	3.8
Fixed capital formation	3.6	1.8	4.5	3.2	1.9	2.9	3.6	5.2	4.4
Facility investment	-1.5	-0.3	6.2	5.8	8.5	5.1	8.3	9.1	8.7
Construction investment	7.6	1.4	3.8	1.9	-1.6	1.7	0.3	2.6	1.5
Producer prices	2.2	4.2	6.2	7.2	6.8	6.1	3.8	2.3	3.1
Consumer prices	3.5	3.3	3.3	4.5	4.1	3.8	3.5	3.0	3.3
Current account balance (US\$100 million)	123.2	61.5	70.8	53.2	44.6	230.0	49.8	52.7	102.6
Commodity balance (US\$100 million)	221.6	86.1	104.5	85.4	63.7	339.7	114.6	110.2	224.8
Exports (US\$100 million)	1976.4	603.8	645.6	630.5	663.1	2543.0	1340.2	1385.0	2725.2
Changes (%)	20.9	35.6	38.8	28.5	15.3	28.7	7.3	7.1	7.2
Imports (US\$100 million)	1754.8	517.7	541.1	545.2	599.3	2203.3	1225.5	1274.8	2500.3
Changes (%)	18.1	19.6	32.7	29.1	21.9	25.6	15.7	11.4	13.5
Services, income & transfer (US\$100 million)	-98.4	-24.6	-33.8	-32.2	-19.2	-109.7	-64.8	-57.4	-122.2
Won/Dollar exchange rate (average)	1191.7	1171.9	1161.9	1149.6	1137.1	1155.1	1126.1	1103.0	1114.5
Corporate bonds (AA- %)	5.4	5.5	5.0	4.4	3.9	4.7	4.2	4.8	4.5
Unemployment rate (%)	3.4	3.8	3.3	3.4	3.6	3.5	3.6	3.4	3.5

1. Economic Recovery First, Please

Despite repeated pledges to focus on economic revival, the government and political leaders are ever increasing intensifying of politicizing very divisive issues. Thus, a top priority should be the resolution of political uncertainties, which are dividing national opinion in matters related to the National Security Law, relocation of the administrative capital, and investigation of national historical issues. Meanwhile, continued effort for consolidating the Korea-U.S. cooperation system remains important.

2. Continue to Promote Economy-Boosting Policies for Job Creation

The government should be active in the creation of more jobs through expansionary macroeconomic policies, especially if domestic demand slowdown should continue. Tax policy should aim at reduction in income tax and special excise tax rates, at least for a limited period, while monetary policy could consider an additional decrease in interest rates, particularly with the price-push pressure from total demand remaining low. Flexible foreign exchange rate policy should be maintained, and only if necessary should the government intervene to the level of mitigating any sharp fluctuations.

3. Establish Labor-Management Relations Respecting Laws and Principles

The government and political circles must seek a viable resolution of labor-management problems and conflicts among interest groups based on the rule of law. The neutral position taken by the government following labor strikes last summer as well as the disputes between credit card firms and discount stores this year has been positively judged. Enterprises should try convert temporary jobs into permanent ones to help alleviate the excessive working conditions of regular workers. A new layoff system based on the notion of 'productivity gap' could be introduced and applied in the event of a 'seriously worsened management situation.'

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