

KERI

Economic Bulletin

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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."



Despite a weak investment sector, the Korean economy is projected to post 5.0% growth in the second half of this year, higher than the 3.2% in the first half, owing to private consumption recovery and a weaker-than-expected export growth slowdown.

A gradual pick up in economic activities is currently underway. The setback in the GDP growth in the first quarter was due to unusually large inventory draw down. Recent recovery in domestic demand is supported by the increase in wholesale and retail sales and a firmer construction investment, as well as output expansion in the service sector since April.

Exports should continue to post slower growth in the second half as well due to comparison with the high growth of about 30% experienced in 2004, as well as a softer foreign demand and a stronger won. Nonetheless, the growth of exports is expected to rise about 8% on the back of a strong demand from China.

The current account surplus is likely to decline to about US\$8.6 billion in the second half of this year from US\$10.2 billion recorded in the first half due to comparatively faster slowdown in exports than imports. The won-dollar exchange rate should experience a mild appreciation, settling at an average of about 1,000 won/dollar in the second half of the year. Consumer prices are expected to stabilize at a 3.2% annual growth rate owing to the weak aggregate demand and exchange rate appreciation.

Concerning the fears of a Japanese-style long-term recession in Korea raised by some observers, it is not as likely as speculated, especially when we consider the differences in the economic structure between Korea and Japan. However, if a situation occurs where the external environment worsens severely while the domestic demand remains sluggish, the possibility of a long-term economic slump can not be ruled out.

Therefore, preventing such a possibility should be a top-priority policy task. For this, Korea needs to stimulate investments through activities such as promoting large-scale investment projects for construction of corporate cities and large-scale recreational facilities as well as through stimulating investments from large domestic and foreign enterprises. As a prerequisite, the government must ease various kinds of restrictions imposed on the business areas managed by enterprises and should facilitate the free movement of necessary resources and management expertise between enterprises.

Although the first quarter growth rate declined to 2.7% compared to the fourth quarter last year (3.3%), economic conditions are in a mild recovery phase owing to the gradual recovery of domestic demand.

A general air of optimism seems to exist. One basis for this optimism is that the growth decline in the first quarter can be attributed mainly to irregular factors caused by inventory changes. If inventories are excluded from the calculation, the first quarter growth this year was somewhat higher than in the fourth quarter of last year. Secondly, the contribution of domestic demand elements, such as consumption and investment, to economic growth were higher in the first quarter this year compared with the preceding quarter as shown in Table 1.

**<Table 1>
Contribution to GDP Growth by Major Expenditure Items**

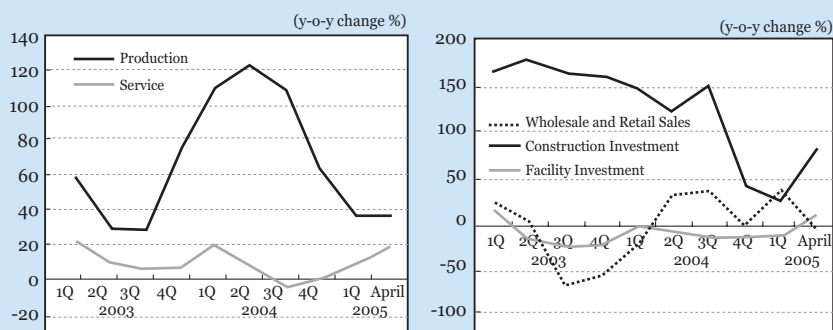
(Unit: % point)

	Consumption	Fixed Investment	Exports	Inventory	GDP
4th Qtr. 2004	0.5	-0.4	4.6	2.6	3.3
1st Qtr. 2005	1.1	0.0	4.0	-0.2	2.7

This trend has continued in the second quarter of 2005. In April, the growth rate of wholesale and retail sales noticeably rose, while the slow-down in construction investment eased and activities in the service sector expanded more than in the first quarter this year.

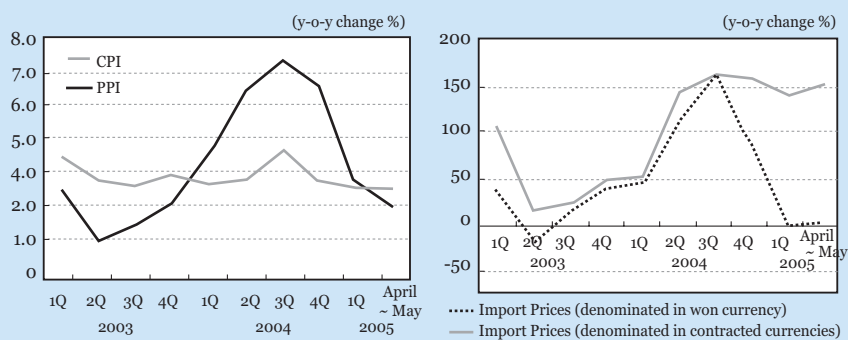
Due to slower export growth, however, production in manufacturing businesses and facility investment have been sluggish, but are likely to rebound with exports recovering in double-digit growth rates in May.

<Figure 1> Production, Consumption and Investment



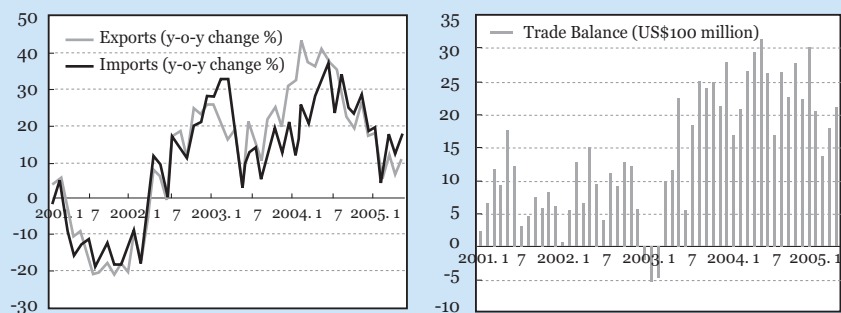
Trends in prices remain stable. The consumer price inflation rate dropped to 3.1% in April-May from 3.2% registered in the same period last year. The rate of growth in producer prices also declined to 3.3% in the first quarter from 6.5% in the fourth quarter last year and fell sharply again to the 2% level in April-May. This can be attributable to very stable import prices influenced by the won's appreciation, which have counterbalanced the impact of international oil price hikes.

**<Figure 2>
Inflation in Consumer Prices, Producer Prices and Import Prices**



The export growth rate fell to the 10% level in the first quarter and further dropped to single digits in April before rebounding in May. Affected by an increase in crude oil imports, the import growth decline was comparatively less than the decline in exports. As a result, the trade surplus contracted slightly.

<Figure 3> Export/Import Growth and Trade Balance



The current account surplus is experiencing contraction due to export slowdown. It posted red in April because of a large deficit in the income balance for the first time since April 2003. The capital balance continued to register a surplus into April since the first quarter of this year.

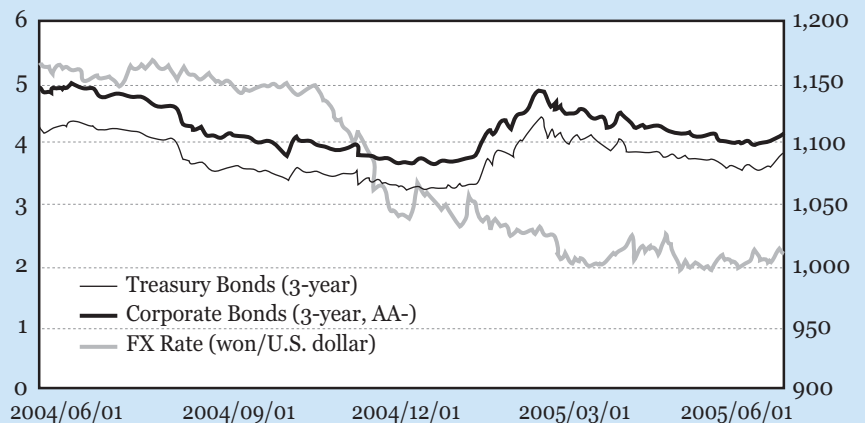
<Table 2> Balance of Payments

(Unit: US\$100 million)

	2004		2005				
	4/4	year	1/4	Jan.	Feb.	Mar.	Apr.
Current Account	73.5	276.1	59.5	38.7	9.7	11.1	9.1
Commodity	92.0	381.6	92.9	44.9	16.9	31.1	24.0
Service	-24.1	-87.7	-30.5	-8.7	-10.5	-11.3	-9.1
Income	11.7	7.2	2.4	5.0	4.6	7.2	21.4
Current Transfer	-6.1	-25.0	-5.2	-2.5	-1.3	-1.4	-2.6
Capital Balance	94.0	83.2	32.1	-8.2	4.9	35.4	19.6

Market interest rates have declined slowly since mid-February with expectations of economic recovery weakening. The won-dollar exchange rate appears to be more or less stable, which reflects the strong dollar trend.

<Figure 4> Market Interest Rates and FX Rate



With recovery in domestic demand and private consumption, as well as the export growth slowdown appearing more modest than expected, the Korean economy is projected to post a 5% growth in the second half and 4.1% for the full year. However, investment growth may remain comparatively weak from the poor performance in the construction and transportation equipment sectors. With the export growth slowdown less than expected, despite uncertain factors in the global economy including high oil prices, exports are still expected to contribute significantly to aggregate economic growth this year.

Amid mild overall demand pressures, consumer price inflation is likely to stabilize at the 3.2% level for this year, largely influenced by the appreciating Korean won.

Due to a faster slowdown in the growth of exports compared with imports, the current account balance surplus could fall to US\$8.6 billion in the second half from US\$10.2 billion in the first half of this year. Imports are expected to record double-digit growth rates in the second half owing to such factors as high oil prices and an import surge following consumption recovery.

Based on the 3-year-maturity corporate bond yield, market interest rates are expected to rise to about 4.8% in the second half from 4.3% in the first half this year. The won-dollar exchange rate is likely show a mild appreciation reflecting the weakening dollar.

<Table 3> Domestic Economic Outlook for 2005

(Unit: y-o-y change %, US\$100 million)

	2004	2005						
	year	1/4	2/4	3/4	4/4	1st half	2nd half	year
GDP	4.6	2.7	3.8	4.6	5.3	3.2	5.0	4.1
Seasonally Adjusted, q-o-q, %	4.6	0.4	1.7	1.6	1.6	1.7	3.2	4.1
Private Consumption	-0.5	1.4	3.2	4.2	5.1	2.3	4.7	3.5
Facility Investment	3.8	3.1	3.5	5.9	7.4	3.4	6.7	5.0
Construction Investment	1.1	-2.9	-0.4	2.2	4.1	-1.4	3.2	1.1
Consumer Prices	3.6	3.1	3.2	3.1	3.2	3.2	3.2	3.2
Current Account Balance	276.1	59.5	42.8	42.5	43.0	102.3	85.5	187.9
Export Growth (%)	30.6	12.9	8.5	7.6	4.2	10.6	5.8	8.1
Import Growth (%)	25.2	13.8	13.4	13.2	9.2	13.6	11.1	12.3
Won-Dollar Exchange Rates (average)	1,146.1	1,022.6	1,004.9	1,001.8	998.4	1,013.7	1,000.1	1,006.9
Corporate Bond Yield Ratios (annual %, average)	4.7	4.4	4.2	4.6	4.9	4.3	4.8	4.6

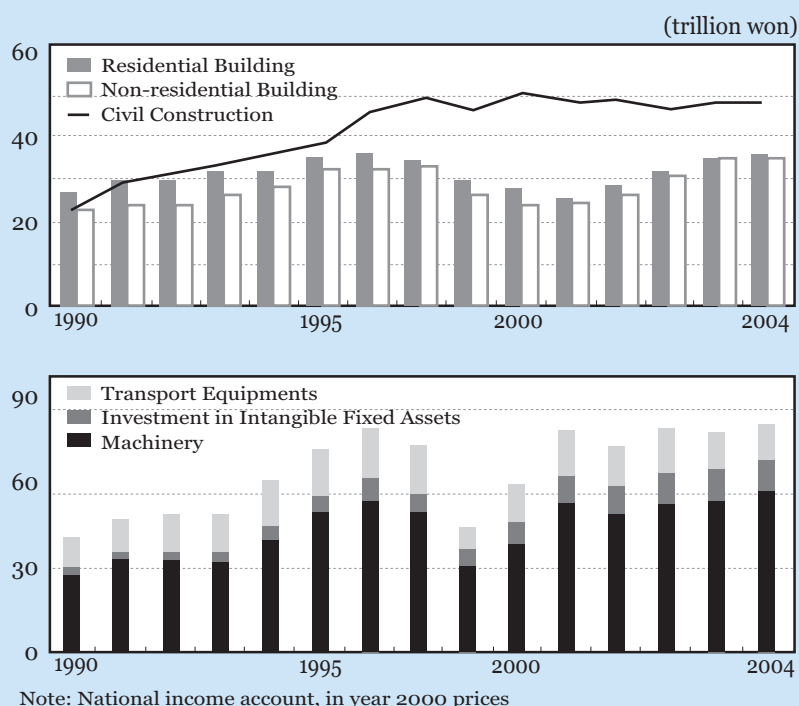
For Korea, the possibility of a Japanese-style long-term recession does not appear to be realistic at present. This is because Korea's export share, based on 2003 data, is about 37%, which is far higher than Japan's at 11%. This means that the contribution of brisk export performance to domestic economic conditions in Korea is greater than in Japan. As long as export performance continues, economic stagnation would be kept at bay even in the event of a domestic demand slump as in Japan.

Despite the differences in economic structure between the two economies, however, if exports sharply decline due to a worsened external environment, the possibility of a long-term economic doldrum cannot be ruled out, especially if domestic demand should remain anemic.

Therefore, a clear preventive measure to avoid a long-term economic depression is to bolster the domestic demand base. So far this year, fortunately, private consumption has started to recover. Hence, if coupled with an investment recovery, it may well provide further impetus to domestic demand recovery.

The recent poor investment performance can be traced to the transportation equipment and civil construction sectors, in particular (see Figure 5).

<Figure 5> Trends in Investments



Investments in large-scale projects, some related to the service sector, such as construction of corporate cities and large amusement facilities, should be vital to invigorate the sagging trend. For this to happen, active and substantial participation by Korean and foreign businesses is critical.

Changes in government policies that tend to restrict business activities are necessary especially to facilitate investment growth. First, it is necessary for the government to change its highly negative stance with respect to business diversification and to revise various policies targeting corporations that reflect such a position. Realistically speaking, existing enterprises are precisely those that have the capacity in the areas of financing and management expertises necessary for major investment projects. Second, restrictions on the movement of critical resources and management expertise between enterprises should be drastically alleviated. The key restriction in this regard is the limit set on equity investments by affiliated firms. Justifications for such restrictions have been common in influencing past corporate practices during periods when Korea did not have proper market mechanisms in place. However, in recent years, there has been considerable and significant change, such that the government might better reconsider its "we know it best" attitude. Furthermore, the government should take a honest look at reasons for the sagging foreign direct investment into Korea despite much efforts by government and the private sector. Rejuvenation of investment growth is an immediate and present task for the Korean economy to remain competitive.

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