

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."



Recent Economic Developments



Production, Consumption and Investment

The domestic economy sustained its recovery in the second quarter of this year with strong export expansion, despite a slowdown in domestic demand, specifically consumption and construction investment. Gross domestic product (GDP) enjoyed a robust growth rate of 6.3% compared with 5.8% in the first quarter. In the second quarter, however, both private consumption and construction investment weakened, with growth rates of 7.7% and 4.1%, respectively, down from 8.4% and 10.1% in the first quarter. Facility investment strengthened by 7.4%, but when seasonal adjustment factors are considered, the increase was a mere 0.2% rise from the preceding quarter, relatively poor progress. Meanwhile, export volume registered the remarkable growth of 13.7%, as compared with 2.5% in the first quarter.

July and August's sustained recovery was due to export expansion that offset the slowdown in domestic demand. As compared with the second quarter, the industrial production index recorded a strong rise of 8.6% from 6.8%. The indices related to consumption and construction, however, continued at a lackluster pace. Facility investment also remained stagnant during the period. Following 9.9% growth in the second quarter, export shipments expanded by a double-digit increase rate during these two months.

Production, Consumption and Investment

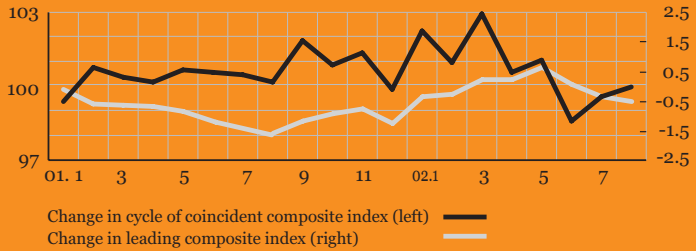
	2001	2002			
		1/4	2/4	July	August
Production	1.8	3.9	6.8	8.7	8.5
Wholesale & retail sales	4.6	8.0	6.4	6.6	6.0
Estimate of facility investment	-5.1	2.2	-0.2	-3.3	1.3
Construction progress payment	5.7	10.3	3.8	12.7	-5.5
Export shipment	-0.3	4.0	10.0	10.2	12.7

Source : National Statistical Office

Although the overall economic recovery is generally on track, the recovery rate is likely to weaken somewhat. The coincident composite index, having shown an upward trend through May, fell again thereafter, with the leading composite index tracing a 3-month consecutive slide since June as well.

●●● International Balance of Payments

Composite Business Index

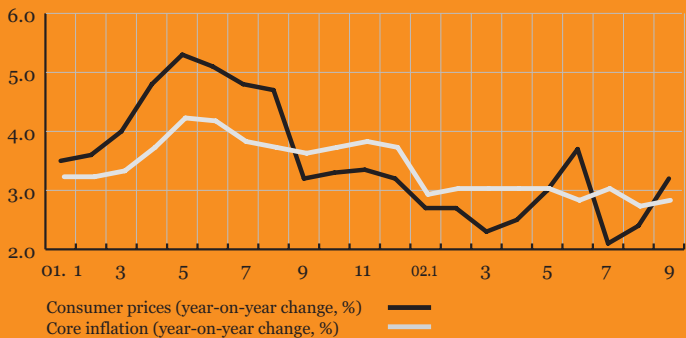


Due to the high growth of exports (U.S. dollar-based), the commodity account balance is continuing to record a surplus on a similar scale as 2001. On the other hand, the service account balance deficit is swelling, causing the current account balance surplus to shrink appreciably. In the January-August period this year, the current account balance recorded a surplus of US\$3.63 billion and the commodity account balance a surplus of US\$9.64 billion surplus, as compared with US\$6.83 billion and US\$9.75 billion respectively in the same period of 2001. Meanwhile, the service account balance suffered a more serious deficit of US\$4.79 billion in contrast to US\$2.01 billion.

●●● Prices

Consumer prices have maintained a stable trend. In June and July the upward price pressure weakened, owing to price decreases in farm, live-stock and fishery products and a reduction in some public fees like residential electricity rates and insured pharmaceutical prices. Consumer prices in August and September rose slightly due to a farm-product price hike directly resulting from flood damage, nevertheless stabilizing at around the 3% level. Core inflation also sustained a relatively stable trend at less than 3%.

Consumer prices & Core Inflation

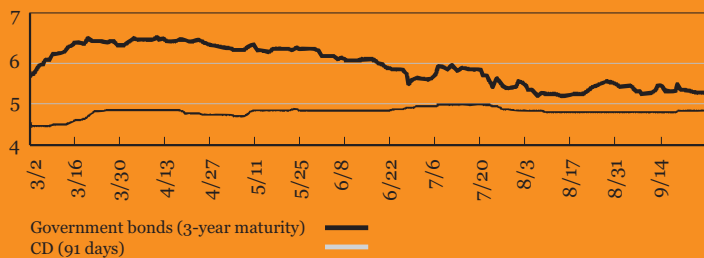




Interest Rates, Foreign Exchange Rate

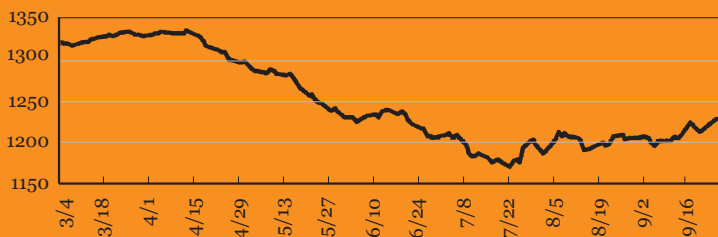
Long-term interest rates soared temporarily due to a hike in the call-interest target rate in May. On the whole, however, a continued downward interest trend is in evidence due to the scarcity of corporate debenture supply, price stabilization and amplified uncertainties over both the domestic and overseas economic environments. This includes weaker expectations of a full-scale surge in the domestic economy and the likelihood of continued instability in the U.S. capital markets.

Short & long-term Interest Rates



Influenced by a large increase in U.S. dollar denominated sales, the won-dollar exchange rate sharply declined to 1,160 won in late July. Nevertheless, the dollar value regained a certain extent of stability with the government's market intervention in combination with a counteraction to such a steep drop, fueling a recent exchange rate rebound to the 1,220-won level.

Won-Dollar Exchange Rate



The pre-eminent factor in the domestic economy forecast is the ongoing situation in Iraq. In this light, our outlook intends to study optimistic and pessimistic views based on the assumption that the current crisis may deepen into the outbreak of war at the year's-end or early next year, that the war may be short, and also in accordance with the future development of the situation.



Economic Outlook for Second Half of 2002

A slowdown in domestic demand is expected in the second half of 2002, including private consumption and construction investment. Even so, the domestic economy is forecast to reach 6.1% annual growth due to an anticipated continued economic recovery at a pace similar to that in the first half. This positive outlook could very well be boosted by an accelerating export recovery and the government's revised supplementary budget that addresses recovery from the typhoon damage.

- Private consumption has been in decline as of the second quarter. The downward trend is expected to continue in the second half when the temporary special excise tax reduction expires. Private consumption, which enjoyed an 8.0% growth rate in the first half, is likely to slacken to 6.1% in the second half.
- Construction investment is forecast to experience a sharp decline in the second half due to the elimination of certain temporary factors such as the rapid construction of residential buildings to avoid future construction restrictions. However, large-scale efforts to restore key infrastructure facilities, such as railroad and road networks hard-hit by typhoon "Rusa," through the government's supplementary budget are expected to brighten the construction growth picture to 1.8% in the second half. This development will tend to replace a negative growth forecast posted earlier in the year.
- Facility investment is projected at approximately an 8% level of growth in anticipation of gradually improving investment sentiment owing to the trend of a continued recovery of exports in addition to the recognition that investment in the

second half of last year dropped sharply.

- As for exports, uncertainties prevail in several areas: a delay in the U.S. economic recovery, instability in the won-dollar exchange rate and protectionist-trade tendency in the wake of growth in the U.S. trade deficit. Nevertheless, the double-digit rate of increase is likely to continue for the time being in view of last year's decline of exports at a rate of about 20% in the second half as well as the recent expansion of exports to China.

The current account balance is expected to record only a US\$4.3 billion surplus, roughly half the level realized last year. This is attributed to continuing oil price hikes, a trend of increased imports outpacing export growth and a persistent service account deficit.

Consumer prices are expected to experience upward pressure due to continued indications of an economic recovery trend. But the rate of increase will be limited due to the continued reduction in public utility charges and stabilization of real estate prices, staying at 2.9% in the second half, leading to an annual increase rate of 2.8%, a figure within range of the target set by the Bank of Korea.

Long-term interest rates are likely to remain low, due to a sluggish demand for funds and an increased demand for debentures caused by a preference for safe assets.



Economic Outlook for 2003

2002's trend of economic growth is expected to continue into 2003, owing to facility investment and export recovery. However, the growth rate in 2003 is expected to fall to 5.8%, slightly lower than the comparatively high rate of 6.1% predicted for 2002, and which is partially a reflection of the low 3.0% growth recorded in 2001.

- No adverse factors are foreseen to affect private consumption in 2003. Therefore, consumption will exhibit a positive trend similar to the GDP growth rate. Affected by the strong surge in the first half of 2002, the increase rate in the first half of 2003 may decline, but will likely recover to a level similar to the economic growth rate.
- Facility investment next year is expected to rise 9.2%, higher than in 2002, and principally due to prospects for a continued economic recovery, a robust export growth, (which is expected to lead to improvement in the investment sentiment) and, finally, to the comparative influence of two consecutive years of slowdown in the 2001-2002 period.
- Construction investment is, on the other hand, likely to stay at an annual growth rate of around 3%, extending the anemic trend from the second half of this year, as the supply volume in the housing sector falls, in addition to an upward swing expected in market interest rates.
- The export recovery should continue through next year, particularly the early months. As uncertainty over the Iraq crisis is expected to diminish, the economic situation in major advanced countries, including the United States, is likely to recover markedly, thus improving the export environment.
- Imports in 2003 are predicted to realize about an 11% expansion, higher than this year, due to the continued economic recovery and subsequent increase in facility investment and imports of capital goods.

The current account balance in 2003 is expected to be written in red ink in the second half, amounting to an approximate US\$700 million annual deficit. Consumer prices are also forecast to rise by about 3%, not unlike 2002. During the coming year, price-push pressure is likely to per-

sist as the approximate 6% economic growth rate continues. However, the breadth of price increase will be restricted, influenced by global oil-price stabilization (assuming an early resolution to the Iraq crisis), won-dollar appreciation trend, etc.

Meanwhile, in tandem with a stabilized world economy, short-term interest rates are expected to rise and long-term interest rates also will embark on an upward trend. The won currency will face gradual appreciation pressure amid the continued inflow of foreign investment funds, however, an unstable exchange rate is anticipated due to the possibility of a Japanese yen devaluation.



Risk Factors for Outlook

A possibility exists that a large-scale military attack on Iraq may not be necessary, if Iraq acquiesces to the United States' demands through UN mediation. In the optimistic scenario that the Iraq crisis does not lead to war and is settled before the end of this year, as compared with the basic scenario projection, the export and investment growth rates in 2003 may further expand, sparking a slight increase in the economic growth rate.

On the other hand, should the Iraq crisis continue and U.S. military action last longer than expected, a substantial effect on the domestic economy would stem largely from two sources. First, due to a long-term conflict, a sharp increase in international oil prices would be unavoidable, triggering a worsening of the domestic current account balance and commodity price increase. Second, the export rally would likely lose steam due to a sharp decline in the world trade volume, together with a chilling effect on consumption and investment sentiment in advanced economies, including the United States. Of course, domestic consumption and investment would also shrink accordingly. Shrinkage of the real economy is a distinct possibility as well as an aggravation of inflation caused by high oil prices. The possibility cannot be ruled out that the growth rate in 2003 would decline by 2-3 percentage points depending on the way the situation develops.



Economic Policy Issues

At present, factors exist for potential economic instability due to uncertainties in the external situation. Under these conditions, any change in macroeconomic policy direction may cause market confusion, impede the consistency and credibility of a given policy and upset the trend of economic recovery. Therefore, it is considered desirable to maintain the present macroeconomic policy direction for the time being.

Domestic Economic Outlook for 2002-2003

Unit : year-on-year change (%), US\$100million (Balance of payment)

	2001	2002		2003			
	Year	1 st half	2 nd half	Year	1 st half	2 nd half	Year
GDP	3.0	6.1	6.1	6.1	5.6	6.0	5.8
(Manufacturing)	1.7	5.0	9.1	7.1	8.1	7.6	7.9
Total consumption	3.7	7.6	5.6	6.6	5.0	5.6	5.3
Private consumption	4.3	8.0	6.1	7.0	5.4	5.8	5.6
Fixed capital formation	-1.6	6.0	4.4	5.1	4.7	6.6	5.7
Facility investment	-9.7	5.2	8.3	6.7	7.7	10.2	8.9
Construction investment	5.8	6.7	1.8	3.9	1.9	4.0	3.1
Consumer price	4.1	2.6	2.9	2.8	2.7	3.3	3.0
Current account balance	86.1	35.3	7.7	43.0	8.9	-16.4	-7.4
Commodity balance	133.9	76.6	49.0	125.6	51.5	27.6	79.0
Exports	1513.7	767.4	845.8	1613.2	832.2	896.9	1729.1
Change (%)	-14.0	-3.2	17.3	6.6	8.5	6.0	7.2
Imports	1379.8	690.8	796.8	1487.6	780.8	869.3	1650.0
Change (%)	-13.3	-2.7	19.0	7.8	13.0	9.1	10.9
Service, incomes & transfer	-47.8	-41.4	-41.3	-82.7	-42.5	-44.0	-86.5
Won/US\$ (end of period)	1326.1	1201.3	1180.0	1180.0	1165.0	1150.0	1150.0
3-yr corporate bond (Avg.,%)	7.0	7.2	6.8	7.0	7.7	8.3	8.0

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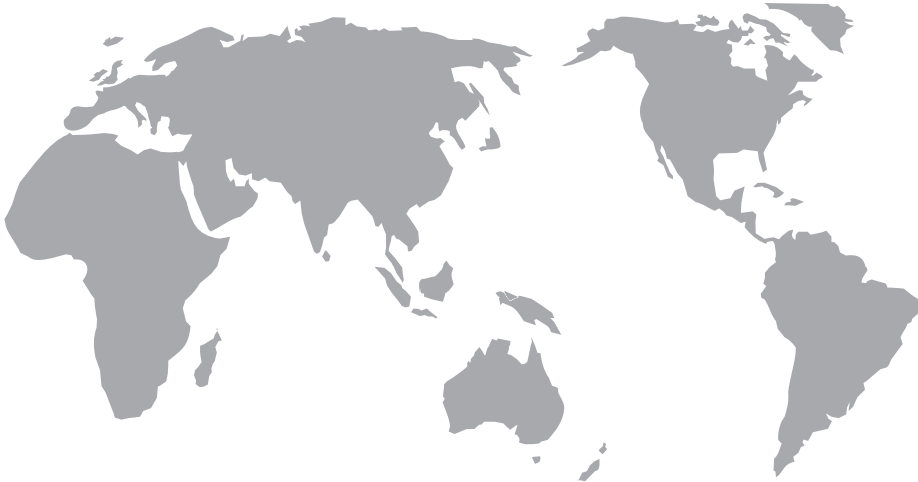
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