

# 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 Developments



### Production, Consumption and Investment

Despite diminished private consumption, the Korean economy in 2002 recorded 6.3% annual growth, largely attributable to export expansion and, to a lesser extent, a recovery in facility investment. Entering 2003, however, the economy on the whole has been aggravated by the aftermath of the Iraq crisis and the North Korean nuclear problem. Nearly all real economic indicators are in decline, except for construction investment, which has been helped by government spending to address the typhoon damage last summer. Both consumption and facility investment went into decline in the first quarter of this year. Industrial production in the first quarter of this year slowed to 5.9% growth, as compared to 9.5% growth witnessed in the fourth quarter of last year, with inventories also on the rise.

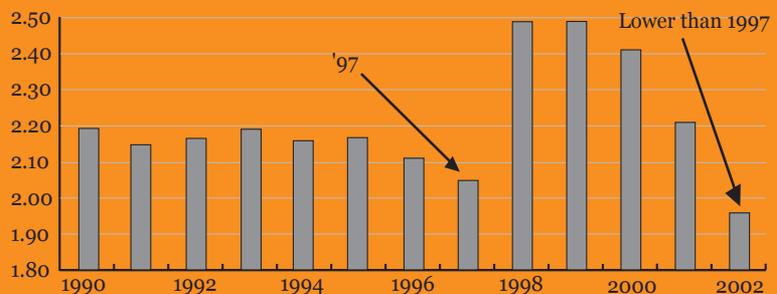
#### Production, Consumption and Investment

	2001	2002					2003
		1/4	2/4	3/4	4/4	Year	1/4
Production	1.3	6.8	7.5	5.3	9.5	7.3	5.9
Wholesale & retail sales	4.6	7.9	6.4	5.1	4.4	6.0	-0.2
Facility investment	-2.3	2.7	0.0	0.4	3.1	1.6	-3.4
Construction investment	10.0	7.9	2.2	-2.8	8.0	3.7	11.4

Source : National Statistical Office

Of particular note, February's wholesale and retail sales declined quite steeply, worst since the foreign exchange crisis period, indicating generally worsening economic conditions and consumer sentiments. As a prime example, the financial asset/debt ratio in the household sector fell to a level lower than that of the foreign exchange crisis. Such data suggest a significantly weak purchasing power at present in the private sector.

#### Financial Asset/Debt Ratio (Individual Sector)



Also a matter of concern, facility investment, in a continued slump since 2001 (though its rate of decline is not high), is likely to contribute to further deterioration of the economy's future growth potential. In fact, the pace of production capacity growth has slackened considerably to the 2% level as of the second half of 2002.

### Trend of Indices of Manufacturing Sector Production Capacity



Note : Indices of manufacturing sector production capacity indicate maximum production under normal operation and given conditions (facilities, workforce, company work hours and days, facility efficiency rate, etc.)

### Exports, Imports and Current Account Balance

In 2003, the trade balance has recorded deficits for three consecutive months, tied to a slowdown in exports and import expansion. But the trade balance in April swung to a surplus of US\$1.0 billion from its three consecutive months of trade balance deficit, owing to a reduction in oil import charge.

### Exports, Imports and Trade Balance

(Custom Clearance basis, USD bil, %)

	2002					2003			
	1/4	2/4	3/4	4/4	Year	Jan.	Feb.	Mar.	Apl.
Exports (FOB)	35.7	40.3	41.3	45.3	162.5	14.3	13.4	15.4	15.9
% of Increase	-11.1	4.9	15.9	24.6	8.0	25.8	21.6	16.3	20.3
Imports (CIF)	33.8	37.2	38.9	42.3	152.1	14.5	13.8	15.9	14.9
% of Increase	-11.4	7.8	13.8	23.1	7.8	27.8	32.1	32.8	18.2
Trade Balance	1.9	3.1	2.4	3.0	10.3	-0.2	-0.4	-0.5	1.0

**Current Account Balance & Capital Balance**

(Unit: US\$100 million)

	2002					2003		
	1/4	2/4	3/4	4/4	Year	Jan.	Feb.	Mar.
Current account balance	15.9	16.0	9.3	19.7	60.9	-4.2	-0.7	-11.9
Commodity balance	31.2	43.7	28.3	38.7	141.8	7.9	5.4	-0.6
Service balance	-15.0	-16.0	-22.2	-21.4	-74.6	-11.9	-8.9	-5.0
Income balance	0.2	-8.8	6.4	6.6	4.5	2.8	4.6	-4.3
Current transfer balance	-0.5	-2.9	-3.2	-4.2	10.8	-3.0	-1.8	-2.0

Source : Bank of Korea

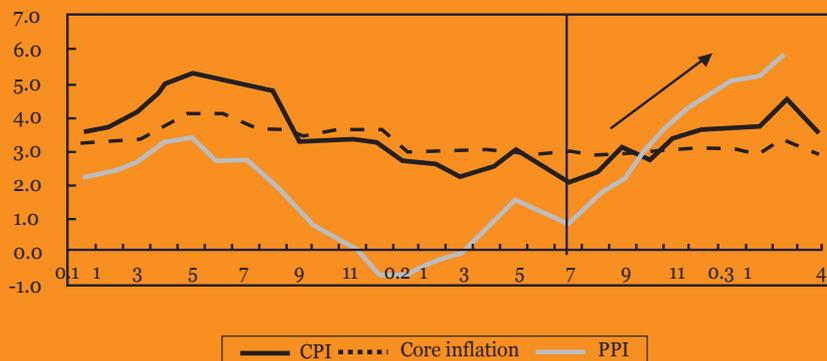
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## Prices

Consumer price hikes exceeded the 4% level in March of this year as compared with the same month last year. Producer prices this year also were at the 5% level for three consecutive months, reflecting strong external pressures of international oil price increases and the rise in won-dollar exchange rates in the stimulation of prices. But CPI in April slowed to 3.7% growth, compared with 4.5% in the previous month as prices of oil products and won/dollar exchange rate fell.

**Consumer Prices & Producer Prices**

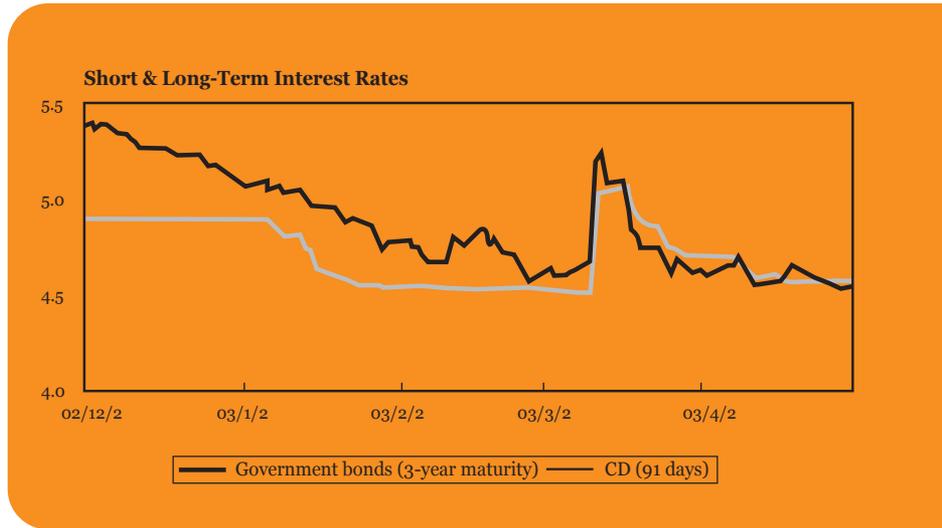
Year-on-year changes, %





## Interest Rates and Foreign Exchange Rate

Long-term interest rates continued to decline as deep-seated uncertainties over economic conditions persisted. Subsequently, long-term and short-term interest rates reversed course since March.



The won-dollar exchange rate rose up from February 2003 due largely to the full-blown impact of North Korean nuclear problem. But in April, it fell to approximately 1,220 to 1,230 won on expectations that the North Korean nuclear problem would be solved peacefully.





## Real Economy Sector

If North Korea's nuclear problem remains unsolved by the second half of 2003 despite the relatively swift end to the U.S. war on Iraq, Korea's annual economic growth this year is projected to remain at 3.5% due to delayed economic recovery. A continuation of the North Korea's nuclear problem is likely to further weaken confidence in the Korean economy. This will lead to a withdrawal of foreign investors from the Korean stock market and decrease in FDI (foreign direct investment), foreign exchange unrest, a withering of both consumer and entrepreneurial sentiment, thereby resulting a slowdown of consumption and investment. Should North Korea's nuclear problem show a visible sign of resolution in the first half, however, the nation's economic growth rate might surge to as much as the mid-4% level.

Private consumption is expected to post 2.7% growth, far below the 6.8% of year 2002. Negative factors for private consumption include a heavy interest burden due to household debt increase, household credit decline, reverse effect of assets caused by real estate and stock price declines and contraction of consumer sentiment.

Facility investment is likely to continue its negative growth that commenced in 2001, with an anticipated delayed recovery of enterprises' investment sentiment. A growing labor union militancy is likely to hurt business sentiment further.



## Current Account Balance

Exports are widely expected to record an annual 10% level of growth with expansion of the world trade volume on the heels of recovery trends of advanced economies, including the United States, as well as a continuation of recent strong progress in exports to China. Nevertheless, the export growth rate is expected to gradually become more sluggish in light of the high growth rate realized in the second half of last year in addition to a number of unstable factors, such as import restrictions by advanced countries and an anticipated delay in the recovery of semiconductor prices.

Imports are expected to experience rapid growth, outpacing export growth in the first half, owing to raw material price hikes, including international oil prices. However, in the second half, the brisk rate of growth will likely subside, affected by a likely international oil price drop and the scaling back of domestic demand.

The surplus in the current account balance is projected to shrink to about US\$1.3 billion this year, a significant decline from US\$6.1 billion in 2002.

## Economic Outlook for 2003

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

	2002 Year	2003 (North Korean nuclear issue continues)				2003 (North Korean nuclear issue solved)	
		1/4	2/4	3/4	4/4	Year	Year
GDP	6.3	4.1	3.7	3.3	3.1	3.5	4.4
Total consumption	6.2	3.0	2.4	2.3	2.3	2.5	3.9
Private consumption	6.8	3.2	2.5	2.4	2.5	2.7	4.1
Fixed capital formation	4.8	1.7	2.5	0.0	0.0	1.0	2.6
Facility investment	6.8	-4.3	-0.8	-0.3	0.1	-1.4	1.7
Construction investment	3.3	8.0	5.2	0.3	0.0	3.0	3.5
Total exports	14.9	20.0	11.1	6.7	2.6	9.7	10.0
Total imports	16.9	25.2	12.9	6.5	1.2	11.0	12.9
Producer price	1.6	5.4	5.6	5.1	4.4	5.1	4.7
Consumer price	2.8	4.1	4.4	4.0	3.5	4.0	3.9
Current account balance	60.9	-10.1	-10.7	11.6	22.3	13.2	-8.3
Commodity balance	141.8	15.5	19.4	28.9	38.0	101.8	82.4
Exports	1,625.6	444.3	448.5	444.6	455.6	1,793.0	1,805.8
Change (%)	7.5	23.3	10.5	8.7	1.1	10.3	11.1
Imports	1,483.7	428.8	429.1	415.7	471.6	1,691.2	1,723.4
Change (%)	7.7	30.3	18.5	9.1	1.4	14.0	16.1
Service, income & transfer	-80.4	-25.6	-30.1	-17.3	-15.6	-88.6	-90.7
Won/US\$ (average)	1,251.8	1,200.4	1,252.3	1,266.2	1,277.2	1,249.0	1,226.5
Corporate bond (Avg.,%)	6.6	5.4	5.5	5.5	5.6	5.5	5.7

## Prices

In line with the cessation of combat operations in the Iraq war, a good possibility exists that oil prices will stabilize downward, defusing the price push pressure. Yet, some time will likely be required for the complete removal of the price increase factors that have occurred. Therefore, CPI inflation this year is projected at 4%. Since sluggishness in total demand may continue, prices are expected to stabilize downward on a gradual basis in the event price push factors can be resolved.



## Interest Rates and Foreign Exchange Rates

With an end to the U.S.-Iraqi war now a reality in the first half of the year, economic uncertainties are predicted to clear up to a certain extent. This said, it should be added that a rapid economic recovery is unlikely in the second half. Accordingly, long-term interest rates this year are expected to remain at their present level. The corporate bond yield rate is projected at 5.6% in the second half, with the annual rate expected to average 5.5%.

The won-dollar exchange rate is expected to maintain an upward trend this year, a reflection of internal and external economic conditions. If North Korea's nuclear problem festers to the point of becoming a key issue in the international community, foreign investment is expected to be cut back significantly. Such a development coupled with a sharp decline in the current account surplus would contribute heavily to a weakened won amid an economic recession triggered by sluggish aggregate demand.



## Downside Risk Factors for Prospects

Despite an early end to the war in Iraq, if the economies in the U.S. and other major advanced countries do not recover relatively quickly, the expansion of Korea's exports, its domestic economy's driving force, will face difficulties.

With the spread of SARS, the economic growth of China, Korea's second largest export market, may diminish somewhat adversely affecting Korea's exports to that country.

The possibilities that either expanding worries over domestic financial markets, due to the SK Global scandal cannot be ruled out or faltering credit card firms, may delay the nation's economic recovery.

### Revitalization Measures Needed

A prolonged economic recession may well weaken the nation's growth potential. To prevent this outcome, a boost to the economy is deemed necessary. With the end of the war in Iraq, the ability to adopt a flexible monetary policy has become comparatively tenable due to stabilizing international oil prices and significantly reduced price pressure. Cuts in interest rates may have to be weighed. In terms of fiscal policy, additional fiscal expansion will be required, in addition to an early execution of the budget in the first half currently underway.

Various measures conducive to the invigoration of enterprise activities should be actively pursued. The first of such measures should be a reduction in corporate tax, a desirable action in view of the recent economic situation as well as from the perspective of improving the business management environment in the mid and long terms. To further enhance the economic growth potential through its stimulus of enterprise investment, tax benefits for facility and R&D investments need to be expanded. To accomplish this, the government should consider converting the current temporary investment tax deduction system into a permanent system.

It is recommended that the government exert continued efforts to stabilize the confidence level in the Korean economy through the pursuit of a peaceful settlement of the North Korean nuclear standoff.

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FKI Building, 28-1 Yoido-dong, Yeongdungpo-ku,  
150-756 Seoul, Korea.

Tel : (82-2)3771-0001, FAX : (82-2)785-0270/1

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**Publisher :** Jwa Sung-Hee

**Editor :** Huh Chan-Guk

**Co-Editor :** Kim Chang-Bae

**Research Team:** Huh Chan-Guk

Bae Sang-Kun, Kim Chang-Bae,  
Suh Joon-Seok

*Designed by Business Time Service (BTS)*

*Phone: (82-2)6000-7870/3 Fax: (82-2)6000-7877*





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Korea Economic Research Institute

FKI Building, 28-1 Yoido-dong, Yeongdungpo-ku, 150-756 Seoul

Telephone:(82)(2)3771-0001