

KERI

Economic Bulletin

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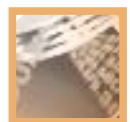
September 2003 No.33 Quarterly



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."





Anemic Domestic Demand, Robust Exports

Economic Growth Projected at 2.7% in 2003 and 4.4% in 2004

With sluggish domestic demand expected to persist, economic growth for 2003 is likely to post a mere 2.7%, less than half of 2002's rate of 6.3%. Despite robust performance anticipated for exports, the setbacks in private consumption and facility investment will continue through the second half, with negative annual growth forecast for both types of spendings in 2003.

The growth for 2004 is projected to be a lackluster 4.4% as well, mainly due to a stalled consumption recovery. Exports are expected to be strong also in 2004 with anticipated improvement in external conditions such as the U.S. economic recovery. However, since weak structural factors - stagnant employment, high household debt, etc.- are unlikely to improve in the short term, private consumption will become a factor in holding back the economic growth rate. Nevertheless, facility investment is expected to post a mild recovery and increase 7%.

As for economic policy direction, it is necessary to consider more aggressive macroeconomic policies to prepare for the possibility of prolonged doldrums in domestic demand. In terms of the current year's budget, the 4.5 trillion won supplementary budget enacted in July appears insufficient to cover the shortfall in the second half of this year, a direct result of the frontloaded spending early this year of about 8.8 trillion won. In regard to monetary policy, there will be room for an additional interest rate cut in view of the stable trend in prices. Efforts should also be made to resolve factors behind debilitating uncertainties that have weighted on economic sentiment such as the North Korean nuclear problem, a lack of coordination in government policies, and militant labor actions. In regard to labor-management issues, in particular, balanced relations must be established on the rule of law. To escape the vicious investment slowdown - employment slowdown - consumption slowdown cycle, solutions to expand growth potential must be developed through stimulating investment. Various systems and regulations restricting corporate activities need to be re-examined. In addition every possible economic incentive that holds the potential to promote investment has to be considered, including more inducement policies for foreign investment in Korea, in parallel with efforts to reverse the negative sentiment of domestic enterprises.

Recent Developments

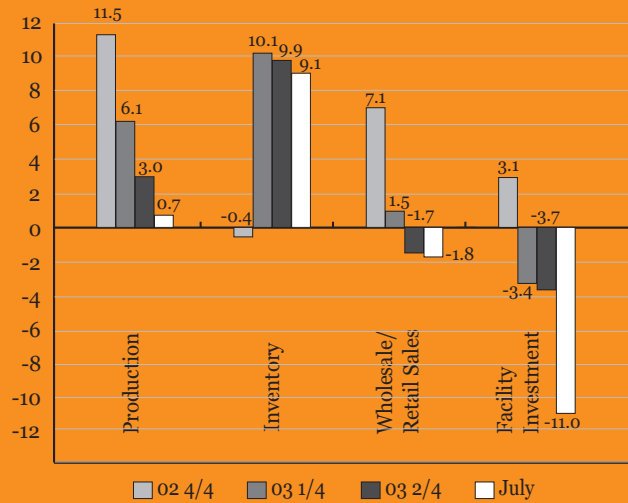
The domestic economy, having experienced negative growth for two consecutive quarters in the first half of 2003, recorded a further slowdown in July to begin the second half.

Weakness in domestic demand is plainly visible. The growth rate of industrial production rapidly decelerated to 0.7% in July from 6.1% and 3.0%, respectively in the first and second quarter, with inventory growth rate exceeding the 9% level in the same period.

In July, wholesale and retail sales also remained on a downward trend with -1.8% growth, while facility investment's 11% fall served to steepen the decline yet further.

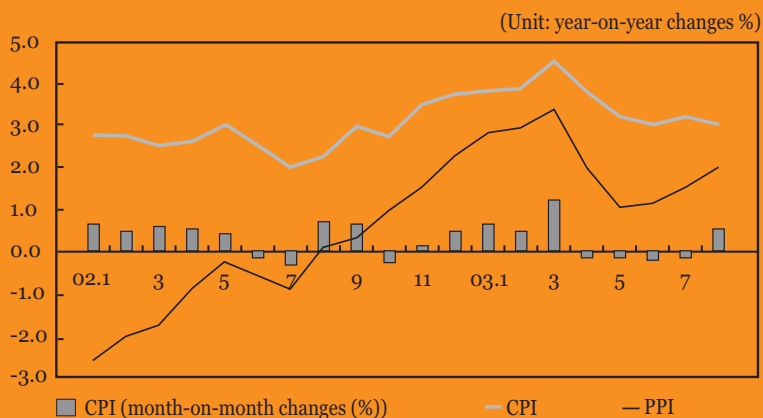
Trends of Real Economic Indicators

(Unit: year-on-year changes %)



Consumer prices in July remained on a stable track on the whole, with less than a 3.5% increase, compared with the same month last year. This can be attributed to the stagnation in domestic demand and a reduction in special excise taxes for certain industrial products this summer.

Trends of CPI & PPI



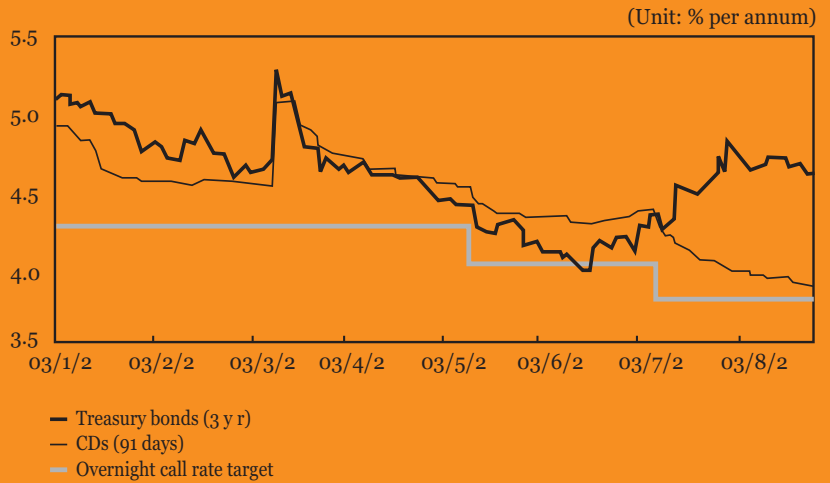
The current account balance has continued to record surpluses as of May this year, affected by slow growth in imports following the poor showing in domestic demand and an increased goods account balance surplus. Meanwhile, the services account deficit has grown larger, with an expanded travel account deficit caused by the tempering off of the SARS scare, start of summer vacation, etc.

Trends of Current Account Balance



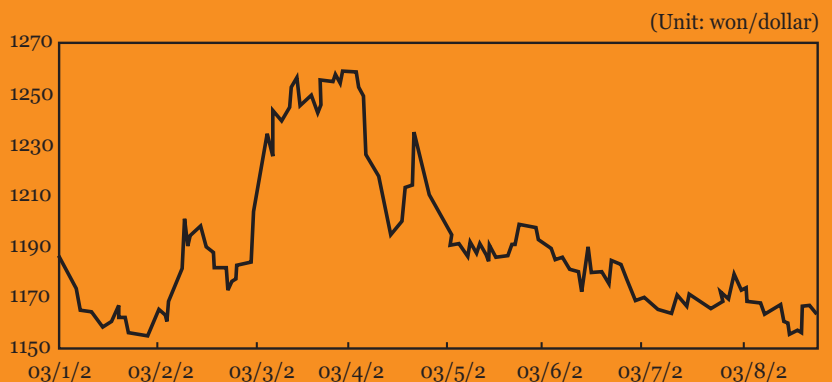
The yield on 3-year treasury bonds rose in anticipation of future economic recovery based on promising signs of a U.S. economic recovery, a cut in the domestic call interest rate target, government's economic stimulus package. However, short-term interest rates, such as CDs (3-month maturity), fell as a result of a cut in the call rate target (from 4% to 3.75%).

Trends of Major Interest Rates



The won-dollar exchange rate has continued to decline since April, in part a reflection of the persistent weakening of the greenback due to the burgeoning U.S. current account deficit. The trend is also reinforced by Korean current account balance surplus as well as the inflow of foreign capital into the stock market in anticipation of a domestic economic recovery.

Trends of Won-Dollar Exchange Rate



Economic Growth: 2.7% Seen for 2003, 4.4% for 2004

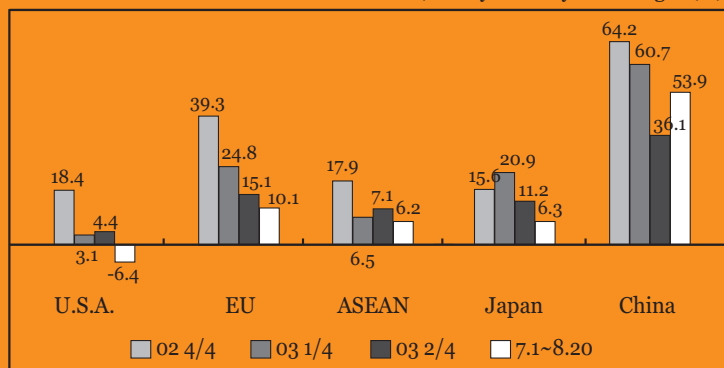
The domestic economy, which recorded negative growth for two consecutive quarters year on year from the first quarter, is expected to post an annual growth rate of 2.7% in 2003, less than half of the 6.3% realized in 2002, due to sluggish domestic demand, which is likely to continue in the second half.

Various monthly economic indicators suggest the possibility that the pick-up in indicators in June was a temporary phenomenon caused by technical seasonal factors. Consumption and facility investment indices that deteriorated in July point to such a conclusion. A series of labor disputes, highly aggravated from this spring, in particular, are expected to have serious adverse effects on macroeconomic variables, including investment and employment. Labor strife constitutes an important obstacle to a sustained economic recovery.

On the other hand, external economic conditions are expected to improve, with growing prospects for a U.S. economic recovery and expectation of China's continued strong economic growth.

Exports by Major Countries and Region

(Unit: year-on-year changes (%))



In 2004, domestic economic growth is forecast to hover around 4.4%, slightly higher than this year, due to a projected mild recovery of domestic demand, and despite continued good performance in exports. The growth rate is projected at 3.8% in the first half, with a gradual increase to 4.9% in the second half.

Owing to an improved external environment, exports will continue to expand and realize an annual growth rate of 9% (based on international bal-

ance of payments).

Private consumption is expected to experience annual growth at the 3% level, falling behind the economic growth rate. During the year, the painful pinch in private consumption may gradually relax due to expanded fiscal expenditure from a revised supplementary budget, interest rate cut, etc. However, a substantial recovery is unlikely as the structural factors undergirding consumption contraction -worsening employment and high household debt - are unlikely to be resolved in the short-term.

Facility investment is projected to post a comparatively high growth rate at the 7% level with pent-up investment sentiment serving as an upward pressure.

Consumer Prices to Stabilize at 3.3% in 2003, 3.4% in 2004

Despite a substantial rise in the first quarter, the annual consumer price increase is expected to stabilize at 3.3%, owing to lower oil prices and weak domestic demand.

The won's mild appreciation with continued strength in addition to the expected total demand shrinkage, will contribute to the downward stabilization of prices.

Overall price stabilization is also expected in 2004. However, with a projected economic recovery, albeit slow, prices are expected to rise slightly to an annual increase rate of 3.4%.

Current Account Balance to Show Deficit in 2004

The current account balance in 2003 is expected to be about US\$3.1 billion, just half the US\$6.1 billion posted in 2002.

Exports through July boasted double-digit growth rates despite labor disputes and foreign exchange rate decline. In view of expected improvement in the external environment during the second half, continued progress in exports is likely, at least for the time being.

The noticeable trend since April of export growth outpacing import growth is also expected to continue until the end of the year. The merchandise balance will likely realize an annual surplus of about US\$15.3 billion.

However, the current account surplus is expected to decline sharply as the chronic deficits in the service account, with the travel account acting as a pivot, are likely to widen.

The current account balance for 2004 is projected to be a US\$2.2 billion deficit. Contributing factors include increased import growth, triggered by the expansion of facility investment and recovery of private consumption, amid a continuing service account deficit.

Long-Term Interest Rates to Show a Mild Increase Trend

In anticipation of domestic economic recovery and an improved external economic environment, long-term interest rates are expected to gradually rise.

Based on 3-year-maturity corporate bonds, long-term interest rates will increase to 5.8% in the second half of 2003 to post an annual average rate of 6.2% in 2004.

Won-Dollar Exchange Rate to Gradually Decline

There is a distinct possibility that the dollar will continue to weaken in the future as a result of the U.S. fiscal deficit, expansion of current account deficit and maintenance of low-interest trend.

The won-dollar exchange rate is expected to settle at 1,167 won on average in the second half and gradually decline to an annual average rate of 1,153 won, indicating a continued pattern of won appreciation.

Domestic Economic Outlook for 2003 and 2004

(Unit: year-on-year change(%), USD billion)

	2002	2003					2004		
	Year	1/4	2/4	3/4	4/4	Year	1st half	2st half	Year
GDP (S.A, quarter-on-quarter %)	6.3	3.7	1.9	2.1	3.2	2.7	3.8	4.9	4.4
Final consumption	6.2	1.2	-1.4	-1.5	-0.7	-0.6	2.5	3.8	3.1
Private	6.8	0.7	-2.2	-2.3	-1.3	-1.3	2.4	3.9	3.2
Fixed capital formation	4.8	4.8	3.5	2.9	2.1	3.2	3.9	5.9	4.9
Equipment	6.8	1.6	-0.8	-1.9	0.1	-0.3	5.7	8.9	7.2
Construction	3.3	8.1	7.2	6.7	3.3	6.0	2.3	3.8	3.1
Exports of goods & services	14.9	17.2	10.3	9.8	8.6	11.3	7.0	8.4	7.7
Imports of goods & services	16.4	17.9	7.5	8.7	7.5	10.2	7.8	9.7	8.8
Producer price	-0.3	3.0	1.3	1.7	1.7	1.9	1.9	2.1	2.0
Consumer price	2.7	4.3	3.2	3.0	2.9	3.3	3.2	3.5	3.4
Current account balance	6.1	-1.7	2.5	0.5	1.8	3.1	-1.3	-1.3	-2.6
Goods	14.2	1.2	5.7	3.8	4.5	15.3	5.5	5.6	11.1
Exports	162.6	44.5	46.5	45.9	49.6	186.5	98.5	104.8	203.3
Changes(%)	7.5	23.5	14.5	12.3	10.0	14.7	8.2	9.7	9.0
Imports	148.4	43.3	40.8	42.1	45.1	171.2	92.9	99.2	192.2
Changes(%)	7.7	31.5	12.6	10.5	9.4	15.4	10.6	13.9	12.3
Services, income& transfer	-8.0	-3.0	-3.2	-3.3	-2.8	-12.2	-6.8	-6.9	-13.7
Won/US\$(Ave.)	1251.8	1201.8	1206.6	1171.5	1163.3	1185.8	1154.7	1150.3	1152.5
Corporate bonds(3 yr. AA-)	6.6	5.5	5.3	5.8	5.9	5.6	6.1	6.3	6.2
Unemployment Rate(%)	3.1	3.6	3.3	3.5	3.5	3.5	3.5	3.4	3.4

More Macroeconomic Policy Stimulus Might Be Necessary

As for the persistent slowdown in domestic demand, the government is holding the position that more time is required to gauge the full effect of policy actions taken thus far.

However, the possibility of a prolonged weakness in domestic demand cannot be ruled out, and insufficient policy stimuli would be one important contributing factor for such an outcome.

The sluggishness in domestic demand, evidently visible from the beginning this year, appeared to have been mainly caused by uncertainty related to geopolitical factors. However, worsening labor disputes as well as confusion about the modality of the new government's responses in this area soon followed. Given such an origin of the current economic woes, therefore, questions are being raised as to the effectiveness of the conventional macroeconomic counter-cyclical measures in resolving current problems.

The possibility cannot be excluded that the government's policy measures taken so far might have been insufficient for the economic situation, particularly if the trend of export growth does not pick up noticeably and the domestic demand slowdown fails to show signs of improvement by the end of the year. Therefore, the government should consider the need for more aggressive macroeconomic policies at this juncture.

Resolve Non-Economic Factors Causing Uncertainty

Efforts should be made to resolve non-economic factors such as geopolitical and social instability that are weighing heavily on economic sentiment.

Regarding North Korea's nuclear issue, etc., the government must further solidify the Korea-U.S. lines of cooperation to root out security-related uncertainties.

The government needs to enhance public confidence in its policies by maintaining consistency in implementing decisions, while at the same time recognizing that debates are desirable in the course of arriving at each decisions.

In resolving the conflicts of various interest groups, the government must establish a consistent and predictable policy position through strict implementation of laws by clearly punishing illegal behavior based on the rule of law.

Establish Law-Based Labor-Management Relations

The government should clearly establish its position on policies regarding the most critical factor in the current instability, namely, labor-management-related issues. The government should refrain from unnecessary intervention in individual labor dispute. Instead, it should expend its energy enforcing existing labor laws and also examining whether the current labor laws can be improved upon.

The government should realize that a positive labor environment and flexibility in hiring and firing workers are critical competitiveness issue for Korea as international investors would make comparisons to the situations in other markets in the region,

Enterprises should make efforts to remove potential causes for militant labor actions and improve labor welfare. Workers should realize that illegal labor strikes will lead eventually lead to loss of their work-place.

Expand Growth Potential thru Investment Stimulation

In order to escape the vicious circle of 'investment slowdown - employment slowdown - consumption slowdown,' solutions should be found through the means of stimulating investment. To achieve this goal, all possible economic incentives with potential to boost investment by domestic and foreign enterprises should be considered.

For investment expansion in the R&D field, the government has to positively consider increasing its direct participation in basic science fields that have wide applicability. This is particularly true because private enterprises' R&D activities tend to be restricted to the short term and direct economic viability that is limited to the funding enterprises' field of interest.

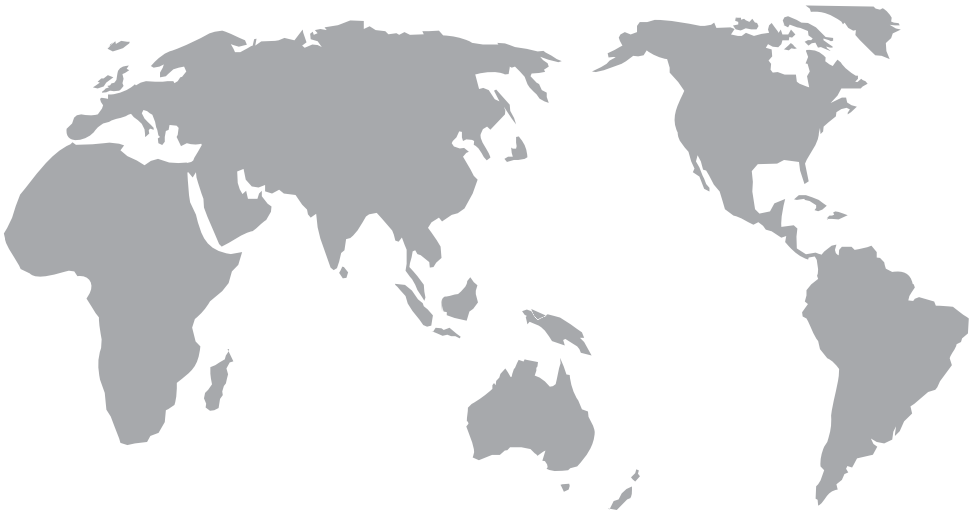
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