

# KERI

# Economic Bulletin

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# 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."



## Economy Projected to Grow 4.8% in 2004

Despite robust exports, the Korean domestic economy in 2004 is expected to post moderate growth of 4.8%, tempered by a sluggish recovery of domestic consumption.

The firming economic recovery in the U.S. and continuation of rapid growth in China are expected to offer a favorable external environment. In contrast, domestic demand, private consumption, in particular, is expected to remain soft next year as weak employment and consumer debt problems are expected to persist for awhile.

The sluggishness in investment has lasted several years thus far, obviously putting pressure on the extant production capacity. Yet, a number of negative variables such as labor-management discord, political instability, anti-business sentiment, etc. continues to dampen the investment sentiment of businesses. Therefore, annual facility investment growth is projected to hover at the 6% level, which is a relatively slower than the average pace seen during past recoveries.

The current account surplus is expected to decrease to about US\$4 billion in 2004 from US\$8.6 billion in 2003. Consumer prices are likely to stabilize at the 2% level due to light price-push pressure, with an international oil price decline and won currency appreciation amid a slow recovery of total demand.

The 2004 economic growth projection crucially hinges on the performance of exports. There are potential pitfalls that could affect exports negatively. First, the U.S. economic recovery and China's robust economic growth rate trend may slacken if the external environment sours due to full-scale trade frictions or terrorist threats. Second, the gradually-intensifying Chinese yuan appreciation pressure may depress the brisk growth trend in China, which has emerged as Korea's largest export market, and prompt appreciation of the Korean won, which will adversely affect Korea's exports.

In 2004, macroeconomic policy should take into account the possibility of the current weakness in domestic demand persisting into the year. As for fiscal policy, a front-loading of fiscal outlay will likely be necessary. If the weakness in domestic demand persists, a more proactive posture is called for, including a limited amount of budget deficit for the year. Regarding monetary policy, an additional interest rate cut may need to be contemplated in light of the recent stable price trend and weak domestic demand.

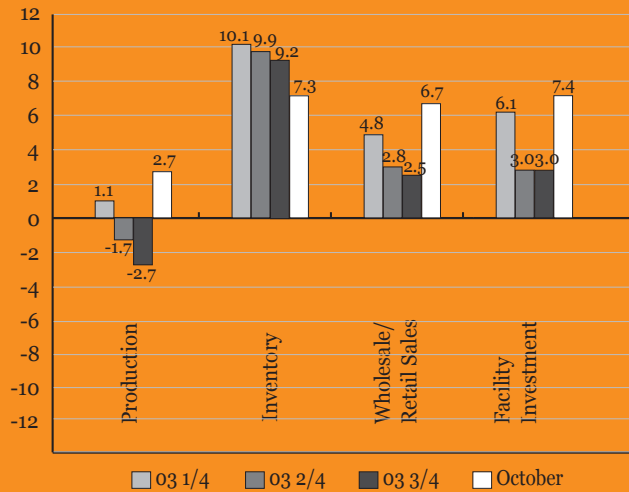
Efforts should be made to minimize ill-effects of non-economic unstable factors that are negatively impacting economic sentiment at present, such as North Korea's nuclear problem, political instability and conflicts among various interest groups. As for the labor-management issue, in particular, a balanced relationship must be established based on the rule of law.

## Recent Developments

Real GDP (seasonally adjusted) of the second quarter rebounded to a positive growth of 1.1% in the third quarter, giving the appearance of an economic recovery, with an increase in production output and a decline in inventory volume.

### Trends of Real Economic Indicators

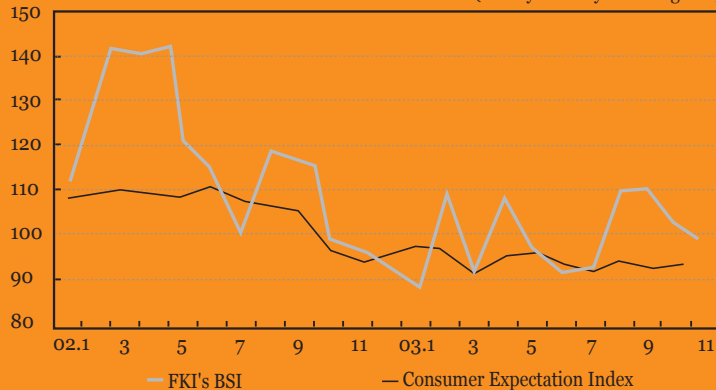
(Unit: year-on-year changes %)



However, both business and consumer sentiment remains subdued. In November, the BSI (Business Survey Index) of the Federation of Korean Industries (FKI) dipped below 100 once again and the BSI continued its fluctuation around the standard level of 100 throughout the year. The Consumer Expectation Index also persisted below the standard 100 mark.

### Trends of Major Economic Sentiment Indices

(Unit: year-on-year changes %)

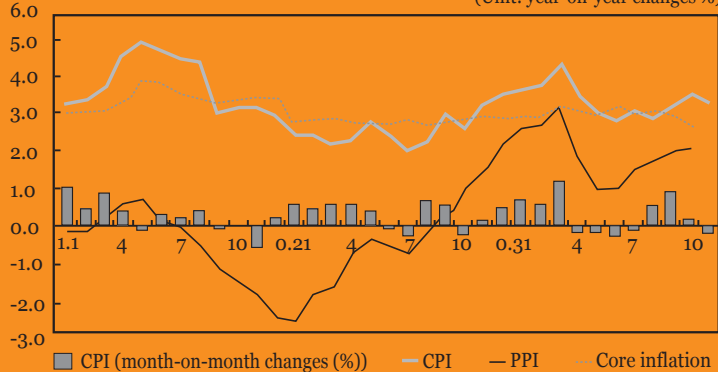


Note: FKJ's BSI is a projection by enterprises pertaining to the business situation for the month following the survey. The Consumer Expectation Index reflects consumers' expectations for the following six months.

Consumer prices inched up as agricultural product prices rose due to typhoons in August. With their re-stabilization in October, a stable price trend since April continues.

### Trends of CPI & PPI

(Unit: year-on-year changes %)

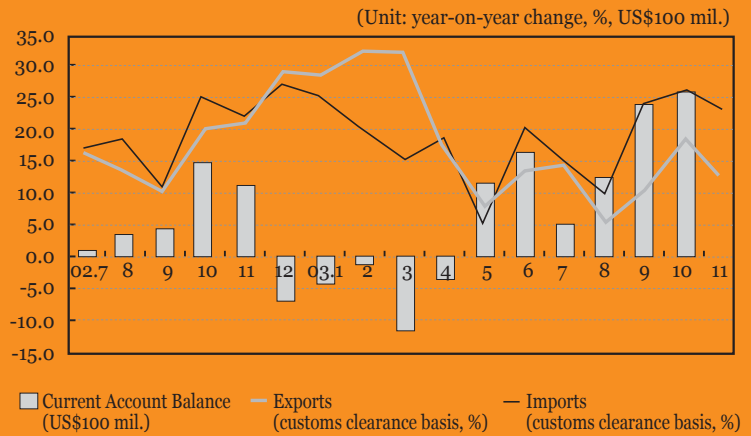


Sources: Bank of Korea (BOK), National Statistical Office (NSO)

October-November exports sustained robust growth thanks to brisk shipments of such key items as semiconductors, automobiles, wireless communication equipment and computers.

With the strong export performance since August, the current account surplus expanded to US\$7.39 billion for the January-October period of 2003, surpassing last year's annual surplus of US\$6.09 billion.

### Trends of Exports/Imports and Current Account Balance



Long-term interest rates, including the yield on 3-year treasury bonds, are expected to rise due to an increase in the issued volume of debentures as well as anticipated domestic and overseas economic recoveries.

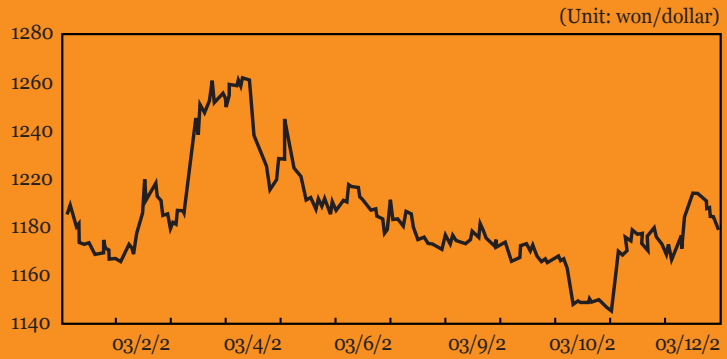
### Trends of Major Interest Rates



The won-dollar exchange rate temporarily fell below 1,150 won, affected by the 'flexible foreign exchange policy' communication of the G7 Finance Ministers' Meeting on September 20.

However, the exchange rate is registering a rebound since then partly owing to intervention by the Korean FX authorities.

### Won-Dollar Exchange Rate Trends



### Moderate 4.8% Growth Expected

As compared with the average patterns of key macroeconomic variables during official economic contraction periods since the mid-1980s, the degree of contraction in the recent domestic economy (1st Qtr.-3rd Qtr., 2003) is considerably worse.

Korea's experience in 2003, posting negative growth figures in consumption, investment and employment, appears most similar to the recent contraction period that includes 1998, marked by a sharp output drop-off following the foreign exchange crisis of 1997. Private consumption in 2003 declined even more sharply than that period. The current surge of exports recalls a similar pattern seen in the latter half of 1998.

#### Comparison of Economic Contraction Periods

Contraction Period	GDP	GDP Components			Employment	Industrial Production
		Private Consumption	Facility Investment	Exports of goods		
1984.2Q~1985.3Q	6.9	7.1	7.1	9.7	2.0	9.0
1988.2Q~1989.2Q	8.0	9.2	9.2	11.2	3.2	7.8
1991.2Q~1993.1Q	6.7	6.5	6.5	3.7	2.1	6.8
1996.2Q~1998.3Q	1.9	-0.3	-0.3	-12.4	-0.4	1.8
2003.1Q~2003.3Q	2.6	-1.1	-1.1	-1.2	-0.2	4.0

*Note: The figures are averages of year-on-year changes of respective quarters in the contraction period.*

In contrast to the post-1997 contraction that was sparked by a clear shock with an external origin, the 2003 slowdown clearly has its roots in domestic factors, as evidenced by a persistent weakening of domestic demand accompanied by relatively strong exports. Therefore, it would be too naive to expect an economic recovery in 2004 based solely on robust exports as strong as the one following the 1998 contraction. Unlike the post-1998 recovery, resolution of factors that are pulling down economic sentiments as well as domestic demand has to take place along with a robust export growth to bring about a broad-based economic recovery in the near future.



Owing to the full-fledged recovery of the U.S. economy and China's continued and rapid growth, brisk export performance will continue, while the domestic consumption trend is likely to remain stagnant. Consequently, the Korean economy is projected to grow at a moderate 4.8% in 2004.

Private consumption in 2004 is expected to be marginally stronger than in 2003, as improvements in the employment situation and the household debt problem is likely to be slow. As a result, private consumption growth is projected at the 3% level, below the economic growth rate.

Facility investment in 2004 is expected to hover at an annual 6% level of growth stemming from a variety of negative factors, e.g. labor-management discord, political unrest and anti-enterprise sentiment, that subdue the investment sentiment of businesses. Construction investment growth will slow to the 3% range with a cooling of the overheated real estate market.

The expectation of a favorable, if slow, turnaround for next year's economy is based mainly on projected brisk exports. However, risk factors also come into play. First, although there is a strong likelihood at present that the trends of the U.S. economic recovery and China's rapid economic growth will continue, certain factors that could lead to the deterioration of the external environment can not be overlooked.

These include the distinct possibility of full-scale trade friction and the spread of terrorism. If realized, such developments may crimp global trade and delay the world's economic recovery. Second, there remains the possibility of the Chinese yuan's appreciation. There is no sign that the U.S. trade deficit will improve in the near term. Therefore, the U.S. pressure to appreciate the yuan, a force grown more evident in the second half of 2003, is likely to surface again ahead of the U.S. presidential election in 2004. The yuan appreciation could lower the robust economic growth trend of China, which has emerged as Korea's largest export market. It may also bring pressure on the won-dollar exchange rate, thereby affecting Korea's exports negatively.

## Consumer Price Increase Forecast at 2% Level

In 2004, consumer prices are expected to grow at the 2% level with anticipated stable international oil prices and a slow recovery of total demand. The projected stronger won against the dollar also will contribute to the stabilization of prices. The price increase rate will likely be higher in the second half, when a full recovery of domestic demand is expected.

## Current Account Surplus to Fall by Half from 2003

The current account surplus in 2004 will be cut in half from 2003. The global trade volume in 2004 is expected to increase by 5% (2% percentage points above this year). Thus, Korea's export growth in 2004 is likely to continue its robust trend. Imports also will grow significantly owing to the anticipated recovery, albeit modest domestic demand. Expansion of the service balance deficit is expected to continue as well. Therefore, surpluses in both the commodity account and current account are projected to be less than in 2003.

### Domestic Economic Outlook for 2003 and 2004

(Unit: Year-on-year change, %, US\$100 mil.)

	2002	2003					2004				
	Year	1Q	2Q	3Q	4Q	Year	1Q	2Q	3Q	4Q	Year
GDP (S.A, quarter-on-quarter %)	6.3	3.7	1.9	2.3	3.5	2.8	4.1	4.3	5.2	5.7	4.8
		-0.4	-0.7	1.1	3.5		0.2	-0.4	1.5	4.4	
Final consumption	6.2	1.2	-1.4	-1.4	-0.9	-0.6	0.4	2.6	3.1	4.1	2.6
Private	6.8	0.7	-2.2	-1.9	-1.4	-1.2	0.2	2.6	3.1	4.2	2.5
Fixed capital formation	4.8	4.8	3.5	2.3	1.9	3.0	2.1	4.4	5.2	5.8	4.5
Equipment	6.8	1.6	-0.8	-4.7	-3.4	-1.8	0.4	6.3	8.8	9.8	6.2
Construction	3.3	8.1	7.2	7.8	5.3	6.9	3.7	3.0	2.7	3.4	3.2
Exports of goods & services	14.9	17.2	10.2	15.2	11.3	13.3	9.8	9.5	9.1	9.9	9.6
Imports of goods & services	16.4	17.9	7.5	9.1	8.6	10.6	7.7	11.7	12.6	13.1	11.3
Producer price	0.3	3.0	1.3	2.0	2.3	2.1	4.5	2.1	2.4	1.8	2.0
Consumer price	2.8	4.1	3.3	3.2	3.6	3.6	2.4	2.5	2.95	2.7	2.6
Current account balance	60.9	17.2	25.2	41.7	36.6	86.3	4.6	5.4	15.0	15.1	40.1
Goods	141.8	12.3	57.0	71.6	66.1	206.9	36.2	46.6	51.0	51.4	185.2
Exports	1625.6	445.1	464.7	491.6	520.9	1922.3	505.9	519.4	540.3	575.3	2140.8
Changes(%)	7.5	23.5	14.5	20.2	15.6	18.2	13.7	11.8	9.9	10.4	11.4
Imports	1483.7	432.8	407.7	420.0	454.8	1715.3	469.6	472.8	489.3	523.9	1955.6
Changes(%)	7.7	31.5	12.6	10.3	10.5	15.6	8.5	15.9	16.5	15.2	14.0
Services, income & transfer	80.4	29.5	-31.7	29.9	-29.5	120.6	31.6	41.3	36.0	36.3	145.1
Won/US\$(Ave.)	1251.8	1201.6	1207.4	1175.1	1190.0	1193.5	1176.9	1152.7	1132.7	1116.8	1144.8
Corporate bonds(3 yr. AA-)	6.6	5.5	5.2	5.6	5.6	5.5	5.9	6.2	6.4	6.4	6.2
Unemployment Rate(%)	3.1	3.6	3.3	3.3	3.4	3.4	3.4	3.4	3.3	3.2	3.3

## Long-Term Interest Rates to Rise Slightly

Affected by a capital demand increase following the recovery of facility investment, long-term interest rates will continue a slow upward trend. Accordingly, the yield rate of 3-year corporate bonds is expected to climb to 6.0% in the first half and gradually rise to 6.4% in the second half, reaching an annual average increase of 6.2%.

## Won-Dollar Exchange Rate to Record a Slow Decline

The won-dollar exchange rate is expected to decline slowly to an annual average of 1,144.8 won in 2004 from the average rate of 1,193.5 won in 2003. With the expansion of U.S. fiscal and current account deficits, an ongoing weakening of the U.S. dollar is likely. However, due to anticipated strong growth of the U.S. economy, the value of the U.S. dollar is unlikely to fall sharply. At the same time the Korean won is expected to come under U.S. pressure to appreciate along with other Asian currencies.

### Positive Macroeconomic Policies Needed for Job Creation

Despite strong exports, the domestic economy appears unable to escape stagnant domestic demand, a departure from the average pattern seen in previous cycles. Contributing factors to this phenomenon include a decrease in household income in the wake of a weakening employment picture, an increase in household debt, and deterioration of labor-management relations. These structural problems have the effect of cooling down private consumption as well as investment sentiment. Accordingly, there remains the possibility that a brisk export trend may fail to lead to the recovery of domestic demand.

Due to such an unbalanced export-led recovery, the domestic economy in 2004 is expected to become more vulnerable to changes in the external environment. Therefore, should risk factors like a sharp won-value appreciation, trade disputes, geopolitical issues and disease outbreaks occur, the sluggish domestic demand may persist and be accompanied by an export slowdown.

If signs of improved domestic demand fail to appear in the near future, the government should take policy measures and exert its utmost efforts to stabilize the economy and create employment. With respect to fiscal policy, 2003's first and second revised supplementary budgets merely made up for the roughly 8.4 trillion won in second half spending reduction that occurred due to early execution of the budget in the first half. Therefore, if the domestic demand recovery remains slow, an early budget implementation will also be needed in the first half along with acceptance of a fiscal deficit, if necessary. Recently, the IMF also recommended implementation of strong economic promotion policies, in a report on the results of its annual economic meeting for the second half of 2003, citing the possibility that the Korean economy may experience continued recession into in the first half of 2004.

Regarding monetary policy, since price-push pressure is expected to be weak, there will be room to consider an additional policy interest rate cut if the domestic demand remains sluggish. In its World Economy Outlook Reports, OECD recently recommended the need for respective countries to maintain an expansionary monetary policy in order to sustain economic recovery trends, while appraising that the world economy is recovering.

## Recovery of Economic Sentiment Thru Resolution of Unstable Non-Economic Factors

A rebound of economic sentiment is very important to a domestic economic recovery. Therefore, efforts must be made to remove non-economic risk factors such as geopolitical and social concerns causing a distinct sobering of economic sentiment. To accomplish this, the following actions are required:

- Solidification of the Korea-U.S. mutual assistance system to resolve the North Korean nuclear problem, etc.
- Early settlement of factors related to brinkmanship politics, such as issue of the proposed referendum on the President, expanded investigations into business slush funds, and extreme confrontations in political circles
- Establishment of a predictable and consistent government role in resolving conflicts among interest groups based on the rule of law
- Pursuit of countermeasures to prevent a financial crisis stemming from the credit card debt problem and credit card firms' lack of liquidity
- Swift action by the government to improve or resolve: political uncertainty, deepening labor-management conflicts, and various regulations or systems that restrict corporate investments

## Establishment of Labor-Management Relations Respecting Laws and Principles

The government should establish a stable labor-management relationship based on laws and principles, while restraining its own unnecessary intervention in labor-management issues. Enterprises must exert their utmost efforts to eliminate illegal labor activities, improve workers' welfare, create jobs that workers want and re-employ jobless workers along with the expansion of reemployment programs and stabilization of employment. Workers also should endeavor to avoid illegal strikes and enhance labor productivity, as well as manifest efforts for self-development and self-restraint in requests for unreasonable working conditions. Considering the principle that increased labor market flexibility will ultimately bring a much needed employment expansion, the present dismissal system, currently applicable only when there is a 'serious management crisis,' should be altered to include legitimate dismissal for 'productivity gap' reasons.



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