

KERI

Economic Bulletin

December 2004 No.38 Quarterly

Contents

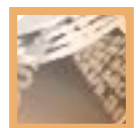
- Executive Summary 3
- Recent Developments 5
- Outlook for 2005 8
- Policy Issues 11



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."



In 2005, the national economy is projected to record 4.1% growth, which is lower than 2004 growth(4.8%), primarily due to expected export slowdown. Domestic demand is, however, likely to show a gradual recovery.

Exports are expected to decline markedly in terms of growth rate in 2005 largely due to the slower growth of the global economy, as well as base effects due to the high growth rate of near 30% in 2004, and strengthening won.

On the other hand, private consumption is expected to grow in the 3% range owing to a gradual improvement in the employment situation and technical effect following two years of sustained consumption shrinkage. Facility investment also is forecast to continue at a 8% level of growth thanks to accumulated investment pressure from this year's brisk export performance and improvements in the financial condition of businesses in the manufacturing sector.

The current account balance is projected to record about US\$13.3 billion next year, which is only about half the US\$27 billion in 2004, reflecting the export growth slowdown. Rise in consumer prices will likely be moderate. Owing to more stable oil prices and a strong won, we expect 3.2% CPI inflation for the year. Affected by expansion of the U.S. budget and current account deficits, the won-dollar exchange rate is expected to fall to an annual average of around 1,020 won.

Downside risk factors related to our baseline forecast are the possible recurrence of high oil price, substantial slowdown of the global economy, acceleration of the won's appreciation, deepening of conflicts in domestic politics and society which would further depressing economic sentiments and delaying a recovery in domestic demand. Should all these factors materialize, economic growth rate could fall as low as 2.8%.

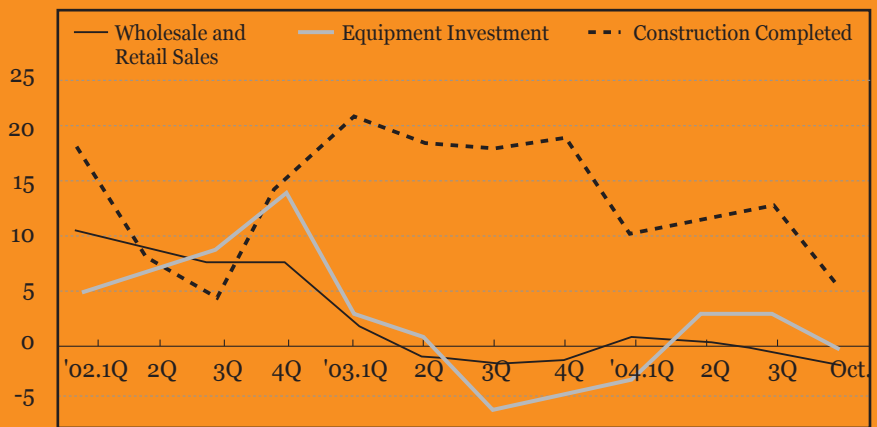
As for future policy tasks, the government should pursue expansionary fiscal and monetary policies to stimulate domestic demand in preparation for the expected export slowdown. Tax reductions should be pursued more actively. With respect to foreign exchange rate policy, a more measured intervention is called for as expectations about the Chinese yuan revaluation make Korean FX authorities' stabilization efforts less effective.

The government should make efforts to resolve high level of political and societal tensions. Controversies caused by the ruling party's attempt to abolish the NSL(National Security Law) and other progressive agenda have proved bit too divisive so far. A more gradualism seems to be in order.

Various regulations and systems restricting corporate investment must be improved steadily, and the government should maintain its recent policy of self-restraint regarding unnecessary intervention in labor-management affairs while respecting laws and principles.

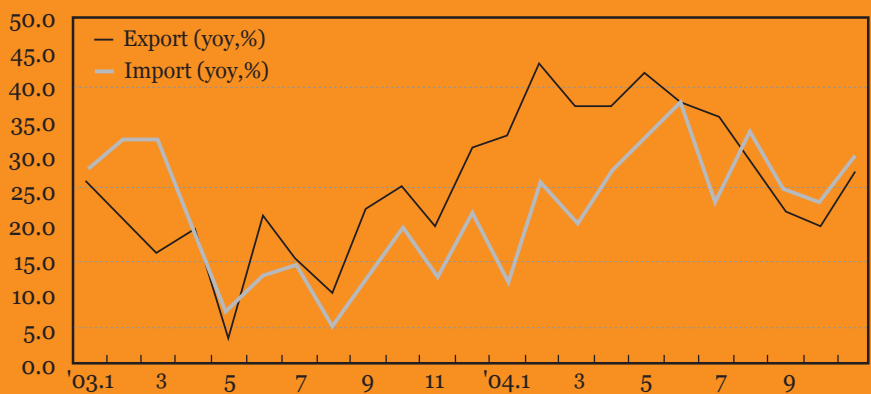
Domestic demand slowdown has been somewhat persistent. Wholesale and retail sales decreased 2.3% in October, continuing a 0.9% decline in the third quarter. Construction investment growth rate has fallen sharply to a single digit and facility investment also has reversed course, starting to decline since September.

Major Indicators of Domestic Demand



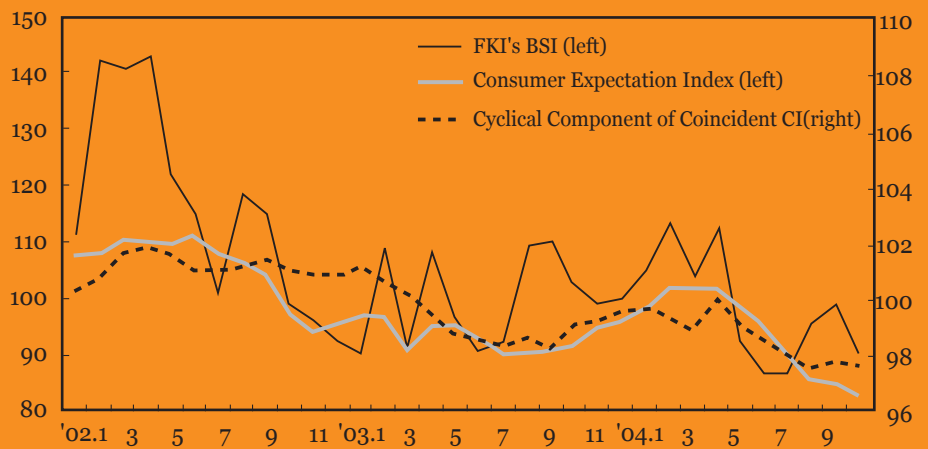
Despite the continuation of good export performance, the growth rate has recently shown signs of a gradual slowdown. Following 38.8% growth in the second quarter, the export expansion rate declined to 28.9% in the third quarter and to 23.9% in the October-November period. On the other hand, the slowdown in imports has not been as noticeable, with export growth falling behind import growth since August.

Trend of Export and Import



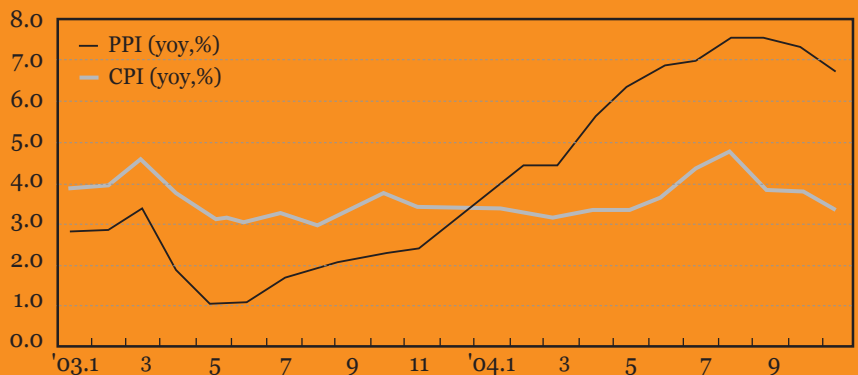
Consequently, contraction of economic sentiment appears to be continuing with economic recovery being delayed. The consumer expectation index of the Federation of Korean Industries (FKI), the major indicator of business and consumer sentiment, has remained below the benchmark value of 100 since May. The cycle of coincident composite index, indicating the present economic trend, also has been declining continuously.

Trend of Major Economic Sentiment Indices



Affected by the stabilization of international oil prices, appreciation of the foreign exchange rate, and other factors, consumer prices have been declining. Recording a 4.8% rate in August compared with the same month last year, consumer price increases fell to 3.9% in September, 3.8% in October and 3.3% in November. The trend of producer prices has also shown signs of slowing down.

Consumer and Producer Price Trends



Continued current account balance surpluses of US\$7.1 billion in the third quarter and US\$2.5 billion in October have contributed to a total surplus of US\$22.8 billion for the January-October period. This surplus has benefitted from stable service, income and current transfer account balances at a level similar to last year's as well as a significant increase in the commodity account balance due to strong export performance.

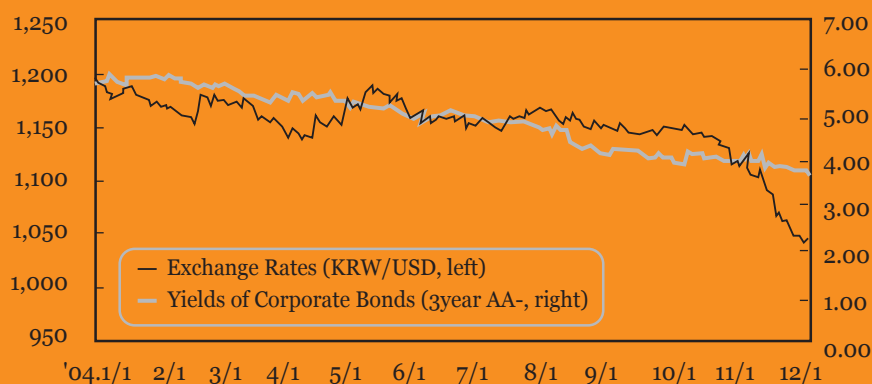
Trend of Current Account Balance

(Unit: US\$100 million)

	2003					2004				
	1/4	2/4	3/4	Oct.	Jan.~Oct.	1/4	2/4	3/4	Oct.	Jan.~Oct.
Current Account	-15.6	25.7	36.7	25.2	72.1	61.5	70.4	71.0	25.0	227.8
Goods	12.0	56.9	67.9	29.9	166.6	86.1	104.1	96.9	29.2	316.2
Services	-21.8	-14.9	-26.3	-2.5	-65.5	-18.8	-15.1	-27.5	-5.4	-66.7
Income	1.5	-10.3	4.3	0.2	-4.2	2.3	-11.6	5.4	1.5	-2.4
Current Transfers	-7.3	-6.0	9.3	-2.4	-24.9	-8.0	-7.1	-3.8	-0.3	-19.3

Due to the slowdown in the economy, reduction in the call interest rate, and other factors, the market interest rates have continued on a downward trend. Meanwhile the won-dollar exchange rate has dropped below the 1,050 won level, reflecting the weakening U.S. dollar.

Trend of Won-Dollar Exchange and Corporate Bond Yield Rates



In 2005, the economy is projected to record 4.1% growth, lower than in 2004, with a pattern of lower growth in the first half and slightly higher growth in the second half. Export growth rate is forecast to slow considerably due to slowdown in the global economy, technical effects caused by high growth of near 30% in 2004, instability of foreign exchange rates, amongst other factors. Conversely, domestic demand is expected to post a somewhat favorable performance. Private consumption is expected to grow at a 3% level owing to a gradual recovery in employment, technical effects from two years of continued consumption depression, the government's policies to stimulate domestic demand. Facility investment also is expected to grow to 8.2% due to an increase in investment pressure following strong export performance and improvement in the financial conditions of businesses in the manufacturing sector.

Consumer inflation is expected to be relatively low with an annual increase of 3.2%, thanks to such factors as stable international oil prices and the won's appreciation against the dollar. A slowdown in wage increases and mild growth in total demand are expected, which will also contribute to stable prices next year.

The market interest rate is forecast to rise gradually from 3.7% in the first half of 2005 and to 4.3% in the second half (based on yields of corporate bonds(3year,AA-)). In the first half of 2005, investment sentiment is expected to be weak due to a stagnation of exports, slow recovery of domestic demand and continuation of geopolitical risks. An additional decrease in the call interest rate also should contribute to the low-interest trend. In the second half, however, interest rates should rise slightly due to an increase in demand for funds as a response to domestic demand recovery.

With the weak dollar continuing due to expansion of the U.S. budget and current account deficits, the won-dollar exchange rate is forecast to fall to an annual average of 1,020 won to the dollar.

Economic Outlook for 2005

(Unit: Year-on-Year Change %)

	2003	2004	2005				
	Year	Year	1st qt.	2nd qt.	3th qt.	4th qt.	Year
GDP	3.1	4.8	3.4	3.6	4.3	4.8	4.1
Private consumption	-1.4	-0.8	1.1	2.8	4.0	4.6	3.2
Facility investment	-1.5	5.0	6.9	8.1	8.1	9.5	8.2
Construction investment	7.6	2.0	-0.8	-0.1	2.2	3.9	1.5
Producer prices	2.2	6.1	4.0	2.8	2.0	1.9	2.6
Consumer prices	3.5	3.6	3.5	3.3	3.0	3.0	3.2
Current account balance (US\$100 million)	119.5	274.3	35.4	34.1	28.0	35.6	133.2
Commodity Balance (US\$100 million)	219.5	377.8	63.0	69.4	61.1	64.4	257.9
Exports (US\$100 million)	1972.9	2558.2	668.9	689.1	668.0	721.6	2747.6
Changes (%)	20.7	29.7	10.8	6.8	5.6	6.6	7.4
Imports (US\$100 million)	1753.4	2180.4	605.8	619.7	606.9	657.2	2489.7
Changes (%)	18.0	24.4	17.0	14.6	13.3	12.1	14.2
Services, income & transfer (US\$100 million)	-100.0	-103.5	-27.6	-35.3	-33.0	-28.8	-124.7
Won/Dollar exchange rate (average)	1191.7	1144.8	1045.8	1030.9	1016.5	1001.5	1023.7
Corporate bonds (AA- %)	5.4	4.7	3.6	3.8	4.1	4.5	4.0
Unemployment rate (%)	3.4	3.4	3.7	3.6	3.5	3.2	3.5

External factors constituting downside risks related to this projection are the possible recurrence of oil price instability, a hard-landing of the Chinese economy following geopolitical risk factors, substantial stagnation of the global economic recovery caused by an increase in U.S. interest rates, and acceleration of foreign exchange rate appreciation due to reinforcement of U.S. efforts to resolve current account deficit. Meanwhile, internal risk factors include the continuation of socio-political conflicts centering on the legislation of four reform laws, including the National Security Law, setback in the government's efforts to boost domestic demand, strengthened of the real estate tax system including the comprehensive real estate tax. These would depress economic sentiments further and delay the expected recovery in domestic demand. If all of these risk factors materialize, next year's growth rate could fall to 2.8%, 1.3 percentage points lower than the basic projection (4.1%).

Effects of downside risk factors*(Unit: US\$100 million)*

Assumptions	GDP(%p)	CPI(%p)	Current Account(USD billion)
A. Oil price (5\$ ↑)	-0.3	+0.4	-1.94
B. Won appreciation (3%p ↑)	-0.2	-0.3	-1.65
C. World trade volume (1%p ↓)	-0.3	+0.1	-1.17
External factor total (A+B+C)	-0.8	+0.2	-4.76
D. Consumer sentiment (8p ↓)	-0.5	-0.3	+2.10
Total (A+B+C+D)	-1.3	-0.1	-2.66

Promote Expansionary Macroeconomic Policies

Korea needs to promote expansionary financial and monetary policies consistently to prepare for risk factors including a possible export slowdown in 2005. The planned expansion of fiscal expenditures must be fully implemented and it is necessary to increase expenditures in specific sectors that are conducive to expanding growth potential, in particular, such as the creation of employment and productivity enhancement. The government should consider more proactive tax cuts. Since price-push factors are being alleviated assisting price stabilization and the won's appreciation, the Bank of Korea should consider an additional decrease in interest rates. The government's intervention in foreign exchange rates meanwhile should be held to a minimum. The recent foreign exchange rate instability is due to a strong external impact and a weakening dollar, while government's stabilization efforts since late 2003 had kept the level of immunity of the Korean FX market very low. Therefore, there is a strong possibility that the foreign exchange rate stabilization efforts may prove ineffective until the Chinese yuan begins to appreciate.

Revive Economic Sentiment Through Resolution of Various Uncertainties

The government should urgently resolve political and social conflicts that undermine social cohesion and depress economic sentiments. Controversies surrounding the legislation of four laws, including the abolition of the National Security Law, temporary workers, excessive collective actions by various interest groups, weakening of Korea-U.S. cooperation on the North Korean nuclear issue among others further worsen. These factors could turn out to be major obstacles to economic recovery and stabilization of the livelihood of ordinary citizens

Threat on management rights of Korean businesses by foreign interest appear to be a source of concern and to have negatively influenced business' capital spending. However, a cure proposed by some using the equity holding of the national pension funds to protect the extant management seems worse than the disease itself. Their type of a 'white knight' could turn out to be a 'Trojan horse' of governmental control of the private business.

The social atmosphere of alienating the high-income earners and social leaders should be addressed, as it has potential to critically impact basic economic vitality. Only when the society applauds the high achievers, the number of people working hard to better their lives should grow, and the economy become stimulated and opportunities should expand.

Establish Labor-Management Relationship Respecting Laws and Principles

The neutral stance of the government in response to the summer and winter labor disputes this year will contribute positively to the stabilization and development of the labor market, as well as help establishment of legal precedent, etc. However, labor-management relations in which laws and principles are respected can be established only through strenuous, consistent efforts over time. In this regard, the government's management of the illegal strike by the Labor Union of Government Civil Servants is expected to become an important benchmark to gauge the government's resolve to respect laws and principles.

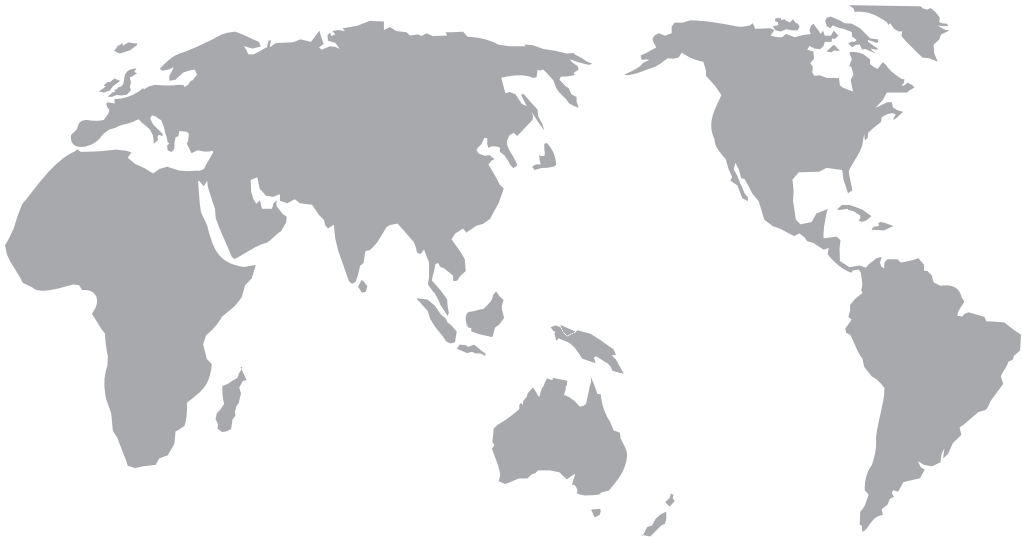
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