

KERI

Economic Bulletin

May 2005 No.39 Quarterly

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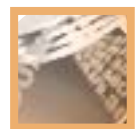
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Korea Economic Research Institute

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."



Korea's economy is expected to grow 4.1% in 2005 with domestic demand recovering gradually. Export growth is likely to decline, however, due to contraction in the growth of the global economy, technical effects caused by the high growth in exports of over 30% in 2004, unfavorable foreign exchange rates, and other factors. On the other hand, private consumption is expected to recover gradually owing to the base effect of the previous two years of sustained stagnation and the government's measures to stimulate domestic demand, including expansionary fiscal policy. Facility investment should achieve 7% growth, affected by an investment pressure build-up following the brisk export performance to date and improvements in the financial situation of enterprises in the manufacturing sector.

The current account surplus in 2005 is forecasted at US\$19.7 billion, which is somewhat lower than last year's US\$27.6 billion, and is affected mainly by the expected slowdown in export growth. The won-dollar exchange rate will likely appreciate to an annual average of 1,010 won per US\$ largely due to the weakening greenback.

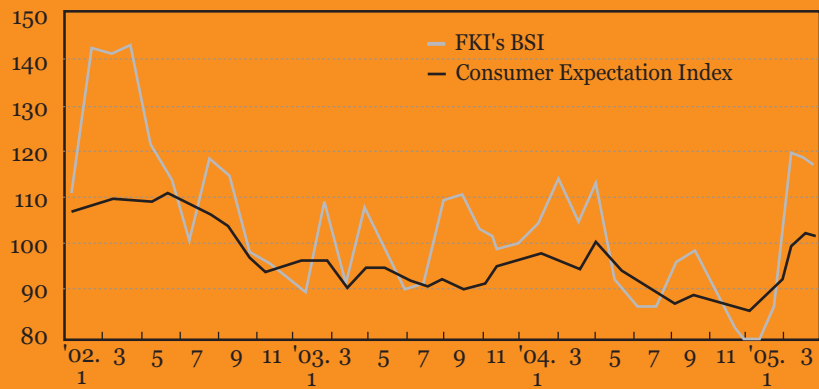
Inflation in consumer prices is expected to stabilize at 3.2% thanks to still soft aggregate demand and the strengthening won value. However, inflation could reach the 4% level if high oil prices persist.

Maintaining the current expansionary macroeconomic policy stance is important to ensure the survival of a nascent recovery in domestic demand in the short run. In particular, efforts have to be made to minimize inconsistency and appearance of discord among various policy makers. Policy makers also need to consider contingencies in the event that the external environment deteriorates further. Persistent high oil prices warrant continued vigilance, for example.

Recent Developments

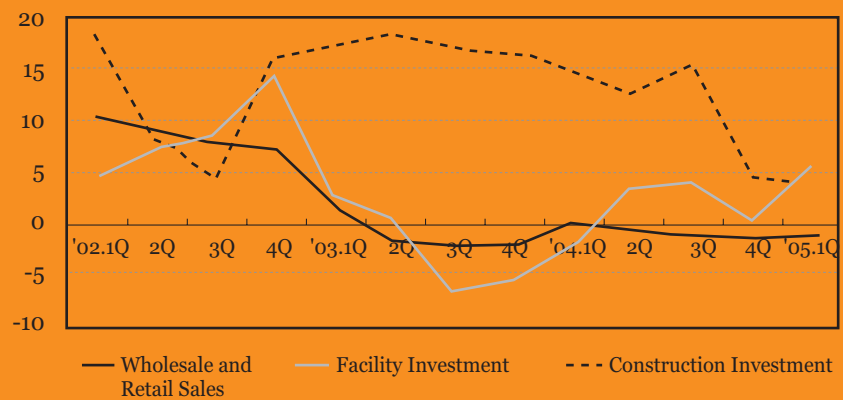
Sentiment indices show improvement since the beginning of the year, reflecting expectations of an economic recovery. In March, both the Business Survey Index (BSI) of the Federation of Korean Industries and the Consumer Expectation Index compiled by the National Statistical Office rose above 100, the neutral benchmark. The rises have been consistent since December.

Economy Sentiment



March industrial production also showed modest improvement. Both sales and investment-related data have edged up, providing somewhat firmer signals of a recovery in domestic demand.

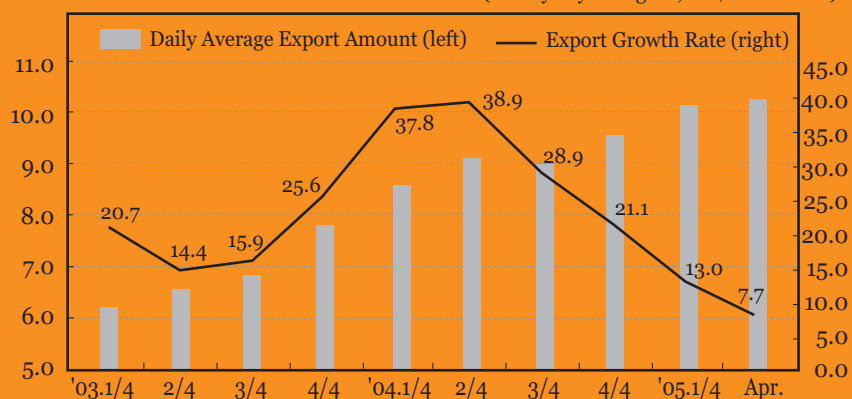
Major Indicators for Domestic Demand



After having risen to more than 30% in 2004, export growth is expected to diminish this year. The mild global growth trend, hit hard by high oil prices, as well as the growing potential of the Korean won's exchange value are main impediments to export growth. On the other hand, the contraction of domestic demand and especially private consumption is expected to reverse and expand. Such a reversal can be attributed to the gradual improvement in employment situation and households' balance sheet conditions along with the government's stimulation measures.

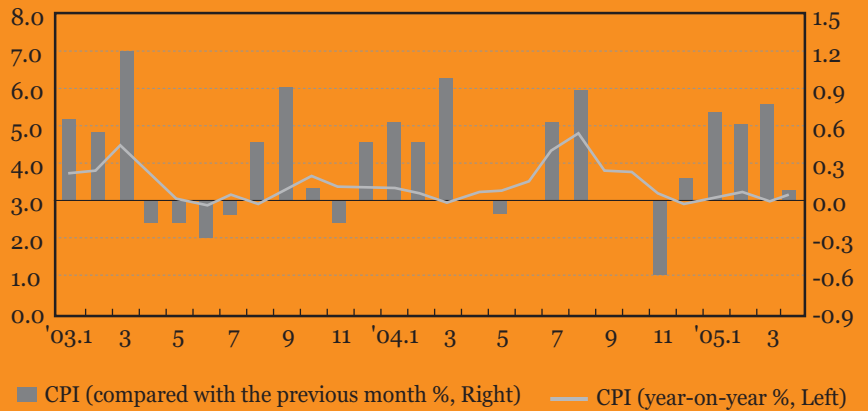
Export Growth Rates and Daily Average Export Amounts

(Unit: y-o-y change %, US\$100 million)



Consumer prices, which had declined continuously since September last year, rebounded slightly at the beginning of this year. Month-on-month increases have been recorded for five consecutive months after having bottomed out in December last year.

Consumer Price Index



The current account balance in the first quarter of this year reached US\$6.1 billion thanks to a continued surplus in the commodity balance. During the first quarter, the commodity balance surplus expanded to US\$9.4 billion compared with US\$8.6 billion in the same period last year, while the service balance deficit widened further to US\$3.1 billion compared with US\$1.9 billion a year earlier.

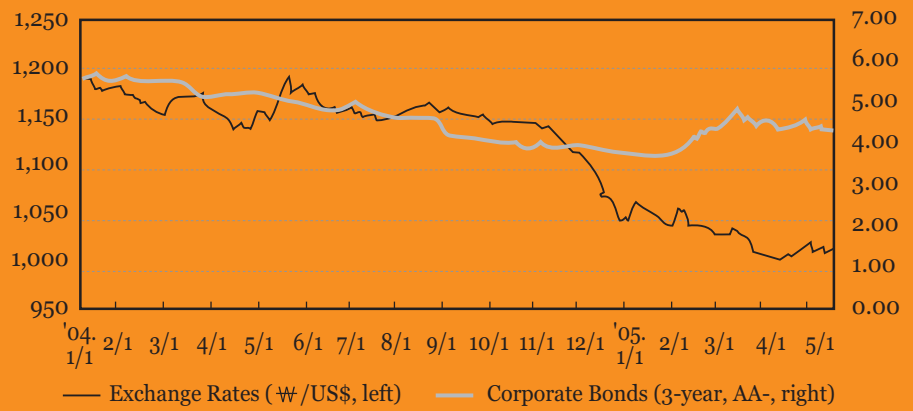
Current Account Balance

(Unit: US\$ billion)

	2004					2005
	1/4	2/4	3/4	4/4	Year	1/4
Current Account Balance	6.1	7.0	7.1	7.4	27.6	6.1
Commodity	8.6	10.5	9.9	9.2	38.2	9.4
Service	-1.9	-1.5	-2.9	-2.4	-8.8	-3.1
Income	0.2	-1.2	0.5	1.2	0.7	0.2
Current Transfer	-0.8	-0.7	-0.4	-0.6	-2.5	-0.5

At the start of this year, market interest rates rose sharply due to expectations of an economic upturn, while the appreciation of the won has slowed reflecting a somewhat stabilized U.S. dollar.

Won-Dollar Exchange and Corporate Bond Yield Rates



Economic Growth Projected at 4.1%

In 2005, the domestic economy is projected to record 4.1% growth supported by external as well as domestic demands in almost equal measure.

Private consumption, which had been on the decline for the past two years, will likely recover, although gradually, starting in the second quarter of this year. Patterns of several related indicators such as consumer sentiment, as well as the improvement in the employment situation, will support recovery.

Facility investment is expected to attain a 7% growth rate owing to accumulated investment pressures following the brisk export performance. The much improved financial situation of manufacturing businesses will likely benefit capital spending growth.

Export growth is expected to decelerate following the near 30% growth achieved in 2004, as well as the slowdown in the global economy, unfavorable foreign exchange rate, and other factors.

Consumer Price Increase to Remain at 3.2%

Due to the continued slack domestic demand, foreign exchange rate appreciation, and slowdown in wage increases since last year, consumer prices are expected to maintain an annual increase of about 3.2%.

Current Account Balance Forecast at US\$19.7 Billion

Thanks to the steady progress in exports, the current account balance surplus is likely to continue. However, export growth is projected to slow at a faster rate compared with import growth, thereby driving down the surplus expected at the end the year to about US\$19.7 billion compared to US\$27.6 billion last year.

Market Interest Rates to Rise 4.5~5%

The long-term market interest rates based on the yield of 3-year corporate bonds are expected to rise gradually to the mid-4% level in the first half of the year and to the 5% level in the second half.

With heightening expectations for improved economic conditions early this year, interest rates have risen rapidly, and an increase in demand for financing facility investments will further serve to push interest rates higher.

Economic Outlook for 2005

(Unit: Year-on-year Change(%), US\$100m)

	2003	2004	2005				
	Year	Year	1/4	2/4	3/4	4/4	Year
GDP	3.1	4.6	2.8	3.5	4.9	5.2	4.1
Private consumption	-1.2	-0.5	0.3	2.5	3.7	4.5	2.8
Facility investment	-1.2	3.8	5.7	6.6	8.0	9.0	7.3
Construction investment	7.9	1.1	-1.2	-0.5	1.6	4.4	1.3
Producer prices	2.2	6.1	3.4	3.0	2.4	2.2	2.8
Consumer prices	3.5	3.6	3.1	3.3	3.2	3.1	3.2
Current account balance	119.5	276.1	60.6	56.0	41.6	38.5	196.7
Commodity balance	219.5	381.6	94.0	89.5	74.7	66.3	324.5
Exports	1972.9	2577.5	682.4	691.0	675.6	724.3	2773.3
Change (%)	20.7	30.6	13.0	7.1	6.8	4.0	7.6
Imports	1753.4	2195.8	588.4	601.5	600.9	658.0	2448.8
Change (%)	18.0	25.2	13.7	11.2	12.2	8.9	11.4
Services, income & transfer	-100.0	-105.5	-33.5	-33.6	-33.1	-27.8	-128.0
Won/dollar exchange rate (average)	1192.0	1146.1	1022.1	1014.7	1008.7	1001.4	1012.2
Corporate bonds (% average)	5.4	4.7	4.4	4.7	4.9	5.1	4.8

Won-Dollar Exchange Rate Forecast at 1,010 Won Level

Affected by a weakening dollar, the won-dollar exchange rate should appreciate to an annual average of 1,010 won per US\$.

Although some factors could weaken the won, such as the narrowing of the difference between domestic and overseas interest rates and a decline in export growth, the weakening dollar in the wake of the large US fiscal and current account deficits will be a more significant factor.

External Risk Factors

There are two major external risk factors associated with the current growth projection, namely, the acceleration of won-dollar exchange rate appreciation and high oil prices.

If these risk factors were to materialize, economic growth could fall below the base projection. If international oil prices, for example, rise US\$5 and the world trade volume growth rate declines by 1 percentage point, domestic economic growth would decrease by about 0.8 percentage point, consumer inflation would increase by about 0.8 percentage point and the current account balance would worsen by about US\$3.2 billion compared with the base projections.

If the foreign exchange rate appreciation reaches 965 won per US\$ on annual average in 2005, economic growth and the consumer price increase rate would decline by 0.6 and 0.5 percentage points respectively, and the current account balance would worsen by about US\$3.5 billion.

Projections Considering Risk Factors

Assumed Risk Factors	Growth Rate (%p)	CPI (%p)	Current Account Balance (US\$ billion)
A. Int'l Oil Prices (US\$5 ↑) + World Trade Volume (1%p ↓)	-0.8	+0.8	-3.2
B. Exchange Rate Appreciation (5% ↑)	-0.6	-0.5	-3.5

Likelihood of Private Consumption Recovery

To gauge the possibility of a recovery in private consumption in 2005, the relationship between private consumption and several related macroeconomic indicators was examined. The table shows the cross-correlation between the quarterly real private consumption (GDP component, rate of change, year-on-year) and several related macroeconomic indicators including the retail and wholesale series, two types of employment, consumer sentiment index and stock price index, and two consumer finance-related variables. Quarterly averages of all monthly data and year-on-year growth rates were used. The sample periods are 1990Q1~2004Q4 for retail and wholesale, employment and stock price series, 2000Q1~2004Q4 for the consumer sentiment index, and 1997Q1~2004Q4 for consumer finance-related series.

It is hardly surprising to find a very close linkage between private consumption and retail, as well as between wholesale and their component series. However, there are couple of other noteworthy points. Private consumption is seen to be more closely related with changes in overall employment rather than those with full-time jobs. The consumer sentiment index appears to have some predictive power regarding private consumption in that an increase in the index this quarter will likely bring about an increase in private consumption in the following quarter. Consumer sales credit (credit card usage and installment sales) in one quarter was quite highly related to private consumption in the next quarter.

Improvements in consumer sentiment and credit card usage in current and previous quarters, along with a gradual improvement in the overall employment in recent periods suggest a visible recovery in the near future.

Correlations of Consumer-Related Indicators and Private Consumption

	Consumption		
	t	t + 1	t + 2
Wholesale(t)	0.88	0.77	0.56
Retail (t)	0.93	0.78	0.48
Automobiles/Fuels (t)	0.88	0.78	0.53
Total Employment (t)	0.86	0.63	0.33
Regular Employment (t)	0.43	0.32	0.20
Consumer Expectation(t)	0.59	0.65	0.43
Stock Price (t)	0.44	0.46	0.35
Household Loan (t)	0.49	0.14	-0.17
Sales Credit (t qt.)	0.66	0.85	0.23

Note: Quarterly data based on year-on-year changes in growth rate.

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