KERI

Economic Bulletin

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Contents

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.”

Executive Summary

Owing to recovery in domestic demand, particularly private consumption, the Korean economy is expected to record 4.5% growth in the second half of this year (3.8% for the whole year) and 4.9% growth next year.

With resolutions of adjustment of household debt to a certain extent coupled with the gradually improving employment conditions, private consumption will likely increase at 4.1% in the second half and at 5.2% next year.

In the second half of this year, facility investment is expected to show a mild recovery at slightly above the economic growth rate, and in 2006, it is projected to expand at about 8%. However, construction investment is likely to experience low growth of 2% to 3% largely as a result of the government's comprehensive and constrictive real estate measures.

Export growth is likely to show somewhat due to high oil prices, the won's appreciation, as well as the expected slowdown in the U.S. and Chinese economies. Nevertheless, it is projected to grow at 12.4% in the second half of this year and 6.8% next year, a comparatively solid growth trend.

As import growth is expected to outpace export growth, the current account surplus is projected to shrink to about US$16.3 billion this year, down from US$27.6 billion in 2004, and is expected to fall even further to US$5.4 billion next year.

Affected by the won's appreciation and other factors, the rate of increase in consumer prices is likely to stabilize at 2.5% in the second half of the year. For 2006, the inflation rate is projected to rise from 2.6% in the first half to 3.0% in the second half of the year, largely due to some upward pressure coming from domestic demand recovery.

Based on the yield of 3-year-maturity corporate bonds, market interest rates are likely to soar from 4.8% in the second half of this year to 5.2% next year due to the more robust economic recovery. The won-dollar exchange rate is expected to appreciate slightly from 1,016 won in the fourth quarter of 2005 to 1,006 won on an annual average next year.

Considering the fact that a negative output gap has accumulated for the past three years, economic growth rates at greater than 5% should entail little inflationary pressure for a considerable period. Therefore, maintaining the current macroeconomic policy tone, including monetary policy and fiscal policy, is desirable in the short term.

In the medium and long term, the growth potential should be boosted through productivity-enhancing technological improvements, a better corporate investment environment and more labor flexibility. However, to ensure that the results of technological development contribute to economic growth, practical commercialization and extensive utilization of new ideas and inventions is imperative and is in turn closely related to how brisk corporate activities are.

Entering the second half of this year, the economic recovery appears to be strengthening, albeit gradually, with consumption on the rise and exports posting double-digit growth.

In the second quarter of this year, real GDP growth reached 3.3%, up 0.5 percentage points from the first quarter (2.7%). This rise was primarily due to domestic demand recovery, which grew 2.6%, up from 1.4% in the first quarter, as well as due to private consumption and construction investment growth. The export growth rate, in contrast, declined to 5.5% compared with 7.4% in the first quarter.

Growth Rates by Expenditure Item

(Unit: y-o-y change %

	2004			2005		
	3/4	4/4	Year	1/4	2/4	1st Hal
Private Consumption	-0.8	0.6	-0.5	1.4	2.8	2.1
Construction Investment	1.3	-3.4	1.1	-2.9	1.7	-0.2
Facility Investment (+Intangible Assets)	5.5	2.3	3.1	3.3	2.7	3.0
Exports (goods and services)	17.7	9.8	19.7	7.4	5.5	6.4
Imports (goods and services)	12.0	11.1	13.8	5.2	5.5	5.4
GDP	4.7	3.3	4.6	2.7	3.3	3.0
Domestic Demand	0.3	-2.6	-0.2	1.4	2.6	2.0

Starting in the second half of the year, the pace of consumption recovery has been quickening. In July-August, sales of consumer goods increased to 5.4%, up from 3.2% in the second quarter, while the service sector grew 4.2% in the same two months, up from 2.4% registered in the second quarter of the year. On the other hand, the recovery in facility investment has been rather weak and construction investment has declined.

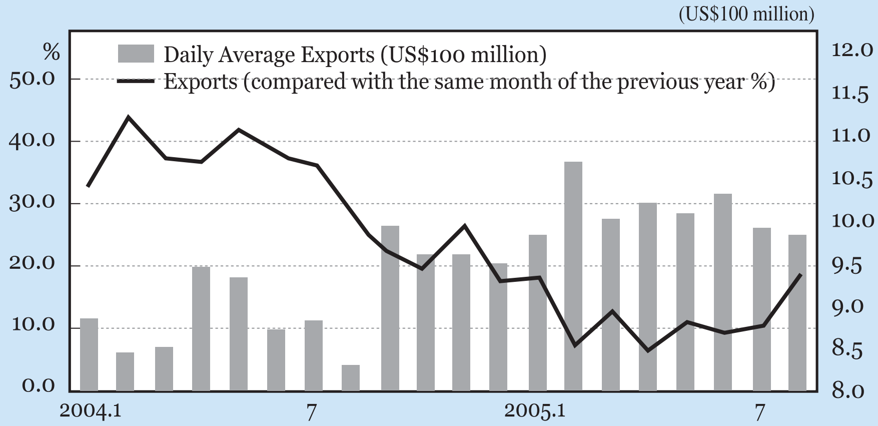
Major Domestic Demand Indicators

(Unit: y-o-y change %)

	2004		2005				
	4/4	Year	1/4	2/4	July-Aug.	July	Aug.
Sales of Consumer Goods	0.2	-0.3	1.2	3.2	5.4	4.8	6.0
Services	-0.2	0.6	0.7	2.4	5.0	4.3	5.6
Facility Investment	0.1	1.4	4.0	1.4	1.7	4.2	-0.9
Construction Progress Payments	4.4	11.0	2.8	10.3	5.1	5.0	5.2

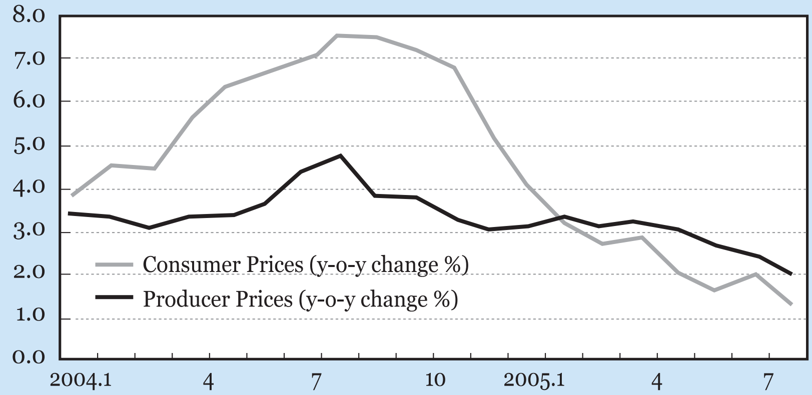
Exports, which had slowed since the second quarter of last year, grew 15.8% in the third quarter this year, up from 9.0% in the second quarter.

Export (Customs Clearance Basis)



Consumer price inflation continued on a stable trend at 3.0% in the second quarter of this year from 3.1% in the first quarter and dropped to 2.4% in the third quarter. Much of this can be attributed to the won's appreciation as well as to technical effects from the high rate of 4.4% recorded in the third quarter last year together with the, as yet, soft aggregate demand.

Consumer Prices and Producer Prices



The current account surplus declined due to a reduction in the commodity account surplus and expansion of deficits in the service, income and current transfer balances. The current account balance for the January to August period recorded US$9.69 billion, a fall of US$7.76 billion from US$17.45 billion registered in the same period last year.

Current Account Balance

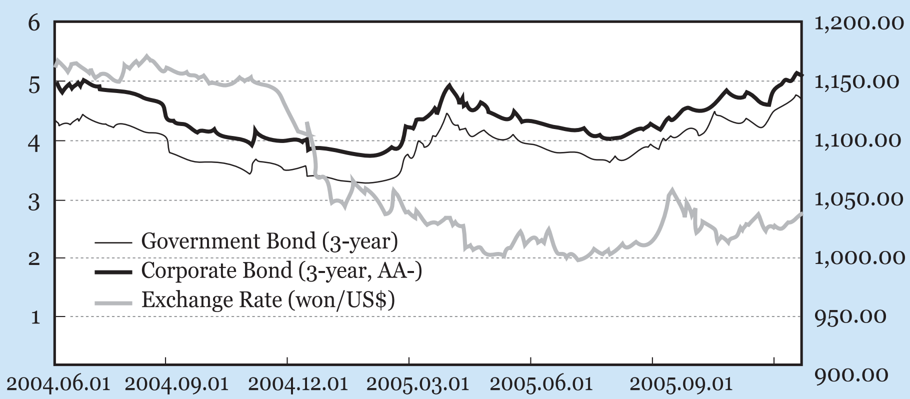
(Unit: US$100 million)

	2004		2005				
	Jan.~Aug.	Annual	1/4	2/4	July	Aug.	Jan.~Aug.
Current Account	174.5	276.1	59.5	27.6	13.8	-4.0	96.9
Commodity	252.3	381.6	92.9	86.5	31.3	17.1	227.8
Service	-54.5	-87.7	-30.5	-30.8	-15.0	-18.6	-94.8
Income	-6.8	7.2	2.4	-21.0	-0.6	-0.4	-19.7
Current Transfer	-16.6	-25.0	-5.2	-7.2	-1.9	-2.1	-16.4

The yields on government and corporate bonds continue to rise since June, as expectations of an interest rate hike become more and more widespread following brisk private consumption and industrial production.

Influenced by the Chinese yuan's appreciation, the won-dollar exchange rate declined in July but rebounded to a mild increase in tandem with the stronger dollar in the wake of persistent oil price hikes and rising U.S. interest rates.

Interest Rates and Foreign Exchange Rate



Growth Rate

The Korean economy is projected to realize a 3.8% growth rate for 2005. A slightly better performance in the second half growth at 4.5% is expected owing to continued export strength and the mild recovery in domestic demand.

Despite risk factors such as higher oil prices and the won's appreciation, Korea's exports will likely maintain solid growth helped mainly by continued expansion of the Chinese economy.

Private consumption is expected to recover to about 4% in the second half of the year with adjustments of household debts being finalized to a certain extent, as well as the improving employment situation.

Facility investment is forecast to recover slowly to slightly exceed the economic growth rate, as improvements in the corporate investment environment remain somewhat insufficient.

Conversely, growth in construction investment is expected to be low at around 2% due to, amongst other factors, the 'August 31 Comprehensive Real Estate Policy' and the conclusion of early implementation of fiscal expenditures in the first half of this year.

With continuing economic recovery backed by the steady improvement in domestic demand, the nation's economic growth is expected to reach 4.9% in 2006.

While the brisk export trend, which led the Korean economy in 2005, may decline slightly in 2006, as the U.S. and Chinese economies slow somwhat, private consumption, construction investment and facility investment (including intangible assets) are projected to realize annual growth rates of 5.2%, 3.1% and 7.7%, respectively, all higher than in 2005.

Consumer Prices

As overall demand pressure appears insignificant and coupled with the effect of the won's appreciation, consumer price inflation is expected to slow to 2.5% in the second half of the year despite the high international oil prices and should stabilize at around 2.8% for the full year.

In 2006, recovery in domestic demand will likely exert some upward pressure on inflation. Consumer prices are projected to grow at 2.6% and 3.0%, in the first and second half, respectively, and to post an annual increase of 2.9%.

Current Account Balance

With import growth outpacing export growth, the current account surplus in the second half is projected at US$7.6 billion, down from US$8.7 billion in the first half of the year.

In 2006, following a reduction in the commodity account surplus and surge in the service account deficit, a sharp decline in the current account balance surplus to US$5.4 billion is expected compared with US$16.3 billion in 2005.

Unlike exports, which have dropped to single-digit growth, imports will most likely post double-digit growth in 2005 owing to improved domestic demand.

Market Interest Rates

Based on the yield rate of the 3-year corporate bonds, market interest rates are expected to rise slightly to 5% in 2006, up from 4.8% in the second half of this year, as economic recovery continues.

Although the Bank of Korea is expected to raise the target call interest rate, no major related effects, such as a sharp jump in interest rates, is likely as the move would have already been reflected in market interest rates.

Won-Dollar Exchange Rate

The won-dollar exchange rate is expected to record a mild appreciation to 1,016 won to the dollar in the fourth quarter of this year, and to 1,008 and 1,003 won to the dollar in the first and second half of next year, holding the line above the 1,000-won level.

Although there are factors that would favor a stronger won, such as the possibility of appreciation of the Chinese yuan, the maintenance of Korea's trade surplus as well as the dollar's weakening trend, further appreciation of the won has been mitigated significantly due to other factors such as interest rate increases in the U.S. this year.

Outlook for 2005~2006

(Year-on-Year Changes %, US$100 million)

	2004	2005					2006		
	Year	1/4	2/4	3/4	4/4	Year	1st H	2nd H	Year
GDP	4.6	2.7	3.3	4.3	4.6	3.8	4.8	5.0	4.9
GDP (se, q-o-q %)	4.6	0.4	1.2	1.8	1.0	3.8	1.6	3.3	
Private consumption	-0.5	1.4	2.8	3.8	4.3	3.1	4.8	5.5	5.2
Construction investment	1.1	-2.9	1.7	1.8	2.3	1.0	2.6	3.6	3.1
Facility investment (+Intangible Assets)	3.1	3.3	2.7	4.7	5.2	4.0	6.5	8.9	7.7
Consumer prices	3.6	3.2	3.0	2.2	2.7	2.8	2.6	3.0	2.9
Current account balance (US$100 million)	276.1	59.5	27.5	39.4	36.3	162.7	31.9	21.6	53.5
Exports (change %)	30.6	12.9	9.4	13.1	11.4	11.7	9.7	7.8	8.8
Imports (change %)	25.2	13.8	14.7	19.3	17.6	16.4	14.5	12.5	13.4
Won-dollar exchange rates (Avg.)	1146.1	1022.1	1008.1	1028.3	1016.0	1018.6	1008.6	1004.2	1006.3
3-Year corporate bond yield (Avg. %)	4.7	4.4	4.2	4.7	4.9	4.6	5.1	5.3	5.2

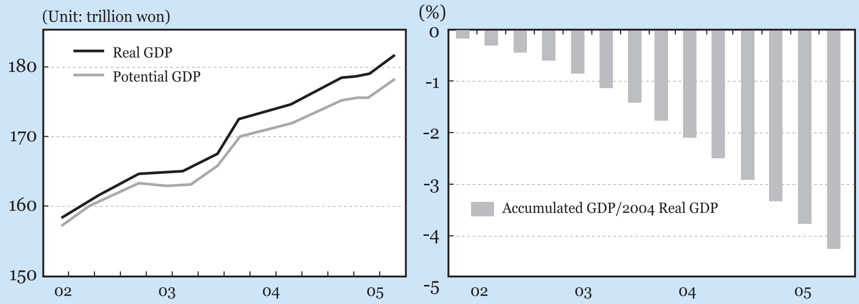
Source: KERI's quarterly model

Maintenance of Present Macroeconomic Policy Tone Needed

Considering the size of the accumulated negative output gap, or deflationary gap, for the past three years, a period of relatively rapid growth should pose no threat to Korea's macroeconomic stability. Rather, to facilitate this, the government should maintain its present macroeconomic policy stance.

The level of real GDP has continuously stayed below that of the potential GDP for the past three years due to very sluggish domestic demand. We estimate the size of the accumulated gap from 2002 through 2004 to be at 4% of real GDP in 2004.

Ratio of Real and Potential GDP Levels vs. Accumulated Output Gaps by Quarter



As such, somewhat rapid growth, exceeding 5% (widely known as the rate of output growth compatible with a non-accelerating inflationary rate of unemployment, or NAIRU), should not present any significant inflationary pressure. So, it would be premature to change the economic policy stance or tone into a retrenchment mode. Such a recommendation applies to both monetary and fiscal policies.

Even though the 0.25% raise in the call market interest rate by the Monetary Policy Board (MPB) of the Bank of Korea (BOK) is not expected to have significant effects, the decision appears to have been somewhat premature. There is still a good deal of uncertainty regarding the strength and timing of the expected full recovery in domestic demand, about which members of the MPB have no more prescience than other economists. For now, the decision does not seem to herald immediate follow-ups unless economic indicators turn consistently strong until the end-of-the-year.

Enhancement of Growth Potential Through Technology Improvement and Increases in Manpower/Physical Capital Resources

New technological developments (or inventions) are an important element in boosting output growth, and may enhance productivity even without increases in manpower/physical resources. To obtain the full benefits of technological development, however, practical commercialization and extensive utilization (ie., innovation and diffusion) are imperative. It necessarily entails increases in purchases and adoption of new equipment and machinery. Therefore, active and economically meaningful technology developments can hardly be expected amidst a long-term slowdown in investment and business activity.

According to the 2005 'Doing Business' survey report of the World Bank, which provides a comparative assessment of the business environments internationally, Korea ranked low in several categories. This implies that Korea's efforts to better its business environment have not been particularly successful when compared with other nations.

To be more specific, labor issues still continue to offer difficult challenges, for example. Since manpower resources will not grow significantly in the next 10 to 20 years, given Korea’s aging population and low birth rates, more efficient utilization of existing available labor is critical. To this end, more diverse (in pay and hours) jobs should be created through enhanced labor market flexibility to accommodate workers with different abilities and availability. For Korea, which ranked 105th among the 155 surveyed nations in the 'Employment and Lay-Off Flexibility' category in the same World Bank survey, it might be difficult to expect a marked expansion in production capability potential without first improving the labor market.

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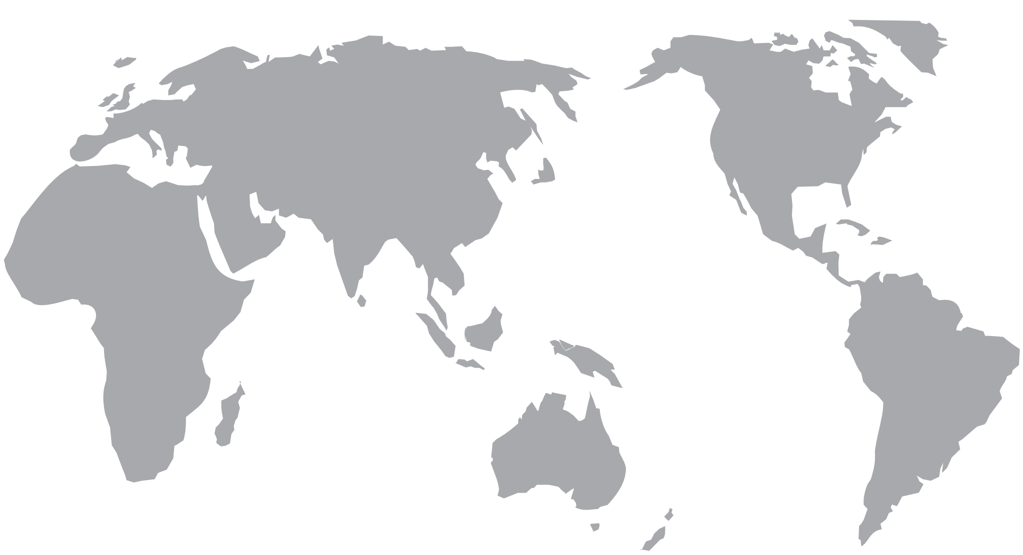

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