

KERI

# Economic Bulletin

January 2003 No.30 Quarterly

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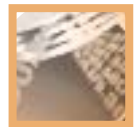
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Korea Economic Research Institute

# 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."



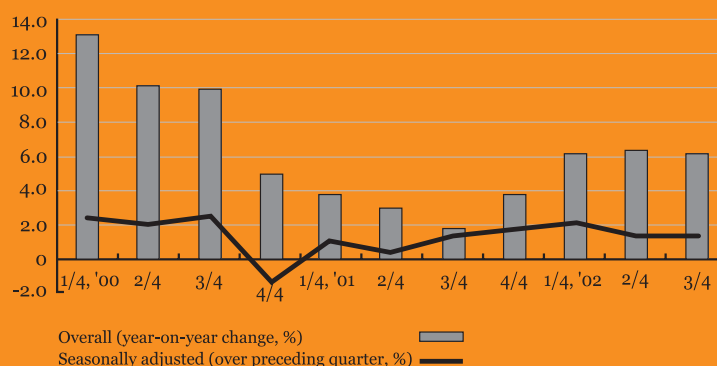
## Recent Developments



### Production, Consumption and Investment

Real GDP grew by 5.8% in the third quarter of 2002, slightly lower than the second quarter's 6.4%, due to a slowdown in domestic demand sectors, most notably consumption and construction. Despite the slight dip in GDP growth, an overall recovery trend was deemed to be on track in light of the effect of seasonal factors, including a major typhoon, and the comparative effect of the strong domestic demand last year. In fact, the seasonally adjusted real GDP growth in the third quarter was up 1.3% over the preceding quarter.

Real GDP



In the October-November 2002 period, a balanced growth pattern emerged between domestic demand and exports, as sluggish domestic demand gradually gained steam amid a continued export expansion.

- Industrial production, temporarily stalemated due to the effect of the typhoon and "Chuseok" (Korean Thanksgiving) holidays, regained vigor once again after October. The industrial production growth rate, having declined to 5.3% in the third quarter from 7.5% in the second quarter, rose to 9.5% in the October-November period.
- Wholesale and retail sales growth edged up to 5.9% in the same period from 5.1% in the third quarter, a reversal of the slowdown trend that commenced in the first quarter.
- Construction progress payments also reversed course and increased by 6.2% in this period from a 1.8% decline in the third quarter.
- Growth of facility investment, which stood at 0.1% in the third quarter, expanded by 3.8% in the October-November period.

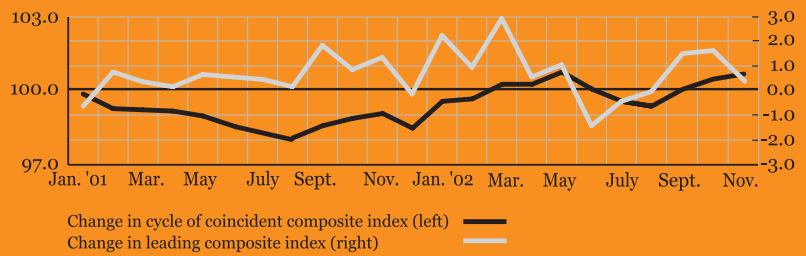
### Production, Consumption and Investment

	2001	2002			
		1/4	2/4	3/4	Oct.~Nov.
Production	1.3	6.8	7.5	5.3	9.5
Wholesale & retail sales	4.6	8.0	6.4	5.1	5.9
Estimated facility investment	-5.1	2.2	-0.2	0.1	3.8
Construction progress payment	5.7	10.3	3.8	-1.8	6.2
Export shipment	1.8	2.6	6.5	5.3	9.3

Source : National Statistical Office

The cyclical coincident composite index, reflecting the current economic situation, is surging once again, having bottomed out in August. The leading composite index, an indicator of future economic activity, also showed continued growth for four consecutive months after August.

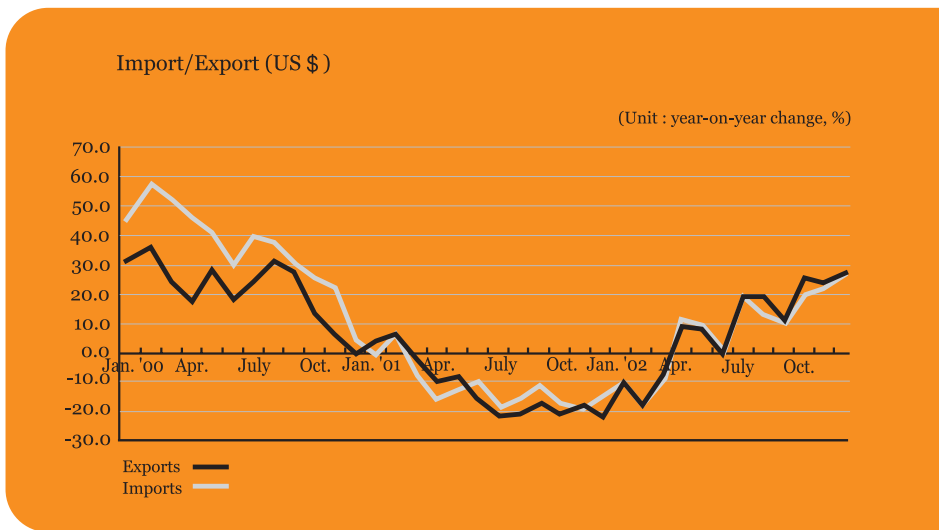
### Composite Business Index



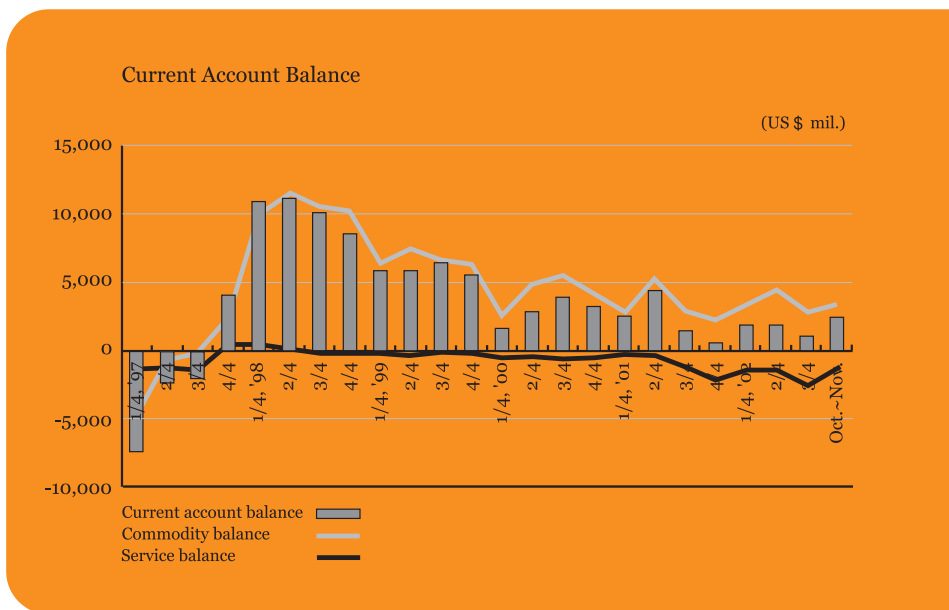


## Exports, Imports and Current Account Balance

Exports surged 25.1% in the fourth quarter, building on the 16.3% increase in the third quarter. Imports also continued their upward trend, keeping pace with exports.



The surplus in the current account, registering US\$0.6 billion in the third quarter, expanded rapidly to US\$2.44 billion in the October-November period. Accordingly, the January-November current account surplus reached US\$6.68 billion.

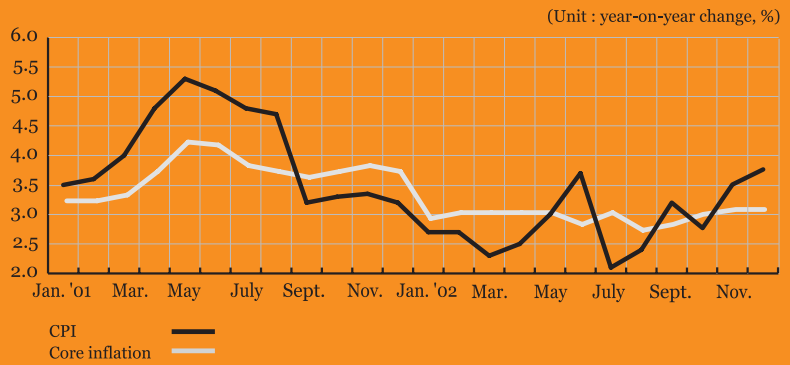




## Prices

Prices experienced a slight upturn in the final four months of 2002. The consumer price increase rate, having hovered at the mid 2% level until August, gradually climbed after September to a high of 3.7% in December. Nevertheless, the recent trend toward price increases was influenced to a certain extent by temporary factors, such as flood damage. It appears, however, that price push pressure is easing gradually thanks to the won currency devaluation, stabilization of real estate price rises, etc.

Consumer Price & Core Inflation

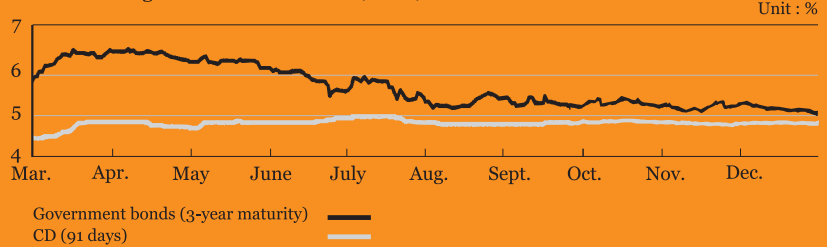




## Interest Rates and Foreign Exchange Rate

The three-year government bond rate, having shown a stabilized pattern within the 5.3%~5.5% range since August, declined after mid-December, reflecting continued uncertainty in both internal and external economic environments.

Short & Long-Term Interest Rates (2002)



The won-dollar exchange rate took an upward turn, due to growing concern about the Japanese economy since August, a subsequent yen devaluation and outflow of foreign funds from the stock market (US\$1.38 billion in the third quarter). However, from the latter part of October the won-dollar rate declined again owing to a return of foreign investment capital, jitters over the crisis in Iraqi, etc.

Won-Dollar Exchange Rates (2002)





### Economic Growth

In 2003, geopolitical risk factors such as a looming war in Iraq, proliferation of terrorism and the North Korean nuclear problem are major considerations. Nevertheless, our projection is based on the assumption that these factors will not have significant negative side effects on the general economy.

Under this assumption, the growth trend is expected to continue in 2003 owing to export expansion and subsequent recovery of facility investment. The low growth (3.0%) in 2001 will have a delayed effect on the growth rate in 2003, which is projected at about 5.8%, and slightly lower than the comparatively high rate realized in 2002.

The slowdown in domestic demand growth in the second half of 2002 is likely to continue through the first half of 2003. Private consumption expansion, therefore, may end the year at about 5.2%, below the projected economic growth rate.

- In 2002, the growth of private consumption, the bellwether of domestic demand increase all year, declined to 6.1% in the third quarter from 8.4% in the first quarter. Recent wholesale and retail sales performance implies that the trend will continue through the first half of 2003.

Exports are expected to expand at a comparatively high growth rate of 8% in 2003 on a U.S. dollar basis in anticipation of expanded world trade volume and sustained progress in exports to China. A gradual economic recovery in advanced countries including the United States is projected to fuel this robust export growth.

Facility investment is projected to record a growth rate of 8.9%, higher than the 6.7% in 2002, thanks to improvement of enterprise investment sentiment due to increased exports and a comparative rebound from two years of continued slowdown in 2001~2002. If exports continue their upward trend, pressure will be brought to bear on the production capacity of enterprises. Based on the track record of the past two years of poor performance in facility investment by enterprises, the upsurge in overseas demand is expected to induce facility investment expansion to secure required production capacity.






## Prices

Prices are projected to receive upward pressure due to the anticipated near 6% economic growth in 2003, similar to that in 2002. Nevertheless, the price increase rate will be limited, affected by a continued slowdown in domestic demand, the won currency appreciation trend, etc., with the likely result of an annual increase of 3.2%, slightly higher than in 2002.

- Prices recorded an increase in the mid-2% range prior to September 2002, attributable to low oil prices, reduction in public utility charges, etc., but suffered a comparatively strong rise in the fourth quarter in the aftermath of price hikes in farm and oil products. This latter trend is expected to continue through the first quarter of 2003.



## Current Account Balance

With import growth outpacing export growth and a continued deficit in the service account balance, the surplus in the current account balance in 2003 is projected to hit an annual total of US\$1 billion, far less than the US\$6 billion (estimated) in 2002.

- With a rapid surge in demand for capital goods and raw materials following facility investment recovery and export growth, imports in 2003 are expected to increase by 11%.

### Domestic Economic Outlook for 2003

Unit: year-on-year change (%), US\$100 million (Balance of payment)

	2001	2002					2003					
	Year	1/4	2/4	3/4	4/4	Year	1/4	2/4	3/4	4/4	Year	
GDP	3.0	5.8	6.4	5.8	6.2	6.1	5.0	5.6	5.9	6.4	5.8	
Total consumption	3.7	8.0	7.3	5.6	5.0	6.4	4.3	4.8	5.1	5.4	4.9	
Private consumption	4.2	8.4	7.6	6.1	5.5	6.9	4.6	5.1	5.4	5.5	5.2	
Fixed capital formation	-1.7	6.5	5.5	0.9	2.3	3.7	2.7	4.5	6.1	5.9	4.8	
Facility investment	-9.8	3.2	7.4	7.7	7.9	6.5	7.9	8.5	8.9	8.7	8.5	
Construction investment	5.8	10.1	3.9	-3.8	-1.2	1.5	-2.7	1.1	3.9	3.9	1.8	
Total exports	1.0	1.8	11.6	18.3	18.4	12.5	12.5	8.9	9.1	8.7	9.7	
Total imports	-2.8	6.2	19.2	20.1	18.0	15.8	14.6	10.5	10.3	9.6	11.2	
Producer price	1.9	-0.2	1.2	1.5	3.5	1.5	3.3	2.2	2.8	2.8	2.8	
Consumer price	4.1	2.5	2.8	2.5	3.2	2.7	3.4	2.8	3.2	3.4	3.2	
Current account balance	86.2	17.1	17.9	6.0	19.1	60.1	11.2	9.6	-6.7	-3.4	10.7	
Commodity balance	133.9	32.7	43.7	30.1	41.2	147.7	32.7	38.4	20.9	24.6	116.7	
Exports	1,513.7	361.3	405.8	410.4	448.8	1,626.3	405.4	439.8	442.2	476.6	1,764.0	
Change (%)	-14.0	-11.1	5.0	13.3	25.1	7.4	12.2	8.4	7.7	6.2	8.5	
Imports	1,379.8	328.6	362.1	380.3	407.6	1,478.6	372.7	401.4	421.3	451.9	1,647.3	
Change (%)	-13.3	-12.1	7.8	14.2	21.0	7.2	13.4	10.9	10.8	10.9	11.4	
Service, income & transfer	-47.7	-15.5	-25.8	-24.1	-22.1	-87.6	-21.5	-28.8	-27.6	-28.1	-106.0	
Won/US\$ (average)	1,290.7	1,319.6	1,270.7	1,196.4	1,211.6	1,249.6	1,200.5	1,193.9	1,188.0	1,191.0	1,193.4	
Corporate bond (Avg.,%)	7.0	7.0	7.0	6.3	5.9	6.6	6.2	6.7	7.2	7.6	6.9	



## Interest Rates and Foreign Exchange Rates

Many observers believe that the present interest rate level does not reflect current economic fundamentals and is extremely low. In this context, short and long-term interest rates are expected to show a gradual increase in the second half from the perspective of reflecting the real economic situation, as the economic recovery becomes more apparent.

- With uncertainties continuing to dog the domestic and global economies, major economic indicators in and outside of Korea are not expected to improve for the time being. Therefore, short and long-term interest rates are likely to remain steady, at least in the first quarter.
- Long-term interest rates, in particular, are expected to rise and narrow the gap with real markets. Subsequently, they are forecast to reach the 7% level based on corporate-bond rate, and record an annual average of 6.9%.

The won-dollar exchange rate is expected to continue a slow downward trend in 2003 to reach an annual average of ₩1,193 level.

- Despite the considerable shrinkage in the current account surplus projected for 2003, supply factors involving the U.S. dollar are forecast to expand due to foreigners' increased investment in domestic stocks, etc. so that the overall dollar supply and demand situation is likely to reflect the superiority of supply over demand.



## Risk Factors for Projection

In this projection there are downside risks as explained below:

- a worsening of the overseas economic situation due to geopolitical risk factors, and
- the possibility of long-term sluggishness in enterprise investment.

First, if geopolitical factors such as the Iraqi crisis, the proliferation of terror and North Korea's nuclear problem should worsen, serious negative effects could result for the global economic recovery, in spite of stimulus endeavors by the United States and EU. Subsequently, a souring of overseas economies will cause a setback in export expansion, the anticipated driving force of the national economy for 2003. The economic growth rate could slide to below 4%, according to developments.

Second, despite the launch of the new government, if labor market flexibility and business management conditions do not improve, there is a possibility that in contrast to this forecast, enterprise investment sentiment may not recover. This carries the potential of converting the current investment slowdown into a long-term one. Such a scenario will not only jeopardize the present economic recovery, but may become a stumbling block to the long-term growth potential of the national economy.

### More Efforts Required to Improve Business Environment

The new government's efforts to enhance our economy's medium and long-term potential growth rate are of supreme importance in establishing policy priorities. Under the market economy system, enterprises are the most important economic units for the creation of added value.

The content of recent legislation on 'free economic zones' enacted recently by the government shows clearly the sort of management environment our enterprises are in. The special law stipulate that while various legal regulations, employment practices, etc. will continue for domestic enterprises, exceptions will be granted to foreign tenant enterprises in the zones.

Let alone discussion about the appropriateness and effectiveness of individual existing regulations, together they have an unintended consequence of restraining business activities for the creation of jobs, income and added value, thereby having negative effects on our economy.

If the management environment deteriorates further in such poor conditions, it will significantly weaken the position of private enterprises that constitute the main axis of the market economy. On the other hand, we can boost Korea's potential growth capacity further if the government improves business environments and thus invigorates enterprise activities.

### Reorganization of Economic Ministries Needed to Strengthen Fiscal Policy Role

There are two important policy tools for the adjustment of the macroeconomy: fiscal policy and monetary policy. In principle, these two means are being used in parallel in Korea, but due to excessive emphasis on a balanced budget, fiscal policy has been exercised too rigidly in the recent past.

In contrast, monetary policy has been used too frequently for a variety of goals - boosting the economy/prevention of overheating, price stabilization, asset value adjustment, etc. Efforts to adjust economic conditions by leaning unduly on monetary policy is bound to be ineffective, and in the worst case, this tool can be rendered useless. Therefore, enhancement of the fiscal policy role in the adjustment of the macroeconomy will be an important task for the incoming administration.

With a sharp decline in exports since the end of 2000 and the nation's economy hobbled by a recession, on several occasions the government's top policy-makers have announced that the government would implement an expansionary fiscal policy through accelerated execution of budgets. Examining the actual results of budgets since 2001, however, the central government has not only maintained a continuous fiscal surplus but also has failed to accelerate outlays in each year.

The problem in the present budget system is its inflexibility once the ink is dry. In other words, if economic conditions change from the time of the budget's approval, there is no room for the government to change the execution speed or expenditure details of the budget, even when modifications would help significantly.

To improve fiscal policy execution, it is desirable for the new government to increase the adjustment function of the macroeconomy through a reorganization of economic ministries. The ministries in charge of budget and fiscal policy need to be merged first. Secondly, budgets need to be made less compartmentalized so that overall budget execution can be controlled by the appropriate fiscal policy ministry when necessary.

If such changes are implemented, concerns may arise that this system could undermine the independence of respective ministries and bolster the position of relevant economic ministries. But we need to realize that government organization does not exist mainly to guarantee equal rights of ministries or bureaucrats. The objective enhancement of national management will have to be the most important judgement criterion. As enterprises undertake restructuring, so the government must reorganize itself as needs arise in order to carry out its basic duties and responsibilities more efficiently.

An active fiscal policy will restore the respective advantages of fiscal and monetary policies and enhance the stability of our economy in the long term.



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