

## Recent Economic Developments

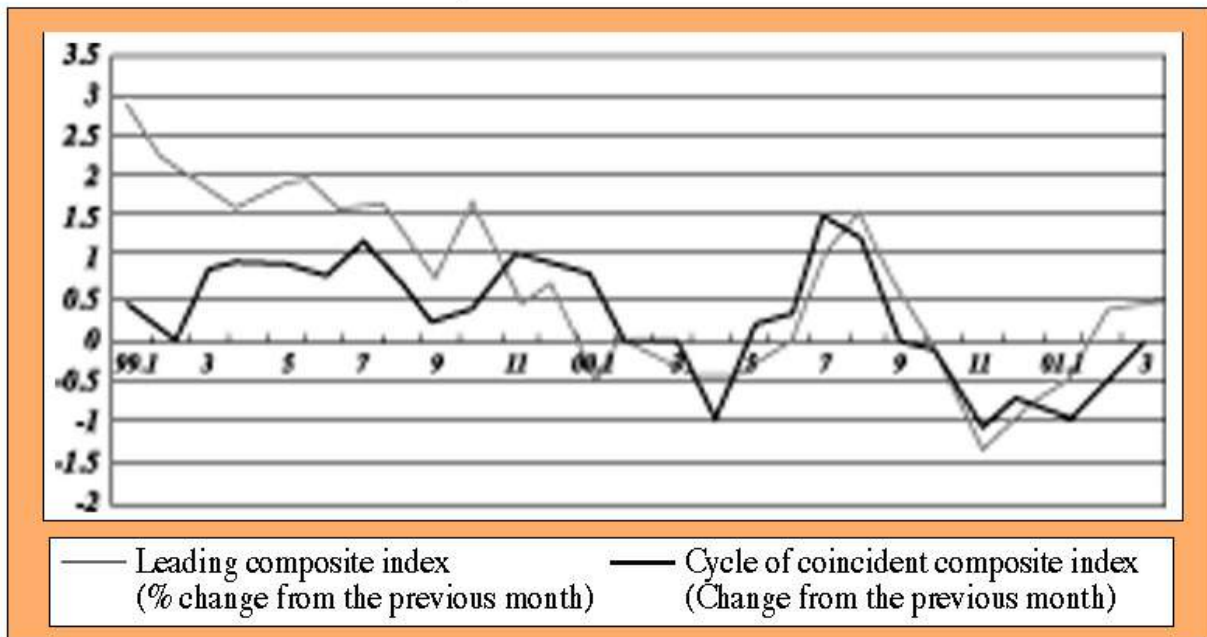
### Production, Consumption and Investment

Real economic indicators, on a downward slope since September 2000, began to show signs of bottoming out and rebounding in January. Industrial production, for example, had continued to slacken until January (0.1%), then grew by 7% in the February-March period. The average operating rate also improved slightly. Facility investments continued to decline, but the rate of decline showed signs of abating. Construction investment reversed course and recorded a small positive growth. Wholesale and retail sales are exhibiting modest positive improvement. The coincident composite index's negative trend has continued but the rate of decline has slowed somewhat. Notably, the leading composite index rose slightly in the February-March period.

	1999	2000				2001				
	Year	1/4	2/4	3/4	4/4	Year	1/4	Jan.	Feb.	Mar.
GDP	-10.9	12.6	9.7	9.2	4.6	8.7	-	-	-	-
Production	24.2	23.6	18.4	19.8	7.6	16.8	4.9	0.1	8.8	6.2
Average operating ratio (%)	76.5	79.4	78.8	79.9	75.0	78.3	74.6	73.9	94.9	94.9
Wholesale & retail sales	13.0	15.1	13.3	8.0	3.9	9.8	2.5	2.2	1.6	3.7
Shipment of domestic consumer goods	21.1	17.7	13.5	-1.8	-1.7	6.4	-8.0	-10.6	-4.8	-8.4
Domestic machinery orders	30.9	15.6	8.0	7.0	17.3	11.7	3.7	-14.5	2.8	19.9
Facility investment	43.5	59.3	34.8	29.5	5.7	30.1	6.3	9.2	4.9	5.1
Area for construction permits	42.3	90.6	35.6	33.4	-35.2	11.8	-14.3	2.7	-4.8	-30.2
Construction turnover	1.2	-6.4	-2.4	-3.1	-1.2	-3.1	1.6	-0.6	5.7	0.2

Sources: The Bank of Korea, National Statistical Office

## Composite Business Index



## Employment

Affected by the general economic stagnation, the unemployment rate as well as the number of unemployed began to increase from November of last year. From a low of 3.4% in October 2000, the unemployment rate reached 5.0% in February.

In March, the unemployment rate fell 0.2 percentage points from the previous month and the number of unemployed fell by 34,000. However, the seasonally adjusted unemployment rate in March was 4.2%, the same as in February. The number of unemployed (seasonally adjusted) in March hit 934,000, up 18,000 from the February totals.

### Employment

	1999	2000							2001		
	Year	Year	1/4	2/4	3/4	4/4	Nov.	Dec.	Jan.	Feb.	Mar.
Economically active population(%)	60.5	60.75	59.5	61.3	61.3	60.8	61.1	59.9	58.5	58.5	59.8
Unemployed persons (1,000 persons)	1,353	889	1,092	840	809	817	797	893	982	1,069	1,035
Unemployment rate (%)	6.3	4.1	5.1	3.8	3.6	3.7	3.6	4.1	4.6	5.0	4.8
Seasonally-adjusted unemployment rate	6.3	4.1	4.5	3.9	3.9	3.9	3.6	4.1	4.1	4.2	4.2

Source: National Statistical Office

## Exports, Imports and Balance of Payments

Despite the slowdown in the export growth rate, a sharp import decline in the first quarter of 2001 gave rise to a trade surplus of US\$2.4 billion, an increase of US\$2.0 billion over the US\$0.4 billion in the first quarter of last year.

The growth rate of Korean exports in the first quarter fell slightly to 3.1%, affected by lower export prices and the economic slowdown experienced in both the United States and Japan.

Meanwhile, imports, which grew by 34% in 2000, declined 2% year-on-year in the first quarter due to the domestic economy's slowdown.

While the merchandise component of the current account maintained a surplus in the same period, the capital component has languished in the red since September 2000 due to foreigners' net capital withdrawal from the stock market and the redemption of overseas loans.

		Exports, Imports and Balance of Payments									Unit: US\$ 100 million, year-on-year change (%)	
		1999	2000			2001						
		Year	Year	1/4	Nov.	Dec.	Jan.	Feb.	Mar.	1/4		
Customs clearance basis	Trade balance	239.3	117.9	4.4	8.3	18.0	3.0	7.5	13.8	24.3		
	Exports	1,436.9	1,722.7	392.7	149.9	149.8	127.4	134.2	143.4	405.0		
	Change	8.6	19.9	29.8	5.6	0.1	4.7	5.8	-0.6	3.1		
	Imports	1,197.5	1,604.8	388.3	141.6	141.8	124.4	126.7	129.6	380.7		
	Change	28.4	34.0	51.9	20.7	4.7	1.2	5.4	8.8	2.0		
Current account		244.8	110.4	13.4	10.6	12.4	6.5	7.0	18.1	31.6		
Capital account		20.4	117.3	93.5	-19.8	2.3	-14.4	-7.9	-14.8	-37.3		

Sources: Ministry of Commerce, Industry & Energy, The Bank of Korea

## Prices

Prices have risen noticeably in 2001. Consumer and producer prices rose 4.2% and 2.5% respectively in the first quarter over the same period in 2000. The main factor contributing to the increase was the hike in public service rates. The surge in medical

insurance premiums, water and sewer rates, etc. pushed up public service prices by 13.8% year-on-year in the first quarter of 2001.

Prices		Unit: year-on-year change (%)							
	2000					2001			
	1/4	2/4	3/4	4/4	Year	Jan.	Feb.	Mar.	1/4
Consumer price index	1.5	1.4	3.2	2.9	2.3	4.2	4.2	4.4	4.2
Agriculture-livestock -fisheries	3.7	0.6	4.3	-0.8	1.9	-0.2	-1.1	1.8	0.2
Industrial products	1.7	0.7	1.9	2.0	1.6	3.6	3.9	3.4	3.6
Public services	3.8	5.2	8.9	10.5	7.1	13.8	13.5	13.0	13.4
Individual services	0.9	2.3	2.4	2.5	2.0	2.6	2.9	3.0	2.8
Producer price index	2.2	1.9	2.7	1.6	2.1	2.3	2.4	2.8	2.5

Sources: National Statistical Office, The Bank of Korea

## Interest Rates and Foreign Exchange Rate

Long-term interest rates hit a record low of 5% on February 12 amidst growing concern over the general economic slowdown. A quarter point cut in the call rate by the Bank of Korea in February softened the fall of long-term interest rates.

However, interest rates have rebounded from 5% since mid-February due to the widespread perception that such a level was unsustainably low, concerns that inflationary pressures would arise from a weaker won, as well as the unwelcome rise in the CPI.

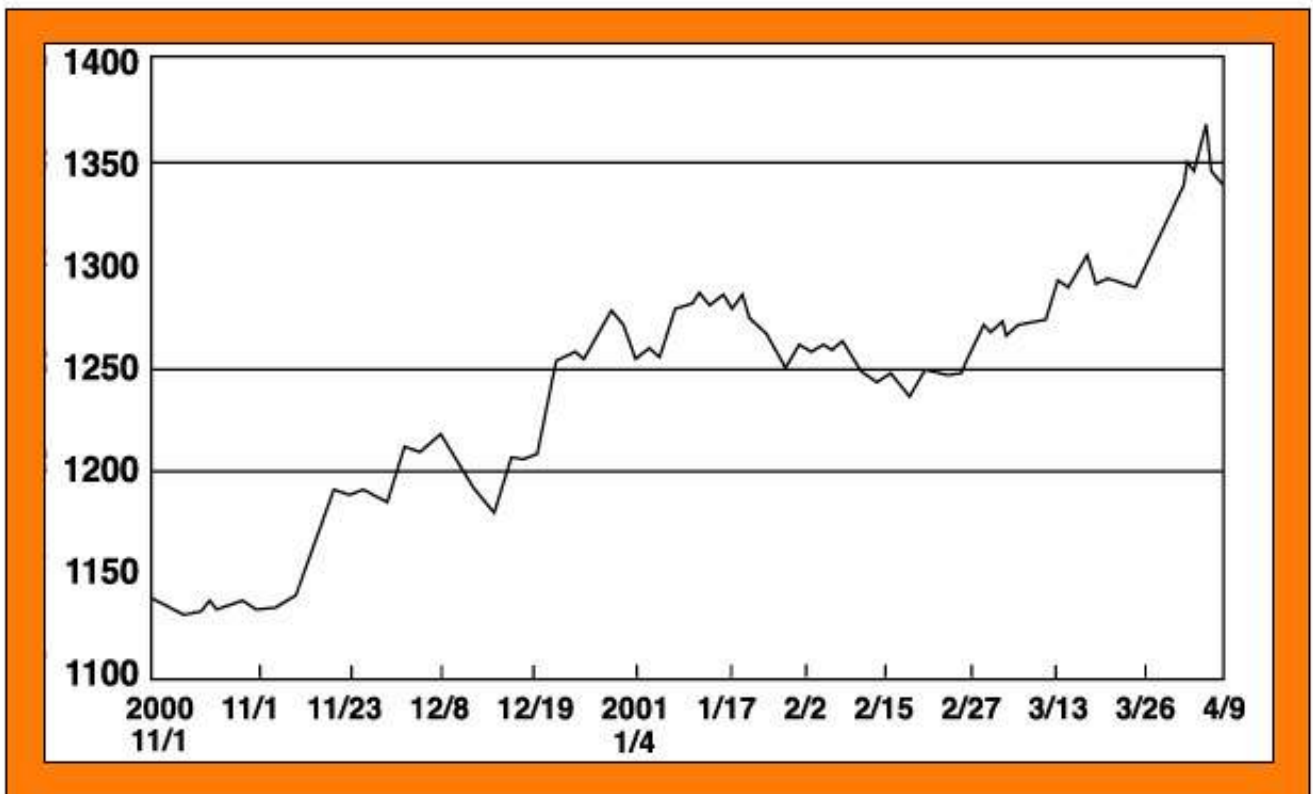
Interest Rates		Unit: Annual rate (%)							
	1999	2000					2001		
	Dec.	Aug.	Sept.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.
Call (next day)	4.71	5.11	5.02	5.37	5.31	6.01	5.27	5.05	4.94
CP (91 days)	7.47	7.24	7.24	7.24	7.26	7.26	6.66	6.20	6.06
Government bonds (3-year maturity)	9.22	7.79	8.07	7.64	7.16	6.70	5.68	5.43	6.31
Corporate bonds (3-year maturity)	9.85	8.98	9.04	8.59	8.35	8.13	7.38	6.77	7.69
B-A (%P)	4.51	2.68	3.05	2.27	1.85	0.69	0.41	0.38	1.37
C-A (%P)	5.14	3.87	4.02	3.22	3.04	2.12	2.11	1.72	2.75

Note: End of period  
Source: The Bank of Korea

Since November 2000, the rapid depreciation of the won has generally reflected the Japanese yen's weakening trend.

During the January-February period, the stock market's net increase in foreign capital investment supported the stability of the foreign exchange rate. However, in March, a reversal in foreign capital inflow following the sharp decline in the NASDAQ and a weakening of the yen led to a sharp depreciation of the won.

## Won-Dollar Exchange Rate



Note: Based on the end of period

Source: The Bank of Korea

# Economic Outlook for 2001

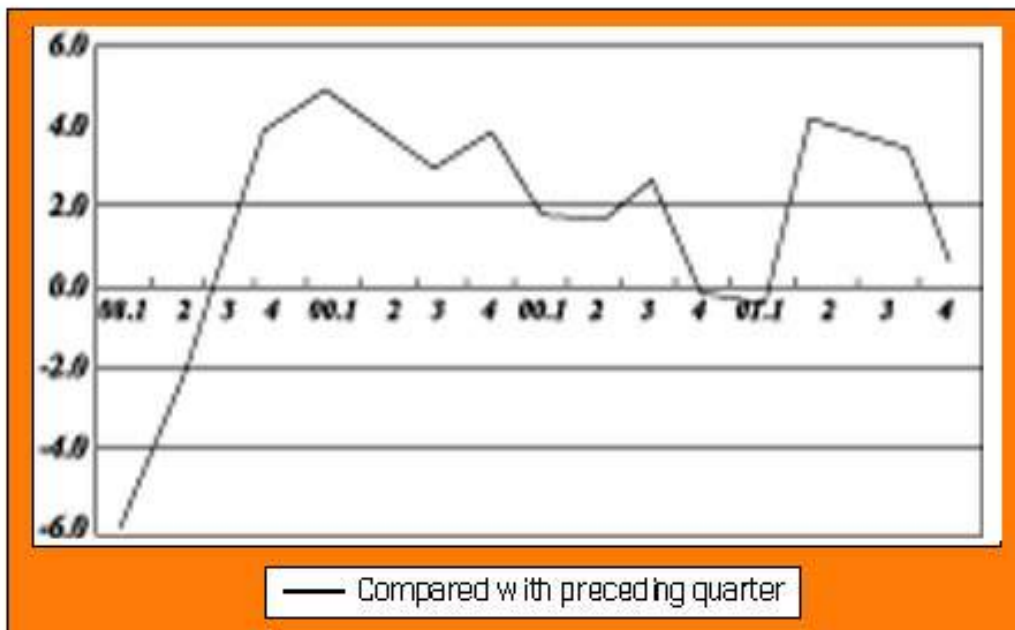
## Economic Growth

As defined by the U.S. classification method, the Korean economy experienced a recession during 2000 Q4~2001 Q1, that is, the seasonally-adjusted GDP growth rate was -0.4%(actual) in 2000 Q4 and fell to 0.8%(KERI forecast) in 2001 Q1.

However, supported by a gradual recovery of consumption and a net export expansion, the GDP is expected to return to positive growth beginning in the second quarter and is likely to achieve 4.2% growth for the full year.

Recently, the household expectation index, consumer goods imports and other consumption indicators have shown improvement, thus providing evidence of noticeably bolstered consumer confidence since late last year.

Seasonally-Adjusted GDP Growth Rate



## Exports

The environment for Korea's exports should show only minor deterioration. The U.S. economy, on the strength of continuous pump-priming policies, is expected to recover before the end of the year. And the European economy at present remains stable. The

prospects for a Japanese economic recovery, however, are uncertain.

The contribution of Korean exports to economic growth has increased by more than 60% this year, prompting the forecast that the domestic demand contribution rate will be lower this year than last. This fluctuation indicates that unexpected changes in the external situation pose the main risk factor for our current forecast.

This forecast also assumes that restructuring in the financial and other sectors will proceed smoothly. If restructuring efforts are disrupted, the growth forecast should be adjusted downward to account for such negative factors.

## Prices

During the first quarter of 2001, consumer prices increased 4.2% year-on-year and are expected to peak at 5.0% growth in the second quarter before beginning to slow. The forecast for all of 2001 is that prices will rise 4.3%.

Factors behind recent price increases include agriculture, fisheries and livestock product prices, which are up due to poor weather conditions. In addition, import product prices have been higher due to unfavorable foreign exchange rates. Higher public service rates have also contributed to the hike in consumer prices.

In the second half of this year, foreign exchange rates are expected to stabilize and the effect of public service rates should weaken due to sluggish aggregate demand, thus causing additional price pressures to dissipate.

## Balance of Payments

Despite a slight increase in exports, a large decline in imports will likely cause the merchandise account surplus to be higher this year than last. The merchandise account surplus is expected to reach US\$19 billion in 2001, US\$2.4 billion higher than the US\$16.6 billion achieved in 2000. The current account surplus for this year is projected to be US\$13 billion, US\$2.0 billion more than the US\$11 billion posted in 2000.

## Interest Rates and Foreign Exchange Rate

Despite sufficient liquidity in the capital market, uncertainty about foreign exchange rates and the maturation of corporate debentures, estimated at 40 trillion won in the

second half of the year, are likely to result in a gradual increase in interest rates by year end.

Considering the overall supply-demand situation, the foreign exchange rate is expected to peak in the second quarter, then fall to 1,250 won to the U.S. dollar by the end of the year.

The twin uncertainties of the financial market and external situation, including the weaker Japanese yen, will work to keep the won weak in the second half. However, the nation's large foreign exchange reserves, trade surplus and inflow of foreign capital will, in all likelihood, prop up the won-dollar exchange rate.

## 2001 Korea Economic Outlook

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

	1999	2000	2001				
	Year	Year	1/4	2/4	3/4	4/4	Year
GDP	10.9	8.8	3.0	3.8	4.8	5.2	4.2
(Manufacturing)	21.8	15.4	3.5	4.8	6.4	7.7	5.7
Total consumption	9.5	6.1	1.8	2.8	3.6	4.8	3.3
Private consumption	11.1	7.0	2.2	3.6	4.2	5.7	4.0
Fixed capital formation	4.6	11.7	-4.7	-1.2	0.9	5.7	0.3
Facility investment	36.7	34.0	-5.9	-0.6	2.8	9.5	1.2
Construction investment	-10.3	-4.1	-3.3	-1.7	-1.2	2.6	-0.7
Total exports	15.9	21.6	2.2	4.5	5.4	5.1	4.3
Total imports	28.8	19.5	-5.2	-1.1	0.7	1.2	-1.1
Producer price	-2.1	2.0	2.5	3.6	3.4	3.2	3.2
Consumer price	0.8	2.3	4.2	5.0	4.0	3.9	4.3
Current account	244.8	110.4	22.7	27.3	37.3	42.4	129.7
Trade account	283.7	166	34.5	46.6	50.9	57.7	189.7
Exports	1,451.6	1,757.8	404.1	438.6	454.3	473.1	1,770.1
Change (%)	9.9	21.1	-2.5	-0.5	0.0	5.5	0.7
Imports	1,167.9	1,591.8	369.6	392	403.4	415.4	1,580.4
Change (%)	29.1	36.3	-5.3	-0.7	0.9	2.1	-0.7
Service incomes & transfer	-38.9	-55.6	-11.8	-19.3	-13.6	-15.3	-6.0
Won/\$ (end of period)	1,145.4	1,259.7	1,327.5	1,350	1,300	1,250	1,250
Yen/\$ (end of period)	102.1	114.4	126.2	130	127	125	125
M3 Change (Avg, %)	11.3	5.7	7.0	7.1	7.2	6.6	7.0
3-yr corporate bond (Avg, %)	8.9	9.4	7.2	7.8	7.9	8.1	7.8



# Policy Issues

## Consistency in Government Policy: Continued Restructuring

The roots of recent problems in the economy lie in the deterioration of the external situation coupled with sluggish domestic demand and, consequently, the increased uncertainty about Korea's economic prospects. Admittedly, developments in the external economic environment are beyond the government's control.

However, there are things that the government can do to improve the internal economic environment. It's very important that the government maintain consistency in its restructuring policies, adhering to the principles laid out thus far. This course of action ultimately will restore confidence in government policies.

Some see the current situation as a crisis and are calling on the government to provide a quick boost. However, under the current environment, short-term ad hoc measures may create new problems, resulting in a breach of consistency and further erosion of confidence.

## Continuation of Counter-cyclical Policies

The increased uncertainty in the external environment raises the relative importance of domestic demand. Therefore, economic policy needs to remain flexible in order to stimulate domestic demand, which is showing faint signs of recovery. Fiscal, monetary and other policy measures should be used flexibly in this regard.

## Stimulation of Business Activities

The difficult economic situation that has followed the 1997 financial crisis has a limiting effect on the range of macro-economic policy options, such as monetary and interest rate controls, that can be employed. The use of public funds to solve pressing economic problems has created a heavy burden for taxpayers and sharply divided the political circles, making consensus-building on a fiscal policy to stimulate the economy all the more difficult.

Also relevant to monetary policy, lingering price instability from early 2001 has limited the policy options of the Bank of Korea (BOK), which has adopted an

"Inflation-targeting" regime.

Such factors as the imposition of the BIS capital adequacy ratio and the 200% debt-to-equity ratio are proving difficult hurdles to a smooth flow of credit to businesses from the Korean financial markets. It is imperative to find ways to restart the economic dynamo. However, stimulation measures should not be carbon copies of past practices such as short-term tax and financing fixes. Rather government should focus on removing bottlenecks to business activities. For example, the environment for M&A and spin-offs should be improved, including policies to enable a smooth adjustment of the work-force. The government also should review the current aggregate ceiling on investment and relax the debt obligation ratio for the establishment of holding companies.

# Commentary

## "Let's Put an End to Government-led Egalitarianism"

One cannot help but wonder about where the Korean economy is heading. Following the 1997 economic crisis, economic reform has taken place largely under the presumption that the ill-effects of past government intervention constituted the main cause of the crisis. However, real changes have been rather illusory.

Suppose that recent widespread criticism of the past 30 years of government-led economic management is correct. Then how would we explain the "miracle" growth of the Korean economy during that same period?

I argue that Korea's rapid economic growth was made possible by the past system's ability to somehow segregate and provide positive incentives only to competent economic agents. Economic dynamism that powers growth comes from just such selective awarding of competent agents, and this process is usually carried out by markets through competition.

From this perspective, the rapid growth throughout the past 30 years has been possible in spite of intrusive government behavior, as government provided discriminating supports to high achievers in exports. This system was not without its problems: namely, cronyism, favoritism and the resultant rise in public "anti-chaebol" sentiment. However, the government-controlled economic system did prove to be successful in fostering economic growth in the past because there was a mechanism that effectively rewarded superior performers.

For the past three years, Korea has sought to establish and build a market economy by getting rid of the government-controlled system. An alarming and disturbing trend of these recent reforms is the government's effort to impose equalization across the board in a non-discriminating manner. As one example, to come to terms with the BIS requirement, the government used public funds to boost capital adequacy ratios of all banks that did not meet the requirement. All banks were required to undergo structural reforms regardless of their performance and peculiarities. Under the banner of enhancing "the managerial transparency," firms over a given size have been asked to adopt identical corporate governance. Moreover, in the name of "reforming the debt structure" all large firms were asked to reduce their debt-equity ratios uniformly to 200 per cent or below. Furthermore, there is no signs of change in the established practice of designating 30 largest firms for the purposes of special regulation (in the name of ?restricting the concentration of economic power? in spite of the rapid changes taking place in the economic environment. All of these policies are the result of an "equalism"

that insist upon treating every economic entity, although diverse in size, character and competence, as if they were identical.

Korea has a long cultural tradition of egalitarianism. Society wants to hold everybody, including entrepreneurs, to saintly high moral standards. We insist on propping up failing firms, even when it is better to let them fold. At the same time, we seldom praise the good performance of competent firms, and rather end up accusing them of disrupting social harmony and causing social division. Such a pronounced egalitarian vein in our culture is a major obstacle to establishing a capitalistic market mechanism.

In this era of an open society, the only viable way forward is "market discrimination": not government discrimination or government-controlled equalization. All the related systems, not merely the economic system, should be allowed to evolve, thus spurring the effective functioning of market discrimination. We should promote competition in all sectors (political/ social/ educational/ public/ legal), instead of forcing everyone to follow a certain rigid standard. In this way, everybody will be able to make the best of their individual abilities. The great thinker, Hayek, who predicted the coming and ending of socialism, firmly stated that implementing rigid mandatory standards is the path toward socialism and conversely, free competition is the only way to create new and unforeseen opportunities and possibilities.

Jwa, Sung-hee (President, KERI)

# Supplement

## Introduction of Selected KERI Publications

### New Round and Market Access in the Manufacturing Sector

Kwon, Youngmin et al.

The schedule of accession that was agreed upon by WTO members in the Uruguay Round was to have been completed by the end of the year 2000 and the next round of multilateral negotiations should start this year.

As additional market access issues on agricultural and service sectors were part of the built-in agenda, negotiations on these sectors will start soon. However, many nations insist that the New Round should cover comprehensively broader issues including further market access to the manufacturing sector. This book is written in the event that issues on the manufacturing goods market are raised on the agenda for the New Round negotiations.

This book analyzes the trade structure of the manufacturing goods sectors of the major trading partners of Korea. The U.S., Japan, EU, China, and other Southeast Asian nations are considered and analyzed. In addition to an analysis of trade structures, this volume also discusses the major remaining trade impediments after full implementation of the UR agreement. The authors also offer a forecast of anticipated changes in Korea's trade volume with its major trading partners. It concludes with various alternative strategies that Korea may use in future New Round negotiations.

### Korea-Japan FTA and Business Cooperation

Kwon, Youngmin et al.

In recent years, discussion has intensified on the possibility of a free trade agreement between Korea and Japan. Proponents of this idea argue that both Korea and Japan may benefit from such an agreement and in fact, suggest that this should help transform their economies by making them more competitive in international markets. Skeptics, however, warn that Korea's economic dependence on Japan may deepen as a result of a free trade agreement, and, moreover, this may even worsen the trade imbalance between

the two countries.

By analyzing trade structures and industrial competitiveness between the two countries, this book effectively distinguishes between sectors that should benefit and those that may be harmed by a free trade agreement between the two nations. In general, Korea's trade deficit with Japan is expected to widen, especially in the electronic machinery, automobile, and steel industries. Not all sectors will suffer, as textile and clothing, wood and furniture, and shipbuilding industries are likely to see some gains.

Throughout the book, we emphasize that a free trade agreement is not concluded for unilateral benefits, but rather, mutual gain. As such, both Korea and Japan should continually consult each other to devise appropriate ways to share the benefits derived from such an agreement. In this regard, we investigate areas in which both countries may work together to establish an optimal agreement.

## Inventories and the Business Cycle

Nam, Kwanghee

Recently, inventory investment has played a key role in economic growth. In 1998 changes in inventory investment accounted for 83% of GDP growth while that figure stood at less than 10% in the early 1990s.

One economic theory considers inventories as a destabilizing factor in the economy following the argument that they are working through the inventory accelerator. From a different perspective, as firms smooth out production activities in response to volatile demand, another theory looks at inventories as a stabilizing factor in the economy. To date, no convincing theoretical or empirical evidence has been found in the economic literature. Also of significance, there have been too few empirical investigations to understand the effects of inventories in the Korean economy.

This paper finds that changes in inventory investment account for GDP growth to a considerable extent in recession periods as well as in boom periods. At the aggregate level, the production smoothing theory is rejected, while it is accepted at many sub-industry levels. Moreover, it is established that heavy and chemical industries are more sensitive to inventory holding costs than light industries.