

# KERI Economic Bulletin January 2002 No. 26 Quarterly

## Recent Economic Developments

### Production, Consumption and Investment

The key economic indices suggest an emerging trend toward general recovery led by healthy surges in both the consumption and construction sectors.

Production and facility investment, having suffered a prolonged decline, demonstrated new vigor. September and October wholesale and retail sales rose by a healthy monthly average of 6.1%, which were exceeded by November's pace of 6.5%.

Construction turnover jumped by a monthly average of 14.8% in both September and October and by 14.1% in November, representing a significant expansion.

Industrial production grew by an average of 1.8% in the September-October period and jumped to 4.9% in November, recovering from a long-standing downturn.

Facility investments, which suffered a double-digit decline in the third quarter, saw its rate of decline shrink to a single digit in October, then reversed course to an upturn of 4.4% in November, the first sign of positive growth since November 2000.

#### Production, Consumption and Investment

Unit: year-on-year change (%)

	2000	2001							
	Year	1/4	2/4	3/4	July	Aug.	Sep.	Oct.	Nov.
GDP growth ratio (National Account)	8.8	3.7	2.7	1.8					
(Seasonally-adjusted GDP growth ratio)	(8.8)	(0.3)	(0.4)	(1.2)					
Production	16.8	5.0	1.6	-1.8	-5.7	-4.4	5.1	-1.3	4.9
Inventory (based on the end of period)	16.2	15.2	14.9	11.5	15.7	14.7	11.5	4.9	2.3
Private consumption (National Account)	7.1	0.9	2.9	3.4					
Wholesale & retail sales	9.8	2.5	4.4	4.8	2.9	3.6	7.8	4.6	6.5
Facility investment (National Account)	34.3	-7.9	-10.8	-15.4					
Facility investment (estimated)	30.1	-6.3	-4.7	-12.2	-10.4	-19.4	-6.4	-4.4	4.4
Construction investment (National Account)	-4.1	1.4	0.9	8.3					
Construction turnover	-3.1	1.6	-0.4	7.9	-8.3	8.7	23.5	6.3	14.1

Sources: The Bank of Korea, National Statistical Office

The present economic improvement can be attributed to the downward adjustment of interest rates and the government's aggressive fiscal policies as of September. Accordingly, at present there is little likelihood that the economy will worsen. At the same time, the low-growth trend is expected to continue until such a time that the U.S. economy improves and Korean exports

recover. Due to a lack of visibility regarding the global economy and the high degree of dependence of the Korean economy on exports, which has reached the 50% level measured by the exports/GDP ratio, economic growth centered around domestic consumption supported by government policies has its limits.

### Exports, Imports and Balance of Payments

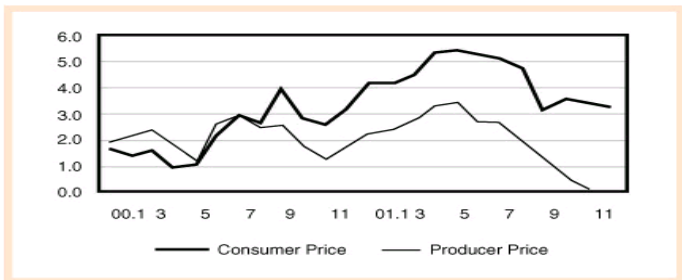
The rate of export decline in the fourth quarter eased slightly as compared with the third quarter, while the rate of import decline accelerated due to reduced crude oil prices. Consequently, the fourth quarter trade surplus surpassed third quarter results.

		2000	2001						
		Year	1/4	2/4	3/4	4/4	Oct.	Nov.	Dec.
Customs clearance basis	Trade account	117.9	20.4	38.7	14.8	21.5	5.7	8.6	7.1
	Exports	1,722.7	401.0	383.7	356.3	365.5	120.9	124.2	120.4
	Change	19.9	2.1	-11.6	-19.7	-19.2	-20.7	-17.1	-19.6
	Imports	1,604.8	380.7	345.0	341.5	344.0	115.2	115.6	113.2
	Change	34.0	-2.0	-13.3	-15.5	-17.0	-18.3	-18.4	-14.1
Current account		114.0	30.7	36.8	9.5	9.5*	2.5	7.0	
Capital account		121.1	-37.1	-36.5	12.5	12.5*	0.3	12.2	

Note: \*Applies to the period from October to November.  
Sources: Ministry of Commerce, Industry & Energy, The Bank of Korea

### Prices

Prices, on the rise earlier in the year, have stabilized since May. Consumer price growth lost steam and declined after reaching a high of 5.4% year-on-year in May. Prices has stabilized at the 3% level since September. Producer price growth also continued to fall after reaching a high of 3.4% in May, registering a 0.1% increase in November.



# Economic Outlook for 2002

## Economic Growth

The key factor in the current economic recession is the significant decline in export growth caused by the global economic slowdown first evident in 2001.

The degree of dependence of Korea's economy on exports jumped sharply to over 50% in 2000 compared to just 35% in 1996. Exports expanded in the wake of increased price competitiveness world wide resulting largely from the exchange rate devaluation following the 1997 financial crisis. However, the current episode of export growth decline, with its genesis in the fourth quarter of 2000, further deepened to nearly 20% in the third quarter of 2001. Consequently, the contribution of exports to economic growth registered a significant decline in the third quarter.

The export setback continued in the fourth quarter. Thanks to a technical upturn, however, as compared with the low growth rate in the same period of 2000, as well as the effects of aggressive fiscal expenditures, the economy is expected to grow 2.5% in the final quarter for an annual growth rate of 2.6%, a mere one-third of the 8.8% achieved in 2000.

Therefore, the timing and speed of the economic recovery, manifesting positive signs recently, will depend on the recovery of exports, the key factor in the current economic recession. This variable is directly linked to the global economy, especially developments in the U.S..

The recovery of the U.S. economy leads itself to two likely scenarios.

The first has the current U.S. economic recession, which began in the second quarter of 2001, continuing for three quarters, then shifting to a slow recovery from the first quarter of 2002 and picking up speed in the second half of 2002.

The second scenario projects the U.S. recession persisting until mid-2002 and recovery delayed until the second half of 2002, when even at that case the ensuing recovery will be weaker than expected.

Recent indicators in the U.S. economy make the first scenario more likely, implying the start of a visible recovery from the second half of 2002.

Positive factors affecting the U.S. economic recovery would include an early resolution of the war in Afghanistan, an increase in semiconductor prices, mitigation of excess capacity in the IT sector, and a decline in oil prices.

Moreover, recently announced indicators appear positive for the U.S. economy, including a strong showing in consumer confidence surveys, burgeoning orders for durable goods, an increase in new housing starts, etc. All of the above reflect the likelihood of an economic recovery in the near future.

Based on these factors, Korea's economic growth rate in the first half of 2002 is projected at the 3% level. Assuming a gradual recovery of exports and domestic consumption, economic growth of around 4% is expected in the second half of 2002, resulting in an annual average

growth rate of 3.6%.

Private consumption should maintain steady growth owing to a combination of special demand generated by the 2002 FIFA World Cup, continued low interest rates and on-going household credit expansion. As a result, the increased pace of private consumption is expected to reach 4% for the year, exceeding the economic growth rate.

Facility investment is expected to continue its decline for an extended period due to the lack of visibility in the internal and external business environment. However, it will likely recover gradually in the second half of 2002 and end the year at around 1% growth, leaving the double-digit contraction of 2001 in its wake.

Construction investment is expected to increase 4% in 2002, reflecting current public sector projects.

### **Exports, Imports and Balance of Payments**

Exports are projected to maintain negative growth through the first half of 2002 due to the continued global economic slowdown and the aftermath of the terrorist attacks in the U.S. However, linked with the U.S. economic recovery, exports are expected to show positive growth in the second half of this year. Burdened by the stronger negative growth in the first half, exports are projected to end the year in the neighborhood of 1% growth.

Imports are expected to recover much faster than exports and should record annual growth at the 3% level, thanks to the anticipated gradual recovery of the economy and subsequent increase in consumer demand and facility investment.

As imports are expected to outpace exports, the commodity and current account surpluses are expected to decline but to remain in positive territory. The current account and commodity account surpluses in 2000 were US\$11.4 billion and US\$16.9 billion respectively. In 2001, the surpluses declined to an estimated US\$9.6 billion and US\$15.2 billion respectively. Surpluses in 2002 are projected to shrink further to US\$5.4 billion and US\$11.1 billion.

### **Prices**

Upward pressure on prices in 2002 is not expected to be significant in light of the economy's projected 3% level of growth. International oil prices are likely to stabilize at around US\$20 per barrel, less than in 2001. However, existing factors that are likely to necessitate a staggered increase in public utility rates in 2002, thus leading to an expected annual consumer price index increase at the 3% level.

## Interest Rates & Exchange Rate

Although prices may stabilize and certain factors exist in the supply and demand of debentures to keep interest rates down, a slight increase in interest rates is expected in the second half of 2002, as the demand for funds becomes more robust.

In 2002, the amount of corporate bonds reaching maturity is expected to decrease to 31.3 trillion won, or 68% of the 45.8 trillion won that matured in 2001.

The won is expected to strengthen slightly against the U.S. dollar in 2002 due to the continued current account surplus, inflow of foreign capital, etc.

## Economic Outlook for 2002

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

	2000	2001		2002				
	Year	4/4	Year	1/4	2/4	3/4	4/4	Year
GDP	8.8	2.5	2.6	2.8	3.2	3.8	4.6	3.6
(Manufacturing)	15.3	1.8	1.6	2.5	3.5	4.3	6.3	4.2
Total consumption	6.2	4.2	2.6	3.6	3.5	3.4	3.6	3.5
Private consumption	7.1	4.6	3.0	3.8	3.7	3.8	4.2	3.9
Fixed capital formation	11.0	-3.5	-3.7	-1.7	1.3	4.7	5.9	2.7
Facility investment	34.1	-14.3	-12.0	-7.4	-2.7	6.1	9.0	0.8
Construction investment	-4.0	4.1	3.8	4.7	4.5	3.8	4.0	4.2
Total exports	21.5	-3.6	0.1	-1.2	0.4	4.6	4.9	2.2
Total imports	19.9	-4.2	-4.5	-1.6	3.3	6.1	10.0	4.5
Producer price	2.0	1.0	2.2	0.9	0.8	1.3	1.8	1.2
Consumer price	2.2	3.3	4.3	2.9	2.6	3.0	3.5	3.0
Current account	114.0	18.6	95.6	21.8	13.9	9.9	8.1	53.6
Trade account	168.7	36.4	151.9	31.6	26.1	27.6	25.9	111.0
Exports	1759.5	371.7	1528.1	374.5	380.5	389.0	399.5	1543.6
Change (%)	21.2	-17.2	-13.1	-7.9	-1.7	7.2	7.5	1.0
Imports	1590.8	335.3	1376.2	343.0	354.5	361.5	373.7	1432.6
Change (%)	36.2	-17.4	-13.5	-7.8	5.5	8.6	11.5	4.1
Service, income & transfer	-54.7	-17.8	-56.2	-9.8	-12.2	-17.7	-17.8	-57.4
Won/\$ (end of period)	1259.7	1265.0	1265.0	1265.0	1247.0	1238.0	1230.0	1230.0
3-yr corporate bond (Avg.,%)	9.4	7.2	7.2	7.4	7.6	7.9	8.1	7.8
World trade volume	12.4		1.1					2.5

## Policy Issues

### Different Policies Needed to Cope with Economic Situations of 2002

With the export slowdown expected to reach into the first half of 2002, Korea should maintain a macro-economic policy stance vis a vis domestic demand. Given the substantial degree of Korea's dependence on exports, a sustainable recovery in Korea is predicated on a U.S. recovery.

The U.S. economy is likely to realize a weak recovery in the first half of 2002, which is expected to gain strength in the second half of the year. Accordingly, Korean exports are not expected to quicken pace until the second half of 2002.

Therefore, the focus of policy management for 2002 should be placed on preventing further deterioration of the domestic economy by stimulating domestic demand in the first half of this year.

With regard to monetary policy, some room exists for a further decline in interest rates as long as the "negative output gap," the difference between real GDP and potential GDP, remains. In particular, as little upward pressure on prices is anticipated this year, the probability that interest rates may spur price instability is relatively small.

Pertaining to fiscal policy, the government should pursue the early execution of its 2002 budget in the first half of the year in order to maximize the stimulus of the government's supplementary budget at the end of 2001, an effect which is expected to stretch into early 2002. Moreover, if surpluses in the central government's budget continue to persist as in 2001, a tax cut policy also should be contemplated to reflect the fiscal realities.

In the event the U.S. economy achieves a more rapid economic recovery than expected in early 2002, the possibility of a switch in policy focus from stimulating the Korean economy to maintaining stability cannot then be excluded. In such a case, exports will likely tick up sharply, leading to increases in domestic investment and production activities.

Furthermore, if such a recovery materializes and is combined with factors such as multiple elections and the 2002 World Cup, there's a distinct possibility that total demand may become overheated as well.

Beyond the early execution of the budget, additional fiscal policy measures, such as a tax reduction, are unlikely to be needed.

As for monetary policy, the present level of interest rates are desirable for the time being. However, if clear signs of a sharp increase in total demand appear, an upward adjustment of interest rates should be considered.

## **Continued Stimulation of Corporate Activities Through Deregulation and System Improvement**

Turning to the corporate sector, it is recommended that regulations and systems incompatible with the realities of the global economy should be re-examined. The regime of interventionist corporate regulations by the government should be changed to one in which market discipline plays a major role.

Policy regarding corporate activity should be carried out in such a way as to accelerate competition among enterprises in accordance with market principles, not executed as a discriminatory policy based solely on the size of corporations.

However, systematic measures to enhance management transparency, such as the availability of complete corporate financial information and the assumption of greater management responsibility in line with the global economy era, should be further reinforced.