

July 2001 No.24

## Recent Economic Developments

### Production, Consumption and Investment

Due to sluggish export performances by semiconductors, computers and other key sectors, real economic indicators for production, shipment and facility investment remain depressed. Production has continued its downward trend for three consecutive months since March of this year and facility investment declined 6.6% in May, marking another month of negative growth which began in November 2000 due to the overall slowdown in the economy.

On the other hand, construction investment and domestic wholesale and retail sales have more or less maintained a recovery tempo. Thanks to order expansion, construction investment has rebounded from negative growth to a posting of positive growth and domestic wholesale and retail sales have registered 4% growth.

Production, Consumption and Investment		Unit: year-on-year change (%)						
		2000			2001			
		1/4	May	Year	1/4	Apr.	May	
Production	Production	23.6	20.3	16.8	5.0	5.6	2.3	
	Shipment	25.2	21.4	16.6	2.2	4.0	0.2	
	Inventory (based on the end of period)	10.2	11.6	16.2	15.2	17.1	18.7	
	Average operating ratio (%)	79.4	79.6	78.3	74.7	74.7	74.7	
Consumption	Wholesale & retail sales	15.1	15.8	9.8	2.5	4.0	4.9	
	Shipment of domestic consumer goods	17.7	19.8	6.4	-8.1	-1.1	3.2	
Investment	Facilities	Machinery imports	64.9	76.9	40.6	-1.2	-32.2	-33.4
		Facility investment estimate	59.3	33.3	30.1	-6.2	-5.8	-6.6
	Domestic machinery orders receipt	15.6	12.0	11.7	3.7	-11.8	3.2	
	Construction	Construction turnover	-6.4	1.1	-3.1	1.6	3.6	1.2
		Domestic construction orders receipt	70.9	18.8	15.1	-25.3	0.0	16.0
		Area for construction permits	90.6	-9.3	11.8	-14.0	-17.6	56.0

Sources: The Bank of Korea, National Statistical Office

Against this backdrop, the overall economy, which had shown promising signs of a recovery in February and March, has returned to the doldrums as of April.

The cyclical components of coincident composite index, the downward trend of which

halted in March, has continued to decline since April. At the same time, the leading composite index, having boasted continuous growth for three consecutive months from February, reversed course to negative growth in May.

Composite Business Index						
	2000.12	2001.1	2	3	4	5
Cycle of coincident composite index (change from the previous month)	-0.7	-0.9	-0.5	0.0	-0.2	-0.2
Leading composite index (% change from the previous month)	-0.8	-0.6	0.5	0.2	0.1	-0.1

Source: National Statistical Office

## Employment

The number of jobless and the unemployment rate, both of which had shown upward movement since November 2000, fell for three consecutive months from March. In May, the number of individuals out of work reached 780,000 and the unemployment rate was 3.5%, the lowest levels since October 2000 at which time comparable statistics were 760,000 and 3.4% respectively.

However, recent improvement has been due to seasonal factors, government employment policy and labor projects that created enhanced opportunities in the agriculture-fisheries and construction sectors.

Employment							Unit: 1,000 persons, %
	2000.11	2000.12	2001.1	2001.2	2001.3	2001.4	2001.5
Unemployed persons (1,000 persons)	797	893	982	1,069	1,035	848	780
Unemployment rate (%)	(3.6)	(4.1)	(4.6)	(5.0)	(4.8)	(3.8)	(3.5)
Seasonally-adjusted unemployment rate	3.9	3.9	4.1	4.2	4.2	3.8	3.6

Source: National Statistical Office

## Exports, Imports and Balance of Payments

The rate of decline in import growth outpaced the decline in export growth to power a greater trade surplus in the second quarter than in the first.

Exports declined 2% in March and continued to remain sluggish due to stagnation in the Japanese and U.S. economies as well as export unit price declines. Second quarter exports fell 10.5%. With the decline in facility investments, imports fell 13.5% in the

second quarter.

The current account maintained a surplus. The capital account, however, has been mired in the red since September 2000 due to net foreign withdrawals of stock market investment and the repayment of overseas loans.

Exports, Imports and Balance of Payments		Unit: US\$ 100 million, year-on-year change (%)						
		1999	2000	2001				
		Year	Year	1/4	2/4	Apr.	May	June
Customs clearance basis	Trade balance	239.3	117.9	20.7	44.2	9.4	19.9	14.9
	Exports	1,436.9	1,722.7	401.1	388.5	121.4	135.1	132.0
	Change	8.6	19.9	2.1	-10.5	-10.2	-7.7	-13.4
	Imports	1,197.5	1,604.8	380.4	344.3	112.0	115.2	117.1
	Change	28.4	34.0	-2.0	-13.5	-16.1	-13.3	-11.1
Current account		244.8	110.4	30.7	28.9*	5.9	23.0	
Capital account		20.4	117.3	-37.1	-23.7*	-14.8	-8.9	

Note: \* is applied to the period from April to May.  
Sources: Ministry of Commerce, Industry & Energy, The Bank of Korea

## Prices

Prices, having demonstrated a steady rise through April, stabilized in May. The consumer price index for the January–April period rose a monthly average of 0.6%. Essentially flat in May, it rose again by 0.3% in June.

Producer prices, which had maintained a steady growth trend since June 2000 before falling 0.1% in May, rose 0.1% in June.

Prices		Unit: year-on-year change (%)									
		2000					2001				
		1/4	2/4	3/4	4/4	Year	1/4	2/4	Apr.	May	June
Consumer price index		1.5	1.4	3.2	2.9	2.3	4.2	5.3	5.3 (0.6)	5.4 (0.0)	5.2 (0.3)
Core inflation		0.8	1.4	2.4	2.9	1.9	4.2	4.6	4.5 (0.3)	4.7 (0.3)	4.6 (0.1)
Producer price index		2.2	1.9	2.7	1.6	2.1	2.5	3.1	3.3 (0.2)	3.4 (-0.1)	2.8 (0.1)

Note: The parenthesis is month-to-month change (%)  
Sources: National Statistical Office, The Bank of Korea

## Interest Rates and Foreign Exchange Rate

Since mid-February, interest rates have inched upward amidst concerns about rising prices and the hike in the won-dollar exchange rate. With the stabilization of the foreign exchange rate in May, however, interest rates have declined slightly.

In early April, the won-dollar rate, rose to a peak of 1,365 (since October 2000) prompted by a sharp rise in yen-dollar exchange rate. In May the tide shifted and the won-dollar exchange rate declined gradually due to the stabilization of the yen-dollar trend as well as the government's strategic intervention in the FX market.

Interest Rates and won-dollar exchange rate		Unit: Annual rate, %							
	1999	2000	2001						
	Dec.	Dec.	Jan.	Feb.	Mar.	Apr.	May	June	
Call (next day) (A)	4.71	6.01	5.27	5.05	4.94	5.01	5.00	4.86	
CP (91 days)	7.47	7.26	6.66	6.20	6.06	6.19	5.89	5.62	
Government bonds (3-year maturity) (B)	9.22	6.70	5.68	5.43	6.31	6.80	6.17	5.93	
Corporate bonds (3-year maturity AA <sup>+</sup> ) (C)	9.85	8.13	7.38	6.77	7.69	8.05	7.37	7.10	
B-A (%p)	4.51	0.69	0.41	0.38	1.37	1.18	1.17	1.07	
C-A (%p)	5.14	2.12	2.11	1.72	2.75	3.04	2.37	2.24	
Won-Dollar Exchange Rate	1,145.4	1,259.7	1,265.5	1,245.7	1,328.0	1,324.7	1,292.9	1,900.7	

Note: End of period  
Source: The Bank of Korea



## Economic Outlook for 2001/2002

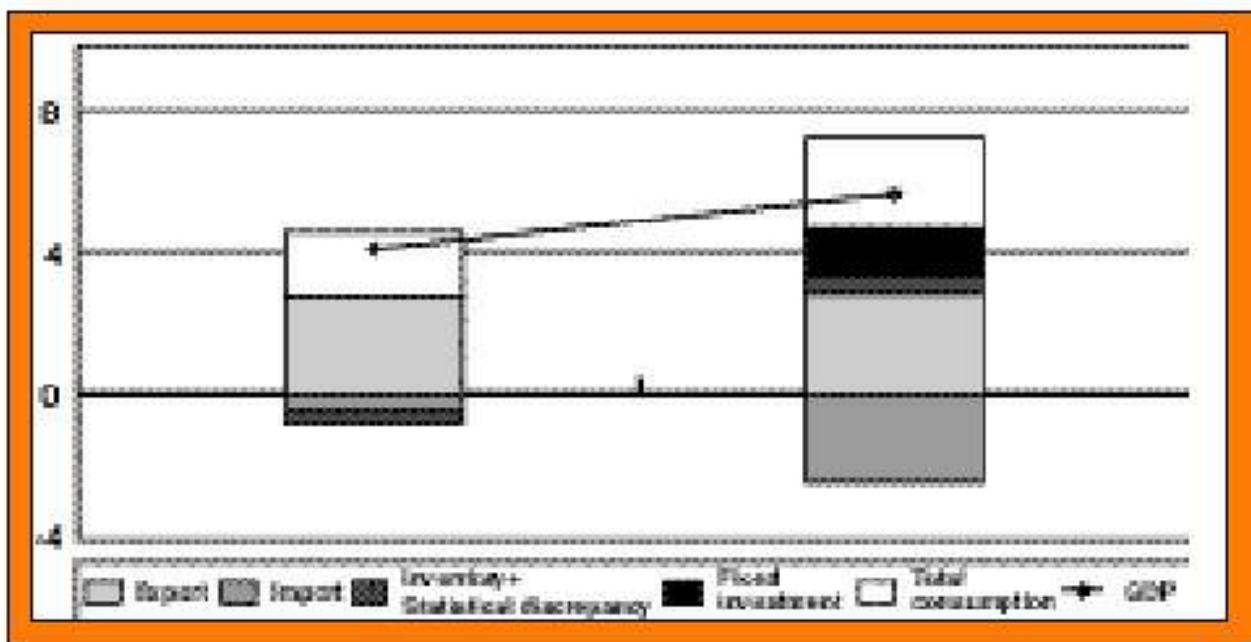
### Economic Growth

Projections of the economy's expansion by 4.8% in the second half are based on anticipated growth of domestic consumption and a gradual increase in exports. Combined with first-half results, GDP growth for 2001 is forecast to be 4.3%. Growth in 2002 is expected to climb to 5.4%.

From the perspective of relative contribution to economic growth, only exports and consumption are expected to make a positive contribution this year. In 2002, however, overall investment, including inventory, is expected to improve and therefore achieve a balanced contribution, with exports, to economic growth.

Performance of exports in the second half of this year is the main source of a downside risk from our current year projection. If exports falter, the GDP growth rate forecast will be lowered accordingly.

Growth Contribution by Final Demand Sector



## Balance of Payments

Commodity and current account surpluses for the current year are expected to outpace those in 2000 despite the sluggish trend in both exports and facility investment, owing primarily to the substantial decline in import growth. The commodity and current account surpluses for 2001 are projected to be US\$18 billion and US\$14.2 billion, constituting increases of US\$1.4 billion and US\$3.2 billion respectively.

With the fulfillment of an anticipated full-dress economic recovery in 2002 and greater demand for facility investment, the import growth rate is expected to exceed the export growth rate. Consequently commodity and current account surpluses are expected to shrink to US\$10.1 billion and US\$6 billion respectively.

## Prices

Public utility rate increases, in conjunction with swollen imported product prices due to the weaker foreign exchange rate, pushed inflation to 4.3% in the first half, threatening to exceed the Bank of Korea's inflation target (3±1%). With further utility rate increases unlikely in the second half of 2001 and a stable won-dollar foreign exchange rate forecast, inflation pressures are expected to abate. Inflation is projected at 3% for 2002 as we expect little inflationary pressure from the aggregate demand in the remainder this year and early next year.

## Interest Rates and Foreign Exchange Rate

Long-term interest rates are expected to climb in the second half of 2001 and into 2002. Despite enhanced liquidity, the maturation of 40 trillion won in corporate debentures in the second half coupled with a projected 4% inflation rate are likely to push up yields on long-term government bonds as well as the corporate bond yield rate. The upward trend in interest rates will continue into 2002 based on the anticipated economic recovery and associated increases in corporations' demand for capital in the facilities investment arena.

Aided by a substantial current account surplus, the won-dollar rate is expected to decline in the second half from its second-quarter peak and finish the year at

approximately 1,250. In 2002, the rate is forecast to stabilize in the range of 1,200 won to the dollar.

We also expect net inflow of foreign capital to increase as the Korean economy

## Economic Outlook for Second Half of 2001 and 2002

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

	2000	2001				2002	
	Year	1/4	2/4	3/4	4/4	Year	Year
GDP	8.8	3.7	3.9	4.8	5.0	4.3	5.4
(Manufacturing)	15.4	4.3	5.0	5.8	7.0	5.6	6.9
Total consumption	6.2	0.4	3.9	4.8	5.3	3.6	4.9
Private consumption	7.1	0.9	4.5	5.2	6.1	4.2	5.5
Fixed capital formation	11.0	-3.8	-1.5	1.8	4.4	0.4	4.4
Facility investment	34.3	-7.9	-4.4	3.0	9.6	-0.1	7.3
Construction investment	-4.1	1.4	1.3	0.6	0.2	0.8	1.6
Total exports	21.6	8.4	2.0	3.5	6.5	5.1	5.3
Total imports	20.0	-0.7	-4.5	-1.0	8.0	1.0	7.2
Producer price	2.0	2.5	3.3	3.1	3.0	3.0	2.5
Consumer price	2.3	4.2	5.3	4.1	3.8	4.3	3.0
Current account	110.4	30.7	41.2	38.8	31.3	141.9	59.8
Trade account	166.0	34.6	55.3	50.3	40.1	180.3	101.1
Exports	1,757.8	406.6	406.8	435.4	463.6	1,712.5	1,800.2
Change (%)	21.1	-1.9	-7.7	-4.1	3.4	-2.6	5.1
Imports	1,591.8	372.0	351.5	385.1	423.6	1,532.2	1,699.1
Change (%)	36.3	-4.7	-11.0	-3.7	4.1	-3.7	10.9
Service, incomes & transfer	-55.6	-3.9	-14.1	-11.5	-8.8	-38.4	-41.3
Won/\$ (end of period)	1,259.7	1,327.5	1,280.0	1,265.0	1,250.0	1,250.0	1,200.0
Yen/\$ (end of period)	114.4	126.2	125.0	123.0	121.0	121.0	118.0
M3 (Avg, %)	5.7	8.2	8.5	7.9	7.4	8.0	8.0
3-yr corporate bond (Avg, %)	9.4	7.2	7.6	7.8	8.0	7.7	8.4

gradually recovers in the second half of this year. This will provide additional support for the exchange rate.

## Policy Issues

### Review of Macroeconomic Policy Stance and Recommendations

#### As sluggishness persists....

Recent trends in a number of economic indicators continue to point to a sluggish economy. Given this backdrop, policy makers have stated that a limited expansionary policy has been in effect since the beginning of the year. These claims notwithstanding, the government's stance on its macroeconomic policies has not been clear to observers.

#### Monetary policy has been effectively tight....

Beginning our analysis with monetary policy, the Bank of Korea has pursued its policy of maintaining interest rates at a fixed level until its recent rate reduction of a quarter percent. The BOK claimed that it was maintaining a neutral policy stance, thus not unduly affecting the economic environment. This, however, is quite misleading. Due to continued sluggishness since late last year, the gap between the actual and potential GDP continues to widen. Under such contractionary circumstances, holding the policy interest rate constant, in fact, amounts to a deliberate tightening of policy. Given that the surge in CPI inflation so far this year has been mainly due to factors that have little to do with the aggregate demand, such as hikes in public service rates, the thought of policy easing should have occurred to the BOK several months ago.

#### While fiscal policy has been more contractionary than expansionary.....

Second, turning to fiscal policy, the Ministry of Finance and Economy (MOFE) has continued to insist that it has maintained a limited expansionary fiscal policy stance by front-loading this year's spending. However, according to a recent accounting of actual government expenditures and tax receipts through the end of May, it turns out



that the government's inflow was about 14 trillion won higher than its outlay within that period. If this indeed constitutes limited expansionary fiscal policy, one shudders to contemplate the scenario in which the government starts to tighten fiscal policy!

True policy stimulus is needed now.

The current sluggish economy requires more accommodating monetary and fiscal policies. Domestic demand needs further attention to prevent the Korean economy from lapsing into a prolonged downturn in the absence of rapid rebound of Korea's exports sparked by a rapid recovery in the U.S. and other advanced countries. If a prolonged downturn takes hold in Korea, a plethora of major and minor structural problems will surface and risk putting the Korean economy on the same slippery slope the Japanese economy stumbled onto more than ten years ago.

Along with conventional macroeconomic policy stimuli, the government needs to consider various deregulatory measures to boost business activities. Providing an environment in which enterprises are better able to concentrate on their core business activities would be an effective way to hasten economic recovery in Korea.