KERI

Economic Bulletin

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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.”

Executive Summary

Economic growth in the second half of 2006 is likely to fall to the 3% level bringing annual growth to 4.6%. Reflecting the negative impact expected from high oil prices and the unfavorable won-dollar exchange rate, the current annual growth forecast is 0.3% point lower than the 4.9% projected in March.

Affected by a decrease in exports and an increase in imports due to sharply stronger Korean won, the current account surplus is expected to be USD70 million, significantly lower than the previously projected level of USD2.78 billion. Meanwhile, the CPI inflation is likely to remain at the 3.0% as predicted earlier offsetting price push pressure from the oil price hike with the effect of won's appreciation.

Cited as major risk factors in the projection are additional hikes of international oil price and further currency appreciation following an imbalance in the global economy. Assuming the risk factors materialize (Dubai oil prices up to USD75/barrel during the next 3 quarters, won-dollar exchange rates further down at 920 in the third quarter and at 900 in the fourth quarter), annual growth rate may decline to 4.3% while the current account balance may record a deficit of USD5.9 billion.

Necessary to the stabilization of the foreign exchange rate are: first, creation of demand for the U.S. dollar through stimulation of corporate investment and overseas investment by the household sector and second, comprehensive measures to revamp the foreign exchange market such as diversification of export payment settlement currencies and relaxation of overseas investment-related restrictions. Lessons can be obtained from the Japanese experience in which Japan has achieved foreign exchange rate stabilization through efficient management of its international balance of payments and invigoration of overseas investment.

In the first quarter of 2006, the seasonally adjusted real GDP growth rate was 1.2%, representing a 0.4% point drop from the fourth quarter of 2005. By expenditure item, except for private consumption, all other sectors were sluggish.

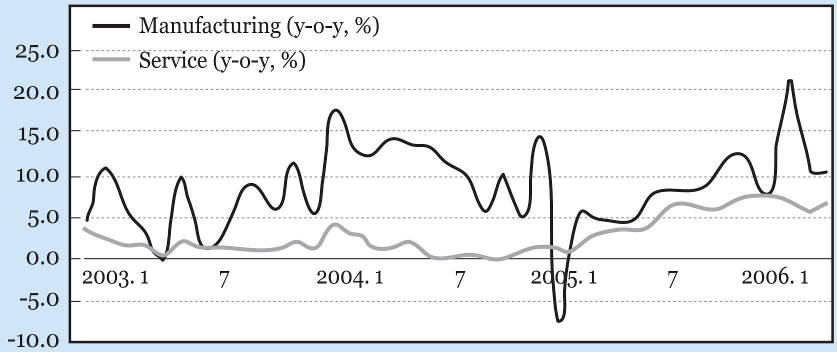
GDP Growth by Final Demand

(Unit: seasonally adjusted, quarter-on-quarter change %)

	2005				2006
	1/4	2/4	3/4	4/4	1/4
GDP	0.5	1.4	1.6	1.6	1.2
Private Consumption	0.5	1.4	1.0	1.1	1.3
Construction Investment	0.4	1.8	-0.8	0.0	0.6
Facility Investment	2.3	2.4	0.8	4.2	-0.4
Net Exports (Export-Imports)	27.2	-13.3	12.8	12.1	-2.7

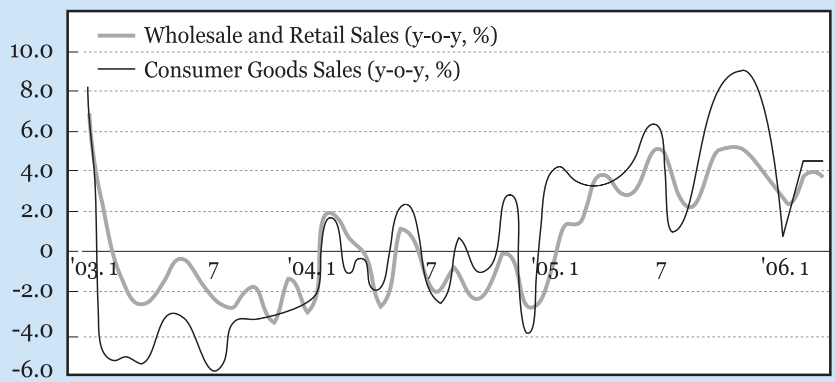
Production activities maintained comparatively good progress. Production output growth in the manufacturing sector increased 12.5% in the January~April period from 7.3% in the third quarter and 10.4% in the fourth quarter of 2005. Service sector activities also continued a growth trend at 6.1% in the January~April period, compared with 5.4% and 5.8% in the third and fourth quarter of last year, respectively.

Production



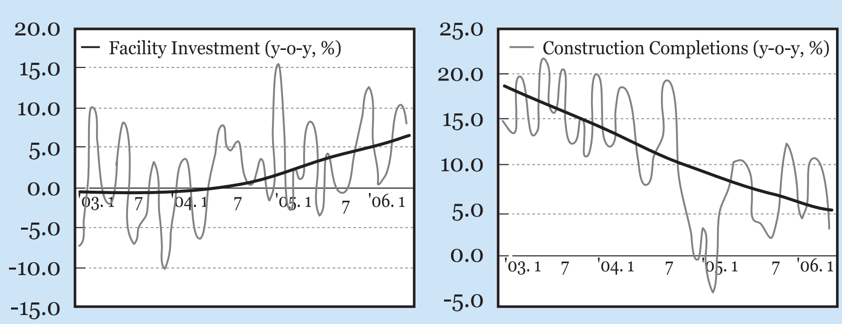
The consumption growth trend slowed slightly. The whole and retail sales growth also declined to 3.7% in the January~April period from 4.3% in the fourth quarter of 2005. Sales growth of consumer goods dropped to 5.0% from 6.8% in the fourth quarter of last year.

Consumption



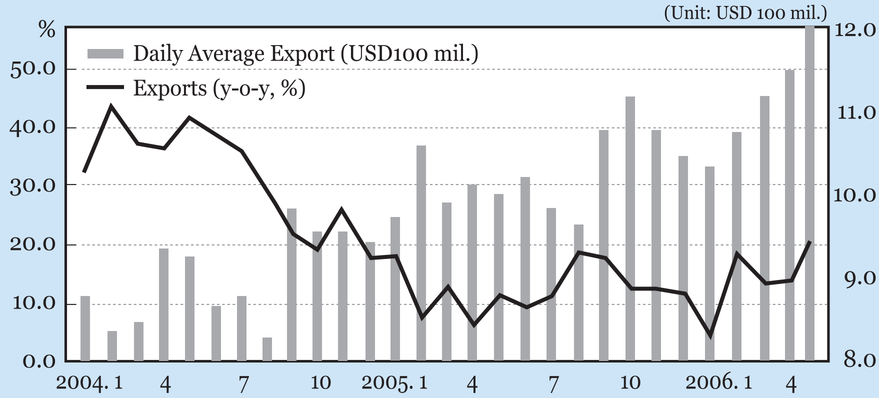
Facility investment is maintaining a mild recovery trend. Since the beginning of the year, it had risen for three consecutive months. Its leading indicator, domestic machinery orders, has also maintained double-digit growth since the third quarter of 2005. Construction investment growth, however, declined to 4.9% in the January~April period from 6.9% in the fourth quarter of last year, posting continued stagnation while experiencing repeated fluctuations.

Investment



Brisk export performance is continuing. Exports, which recorded 11.4% growth (customs clearance basis) in the fourth quarter of last year, slightly slowed to 10.6% in the first quarter of 2006. In the April~May period, however, the export growth rate surged to 16.5% and the daily average export amount rose to USD1.18 billion from USD1.08 billion in the first quarter.

Export



The current account balance during the January~April period recorded a USD2.65 billion deficit due to shrinkage of the surplus in commodity balance, expansion of service balance deficit, etc. The current account balance has worsened dramatically compared with a USD5.43 billion surplus in the fourth quarter of 2005.

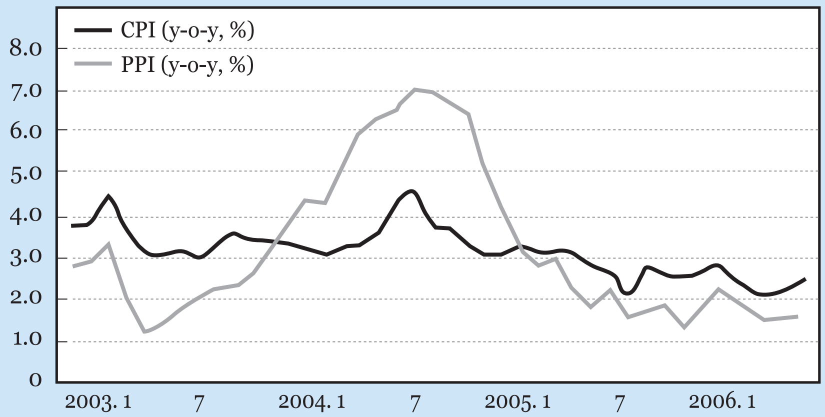
Current Account Balance

(Unit: USD 100 mil.)

	2005					2006		
	1/4	2/4	3/4	4/4	Year	1/4	Apr.	Jan.~Apr.
Current Account Balance	58.8	26.0	26.5	54.3	165.6	-10.6	-15.3	-26.5
Commodity	91.6	86.4	75.8	80.9	334.7	52.3	19.6	71.8
Service	-30.1	-32.4	-43.6	-24.9	-130.9	-50.0	-13.5	-63.4
Income	2.4	-20.9	0.3	5.0	-13.2	-4.8	-18.8	-23.6
Current Transfer	-5.2	-7.1	-6.0	-6.7	-25.0	-8.1	-2.7	-11.3

Despite international oil price hikes, a steady downward trend of price index is continuing owing to the won's appreciation, stable total demand, and other factors. The increasing rate of consumer price index stood at 2.4% in the first quarter and 2.2% in the April~May period this year, and that of producer price index also recorded a relatively low 1.7% in the first quarter and 1.5% in April.

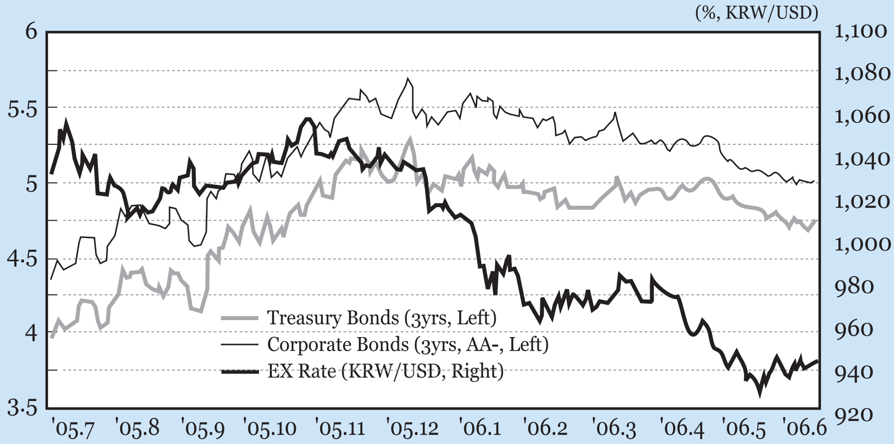
Prices



Market interest rates, which had been on a steady downward trend since the end of last year, sharply dropped recently due to fears of an economic recession following a projected freeze of the target call rate in May, continuation of international oil price hikes, foreign exchange rate appreciation, etc. The yield rate of treasury bonds, which had maintained 4.9~5.0%, declined to the 4.7% level, and that of corporate bonds fell to the 5.0% level from 5.3~5.5%.

Amid the global trend of a weakening U.S. dollar, the decline in won-dollar exchange rates is accelerating. The exchange rates stayed at around the 970 won/dollar level in February and March this year, but fell to less than 940 won/dollar level at the end of April.

Interest Rates and Exchange Rate



Due to the emergence of such external factors as the won's appreciation and oil price hikes, GDP growth is expected at the 3% level in the second half and the annual growth for this year is projected to be 4.6%. The deceleration projection is also due to relatively high economic growth recorded during the second half of the last year. With a gradual recovery of consumer sentiment owing to employment improvement and the final stage of household debt adjustment, private consumption is expected to recover to the 4% level for the year. Facility investment may reach the 7% level on a recovery trend, but construction investment is likely to make little progress, affected by the government's real estate price-curbing policies and the change to a neutral fiscal policy.

Although the price increase trend is expected to be steeper in the second half of this year due to high oil prices, the pace is likely to be limited considering the accumulated deflation gap, won value appreciation, etc.

Commodity exports (based on international balance of payments) are expected to maintain sound growth of about 10% owing to strengthened non-price competitiveness of export goods, continuation of robust growth in the global economy and recovery in the IT sector. However, commodity imports (based on international balance of payments) are likely to post higher growth than commodity exports in line with the consumption recovery, won appreciation, oil price hikes, etc. Consequently, the current account balance is projected to post only a USD70 million surplus for the year.

An expected policy interest rate increase and higher prices in the second half may serve as push factors on interest rates, but the range of long-term interest rate increases is likely to be limited due to the weak pace of economic recovery. The yield rate on corporate bonds (3-year maturity, AA-) is projected at an annual rate of 5.3%.

Affected by the possibility of interest rate increases in Japan and Europe, Chinese yuan appreciation and the global dollar weakening trend following spreading awareness of the end of U.S. interest rate increases, etc., the won-dollar exchange rate is expected to be 954 in the first half and 923 in the second half of this year.

Outlook for 2006

(y-o-y, change %, USD100 mil.)

	2004	2005	2006				
	Year	Year	1/4	2/4	3/4	4/4	Year
GDP	4.6	4.0	6.1 (1.2)	5.1 (0.6)	4.2 (0.8)	3.3 (0.8)	4.6
Private Consumption	-0.5	3.2	4.8 (1.3)	4.6 (1.2)	4.3 (0.8)	4.2 (1.0)	4.5
Construction Investment	1.1	0.4	1.1 (0.6)	0.7 (1.9)	1.1 (-0.4)	1.3 (0.2)	1.0
Facility Investment *	3.1	4.9	6.7 (0.0)	7.0 (2.2)	7.9 (1.7)	6.1 (2.3)	6.9
Consumer Prices	3.6	2.7	2.4	2.5	3.1	3.9	3.0
Current Account Balance (USD100 mil.)	281.7	167.8	-11.2	-10.9	-2.5	25.3	0.7
Exports (BOP basis)	2,577.1	2,890.8	758.0	784.8	787.3	841.5	3,171.6
Growth (%)	30.6	12.2	11.4	11.2	8.8	7.9	9.7
Imports (BOP basis)	2,201.4	2,555.1	705.8	731.1	738.9	781.4	2,957.2
Growth (%)	25.6	16.4	19.8	17.9	14.1	11.9	15.7
Service Balance and Other Balances	-94.0	-167.9	-63.4	-64.6	-50.9	-34.8	-213.7
Exchange Rate (won/dollar, average)	1,145.7	1,024.0	976.5	930.7	925.9	920.3	938.3
Yield Rate on Corporate Bonds (3-year, AA-)	4.7	4.7	5.4	5.2	5.2	5.3	5.3

Note: The figures in parentheses are seasonally adjusted quarter-on-quarter changes.
* Including intangible fixed assets.

Risk factors associated with these projections are additional hikes of international oil price and further currency appreciation following an imbalance in the global economy. Reflecting these factors and with an assumed scenario (Dubai oil prices up to USD75/barrel during the next 3 quarters, won-dollar exchange rates further down at 920 in the third quarter and at 900 in the fourth quarter), a simulation indicated that the oil price increase would worsen economic growth by 0.2% point and the current account balance by about USD4 billion through its ripple effect on total expenditures.

Economic Effects of Further Oil Price Hike and Won-Dollar Exchange Rate Decline

	2006	
	Basic Projections	Scenario Projections
GDP (%)	4.6	4.3 (4.4)
Consumer Prices (%)	2.9	3.0 (3.1)
Current Account Balance (USD100 mil.)	1.4	-58.5 (-41.0)

Note: The figures in parentheses show the case with only an international oil price hike.

When the additional declines in the won-dollar exchange rate were factored in, economic growth declined to 4.3%, down about 0.3% point from the basic projection, and the current account balance would project to a deficit of about USD6 billion. Prices in the simulated scenario, meanwhile, increased by only about 0.1% point, as high oil prices and the won-dollar exchange rate decline served to offset each other.

Reality of FX Market and Exchange Rate Stabilization Measures

Entering the 2000s, there were structural changes that affected foreign currency supply and demand. Foreign exchange transactions related to the market activity such as export and import transactions and inflows and outflows of foreign capital are relatively contracted. On the other hand, ones related to external environment such as market speculation and risk hedges are more increasing. As a result, market participants and intervening authorities experience difficulties in their projections due to a reduction in the foreign exchange transactions based on market activity, and consequently the uncertainty in the foreign exchange market is amplified.

In order to ensure a stable foreign exchange rate under the changed environments, the primary tasks are to adjust the excess supply of U.S. dollars through a foreign exchange liberalization policy and expansion of overseas investment. For this, first, the corporate investment environment must be improved to create medium and long-term dollar demand especially for import of capital goods by enterprises. Second, there is a need to encourage overseas investment by the household sector through reduction in transaction costs related to overseas funds, development of new overseas investment and financing products and cultivation of capable investment firms. Third, a comprehensive foreign exchange market reorganization plan is required to resolve the structural imbalance in foreign exchange supply and demand, including diversification of export payment settlement currencies and stimulation of direct deals between different foreign currencies.

Japan's past experience in overcoming its high-yen problem can be helpful to Korea in devising measures to stabilize foreign exchange rates. During the high-yen period of the mid-1980s and 1990s, Japan continued efforts to boost its weak economic conditions through enactment of laws in 1986 to accelerate private investment and large-scale common investment projects in the early 1990s along with implementation of support policies for export firms trapped by difficulties caused by the strong yen. The lesson is that Japan implemented corporate support policies in parallel with macroeconomic policy responses.

In the later half of the 1990s, Japan also pursued full-scale liberalization of foreign exchange transactions with enactment of a new foreign exchange law. The revised law - the gist of which was liberalization of capital transactions and foreign exchange affairs - is praised as having contributed significantly to the creation of environments to stabilize foreign exchange rates through stimulation of overseas investment. Based on these efforts, Japan achieved efficient management of its international balance of payments through expansion of overseas capital investment. Since 2000, except for 2003 and 2004, Japan's investment balance posted a deficit each year. Also, in the 2000-2005 period, Japan's direct investment balance deficit accounted for about 22% of the surplus in the current account balance. As a result, despite a lack of direct market intervention, Japan has been able to maintain comparatively stable yen currency exchange rates since March 2004.

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