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Recent Economic Developments

◆ Production, Consumption and Investment

Production and shipments have decreased for three consecutive months since June this year. Facility investment, in steady decline since November of last year, has been falling faster. Despite a slight upturn in the first half of this year, construction investment lost momentum in June and July and decreased. Wholesale and retail sales have also declined from about 4% growth to the 3% level in the second half. The average operating ratio remains at a low level, although it rose slightly in August from the 71.0% marked in July.

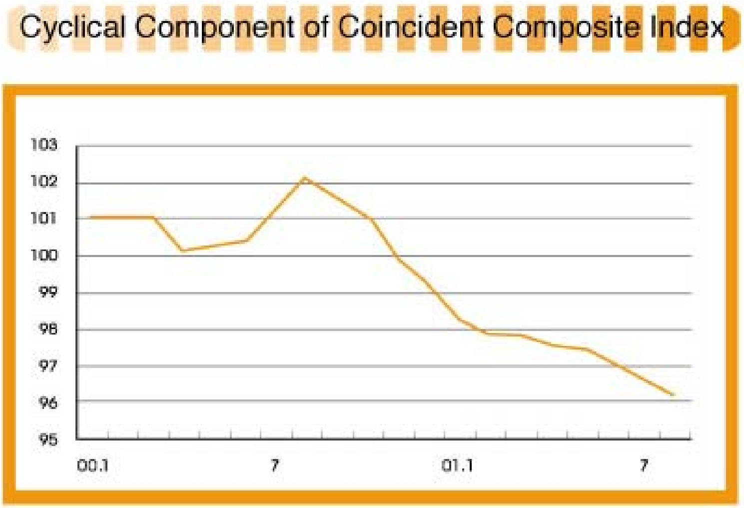
Production, Consumption and Investment

Unit: year-on-year change (%)

	2000	2001				
	Year	1/4	2/4	June	July	Aug.
Production	16.8	5.0	1.6	-2.8	-5.7	-4.7
Shipment	16.6	2.2	1.1	-0.9	-5.8	-5.8
Inventory (based on the end of period)	16.2	15.2	14.9	14.9	15.7	14.8
Average operating ratio (%)	78.3	74.7	74.5	74.1	71.0	73.4
Wholesale & retail sales	9.8	2.5	4.4	4.5	2.9	3.5
Shipment of domestic consumer goods	6.4	-8.1	5.0	13.7	6.9	10.4
Machinery imports	40.6	-1.2	-30.6	-25.5	-23.7	-34.1
Facility investment	30.1	-6.3	-4.7	-2.8	-10.4	-19.0
Domestic machinery order receipt	11.7	3.7	-2.8	0.7	-11.8	-8.9
Construction turnover	-3.1	1.6	-0.4	-5.4	-11.0	8.1
Domestic construction order receipt	15.1	-25.3	1.7	-8.3	11.9	-18.8

Sources: The Bank of Korea, National Statistical Office

Reflecting the backdrop of the overall economy, the cyclical component of coincident composite index indicates a continued economic slowdown.



◆ Employment

The downward trend of the unemployment rate beginning March of this year reversed course in July and August. The rate increased slightly to 3.4% in July and August from 3.3% in June.

Employment

Unit: 1,000 persons, %

	2001.1	2001.2	2001.3	2001.4	2001.5	2001.6	2001.7	2001.8
Unemployed persons (1,000 persons)	982	1,069	1,035	848	780	745	760	752
Unemployment rate (%)	(4.6)	(5.0)	(4.8)	(3.8)	(3.5)	(3.3)	(3.4)	(3.4)
Seasonally-adjusted unemployment rate	4.1	4.2	4.2	3.8	3.6	3.6	3.7	3.6

Source: National Statistical Office

◆ Exports, Imports and Balance of Payments

This year's 3Q saw an accelerated rate of decline in exports and imports as compared with the second quarter. Third quarter exports declined by 19.2%, in large part due to the sluggish semiconductor business climate, while imports also fell by 15.4% due to the setbacks in facility investment and exports.

The trade balance has continued a trend in surpluses, but the surplus is shrinking as the decline in the rate of exports is larger than that of imports. Despite the trade surplus, the current account balance is being written in red ink for the first time in 16 months, since April 2000. This development can be attributed mainly to worsening deficits in the travel and service sectors.

Exports, Imports and Balance of Payments

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

		2000	2001					
		Year	1/4	2/4	3/4	July	Aug.	Sept.
Customs clearance basis	Trade account	117.9	20.4	39.2	16.7	3.3	4.6	8.9
	Exports	1,722.7	401.0	384.0	358.6	114.2	118.1	126.2
	Change	19.9	2.1	-11.5	-19.2	-21.0	-20.1	-16.6
	Imports	1,604.8	380.6	344.8	341.8	110.9	113.6	117.4
	Change	34.0	-2.0	-13.4	-15.4	-18.9	-15.5	-11.7
Current account		114.0	30.7	36.8	3.3'	4.4	-1.1	
Capital account		121.1	-37.1	-36.5	22.2'	8.1	13.9	

Note: Applies to the period from July to August.
Sources: Ministry of Commerce, Industry & Energy, The Bank of Korea

◆ Prices

Prices, which had risen noticeably through April, have stabilized since May. After increasing to the 5% level in the second quarter, consumer prices gradually dipped to the 4% level in August and then to the 3% plateau in September, with the month of May as the turning point. Producer prices also stabilized largely at the 2% level in the third quarter.

Prices

Unit: year-on-year change (%)

	2000					2001				
	1/4	2/4	3/4	4/4	Year	1/4	2/4	July	Aug.	Sept.
Consumer price index	1.5	1.4	3.2	2.9	2.3	4.2	5.3	5.0 (0.2)	4.7 (0.5)	3.2 (0.0)
Core inflation	0.8	1.4	2.4	2.9	1.9	4.2	4.6	4.3 (0.0)	4.0 (0.3)	3.6 (0.3)
Producer price index	2.2	1.9	2.7	1.6	2.1	2.5	3.1	2.7 (0.1)	2.0 (-0.4)	1.2 (-0.2)

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

◆ Interest Rates and Foreign Exchange Rate

Owing largely to mitigated expectations for price increases in line with the continued decline of the economy, short- and long-term interest rates have continued a steady downward but stable trend since May. The won-dollar exchange rate, having stood at the 1,280 won level in the wake of a gradually stablizing trend since August, reversed course and swung upward from September, evidently affected by the terrorist attacks in America.

Interest Rates

Unit: Annual rate,%

	2000	2001								
	Dec.	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.
Call (next day) (A)	6.01	5.27	5.05	4.94	5.01	5.00	5.03	4.76	4.51	3.97
CP (91 days)	7.26	6.66	6.20	6.06	6.19	5.89	5.69	5.30	4.96	4.67
Government bonds (3-year maturity) (B)	6.70	5.68	5.43	6.31	6.80	6.17	5.93	5.58	5.15	4.45
Corporate bonds (3-year maturity) (C)	8.13	7.38	6.77	7.69	8.05	7.37	7.10	6.89	6.55	5.95
B-A (%p)	0.69	0.41	0.38	1.37	1.18	1.17	0.90	0.82	0.59	0.48
C-A (%p)	2.12	2.11	1.72	2.75	3.04	2.37	2.07	2.13	2.01	1.98

Note: End of period
Source: The Bank of Korea

◆ Won-Dollar Exchange Rate

Won-Dollar Exchange Rate

◆ Economic Growth

As our institute has pointed out, the recovery of the world economy is the most important "downside risk" in our projections. A setback in exports is occuring at present due to a delayed global economic recovery. In the wake of the foreign exchange crisis in 1997, exports had surged thanks to enhanced competitiveness linked to the won-dollar devaluation. As a result, our degree of dependence on exports (on a nominal term basis) jumped considerably to 45% in 2000 from 29.5% in 1996. However, domestic consumption has shrunk since the fourth quarter of 2000 and export growth has turned negative as of March this year, with the decline growing to near 20%. Consequently, the sluggish drift of the real economy has deepened all the more recently in the wake of the September 11 terrorist attacks on the U.S.

Industrial production decreased for the third consecutive month since June. The average operating ratio remains at a low level.

Facility investment, already on a prolonged decline since November 2000, took a steeper downward track following August's decline of 19.0%.

It is anticipated that the speed of and time needed for recovery of the domestic economy in the future will depend largely upon the recovery of the U.S. and world economies, particularly in the IT industry. From the perspective of indicators showing the U.S. economy still on an uncertain footing, a downward adjustment of its interest rate as well as tax reduction measures are expected to contribute to an economic recovery towards the end of this year. However, the effect of such measures is not expected to be particularly significant.

All things considered, domestic economic growth in the third quarter is forecast to stand at a rate of 0.9%, lower than in the second quarter. Growth in the fourth quarter is expected to be 2.9%, a mere technical upturn following the sluggish growth during the corresponding period last year. Accordingly, annual economic growth is projected to be 2.6%, less than a third of last year's 8.8%.

Such a low-growth trend is expected to continue until the first half of next year. Consequently, the growth rate in the first half of 2002 is not expected to exceed 4%. However, with a gradual recovery in exports and domestic consumption, the growth rate is expected to reach 4.9% in the second half, thereby achieving an annual growth rate of 4.4% in 2002.

Our growth projection would be lowered if the world economy contracts further in the wake of the current military actions taken by allied forces against Afghanistan. The volume of global trade will likely shrink perceptibly if the current war continues well into the next year. Under such a scenario, Korea's export will be adversely affected lowering our projection of real GDP growth for year 2002 down to 3.4% instead of 4.4%. If an unlikely scenario of the war spreading to a wider Middle East region takes place, our growth projection for next year will be further lowered to 1.6%.

◆ Balance of Payments

Despite sluggish exports, the trade and current account balance of payments are expected to maintain a trend of surpluses this year, due largely to declining imports.

However, as the decline of exports continues to outpace that of imports in the second half, the surplus scale in the trade balance of payments this year is no longer expected to exceed that of last year, in contrast to earlier expectations. On the other hand, the current account balance of payments this year is expected to show a slight increase over last year due to reduced overseas interest payments following the early completion of repayment of IMF loans. This should more than offset the diminished surplus in the trade balance of payments. The surplus in the trade balance of payments is expected to reach US$15.5 billion, US$1.1 billion less than the US$16.6 billion of last year, while the surplus in the current account is projected at US$11.7 billion, representing a US$700 million increase from US$11 billion last year.

Due to a gradual economic recovery trend anticipated in 2002, the demand for facility investement is expected to rise and the import growth rate is likely to outpace that of exports. Consequently, the surpluses in the balance of payments of the trade and the current accounts are projected to be US$11.5 billion and US$6.9 billion respectively, somewhat shy of levels in 2001.

◆ Prices

Consumer prices during the second half this year are forecast to maintain a gradual downward trend, due to weak upward pressure from the demand side and stabilization of the exchange rate as well as raw material prices from the cost side. It is also anticipated that increases in public utility rates will be controlled to the maximum extent through government efforts. The consumer price increase rate is expected to be 4.3% in the third quarter and 3.2% in the fourth quarter resulting in an annual increase of 4.3%.

A 4% growth rate for the domestic economy is forecast for next year, and the overall price increase pressure is not expected to be severe. However, as the speed of economic recovery gradually quickens entering the second half, prices will likely show a small upward trend. Consumer prices in the next year are expected to record a 3.0% increase in the first half and 3.4% in the second half to account for a total annual increase of 3.2%.

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	1st Half	2st Half	Year
GDP	8.8	3.7	2.7	0.9	3.1	2.6	3.9	4.9	4.4
(Manufacturing)	15.3	4.4	2.2	1.0	4.2	2.9	5.0	6.3	5.7
Total consumption	6.2	0.4	2.4	2.2	2.6	1.9	2.9	4.2	3.6
Private consumption	7.0	0.9	2.9	2.6	3.2	2.4	3.7	4.9	4.3
Fixed capital formation	10.9	-3.7	-4.7	-3.3	0.3	-2.8	1.4	4.8	3.2
Facility investment	34.1	-7.9	-10.8	-8.6	-0.5	-7.1	1.8	8.8	5.3
Construction investment	-4.0	1.4	0.9	1.3	0.8	1.1	1.0	1.9	1.5
Total exports	21.5	8.4	1.2	-2.1	3.8	2.8	4.1	4.9	4.5
Total imports	19.9	-0.7	-7.2	-6.9	1.2	-3.4	4.1	5.7	4.9
Producer price	2.0	2.5	3.1	2.0	1.5	2.3	2.0	2.3	2.1
Consumer price	2.2	4.2	5.3	4.3	3.2	4.3	3.0	3.4	3.2
Current account	110.4	30.7	38.3	27.7	20.5	117.2	41.4	28.0	69.4
Trade account	166.0	34.6	52.5	37.0	31.0	155.1	61.5	53.6	115.0
Exports	1,757.8	406.6	387.9	379.4	416.8	1,590.7	799.5	858.0	1,657.5
Change (%)	21.1	-1.9	-12.0	-16.4	-7.1	-9.5	0.6	7.8	4.2
Imports	1,591.8	372.0	335.4	342.4	385.8	1,435.6	738.0	804.4	1,542.4
Change (%)	36.3	-4.7	-15.0	-14.4	-5.2	-9.8	4.3	10.5	7.4
Service, incomes & transfer	-55.6	-3.9	-14.2	-9.3	-10.4	-37.8	-20.1	-25.6	-45.6
Won/$ (end of period)	1,259.7	1,327.5	1,297.5	1,280.0	1,260.0	1,260.0	1,245.0	1,230.0	1,230.0
Yen/$ (end of period)	114.4	126.2	124.7	119.0	118.0	118.0	116.5	115.0	115.0
M3 (Avg., %)	5.7	8.2	8.1	7.7	7.4	7.8	7.9	8.2	8.1
3-yr corporate bond (Avg.,%)	9.4	7.3	7.5	6.7	7.0	7.1	7.1	7.7	7.4

◆ Interest Rates & Exchange Rate

Amidst the uncertainty of the requisite time for economic recovery to take place and the continued setback in demand for investment funds, there exists a possibility that the Bank of Korea (BOK) may reduce the interest rate further. Due to insufficient fund sources, except for the debenture market, the present low level of interest rates is expected to continue at least until the third quarter or early fourth quarter of 2001. In the latter part of the fourth quarter, the interest rate may reverse to an upward swing, but a sharp increase is not expected due to the BOK's flexible liquidity control. The gradual increase is expected to continue in 2002.

The won-dollar exchange rate is expected to move only within a narrow range and to remain around the 1,260 won level until the end of the year in the absence of a dramatic change in the value of the Japanese yen. As there is slim chance that the U.S. economy will recover quickly, the strength of the Korean currency against the U.S. dollar is likely to continue through 2002.

Policy Issues

◆ Flexible Policies Necessary to Reflate Economy

Fiscal policies should be managed flexibly from the viewpoint of mid-term financial stability. To counter the downward pressures on the economy brought on by falling exports, a more pro-active fiscal policy stance is called for. For this, measures such as increased spending on SOC projects and income tax reduction should be considered seriously. As a minimum, in light of the prolonged sluggish economic situation at present, the surplus trend of the central government's budget balance is not recommended.

Monetary policy should be relaxed for the short term. Price pressures have diminished substantially while aggregate demand continues to abate. The central bank is not going to face a rise in inflation any time soon. The possibility of a deflationary trend should command attention as we go forward. As observed in Japan, a deflationary trend coupled with anemic aggregate demand can be as harmful as inflation. Thus, the BOK should consider measures that are necessary to prevent a deflationary trend taking root.

Along with expansionary fiscal and monetary policies, the policy towards enterprises needs to be reexamined. Obstacles to entrepreneurial activities should be eliminated through regulatory reform and improvement of systems that are no longer compatible with the era of a global economy. Providing a less constrictive environment for entrepreneurs could play a part in nudging the Korean economy toward a more stable growth path.

Commentary

Korean Bond Market since 1997: Rapid growth in size with credit quality bifurcation

◆ Rapid Growth in Debts

The total outstanding amount of listed bonds (both public and private) has grown rapidly since 1997 in Korea. The ratio of the total outstanding bonds to current GDP in 1995 stood at 33%. It steadily rose to 49% by 1997 and surged to 75% in 1998 and 1999. Along with the rapid growth of the total amount as shown in Figure 1, there is a clearly visible shift in the composition of the total. That is, Figure 2 shows that the share of corporate bonds to the total has steadily declined while the share of government and public agency bonds has risen. The corporate bond share stood at 45% in 1995, but fell sharply and has remained near 30% since 1999. In the same period, the share of government and public agency bonds rose from 32% to 51%. The share of public bonds rises to 60-65% if the share of Monetary Stabilization Bonds (MSB), a bond issued by the central bank, is added to that of government and public agencies.

Figure 1. Total Outstanding Bonds and Bonds/GDP Ratio

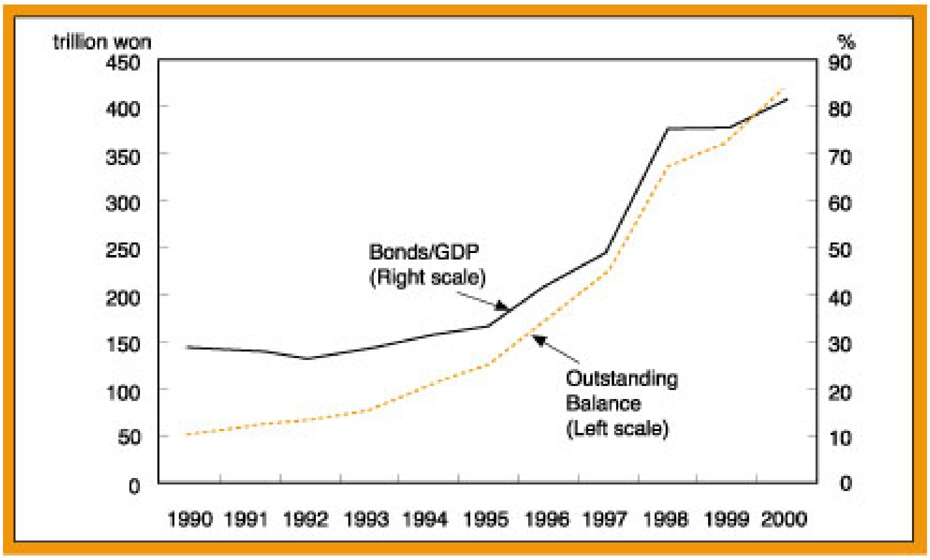
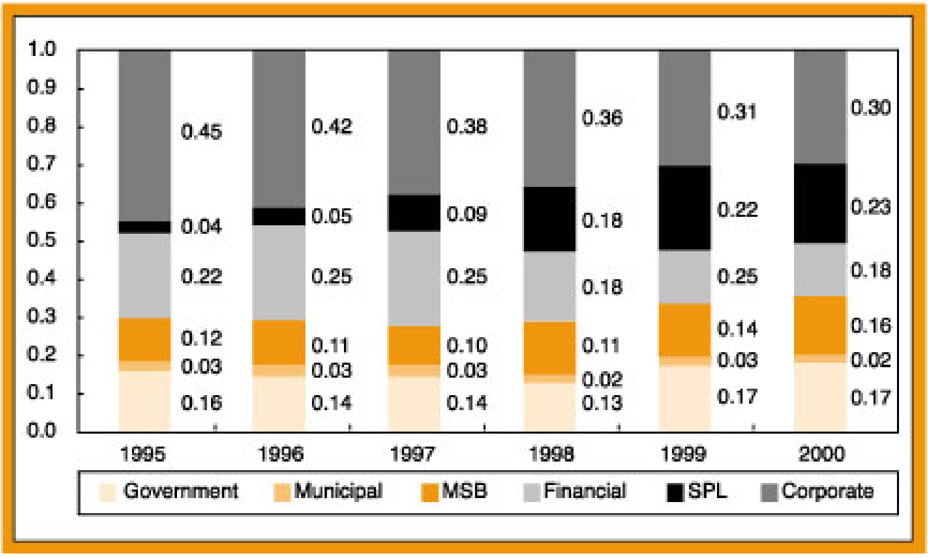


Figure 2. Composition of Outstanding Bonds



This significant shift took place over a relatively short period of several years as a direct consequence of the 1997 financial market crisis and the consequent need for public funds to restructure various financial institutions. Typically, when the public sector's demand for financial resources rises so rapidly, one anticipates a 'crowding out' effect and an attendant rise in interest rates. Unusual situations that developed in Korean financial markets in the wake of the financial crisis prevented this from taking place. A type of general paralysis developed among various lenders in the wake of the 1997 financial crisis. Lenders grew extremely averse to lending to businesses. In addition, a quantitative limit, for funds in the form of a targeted debt ratio, was put on large businesses that had previously relied on the issuances of corporate bonds. In one sense, a precondition was put in place for public bonds. Bonds issued by the government or with government guarantees fall into a different category of assets, in terms of risk characteristics, as compared to privately issued papers. In such circumstances, a large increase in public sector borrowing did not entail visible 'crowding out' effects.

One important policy implication is that the Korean government, as well as the central bank, should take this opportunity to foster and normalize the market for government bonds. A well-functioning government bond market and liquid secondary market are essential elements for modernizing the bond market.

◆ Bifurcation of credit quality

A strange bifurcation has taken place in terms of risk characteristics related to the bond market in Korea since 1998. As demonstrated earlier, the volume of public bonds with very low credit risk has grown very rapidly at the expense of bonds issued by businesses. At the same time, the balance of low-grade bonds has grown in terms of private sector papers. This second group of bonds, first issued in 1998, has been a recurring source of problems in the bond market ever since the day they fell due. The government's solution has been to make them more marketable by offering credit-enhancement. In a nutshell, the government is offering a guarantee. However, despite such measures, they are not exactly "hotcakes" that every investor is lining up to buy.

In 1998, the determination to lower the leverage ratio of the top 5 business groups was riding high. One measure implemented to reduce financial institutions' exposure to a small number of large businesses was to limit the share of financial institutions' holdings of commercial paper and corporate bonds of firms belonging to a single business group to between 10-15% of the total debt securities holdings.

Table 1. Corporate Bonds Issued in 1998

Unit: %

	1998. I	II	July	Aug.	Sep.	Oct.	Nov.	Dec.
Guarantee	87.5	82.5	63.4	17.2	14.9	1.7	8.6	8.0
W/O Guarantee	12.5	17.5	36.6	82.8	85.1	98.3	91.4	92.0
(above A)	-	-	-	61.7	52.4	52.4	32.7	10.7
(above BBB-)	-	-	-	17.0	24.3	40.3	38.9	38.4
(below BB+)	-	-	-	4.1	8.4	5.6	19.8	42.9

As a direct consequence of this measure, the share of the top five business groups' firms in the issuance market fell from 87 percent in August 1998 to 35 percent in December 1998. To fill the 'vacuum', firms with lower credit ratings increased their supply of corporate bonds. For example, the proportion of corporate bonds with a rating of BB+ or lower to total newly issued unsecured bonds rose from 4.1 percent in August to 42.9 percent in December of 1998 (see Table 1). In terms of amount, bonds with credit rating below BBB+ made up at least 11 trillion won, 24% of all newly issued bonds that year. Low grade papers, issued in such large numbers, have continued to present difficulties for the Korean bond market ever since they began to mature. Issuers partly paid down the outstanding amount but the majority had to be re-issued with the help of the government's credit enhancement through Collateralized Bond Obligations.

Table 2. Composition of Corporate Bonds Issued with and without Guarantee

Unit: trillion won, %

	1995	1996	1997	1998	1999	2000
W Guarantee	16.5 (69.8%)	27.4 (91.6%)	29.2 (85%)	17.5 (31.3%)	1.3 (4.2%)	1.5(2.5%)
W/O Guarantee	7.1 (30.2%)	2.5 (8.4%)	5.1 (15%)	38.4 (68.7%)	29.3 (95.8%)	57.4 (97.5%)

Another important factor contributed to the lowering of overall credit quality of corporate bonds since 1998, as shown in Table 2. Until then, the majority of businesses issuing bonds obtained guarantees from banks or credit insurance funds for their bonds to enhance marketability. Essentially banks offered guarantees for a fee. This seemed an easy source of fee income for banks as there had been no significant default on corporate bonds until 1997. However, banks became very sensitive to the credit risks of businesses after the onset of the1997 crisis and, hence, stopped offering guarantees on corporate bonds. In addition, the rule regarding the operation of credit insurance funds was changed in August 1998 and it similarly prohibited the insurance funds from offering guarantees on corporate bonds. About 86% of all corporate bonds issued since the second half of 1998 did not have a third-party guarantee. This figure is in contrast to the 80% level before mid-1998. Hence, this development alone should have had negative effects on the overall credit quality of corporate bonds.

Strong credit has been the critical qualification enabling firms to issue bonds in an open market. Only businesses with high credit rating typically participate and issue papers in most countries with well-functioning bond markets. Market-based credit assessment is the ultimate yardstick that participants rely upon in such a market and no official guarantee is necessary. As it stands now in Korea's bond market, however, governmental guarantees (through public agencies) have become an essential factor that supports a large segment of the market. Such governmental intervention does not seem desirable from the perspective of fostering a healthy bond market in the long run.

Offering governmental support to some papers has the same effect and smacks of previous government guidance and implicit guarantees to commercial banks that extended credit to targeted industries. Korea's banking sector has suffered a great deal from this legacy. If the government is concerned about funding businesses with low credit rating, it might be preferable to have government-run banks lend to them rather than mobilizing such a problematic means as the bond market. Governmental involvement in backing liabilities of firms with low credit rating could also have unintended and potentially serious consequences. In particular, concerns about public guarantee agencies' losses if those firms are closed has the potential to influence government decisions (via government controlled-commercial banks) on letting marginal businesses fail.

Excerpt from "A Case Study of Korean Credit Market Anomalies in 1999 : Issues and Lessons", forthcoming, by Huh, Chan-guk (Director for Macroeconomic Studies, KERI)