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

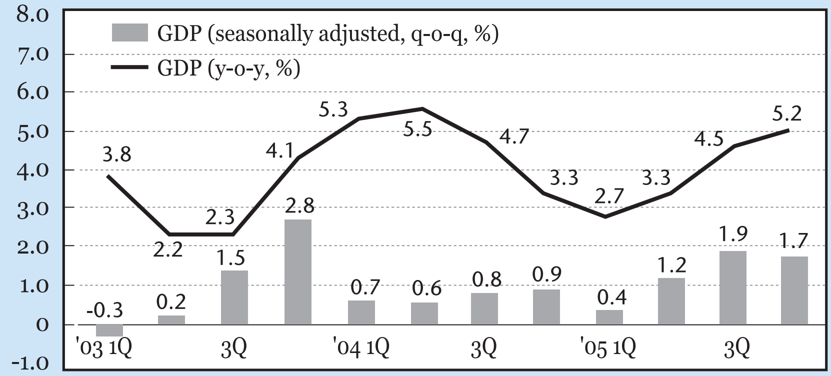
The Korean economy continues a robust recovery including a rebound in domestic demand, and improvements in consumer and business indicators and other areas. However, due to a slowdown in export growth, influenced by unfavorable foreign exchange rates and a reflection of uncertainties like high oil prices and the recent U.S. monetary policy change, the economic growth forecast is maintained at 4.9% as projected in December last year. The projected surplus in the current account balance for 2006 is adjusted to US$2.8 billion from the previous US$6.8 billion, considering the unexpected impact from the sudden decrease in foreign exchange rates.

If a change in U.S. monetary policy following the replacement of U.S. FRB Chairman Alan Greenspan is adopted earlier than expected, its impact on the Korean economy may be significant. Ben Bernanke, the new chairman, tends to take a more aggressive position on interest rate policy, if necessary, than the more cautions stance by Alan Greenspan, his predecessor, who emphasized prudence in adjusting interest rates. Considering the tendency of the new chairman with the recent trend of a firm real economy, there is a good chance of further increases in the interest rate throughout this year. Coinciding with the situation in Japan, seemingly committed to ending its zero interest rate policy, the projected U.S. measure could increasingly attract the outflow of overseas investment funds that thus far have favored Korea. In such a case, subsequent domestic interest rate hikes, with the consequent delay on the recovery of real economic conditions, might accelerate the further outflow of overseas investment funds.

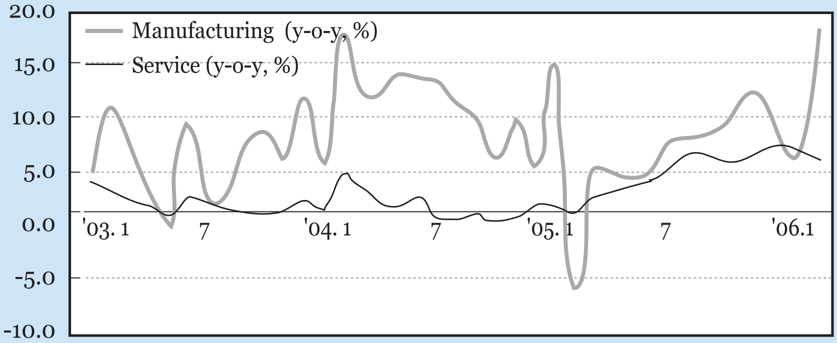
Also, last year Chairman Bernanke said that expansion of the U.S. current account deficit was not caused by low savings in the U.S. but by excessive savings in other major economies. Therefore, it is highly likely that he would support a more active U.S. government position with respect to external policies in order to maintain the independence of monetary policy. In connection with a Korea-U.S. FTA, U.S. demand for greater opening of Korea's service and financial sectors is expected to become much stronger.

The real GDP growth rate continued on an upward trend with the first quarter of 2005 as the low point at 2.7%. In the fourth quarter of 2005, the growth rate surged to 5.2% year-on-year, up 0.7% point from 4.5% in the third quarter. The growth rate of manufacturing production in the January-February period increased to 12.6%. The service sector in the January-February period this year also remained brisk, recording a year-on-year growth rate at 6.5%, up slightly from 5.8% in the fourth quarter of last year.

GDP Growth

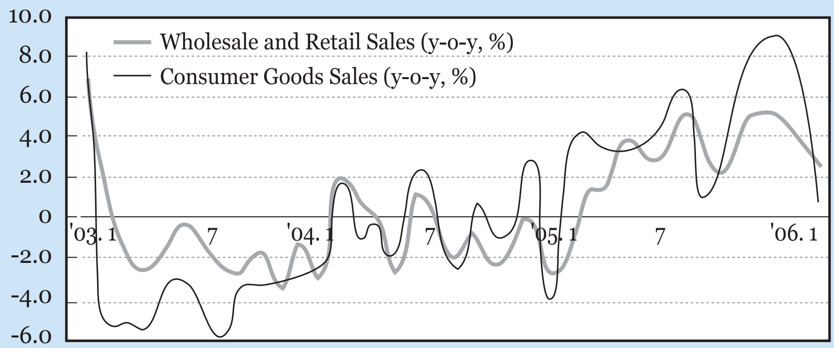


Production



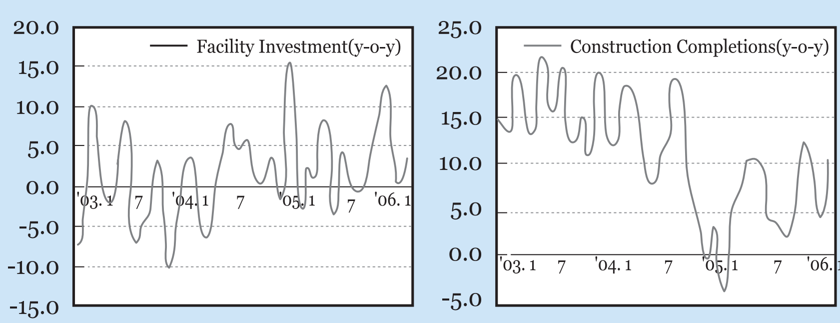
The pace of consumption recovery is also picking up. Building on a rebound to positive growth that began in March 2005, the growth rates of wholesale and retail sales have been gradually rising. And sales of consumer goods increased at the year-on-year rate of 5.1% in the January-February period this year.

Consumption



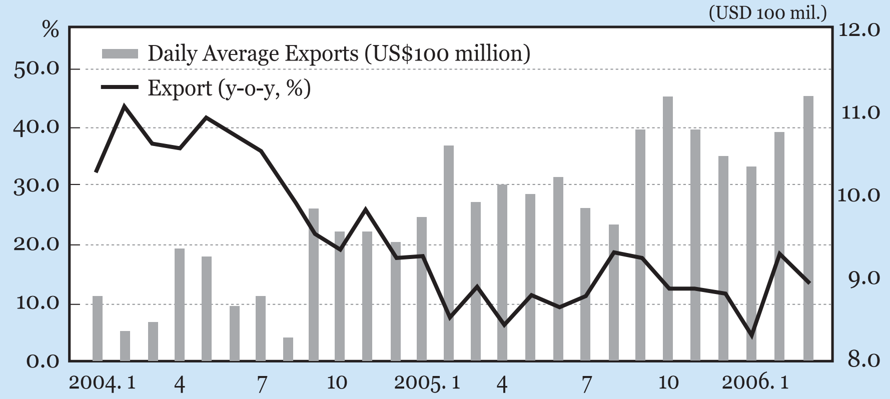
Facility investment posted 7.0% growth in the fourth quarter of last year, but the future of the recovery is still uncertain with a mere 1.2% growth in the January-February period this year. The growth rate of construction completions has been bouncing up and down repeatedly but tends toward a decline trend, and overall construction investment remains sluggish.

Investment



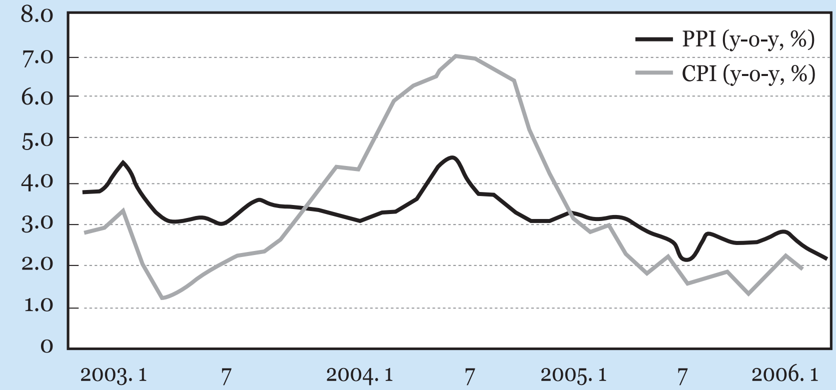
Export growth (customs clearance basis), which marked rates of 15.4% in the third quarter and 11.4% in the fourth quarter of last year, maintained a double-digit rate in 2006 at 11.0% in the first quarter, although slightly lower than the previous quarters.

Export



Prices are maintaining a stable downward trend due to won currency appreciation, stabilization of total demand, and other factors, despite international oil price hikes. Consumer prices rose 2.4% in the first quarter this year, maintaining the 2% level since June 2005. Meanwhile, producer prices also posted a mere 1.9% increase in the January-February period.

Price



The current account in the January-February period this year has recorded USD670 million due to a contraction of the surplus in the commodity balance and a sharp expansion in the service balance deficit.

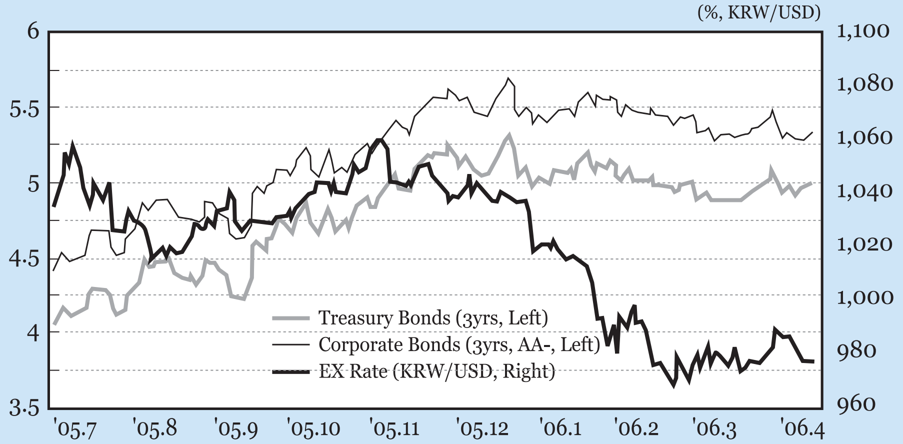
Current Account Balance

(USD 100 mil.)

	2005					2006
	1/4	2/4	3/4	4/4	Year	Jan.~Feb.
Current Account Balance	58.8	26.0	26.5	54.3	165.6	-6.7
Commodity	91.6	86.4	75.8	80.9	334.7	23.4
Service	-30.1	-32.4	-43.6	-24.9	-130.9	-34.6
Income	2.4	-20.9	0.3	5.0	-13.2	10.0
Current Transfer	-5.2	-7.1	-6.0	-6.7	-25.0	-5.5

Market interest rates, which started to rise in the third quarter of last year, turned downward at the end of the year. Entering this year, interest rates continued on a stable downward trend with yield rates on the national treasury and corporate bonds fluctuating between 4.9~5.0% and 5.3~5.5%, respectively. Meanwhile, the KRW/USD exchange rate continues on a steady decline since October 2005, posting 987 won/US$ in January and 970 won/US$ in February this year, which represent declines of 3.6% and 5.2% respectively compared with the average rate of 1,024 KRW/USD in 2005.

Interest Rates and Exchange Rate



Growth Projection: 4.0% (2005) →4.9% (2006)

The Korean economy is expected to realize 4.9% growth in 2006, a slight rise from the 4.0% recorded in 2005. Factors expected to support the growth are a gradual domestic demand recovery with a rebound in private consumption stimulated by improvement of employment conditions, completion of household debt adjustment, and with facility investment growth buoyed by increasing pressure on new investment. These positives will be complemented by robust export growth of about 9% with reinforcement in non-price competitiveness of export goods and continued growth of the Chinese economy, despite slow growth in construction investment due to the government's strict policy on real estate prices and the policy change to a balanced budget trend.

Consumer Prices: 2.7% (2005) →2.9% (2006)

Notwithstanding the recovery trend in domestic demand, total demand pressure is unlikely to be significant due to the accumulated deflation gap. Won currency appreciation is also expected to be a factor in alleviating the price push pressure.

Current Account Balance: US$16.6 Bil. (2005) →US$2.8 Bil. (2006)

With import growth outpacing export growth, the commodity balance surplus is expected to fall sharply. In addition, the service balance deficit is likely to continue on an expansion trend due to the vulnerability of the service sector's international competitiveness. As a result, the current account surplus is expected to experience a steep drop in 2006, projected to end the year as low as US$2.8 billion.

Interest and Foreign Exchange Rates

The yield rate on 3-year-maturity corporate bonds is projected to rise gradually to an annual rate of 5.6%, influenced by policy interest rate hikes and the economic recovery trend. The KRW/USD exchange rate is also likely to continue to appreciate due to U.S. policy interest rate increases to be finalized in the first half of 2006, expansion of deficits in the U.S. government budget and current account balance, possibility of Chinese yuan's appreciation, and other factors.

Outlook for 2006

(y-o-y change %, USD 100 mil.)

	2004	2005	2006				
	Year	Year	1/4	2/4	3/4	4/4	Year
GDP	4.6	4.0	5.1	4.7	4.8	5.0	4.9
Private Consumption	-0.5	3.2	4.5	4.6	4.9	5.0	4.7
Construction Investment	1.1	0.3	0.4	1.0	1.8	2.2	1.5
Facility Investment *	3.1	4.7	5.0	5.1	6.8	7.7	6.2
Consumer Prices	3.6	2.7	2.6	2.9	3.1	3.2	2.9
Producer Prices	6.1	2.1	2.1	2.3	2.1	2.1	2.1
Current Account Balance (US$100 mil.)	281.7	165.6	14.2	11.1	-5.5	8.1	27.8
Commodity Balance (US$100 mil.)	375.7	334.7	63.2	74.6	60.4	57.3	255.4
Exports (BOP basis)	2577.1	2890.0	745.1	772.0	786.6	841.1	3144.8
y-o-y change (%)	30.6	12.1	9.5	9.3	8.7	7.9	8.8
Imports (BOP basis)	2201.4	2555.2	682.0	697.4	726.2	783.9	2889.4
y-o-y change (%)	25.6	16.1	15.8	12.5	12.1	12.2	13.1
Service and Other Balances	-94.0	-169.1	-49.0	-63.5	-65.9	-49.2	-227.6
Exchange Rate (KRW/USD, avg.)	1143.7	1024.1	980.7	986.5	975.8	969.9	978.2
Corporate Bond Yield Rate (3 year, AA-)	4.7	4.7	5.4	5.5	5.7	5.9	5.6
Unemployment Rate (%)	3.6	3.7	3.8	3.7	3.6	3.6	3.7

Source: KERI's Quarterly Econometric Model
* Including intangible fixed assets.

Recently Ben Bernanke took office as the new chairman of the U.S. Federal Reserve Board. His replacement of former Chairman Alan Greenspan is expected to bring changes in U.S. monetary policy, which could have an important external impact on the Korean economy as well. Here, first, we would like to analyze future changes following inauguration of the new U.S. FRB chairman, and second, review the impact of U.S. monetary policy changes on the Korean economy.

The most important characteristic of Chairman Bernanke is the fact that he is a scholar. Bernanke is the first FRB chairman with a scholarly background since Arthur Burns, who served as chairman from 1969 to 1978. Since the 1950s, five FRB chairmen, including Alan Greenspan, have been from the financial community or economic bureaucrats.

Alan Greenspan was excellent at crisis management in the financial market, and consequently gained the full confidence of the market. However, Bernanke's experience in the market is virtually nill. Therefore, it will be a big task for him to earn full confidence and support from the financial market in the future.

Nevertheless, his theoretical expertise on monetary policy is a strength that no one can question. This fact gives us some implications for the future of U.S. monetary policy. First, policy enforcement will be more transparent. This is because Bernanke is much more straightforward than Greenspan and hence is expected to express a clear position on whether the tone of present policy is appropriate in view of economic conditions, especially with the inflation trend. Second, as it is very possible that his policy changes will be wider compared with Greenspan, the predictability of his policy decisions will likely be lower. In the case of Greenspan, such predictions were possible on a short-term basis due to his cautious moves in increments of 0.25 percentage point. However, Bernanke is not one to be concerned with minimization of the range of changes but is expected to adjust interest rates according to the needs of the economic situation, as he once, while serving as a director of the FRB, mentioned that the rate could be even brought down to zero (0) in order to prevent deflation. Third, as compared with Greenspan, political considerations will not play so important a part in the establishment of policy. Therefore, there is a possibility that conflicts with Congress may occur and grow in specific situations.

Considering the tendencies of the new chairman with the recent trend of a slower real economy, there is a good chance of further increases in the interest rate throughout this year. Coinciding with the situation in Japan, seemingly committed to ending its zero interest rate policy, the projected U.S. measures could increasingly attract the outflow of overseas investment funds that thus far have favored Korea. In such a case, subsequent domestic interest rate hikes, with the consequent delay on the recovery of real economic conditions, followed by some negative effect on stock prices might accelerate the further outflow of overseas investment funds.

There is also a good possibility that Chairman Bernanke may advocate a more active U.S. government position on external policies in order to maintain the independence of monetary policy. Last year, he mentioned that expansion of the U.S. current account deficit was not caused by low savings in the U.S. but by excessive savings in other major economies. In connection with a Korea-U.S. FTA, consequently, U.S. demand for greater opening of Korea's service and financial sectors is expected to become much stronger.

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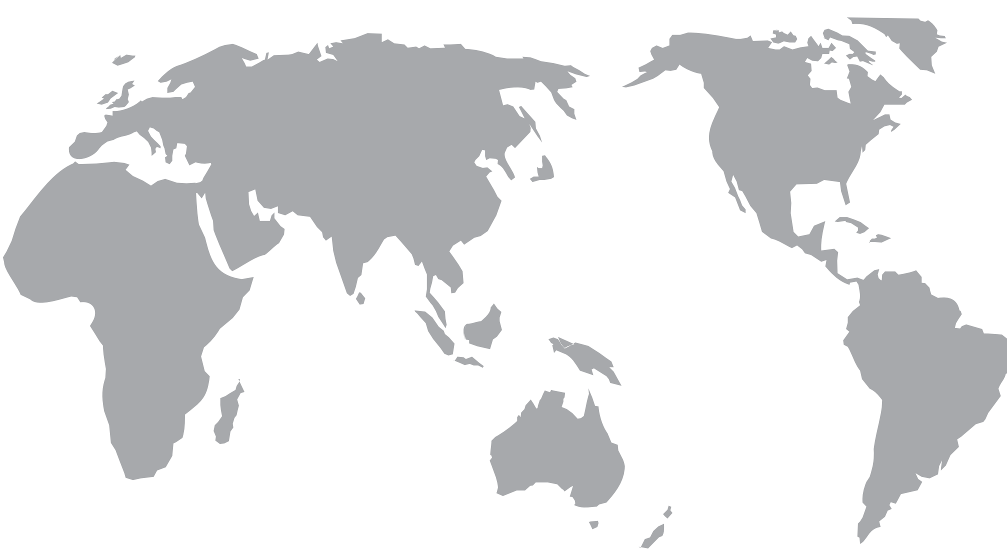

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