

# 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."



The Korean economy in the second half of 2004 is projected to grow at less than 5.0%, a level lower than in the first half of the year, due largely to a delay in the recovery of domestic demand and a slowdown in the export growth trend. Compared with the first half of the year, export growth in the second half will most likely decline, as it becomes affected by China's belt-tightening policies and a won-value appreciation. Both consumption and facility investment are expected to post a mild recovery on the basis of a technical rebound, while the construction sector is expected to remain soft for the remainder of this year.

With the narrowing gap between export and import growth rates, the current account surplus is likely to be about 7.1 billion won in the second half, down from the 11.8 billion won recorded in the first half of the year. Consumer prices, meanwhile, should rise about 3.6%, which is similar to the first half. The slow recovery in domestic demand, the won exchange rate appreciation, and stabilizing international oil prices are expected to mitigate upward pressures from high oil prices.

Multi-faceted policy efforts will be required to boost the economy and to reduce the risk of extending the current slowdown in economic recovery into the second half of this year and beyond. In addition to additional fiscal outlay, various development projects such as the establishment of free economic zones and special enterprise cities being pursued by regional governments might provide positive stimulus to the anemic Korean economy. These measures should be afforded careful attention and support from the central government.

With the emergence of the new progressive political leadership, concerns seem natural that anti-market and equity-first policies, smacking of populism, may take hold. Though at a very early stage, discussions of a 'wealth tax' and 'compulsory social contribution funds' by businesses are worrisome examples. Such initiatives could worsen anti-business sentiment in Korea and further deteriorate the business environment. Consequently, the government and political leaders should make their positions clear regarding these issues, so as to eliminate uncertainties and serious market concerns.

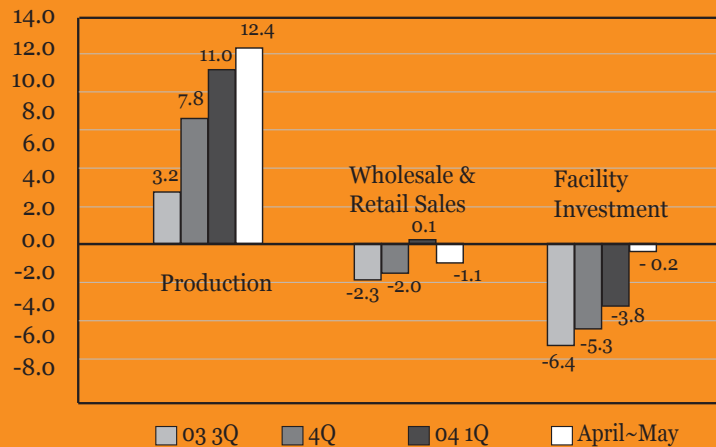
## Recent Developments

With the significant expansion of export growth, the national economy overall could experience a recovery, but this is being weighed down by the sluggishness in domestic demand, especially prevalent in consumption and facility investment.

Real GDP in the first quarter of this year rose 5.3% year on year, following 2.2% in the second quarter of last year. In this sense, growth is continuing on a gradual basis. Industrial production has managed to sustain strong growth as well.

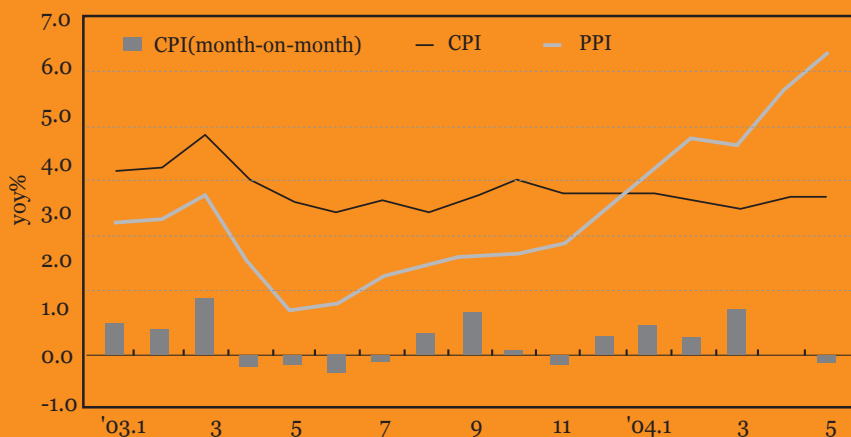
Since the private consumption, including wholesale and retail sales, is weak and facility investment stagnation continues to persist, the domestic demand slowdown remains a major unresolved problem in the new future.

Real Economy Trend (yoy%)



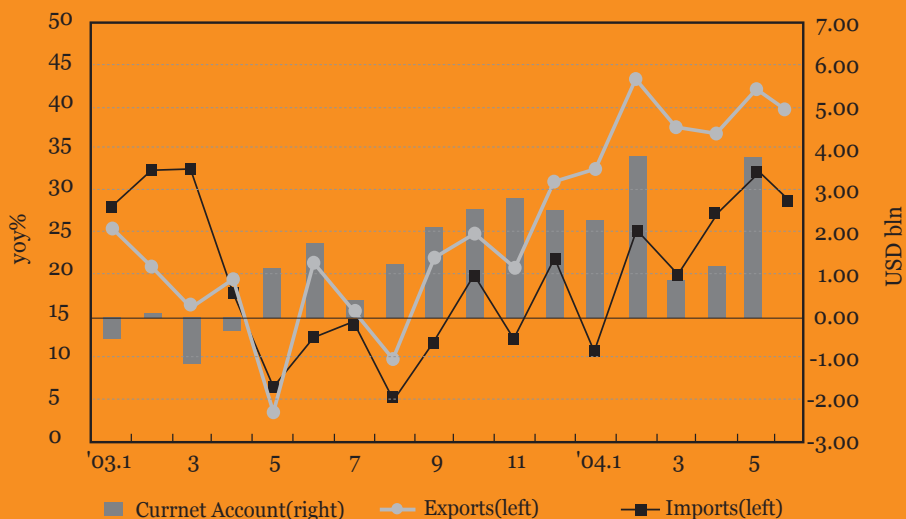
Affected by raw material price hikes, the trend of rising producer prices is quickening. On the other hand, the growth of consumer prices is at a standstill due to poor domestic demand and a fall in the prices of farm products.

### Prices Trend



The current account recorded a US\$11.0 billion surplus in the January-May period this year thanks to a sharp increase in the commodity account surplus from strong export performance.

### Trade and Current Account Balance



### 2nd Half Growth Will likely Decline to Below 5.0%

Thanks to sharp export growth, economic growth in the first half is estimated at a high 5.4%. However, a decline in the second half of this year is expected due to a sharp slowdown in the trend of export growth coupled with the delay in the recovery of domestic demand, which should result in an annual growth rate of about 5.0%.

Affected by China's retrenchment policies, a won value appreciation is expected. This, along with technical factors following the high growth rate since the second half of last year, will lead to slower export growth in the second half of 2004.

In view of the weakness in recent consumption indicators and with no significant progress in addressing the causes of the weakening consumption, employment instability and heavy household debts, private consumption in the second half also is projected to achieve only a mild recovery, barely exceeding the level of a technical rebound.

Facility investment is likely to take a favorable turn in the second half with the help of growth in machinery orders - a leading indicator, as well as investment pressure increase following brisk export progress and improvement in the financial situation of manufacturing businesses, among other factors. Nevertheless, there is a strong possibility that facility investment growth may concentrate in large export firms, thereby restricting the growth effects.

Construction investment is expected to decline in the second half of this year due to the impact of the government's reinforced restrictions on housing and real estate and also because of raw material price increases.

Consequently, the annual growth rates of items essential to domestic demand recovery - private consumption, facility investment and construction investment - will likely be at 0.6%, 2.2% and 0.1%, respectively (April forecasts were 2.2%, 5.0% and 1.5%).

Projected contributions to GDP growth by final demand items indicate that the net export contribution has been rising sharply, while the contribution of domestic demand (consumption + investment) has been declining.

### GDP Contributions (%p) by Final Demand Components

(Unit: Percentage Point)

Year	Private Consumption	Investment		Exports	Imports	Net Exports	GDP
		Facility	Construction				
2002	4.3	0.8	0.9	5.1	-5.3	-0.2	7.0
2003	-0.8	-0.2	1.3	6.4	-3.6	2.8	3.1
2004	April Forecasts <sup>2)</sup>	1.0	0.3	8.3	-5.7	2.5	5.0
	June Forecasts <sup>2)</sup>	0.3	0.0	10.0	5.9	4.1	5.0

Notes: 1) Final figures for 2002 and 2003.

2) Figures for 2004 are estimated by KERI.

## Key External Risk Factors

External factors like high oil prices and China's economic entrenchment policies might still have important negative influences. Comparatively, the impact of U.S. interest rate hikes on Korea's real economy is likely to be limited.

The high oil prices witnessed thus far are already contributing to higher domestic prices, as well as to the worsening of corporate profitability and a fall in disposable income for households. Though the recent high oil price march appears to have stalled, there is always the possibility of a recurrence if the instability in the Middle East worsens.

With China's retrenchment policies in full swing, the possibility of a rapid deceleration of export growth should not be ignored. The effect of curtailment measures is starting to appear in the sales of automobiles and other items. If curtailment effects become widespread, Korean exports to China will be adversely affected.

Due to the large-scale U.S. current account deficit and a continued U.S. trade imbalance with China, the yuan appreciation remains a critical issue. The larger its adjustment, the greater the pressure for the Korean won to appreciate.

## Consumer Prices to Rise About 3.6%

With the high level of international oil and raw materials prices and the influence of the won's foreign exchange rate, which has been so far kept high working as upward pressure on domestic prices, consumer prices will likely expand by about 3.6% in the second half of this year.

Import prices recorded sharp increases of 8.2% in April and 14.6% in May. Producer prices also rose 6.3% and 6.8% in May and June, predicting future consumer price increases.

However, a rapid price hike is unlikely based on expectations of a mild recovery of domestic demand, won currency appreciation, and slowdown in international price hikes.



## Current Account Surplus to Record US\$18.9 billion

With the gap between export and import growth rates narrowing, the current account surplus in the second half of this year will be about US\$7.1 billion, which is lower than the US\$11.8 billion achieved in the first half of the year. Nevertheless, the surplus for the whole year should reach a historic record high since the foreign exchange crisis, if we exclude 1998-99, of about US\$18.9 billion

Based on international balance of payments, the export growth rate will decline to about 15% in the second half of the year from about 35% in the first six months of this year. As a result, the annual export growth rate should register about 27%.

Due to the aftereffects of oil and raw material price hikes, imports will likely continue to grow about 25% year-on-year, following the trend in the first half.

## Long-Term Interest Rates to Remain Stable

Based on the yield ratio of three-year-maturity corporate bonds, long-term interest rates are expected to be 5.3% in the first half of this year and 5.2% in the second half, leading to an annual average of about 5.2%.

Despite an improvement in the external economic environment with the prospects for economic recovery of the U.S. and global economies, coupled with good export performance, long-term interest rates are expected to move in a narrow range as long as there is no significant improvement in investment sentiment, which has remained dull due to uncertainties generated by geopolitical risks and a delay in the recovery of domestic demand.

## Won-Dollar Exchange Rate to Decline Gradually

The won-dollar exchange rate is expected to record a slight decline to reach an average level of 1,130 won per U.S. dollar in the second half of this year from an average of 1,160 won in the first half.

Together with factors weakening the greenback, such as the U.S. budget and current account deficits, a projected expansion of the surplus in Korea's current account should, among other factors, sustain the strength of the won.

Due to the projected high growth of the U.S. economy, increases in U.S. policy interest rates, among other factors, the dollar is not expected to weaken drastically, and the won's appreciation is expected to be rather mild.

### Economic Outlook for 2004

(Unit: Year-on-Year Change %)

	2002	2003	2004				
	Year	Year	Q1	Q2	Q3	Q4	Year
GDP	7.0	3.1	5.3	5.5	4.8	4.5	5.0
Seasonally adjusted (quarter-on-quarter %)			0.8	0.3	1.0	2.4	
Private consumption	7.9	-1.4	-1.4	0.3	1.1	2.1	0.6
Fixed capital formation	6.6	3.6	1.8	1.7	0.8	-0.3	0.9
Facility investment	7.5	-1.5	-0.3	0.9	3.9	4.2	2.2
Construction investment	5.3	7.6	4.1	2.3	-1.3	-3.0	0.1
Producer prices	-0.3	2.2	4.2	5.9	5.4	4.5	5.0
Consumer prices	2.8	3.5	3.3	3.4	3.6	3.5	3.5
Current account balance (US\$100 million)	53.9	123.2	61.5	56.9	41.0	29.3	188.6
Commodity balance (US\$100 million)	147.8	221.6	86.1	98.9	71.2	53.5	309.7
Exports (US\$100 million)	1634.1	1976.4	603.8	633.6	616.6	654.7	2,508.7
Changes (%)	7.9	20.9	35.6	36.2	25.7	13.8	26.9
Imports (US\$100 million)	1486.4	1754.8	517.7	534.7	545.4	601.2	2,199.0
Changes (%)	7.7	18.1	19.6	31.2	29.1	22.2	25.3
Services, income & transfer (US\$100 million)	-93.8	-98.4	-24.6	-42.0	-30.2	-24.3	-121.1
Corporate bonds (3-yr. AA- %)	6.5	5.4	5.5	5.0	5.1	5.3	5.2
Unemployment rate (%)	3.1	3.4	3.8	3.4	3.3	3.3	3.4
World trade volume (%)	2.0	4.5					7.5

### A multi-faceted approach required to boost economy and to remove risk factors

As there are few signs that the domestic demand slowdown will be ending soon, it is desirable to maintain an expansionary policy tone.

Regarding fiscal policy, additional expenditure is necessary to support domestic demand. In organizing a revised supplementary budget, the focus should not be on the creation of simple, short-term jobs in the public sector, but on enhancing future growth potential in private as well as public sectors. Despite recent upward price pressures led by high oil prices, the central bank cannot afford to raise interest rates at the moment for at least two reasons: one, prolonged weakness in domestic demand is indeed real, and two, there are signs that current cost factors are stabilizing.

The government should consider all possible measures in addition to conventional macroeconomic policies. Since projects such as designating 'free economic zones' and 'enterprise cities' can contribute to the invigoration of the economy, it is desirable to press ahead with these projects. Other measures to stimulate regional economies must be pursued actively under the leadership of local autonomous bodies.

## Concerns over possibility of anti-market and equity-first policies must be addressed

Concerns are rising over the possibility that anti-market and equity-first priorities may take root as populism spreads in the political sphere in line with recent changes in the political landscape. The recent current of emotional, demagogic and collective expression of opinions may distort discussions on important national matters that require cool-headed analyses. Though at an early stage, growing discussions on a new 'wealth tax' targeting high-income earners, as well as creation of a compulsory 'social contribution fund' by businesses are worrisome examples.

The discussion of imposing a new wealth tax exemplifies the lack of expertise and intellectual capacity of many of its proponents. They appear to be pursuing a new popularity-seeking opportunistic system rather than trying to achieve various objectives through improvement of the existing tax system. Undoubtedly, if this goes unchecked, a new wealth tax will create further complication in the already tattered Korean tax system. Creation of a new compulsory 'social contribution fund' is another example, which is based on the view that considers enterprises as a public policy tool to achieve public goals, rather than as private entities that pursue profits.

Therefore, the government and political leaders must state their positions clearly in order to help eliminate concerns over the possibility of a change in basic policy stance regarding the preservation of the market economic system. In this regard, the President's expression of his objection to publication of the construction costs of apartments and houses, and the Ministry of Finance and Economy's raising issues with the wealth tax are very positive developments.

## Appendix: Key Statistics of Korea

### National Accounts

	GDP <sub>1)</sub>		Consumption <sub>1)</sub>		Gross Fixed Capital Formation <sub>1)</sub>			GNI per capita USD
	yoy%	Mfg. yoy%	Private yoy%	Gov't yoy%	yoy%	Construction yoy%	Facilities yoy%	
1996	7.0	6.4	6.7	8.0	8.4	7.5	9.2	12,197
1997	4.7	4.9	3.3	2.6	-2.3	2.3	-9.6	11,176
1998	-6.9	-7.9	-13.4	2.3	-22.9	-12.4	-42.3	7,355
1999	9.5	21.8	11.5	2.9	8.3	-3.7	36.8	9,438
2000	8.5	17.0	8.4	1.6	12.2	-0.7	33.6	10,841
2001	3.8	2.2	4.9	4.9	-0.2	6.0	-9.0	10,162
2002	7.0	7.6	7.9	6.0	6.6	5.3	7.5	11,493
2003	3.1	4.8	-1.4	3.7	3.6	7.6	-1.5	12,646
2003 1Q	3.7	5.1	0.3	4.0	4.6	8.0	1.9	
2Q	2.2	2.6	-1.8	3.7	3.7	7.3	-0.6	
3Q	2.4	3.3	-1.9	3.5	2.6	7.9	-5.0	
4Q	3.9	8.0	-2.2	3.5	3.6	7.4	-2.4	
2004 1Q	5.3	12.1	-1.4	2.8	1.8	4.1	-0.3	

Note: 1) constant prices

### External Transactions

	Exports (FOB)		Imports (CIF)		Current Account Balance	Foreign Exchange Reserves	Exchange Rate <sub>2)</sub>
	USD bln	yoy%	USD bln	yoy%	USD bln	USD bln	KRW/USD
1995	125.1	30.3	135.1	32.0	-8.7	32.7	771.0
1996	129.7	3.7	150.3	11.3	-23.1	33.2	804.8
1997	136.2	5.0	144.6	-3.8	-8.3	20.4	951.1
1998	132.3	-2.8	93.3	-35.5	40.4	52.0	1,398.9
1999	143.7	8.6	119.8	28.4	24.5	74.1	1,189.5
2000	172.3	19.9	160.5	34.0	12.3	96.2	1,130.6
2001	150.4	-12.7	141.1	-12.1	8.0	102.8	1,290.8
2002	162.5	8.0	152.1	7.8	5.4	121.4	1,251.2
2003	193.8	19.3	178.8	17.6	12.3	155.4	1,191.9
2004 Jan	19.0	32.5	16.2	11.5	2.3	157.4	1,184.3
Feb	19.1	43.4	17.4	25.8	2.9	163.0	1,166.7
Mar	21.2	37.7	19.1	20.3	0.9	163.6	1,166.3
Apr	21.5	36.8	18.8	27.5	1.1	163.6	1,150.9
May	20.8	42.0	17.9	32.0	3.8	166.5	1,177.4
Jun	21.9	39.6	18.6	38.6		167.0	

Note: 2) average

## Prices, Money and Wages

	PPI	CPI	M2 <sup>3)</sup>	Yield on Corporate Bonds <sup>4)</sup>	KOSPI <sup>5)</sup>	Wages <sup>6)</sup>	Unemployment Rate <sup>7)</sup>
	yoy%	yoy%	yoy%	%		yoy%	%
1995	4.7	4.4	23.3	13.8	934.9	9.9	2.1
1996	3.2	5.0	16.7	11.9	833.4	12.2	2
1997	3.8	4.4	19.7	13.4	654.5	5.2	2.6
1998	12.2	7.5	23.7	15.1	406.1	-3.1	7
1999	-2.1	0.8	5.1	8.9	806.8	14.9	6.3
2000	2.0	2.2	5.2	9.4	734.2	8.6	4.1
2001	-0.5	4.1	8.1	7.1	572.8	5.8	3.8
2002	-0.3	2.7	14.0	6.6	757.0	11.9	3.1
2003	2.2	3.6	3.0	5.4	679.8	8.7	3.4
2004 Jan	3.8	3.4	1.7	5.7	845.5	-0.3	3.3
Feb	4.5	3.3	3.0	5.6	867.5	11.5	3.3
Mar	4.4	3.1	2.9	5.4	875.6	9.2	3.4
Apr	5.5	3.3	4.4	5.3	907.1		3.4
May	6.3	3.3		5.1	798.8		3.5
Jun	6.8	3.6					

Note: 3) End of period 4) nonguaranteed bonds(AA-) 5) Jan. 4th 1980=100 6) manufacturing 7) S.A.

## Government and External Finances

	Government Finance			External Debt		Inward FDI
	Total Revenues	Total Exp. & Net Lend.	Balance			
	KRW bln	KRW bln	% of GDP	USD bln	% of GDP	USD mln
1995	72,820	71,579	0.3	119.8	2.3	1,941.0
1996	85,528	84,429	0.2	157.4	2.8	3,203.0
1997	93,368	100,327	- 1.4	174.2	3.4	6,971.0
1998	96,673	115,430	- 3.9	163.8	4.7	8,853.0
1999	107,923	120,988	- 2.5	152.9	3.4	15,542.0
2000	135,811	129,284	1.1	148.5	2.9	15,271.0
2001	144,033	136,765	1.2	130.8	2.7	11,292.0
2002	158,712	136,047	3.3	144.0	2.6	9,101.0
2003	172,226	164,086	1.1	159.8	2.6	6,467.0
2003 1Q				151.0		1,108.0
2Q				159.7		1,553.0
3Q				161.0		1,969.0
4Q				159.8		1,837.0
2004 1Q						3,049.0

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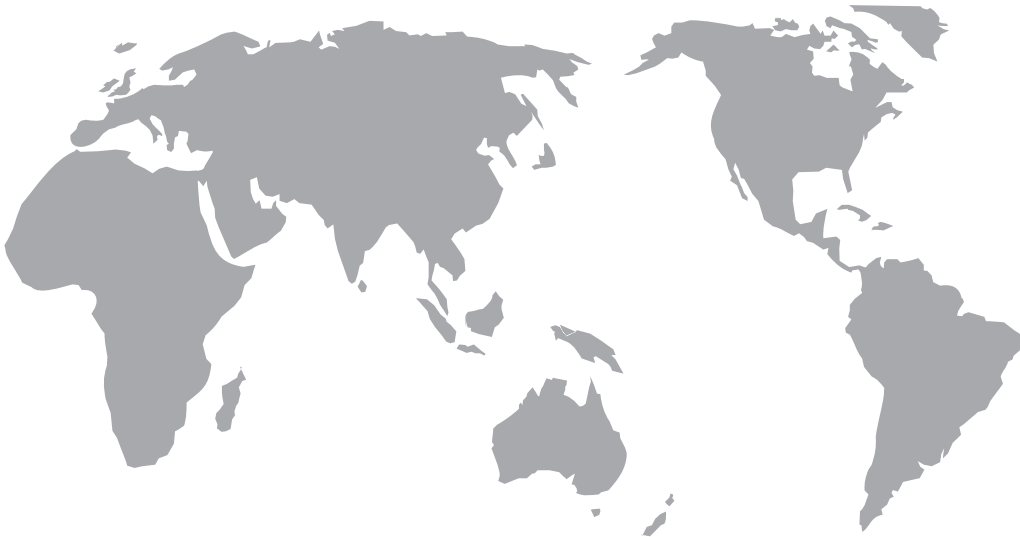
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