KERI Economic Bulletin

July 2003 No.32 Quarterly

Contents

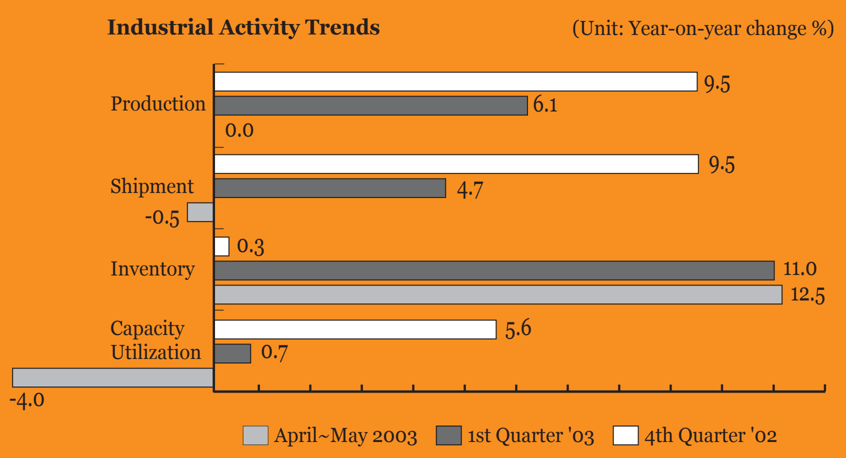
Korea Economic Research Institute

What is KERI?

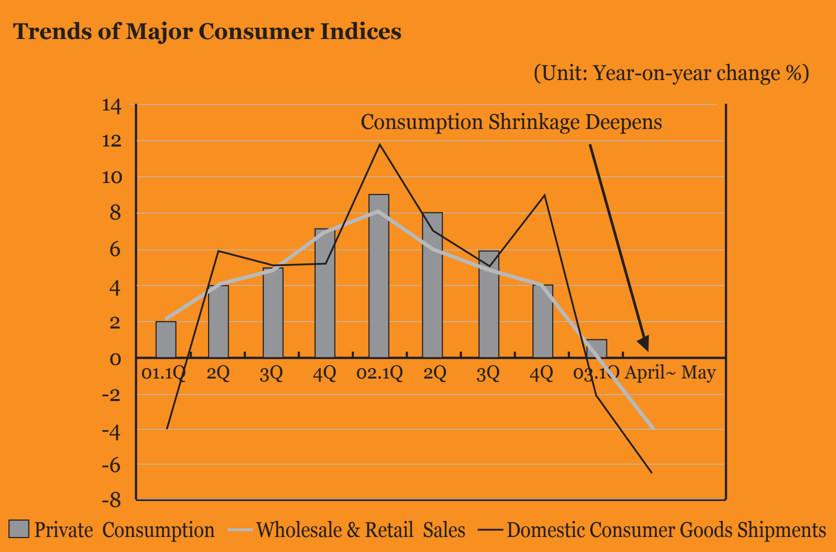
Korea Economic Research Institute (KERI), a private economic research institute, was founded on April 1, 1981. Its purpose is to contribute to the growth and development of the national economy through "the building of an efficient free-market economy system and the nurturing of healthy corporate growth." 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.”

Production, Consumption and Investment

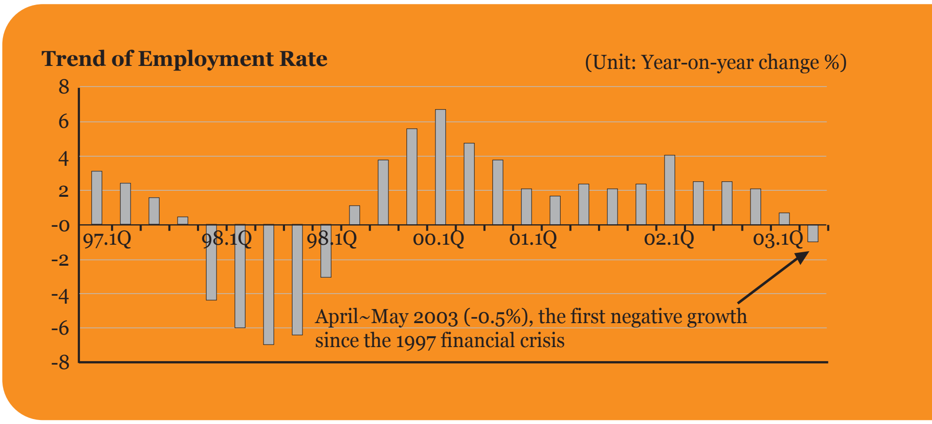
Declining growth of production output and shipments as well as increasing inventory levels have reflected a general economic stagnation since the beginning of 2003.



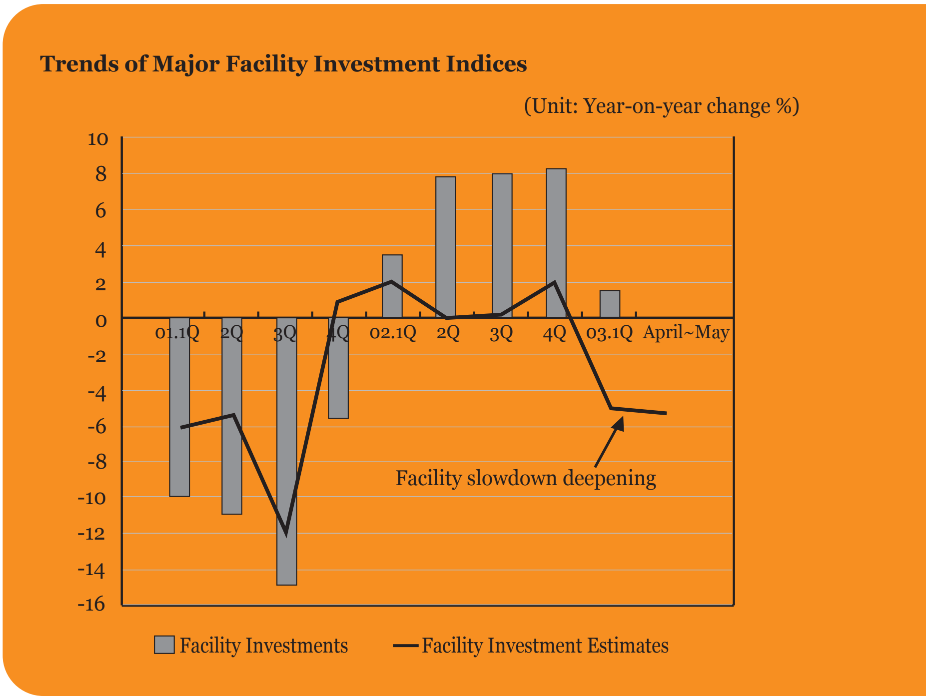
Since February, wholesale and retail sales have declined for three consecutive months, highlighting the accelerated pace of consumption contraction.



Analyses attribute consumers' increasingly tightened purses to widening concerns over a deteriorating employment situation with the dubious distinction of marking the first negative growth rate in April-May since the 1997 foreign exchange crisis. Analysts note a weakened foundation for asset income in the household sector due to increased household debt, interest rate cut, etc.



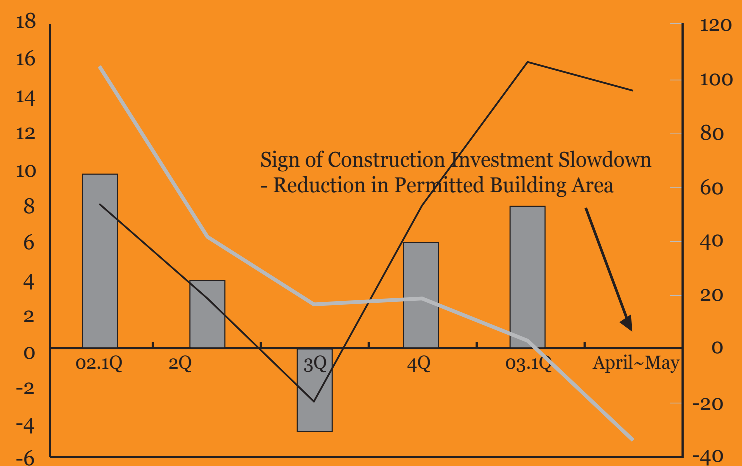
Facility investment (as estimated by the National Statistical Office) declined by 4.2% in April, on the heels of a 3.4% decrease in the first quarter, a further setback.



Construction investment growth also showed signs of a slowdown with a slight decline in progress payments in April, despite solid growth in the first quarter, and a reduction in the issuance of building permits, the leading indicator.

Trends of Construction Indices

(Unit: Year-on-year change %)



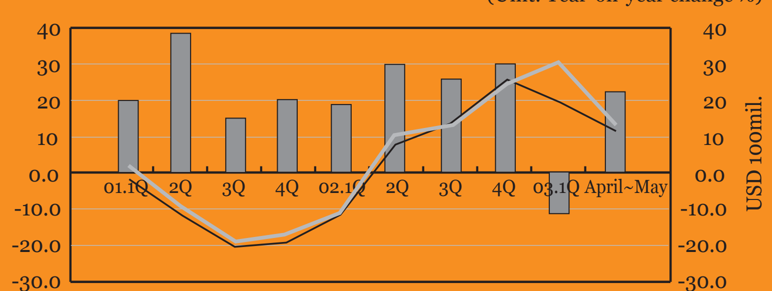
Construction Investment (left)
Value of Construction (left)
Construction Permit Area (right)

Exports, Imports and Current Account Balance

Due to a significant slowdown in import growth in April-May, led by the fall in international oil prices and sluggishness in domestic demand, the trade balance, having posted deficits for three consecutive months in Q1, reversed course to a surplus.

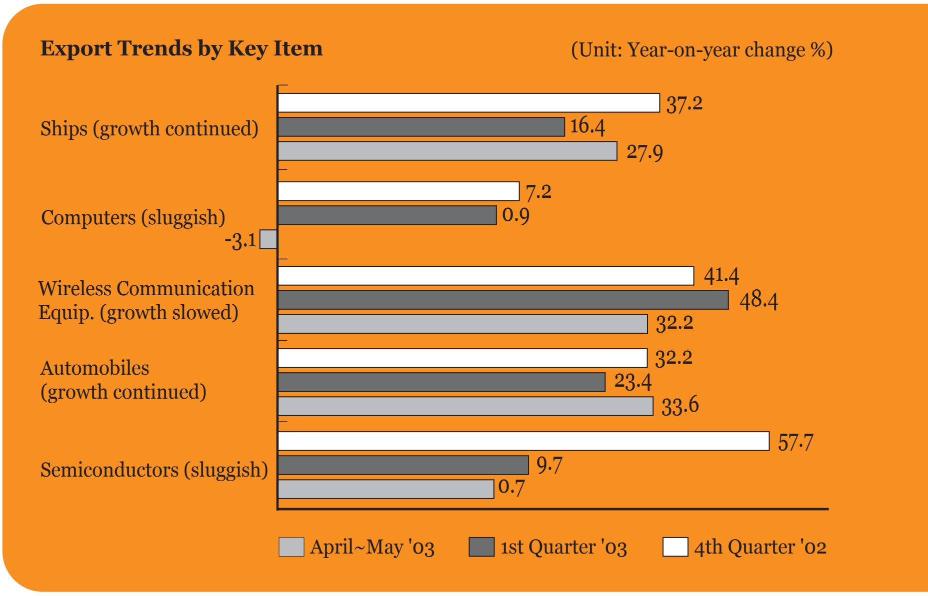
Trends of Imports, Exports and Trade Balance

(Unit: Year-on-year change %)

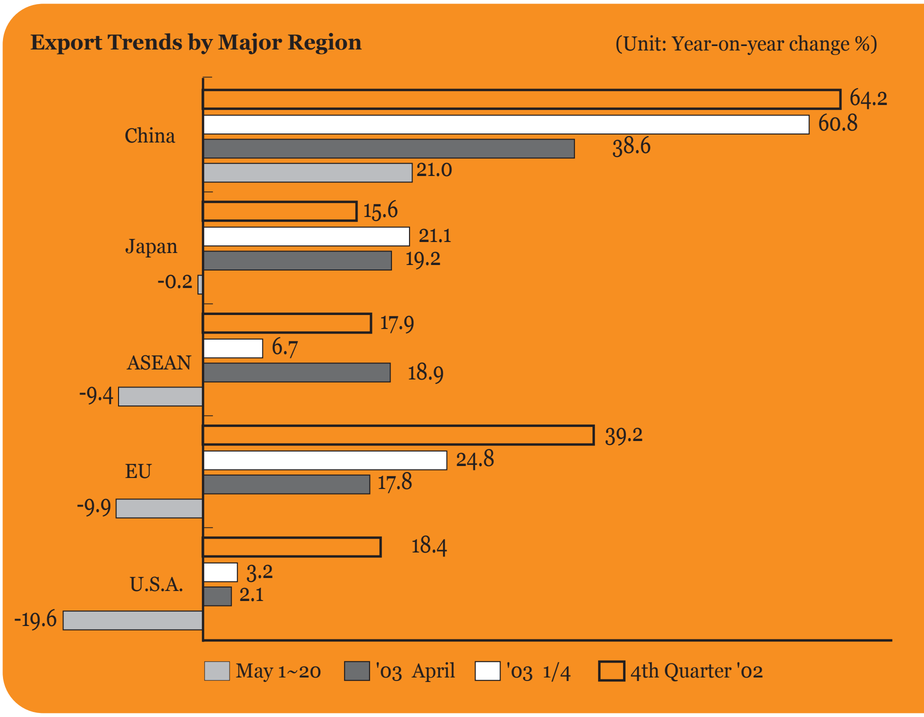


Trade Balance (US$100 mil.) — Exports (y-o-y %) — Imports (y-o-y %)

In terms of exports of key items, automobiles continued their strong performance while growth in wireless communication equipment slowed. Semiconductors and computers managed only slight progress.



By major region, exports to the United States, Japan, EU and ASEAN skidded on a downward trend and exports to China slowed significantly, adversely affected by SARS in particular.



The current account balance has recorded five consecutive months of deficits since December of last year, with a reduced commodity balance surplus amid a continuing deficit trend in the services balance.

Current Account Balance

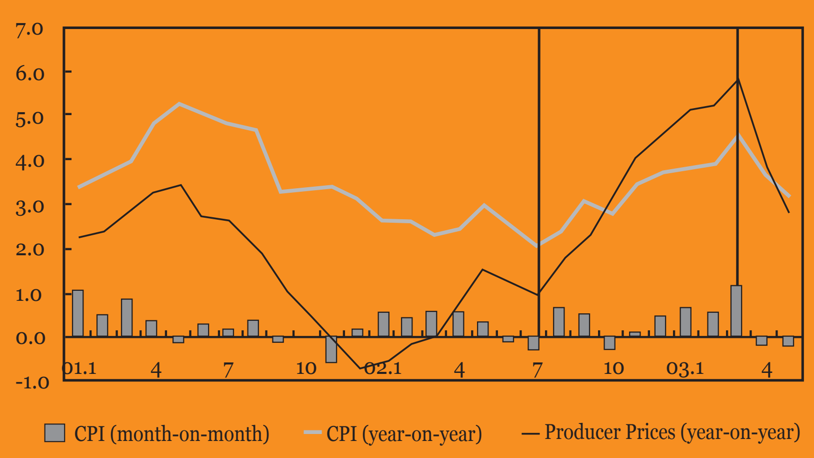
(Unit: US$million)

	2002					2003					
	1/4	2/4	3/4	4/4	Year	Jan.	Feb.	Mar.	1/4	Apl.	May
Current Account Balance	15.9	16.0	9.3	19.7	60.9	-4.2	-1.1	-11.9	-17.2	-3.7	11.8
Goods Trade Balance	31.2	43.7	28.3	38.7	141.8	7.9	5.0	-0.6	12.3	12.7	16.9
Service Balance	-15.0	-16.0	-22.2	-21.4	-74.6	-11.9	-8.9	-5.0	-25.7	-3.5	-5.0
Income Balance	0.2	-8.8	6.4	6.6	4.5	2.8	4.6	4.3	3.1	-12.0	2.3
Current Transfer	-0.5	-2.9	-3.2	-4.2	-10.8	-3.0	-1.8	-4.8	-2.0	-0.8	-2.3

Prices

The upward price trend since August last year significantly slowed after the first quarter of this year. The consumer price increase rate, reported at 4.5% in March, fell to 3.7% in April and 3.2% in May, compared with the same months of 2002, thereby posting two consecutive months of decline in April and May from the preceding months.

Trends of Prices

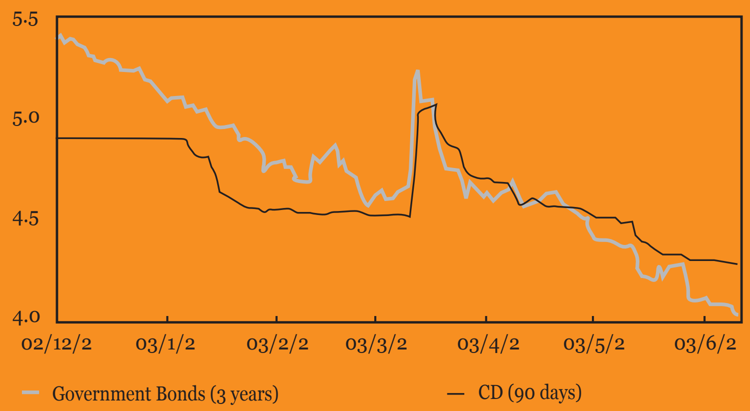


The current price slowdown is attributed to greatly weakened price push pressure on the expenditure side owing to the downward stabilization of international oil prices and the won-dollar exchange rate in tandem with price-reducing factors on the demand side, triggered by a deeper setback in domestic demand.

Interest Rates and Foreign Exchange Rate

Long-term market interest rates, including the yield on government bonds (3-year maturity), have sustained a downward trend since mid-December of 2002 due to uncertainties pertaining to future domestic economic prospects, contraction in the issue of long-term bonds, continued instability in financial markets, a reduced call interest rate on May 13, etc.

Short & Long-Term Interest Rate Trends



The won-dollar exchange rate, having boasted an upward trend since February due to the U.S. war in Iraq and the North Korean nuclear standoff, continued a decline that began in April, affected by a weaker U.S. dollar due to delay in the recovery of the U.S. economy, accumulated current account deficits and a sustained low-interest rate policy.

Won-Dollar Exchange Rates

Outlook for 2003

Real Sector

Due to persistent slowdowns in consumption, investment and exports, the economic growth rate for 2003 is projected at 2.9%, less than half of the rate recorded last year.

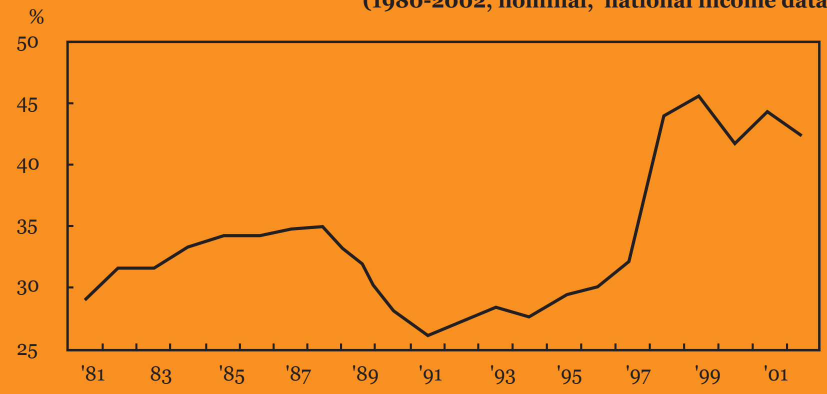
- The sharply falling trend of real economic indicators in the second quarter follows a similar pattern in the first quarter and signals the negative growth of our economy with the strong implication of an impending recession.

- Contraction in consumption is likely to continue amid an unimproved employment situation; the basic reason for chilled consumption being employment uncertainty. The employment growth rate turned negative in April and is expected to heighten concerns over the stability of labor income, the principal income source in the household sector.

- A pattern of stagnant investment is expected to continue into the second half as the investment sentiment of enterprises is unlikely to recover in the short term, due to uncertain internal and external economic conditions, a lack of confidence in government policies, etc. The previously promising trend in total capital volume appears to be declining significantly due to the investment slowdown. The rate of depreciated fixed capital assets against new investment fell to less than 30% until the foreign exchange crisis but has exceeded 40% since 1998, showing that the increase rate of total capital stock has plummeted to that extent.

- Exports, which constitute the primary factor in maintaining the present economic pitch, also are likely to post limited growth, affected by uncertainty over the U.S. economic recovery and the economic slowdown in the Chinese sphere.

Trends of Capital Depreciation / New Investment Ratio
(1980-2002, nominal, national income data)

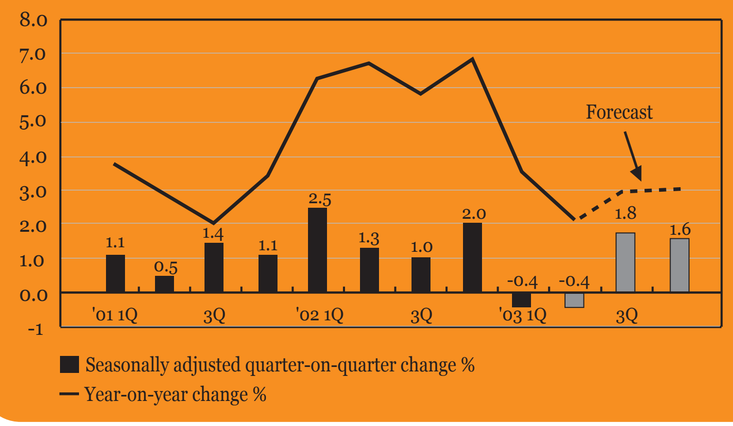


The annual economic growth rate will fall sharply to the 2% level in contrast to last year. In terms of quarter on quarter, however, the economy is expected to enjoy a mild recovery, with the second quarter seen as the bottom.

- Korea's economy, with consecutive negative growth anticipated in the first and second quarter, will achieve 1.8% and 1.6% growth in the third and fourth quarters, respectively, over the preceding quarters. This indicates that the second half will post a modest recovery, pale in comparison with past economic recovery periods, yet a gradual improvement.

- Of course, such a recovery trend is based on the assumption that the government's economic stimulus policies, such as yet another round of interest rate cuts and the execution of a revised supplementary budget, will have the desired effect on the economy.

Real GDP Growth Trends



Prices

Consumer price growth is likely to gradually slow to slightly over a 3% annual increase rate in anticipation of international oil price and won-dollar exchange rate stabilization and continued total demand contraction.

External Transactions

The current account balance is expected to post an estimated US$900 million deficit since the deficit trend in the services balance, etc. is likely to continue. This projection is made despite the anticipation of a continued commodity balance surplus amid a slowdown in imports driven by oil price decline, domestic demand contraction, etc.

- The trend of import growth (30.7%) far outpacing export growth (21.5%) ended in April in line with the international oil price cut.

- Regarding the services balance composition, deficits in travel, communications, insurance, etc. are expected to continue expansion for the time being, in light of the external competitiveness of these sectors.

Finance

Long-term interest rates are expected to fall below the present level this year due to a delayed economic recovery caused by a slowdown in prices and shrinkage of consumption and investment sentiment, and despite the de facto end of the U.S. war on Iraq. Based on the yield rate of three-year corporate bonds, the long-term interest rate is likely to settle at 5.1%, leading to an annual average of 5.2%.

The weakening dollar reflecting a delayed U.S. economic recovery, accumulation of current account balance deficits and maintenance of a low-interest rate policy, will work as factors to strengthen the won currency. On the other hand, an economic recession caused by diminished domestic demand and a projected worsening of the current account balance would constitute factors to weaken the won. In the event of a collision of these factors, the won-dollar exchange rate is expected to fluctuate around the 1,200 won/dollar level.

Economic Outlook for 2003

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

	2002	2003				
	Year	1/4	2/4	3/4	4/4	Year
GDP	6.3	3.7	2.2	2.9	3.0	2.9
Total Consumption	6.2	1.2	-0.3	1.0	1.5	0.9
Private Consumption	6.8	0.9	-0.7	0.8	1.3	0.6
Fixed Capital Formation	4.8	4.8	1.3	2.6	3.3	3.0
Facility Investment	6.8	1.6	-1.8	2.4	4.4	1.6
Construction Investment	3.3	8.1	4.0	2.9	2.5	4.1
Total Exports	14.9	17.3	9.5	6.7	3.3	8.9
Total Imports	16.4	18.0	11.3	8.6	5.8	10.7
Producer Price	1.6	5.4	3.2	2.4	1.0	2.9
Consumer Price	2.8	4.2	3.3	2.8	2.4	3.2
Current Account Balance	60.9	-17.2	-1.2	2.3	7.1	-8.9
Goods Trade Balance	141.8	12.3	43.0	27.6	29.9	112.8
Exports	1,625.6	445.1	448.8	442.5	461.6	1798.0
Change (%)	7.5	23.5	10.6	8.1	2.5	10.6
Imports	1,483.7	432.8	405.8	414.9	431.7	1685.2
Change (%)	7.7	31.5	12.1	8.9	4.9	13.6
Service, Income & Transfer Balance	-80.4	-29.5	-44.2	-25.2	-22.7	-121.7
Won/US$ (Avg.)	1,251.8	1202.1	1208.5	1196.7	1194.1	1200.3
Corporate bond (Avg.,%)	6.6	5.4	5.2	5.1	5.1	5.2

Remove Uncertainty from the Domestic Economy

- Concerted efforts should be made to solidify the Korea-U.S. mutual cooperation to deal with the North Korean nuclear problem and to buttress the external confidence in Korea.

- Consistency and confidence are paramount requirements in the establishment and implementation of economic policies, so policy cooperation between related ministries is an utmost priority.

- The reform policies of the "participatory government' have to be market-friendly and current economic conditions and realities should be taken into consideration . Also, the government needs to recognize that dire economic consequences will follow if the militant union actions continue unchecked.

Stimulus Policies Should Be Continued

- Domestic economic policies must be managed in light of the possibility that real GDP growth may continue to slow in the second quarter, dragging the economy into recession, and in recognition that the economy may continue to decline.

- The government should clarify its policy direction in accordance with the fortunes of the economy and promote a lower policy interest rate on a consistent and gradual basis to maintain policy stability. It also should adopt an expansionary monetary policy to lessen risk to the direct monetary supply vis-a-vis corporate bonds and drafts.

- The early execution of budgets, presently underway, must be monitored more closely. If economic recovery stalls in the second half, a revised supplementary budget and deficit fiscal policy should be considered to compensate for insufficiency in fiscal expenditures that could arise due to the early expenditure of the budget in the first half.

Strengthen Efforts to Invigorate Corporate Activities

Concerted efforts are required in the following areas:

- Joint efforts should be undertaken to establish a balanced labor-management relationship based on rule of law, the introduction of working condition systems matching international standards and to maintain industrial labor peace between government, business and labor communities, while endeavoring to reinforce flexibility in the labor market.

- To encourage foreign direct investment, the government should lower corporate taxes to the level of investment-competing countries and expand various investment tax reduction measures to increase the effect on corporate investment policies.

- Efforts should also be made to stimulate corporate investments and improve economic conditions through the elimination of investment restraint factors, together with the improvement of rigid systems and the relaxation of regulations.

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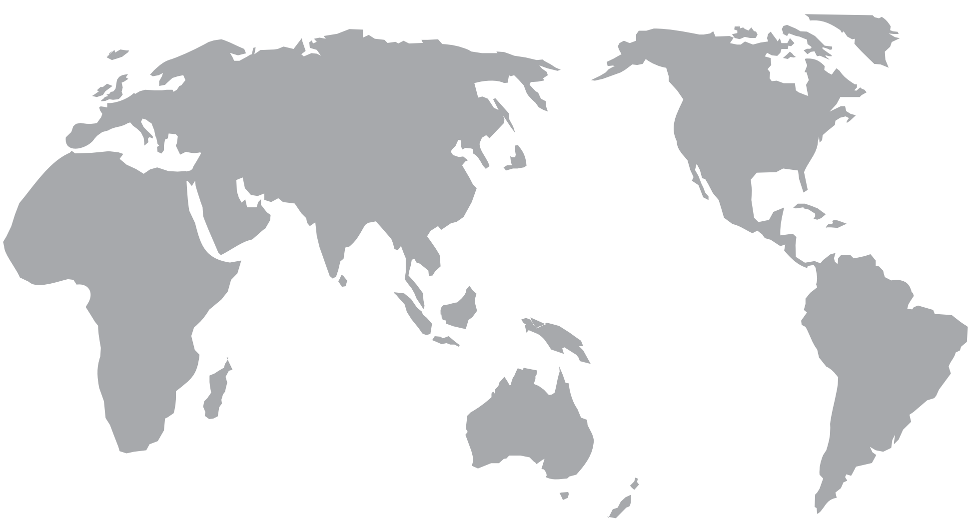

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