KERI Economic Bulletin

May 2004 No.35 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.”

Executive Summary

The Korean economy in 2004 is projected to achieve 5.0% growth, higher than the 3.1% recorded in 2003, with a slight recovery in domestic demand due to a technical rebound from the sluggishness of last year and strong exports leading the growth.

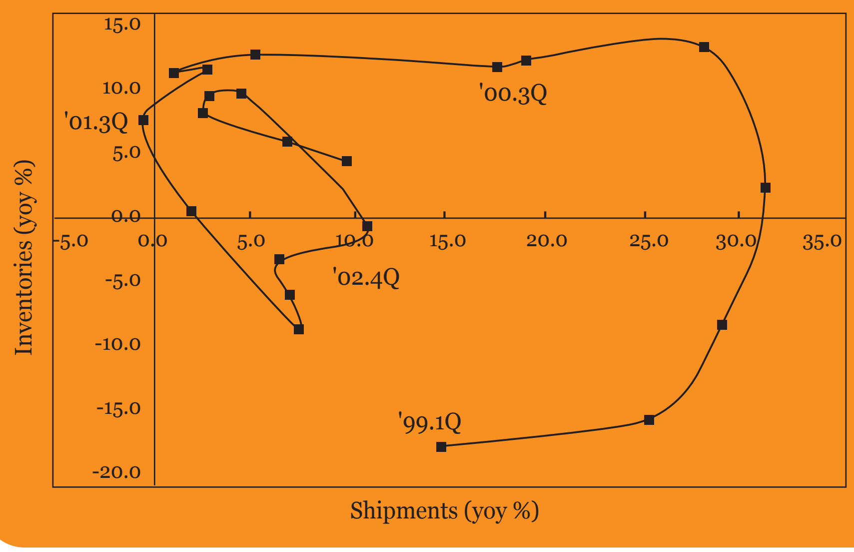
Owing to a significant increase in exports, meanwhile, the surplus in the current account is expected to reach about US$14 billion, exceeding the US$12.3 billion of last year, while consumer prices will likely climb 3.5% in the aftermath of imported raw material price hikes, including international oil prices.

However, a confluence of downside risk factors could substantially lower our growth projection to as low as around 4% with inflation flare-up in the worst case. To list those in the order of their potential impact: high oil prices; a sharp deceleration of the Chinese economy and repercussion of possible revaluation of the Chinese renminbi.

Also, concerns remain about a shift in government policy on wide ranging issues in the aftermath of the ascendency of the new ruling party with many left-of-the-center members, as well as the leftist Democratic Labor Party. Any discrete movements of the policy orientation of the government is likely to dampen business sentiments further and extend the current sluggish trend in investment and employment.

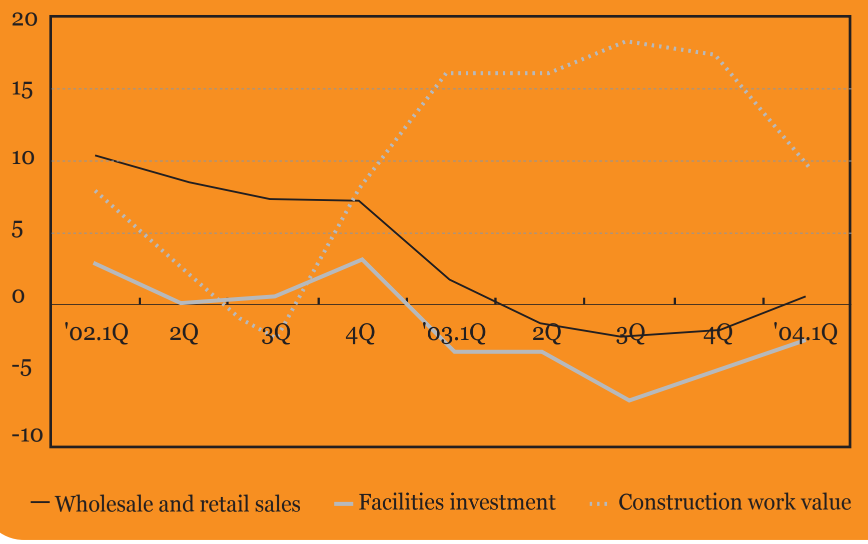
With last year's second quarter seen as a trough (2.2%), real GDP growth has gradually expanded reaching 2.4% in the third quarter and 3.9% in the fourth quarter. Since the third quarter last year, the trends of shipments and inventories have followed the traditional expectations of an economic recovery period - a rise in the shipment rate and decline in inventory growth since the third quarter of 2003.

Shipments-Inventories cycle shows recovery



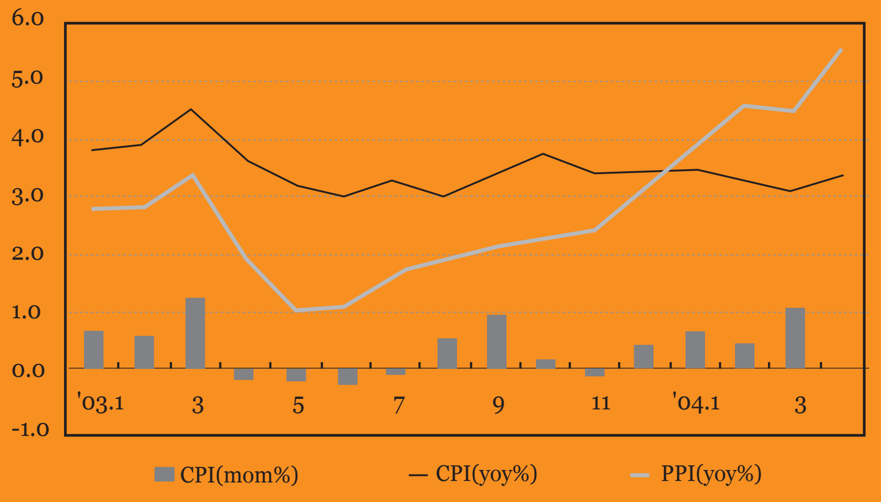
Due to persisting weaknesses in domestic demand, however, economic recovery remains slow and, consequently, the recovery of economic sentiment has been delayed. In addition to wholesale and retail sales and facility investment still showing poor progress in the first quarter of this year, the indicators of construction activities have also sharply declined. The Federation of Korean industries (FKI) BSI (Business Survey Index) has been fluctuating above and below the standard level of 100, with the consumer expectation index still below 100 despite some improvement.

Domestic demand remains sluggish



Prices are moving up sharply as a result of higher oil and other commodity prices. Consumer prices soared 2.1% in the January-April period alone, and producer prices also jumped to the 5% level in April.

Prices rise



Thanks to the significant growth in the goods account caused by strong export performance, the current account surplus was US$ 6.2 billion in January-March this year.

Current Account Surplus continues

	2003		2004			
	Jan.~Mar.	Year	Jan.	Feb.	Mar.	Jan.~Mar.
Current Account(USD Bil.)	-15.2	123.2	23.4	28.9	9.7	62.0
Goods	12.4	221.6	29.8	30.0	26.9	86.6
Service	-23.0	-76.1	-7.7	-4.6	-6.5	-18.8
Income	2.5	6.0	3.5	5.9	-7.2	2.3
Current transfers	-7.2	-28.2	-2.2	-2.4	-3.4	-8.0

Baseline Outlook

Real GDP to Grow 5.0% Due to Strong Exports and Technical Rebound in Domestic Demand

While exports are leading economic growth, the domestic demand sector will likely recover although at a slower pace. As a result, in 2004, the Korean economy is expected to achieve a high growth rate of 5.0%, compared with 3.1% in 2003. The contributions by the final demand components are illustrated in the table below.

In strong contrast to 2002, when growth was led by domestic demand, the 3.1% growth in 2003 was mostly accounted for by an increase in net exports (2.8%). In the projected 5% growth for 2004, both net exports and domestic demand increases are expected to contribute an equal 2.5% each.

Contribution of Components to Real GDP Growth

(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*	1.0	0.5	0.3	8.3	-5.7	2.5	5.0

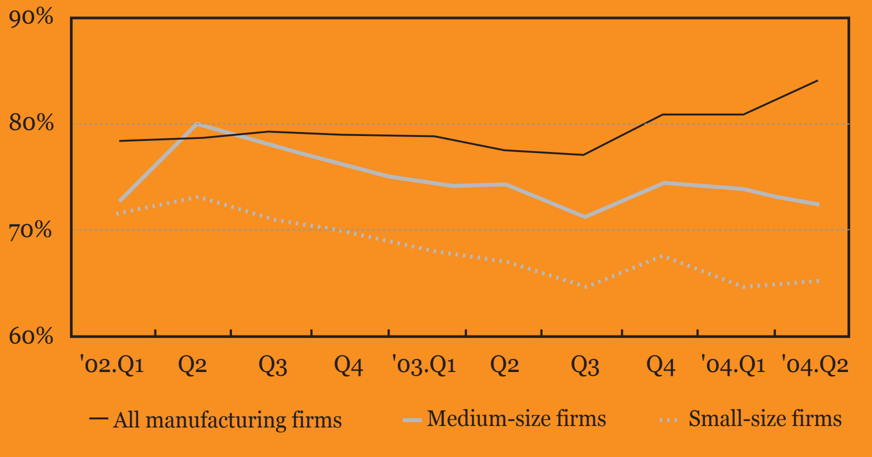
*: *KERI projection.*

In addition to the continuation of the strong performance of Korea's exports to China, exports to advanced countries, including the United States, are projected to grow noticeably. Consequently, the nation's exports are expected to record significant growth of 22.0% (customs-clearance basis).

The recent slump in domestic demand was caused by structural factors such as burdens from a sharp increase in household debt and income insecurity owing to sluggish employment growth whose resolutions will take some time.

Some observers have pointed to the recent trend of high capacity utilization rate as a precursor to imminent investment recovery. However, a closer look at the composition of the headline utilization rate tells a different story. In sum, small and medium sized firms are operating at a much lower capacity utilization rate and furthermore, they seem to be on a declining trend.

Capacity Utilization Ratio of Manufacturing Industries



Note: Medium-size firms (50~299 employees), Small firms (5~49 employees).

Consumer Prices to Rise 3.5% in Aftermath of Import Price Hikes

Rises in the prices of crude oil and raw materials and the won-U.S. dollar exchange rate, which has thus far maintained a high level, will put upward pressure on domestic prices. Consequently, consumer prices this year will likely rise 3.5%.

The PPI and import prices have risen more sharply than the CPI so far this year and are expected to rise further. The headline CPI inflation is likely to turn out much higher than our current projection if oil prices remain at the US$40 a barrel or higher.

Current Account Balance Surplus to Reach About US$14 Billion

The 2004 current account balance surplus is projected at about US$14 billion, thanks to significant export growth, surpassing last year's surplus of US$12.3 billion.

Given Korea's complete dependence on imported oil, high oil prices remain the most prominent risk factor that could negatively affect current account balance going ahead.

Long-term Interest Rates Will Rise, Expecting Economic Recovery

Long-term interest rates are likely to rise mildly with the improvement in investment sentiment more or less in expectation of a future domestic economic recovery owing to the strong export performance.

Based on the three-year-maturity corporate bond yield rate, long-term interest rates are expected to register 5.7% in the first half and gradually rise to 5.9% in the second half to reach an annual average increase rate of 5.8%.

Won-Dollar Exchange Rate to Decline Slightly

Large and persisting U.S. current account deficits will likely exert downward pressures on the exchange value of the U.S.dollar. Nevertheless, the pace of weakening is not expected to be very fast and night not even be driven by growing expectations of early interest rate hikes in the U.S..

The won-dollar exchange rate is expected to slowly drop to an average of 1,138.1 won from last year's 1,191.7 won due to a rise in won currency value. If the Chinese yuan appreciates, a further appreciation of the won against the dollar is likely.

Domestic Economic Outlook, 2004

(Unit: Year-on-Year Change %)

	2002	2003					2004				
	Year	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Year
GDP	7.0	3.7	2.2	2.4	3.9	3.1	5.3	5.0	5.1	4.9	5.1
Seasonal adjustment (month-on-month %)	6.9	-0.3	-0.1	1.6	2.7	3.1	0.8	0.1	1.7	2.6	5.1
Private consumption	7.9	0.3	-1.8	-1.9	-2.2	-1.4	-1.4	1.6	2.9	3.5	1.7
Fixed capital formation	6.6	4.6	3.7	2.6	3.6	3.6	1.8	2.1	4.5	4.0	2.8
Facility investment	7.5	1.9	-0.6	-5.0	-2.4	-1.5	0.3	2.5	9.9	9.1	5.1
Construction investment	5.3	8.0	7.3	7.9	7.4	7.6	4.1	1.7	1.2	0.9	1.7
Producer prices	-0.3	3.0	1.3	1.9	2.6	2.2	4.2	4.8	4.9	4.0	4.5
Consumer prices	2.8	4.1	3.4	3.2	3.5	3.5	3.3	3.4	3.7	3.5	3.5
Current account balance (US$100 million)	53.9	-15.2	24.3	37.6	76.6	123.2	62.0	25.4	24.9	20.6	138.1
Commodity balance (US$100 million)	147.8	12.4	57.6	68.2	83.4	221.6	86.6	64.3	56.2	47.5	254.7
Exports (US$100 million)	1634.1	445.4	465.2	490.5	575.3	1976.4	604.1	581.3	585.9	627.2	2398.5
Changes (%)	7.9	23.0	13.9	19.2	27.2	20.9	35.6	25	19.4	9.0	21.4
Imports (US$100 million)	1486.4	432.9	407.7	422.3	491.8	1754.8	517.8	517.0	529.6	579.7	2143.8
Changes (%)	7.7	31.4	12.1	10.8	19.4	18.1	19.5	26.8	25.4	17.9	22.2
Services, income & transfer (US$100 million)	-93.8	-27.7	-33.3	-30.6	-6.8	-98.4	-24.6	-39.0	-31.3	-26.9	-116.6
Corporate bonds (3-yr. AA %)	6.5	5.4	5.3	5.6	5.4	5.4	5.6	5.7	5.8	6.0	5.8
Unemployment rate (%)	3.1	3.6	3.3	3.3	3.4	3.4	3.8	3.7	3.6	3.5	3.6
World trade volume (%)	2.1					4.5					7.5

Down-side Risks for Korean Economy

Domestic Factor: 'Equity' at the expense of 'Growth'?

With the ascendency of the left-of-the-center ruling party and the leftist Democratic Labor Party after the April National Assembly general election, issues that have been espoused by labor unions are likely to surface at the forefront. One contentious issue that is already gathering steam is the raising of wages of irregular (i.e., part-time and temporary) workers to 85% of that of regular workers. This issue has potential for wide ramification as the proportion of irregular workers has rapidly grown since the 1997 financial crisis in Korea.

This measure is expected to cost about 20 trillion won per year according to an estimates by an economist at the Korea Institute of Finance. We expect such a measure will lower Korea's GDP by about 4 trillion won, about 0.6% of the current GDP. In addition, such a measure without a discrete improvement in labor market flexibility and additional adjustments, such as freezing of wages of regular workers, is expected to further slow down employment growth in Korea in the future.

External Factor: High Oil Price

Two factors make high oil prices particularly burdensome to the Korean economy. The first is Korea's near 100% dependency on imported oil. And the second is that Korea has emerged as one of top ten consumers of oil even surpassing Brazil, Canada, and France. Our current forecast are based on the assumption that oil prices will fall to US$30 per barrel (using Dubai crude). If oil prices remain at the current level in the remainder of the year, our growth projection for 2004 would be lowered by at least 0.3%.

External Factor: China Syndrome I, Hard Landing

China has emerged as the biggest market for Korean exports as of 2003, making up 18.1% of the total exports. The weight goes up close to 30% once both exports to Hong Kong and Taiwan are added. Thus a sharp deceleration of the Chinese economy is expected to have a substantial effect on Korean exports as well as on overall growth. If Korea's exports to China slow down by about 10% (that is, 20% increase instead of 30% as assumed in our forecast), then the 2004 growth rate will be lowered by about 0.4 to 0.6%p.

External Factor: China Syndrome II, Revaluation of Yuan

With the formation of an international consensus that the yuan is undervalued, Chinese authorities are signaling the possibility of a change in its foreign exchange rate system. If it is judged that a yuan appreciation would be conducive to a soft-landing for the Chinese economy, appreciation measures could become effective at an early date.

As a yuan appreciation would play a catalytic role in bringing about an appreciation of other currencies in Asia, an additional appreciation in the won-dollar exchange rate also would seem unavoidable. This would slow down Korean economic growth by way of a net export reduction.

If the won-dollar exchange rate in the second half appreciated by 5% versus the basic projection (Japanese yen appreciation assumed at 3%), estimates are that Korean GDP would be 0.2% lower with consumer prices also 0.2% lower, while the current account balance is projected to worsen by about US$2.1 billion due to the decrease in net exports.

Economic Effects of 5% Won-Dollar Exchange Rate Appreciation

	3rd Qtr., 2004	4th Qtr., 2004	2004 (Annual)
GDP (percentage point)	-0.3	0.45	-0.2
Consumer Prices (percentage point)	-0.27	0.46	-0.18
Current Account Balance (US$100 million)	-8.9	-12.2	-21.1

More focused efforts to reflate domestic demand are needed

It is uncertain whether the recent up-tick in few economic indicators is simply a passing reflection of the front-loaded fiscal expenditures and brisk export performance or a more durable sign of things to come. The budget implementation in the first quarter of this year was 43.4 trillion won, an increase of 4 trillion won (about 2% of the quarter's GDP) compared with 39.4 trillion won in the same quarter of last year.

Despite the current breakneck pace increases, high oil prices and the China factor could worsen the Korean economy's external environment quite substantially. Furthermore, chances of a visible recovery in domestic demand still appear slim. Factors behind weak consumption and investment spending do not appear easily mendable. A rebound in consumption would be possible only when we see improvements to at least some parts of the following situation; sluggish income growth following worsening of employment, excessive household debt, and large number of consumers with credit problems. The same can be said about capital spending. Instability in labor-management relations, and other poor business conditions are critical.

Despite apparent difficulties, reflating domestic demand becomes more and more important especially when the external environment is expected to worsen in the near term. Both fiscal and monetary policies should be part of such an effort. Fiscal stimulus should not be restricted to increases in spending but extended to lowering personal as well as corporate income taxes. Monetary policy is going to face a difficult choice when prices rise while aggregate demand stall or contract. However, responses should be measured carefully as there exists a distinct risk of higher interest rates that could surely prolong economic weakness. It is worrisome to see long-term interest rates falling even when prices are moving up. Expectations of weakness in the economy going forward seem to overwhelm those of near term inflation.

More exchange rate flexibility should be allowed now in view of risk factors that could affect the Won value in the near future. A more accurate indication of market pressures on the exchange rate should be given to market participants so they can prepare for changes to come. This can be best achieved by removing rigidities induced by policy. An extreme rise in exchange rate volatility in the near future might call for genuine market stabilization role of foreign exchange authorities.

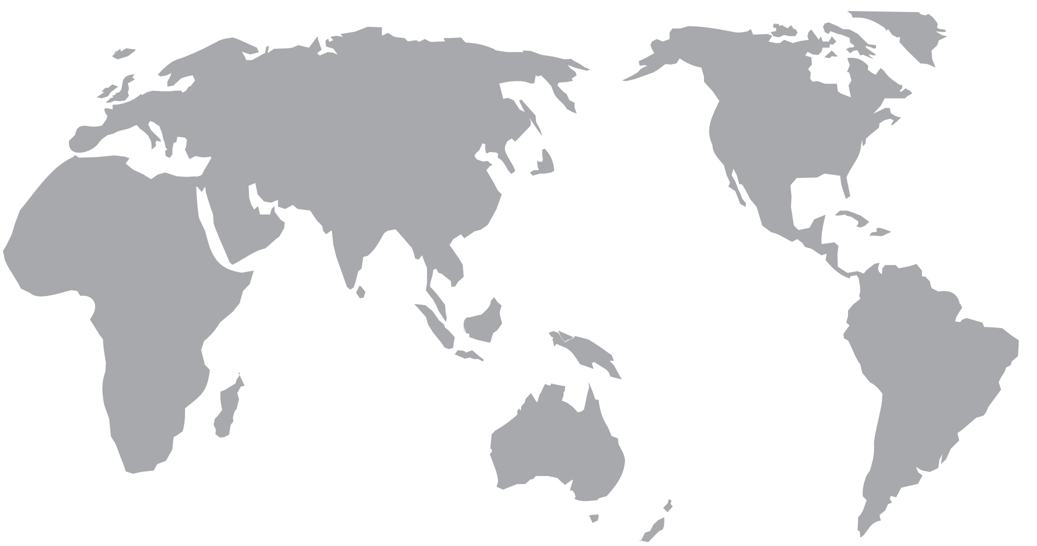
Efforts to enhance the efficacy of macroeconomic policies must be accompanied by microeconomic policies to stimulate corporate investment. Instead of making sporadic and piecemeal deregulation attempts, various regulations and restrictions on businesses should be examined with a firm focus on boosting investment and creating jobs. In a similar vein, hasty attempts to put 'equity' issues ahead of 'growth', could bring about a prolonged economic slump, which at the end would have an adverse effect on the standard of living of everybody, including most certainly the less well-to-do persons.

KERI Economic Bulletin
is published quarterly by Korea Economic Research Institute,
FKI Building, 28-1 Yoido-dong, Yeongdungpo-ku,
150-756 Seoul, Korea.
Tel : (82-2)3771-0001, FAX : (82-2)785-0270/1

www.keri.org

Publisher : Jwa Sung-Hee
Editor : Huh Chan-Guk
Co-Editor : Kim Chang-Bae
Research Team: Huh Chan-Guk
Bae Sang-Kun, Kim Chang-Bae,

Designed by Blue-Ribbon Content & Strategy (BCS)
Phone: (82-2)6258-7870/3 Fax: (82-2)6258-7877



KERI Economic Bulletin

Korea Economic Research Institute

FKI Building, 28-1 Yoido-dong, Yeongdungpo-ku, 150-756 Seoul

Telephone:(82)(2)3771-0001