KERI

Economic Bulletin

July 2002 No.28 Quarterly

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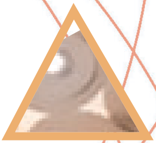
Korea Economic Research Institute

What is KERI?

The Korea Economic Research Institute (KERI) was founded in 1981 upon the basic philosophy, "Free Market, Free Enterprise, Free Competition." KERI is committed to the development of the national economy through the encouragement of principles inherent in a free-market economy.

For over 30 years our scholars have conducted integrated research on all vital aspects of the Korean economy with a special focus on both short-term and long-term prospects for corporate growth.

The soundness of KERI's scholarship and its uncompromising defense of the efficiency of an unfettered marketplace have given the institute a stature of global significance.

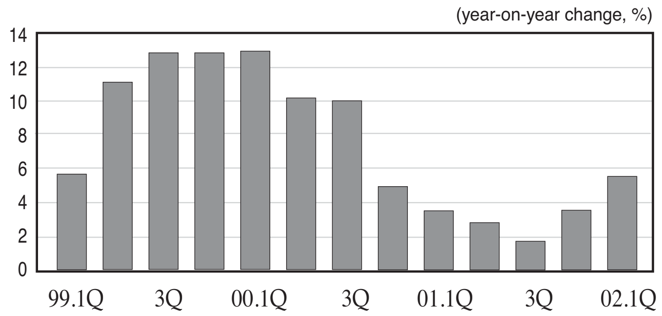


Real Economy Sectors

Recovery Continues

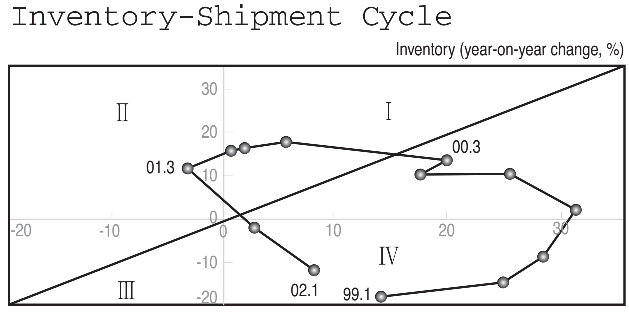
The Korean economy continues unabated on its road to recovery from the nadir recorded in the third quarter of 2001. Last year the real GDP growth rate stood at 1.9% in the third quarter but rose to 3.7% in the fourth quarter and climbed to 5.7% in the first quarter of 2002, picking up steam quickly.

Real GDP



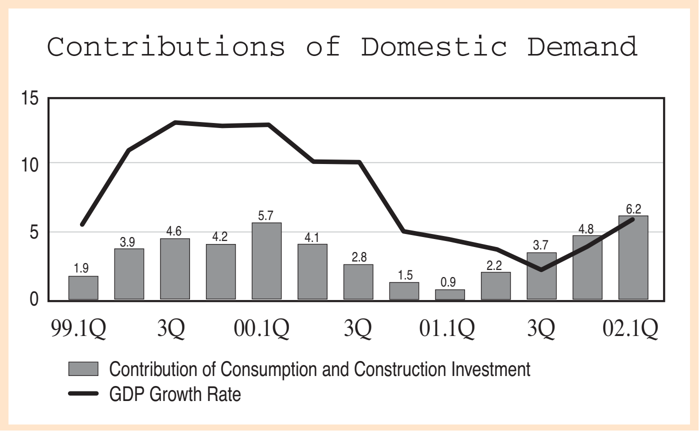
The economy as seen from an inventory-shipment cycle perspective also confirms that Korea has advanced to a recovery phase. The inventory-shipment cycle graph clearly indicates that from fourth quarter of 2001 onward, the economy has definite earmarks of a recovery trend (Phase IV as illustrated below), i.e inventories are shrinking and shipments are on the rise.

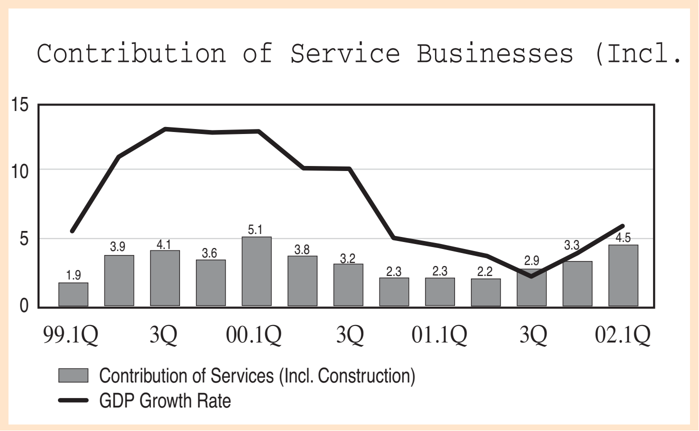
Inventory-Shipment Cycle



Domestic Consumption and Services Lead Recovery

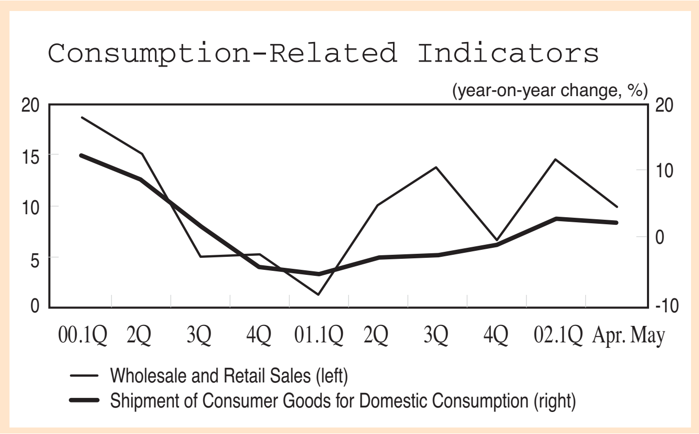
Since the third quarter of last year, the dual contribution to domestic demand of consumption and construction investment has exceeded the GDP growth rate. Healthy input by the service sector has also been significant.

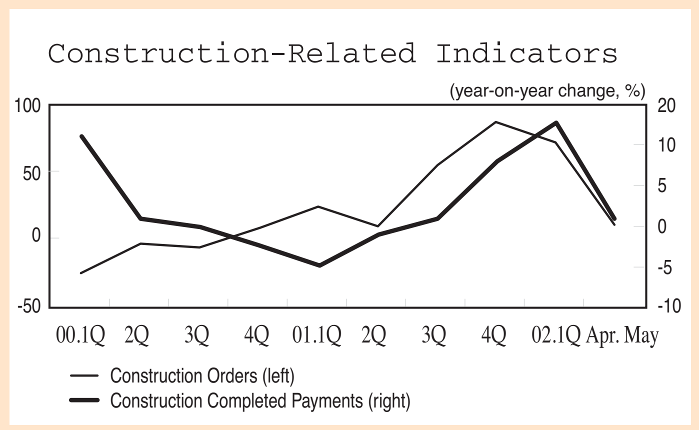




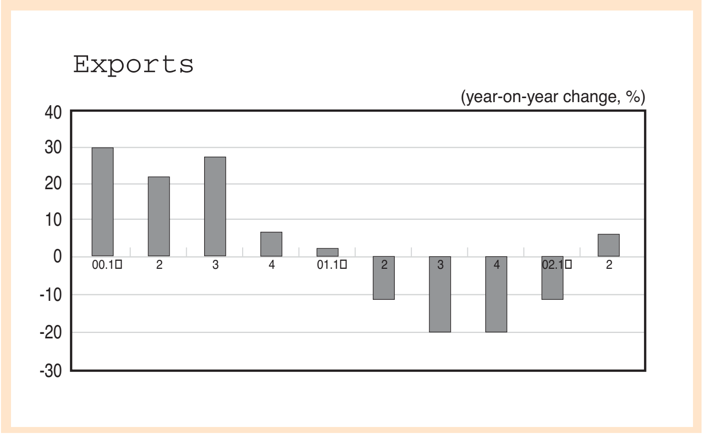
Emerging Signs of Shift to an Export-Led Recovery Phase

The surge in domestic demand, which has thus far taken the lead in the economy's recovery, is losing steam. The growth in wholesale and retail sales volume, a yardstick for the consumer index, slackened considerably to 5.7% in April-May from a robust 12.0% in the first quarter. The decline in construction investment indices is particularly worrisome. Construction progress payments showed a mere 0.7% rise in April-May, as compared with the 10% increase realized in the first quarter. Construction order growth plummeted to 17.0% in those two months from 85.6% growth in the first quarter.



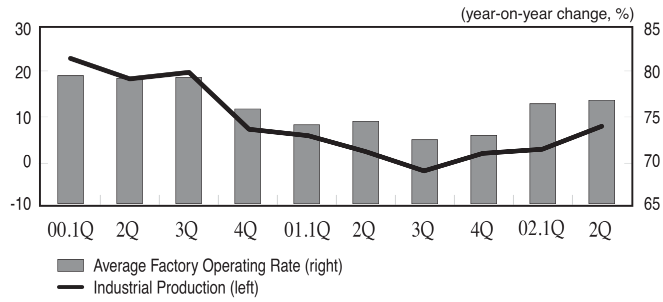


Meanwhile, exports of semiconductors, chemical products, machinery, the shipbuilding industry, etc. reversed course and recorded a very healthy 5.4% growth in the second quarter of the year amid the trend of burgeoning exports in information/telecommunication devices, home appliances and cars.

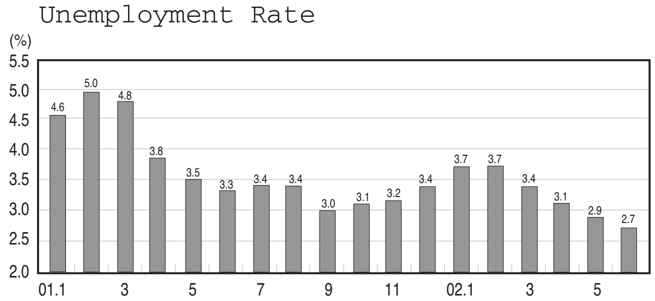


As a result, production is expanding and the average factory operating ratio also has soared above the average of last year's 73.2% . The industrial production increase rate surged to 7.5% in the April-May period from 3.9% in the first quarter, and the average factory operating ratio grew to 77.1% during the same two months as compared to 76.8% in the first quarter and 72.4% in the fourth quarter of 2001. In the wake of economic recovery, the unemployment rate continued to decline to a level of less than 3% in May 2002, effectively reversing a trend that had begun in September 2001.

Industrial Production and Average Factory Ope



Unemployment Rate



Uncertainty Shrouds Continued Recovery

Of primary primary, the evident sluggish trend in domestic demand will likely worsen. Brisk domestic demand that is not buttressed by vigorous production activity is destined to reach its limit. Considering the fact that the strong domestic demand has been fueled largely by temporary factors, such as a reduction in the special excise tax as well as a sharp rise in residential construction that seeks to avoid future construction restrictions, have largely shaped the recent sure in domestic demand. A good possibility exists that the trend of increased consumption and construction investment may quickly slow in the second half as the effect of temporary factors fades.

The favorable tone in the service sector mostly reflects a transient effect and the consumption increase trend caused by the boom in stock and real estate dealings. Therefore, these factors will not be sufficient to provide an independent push for a continued economic recovery in the future. If stock and real estate prices continue their downward trend, the domestic demand sector, including consumption and service businesses, run the risk of constricting further.

Despite indications of an economic recovery, facility investment remains anemic and uncertainty prevails as to whether exports, the key to a continued economic recovery, will sustain the upswing. Increased exports, measuring 8.9% in April, stood at 6.9% in May and fell to a low of 0.5% in June.

The prospects for exports in the second half are less than promising as a resurgence in the U.S. economy is uncertain and corporate facility investments have remained tepid (0.5% decline in the first quarter).

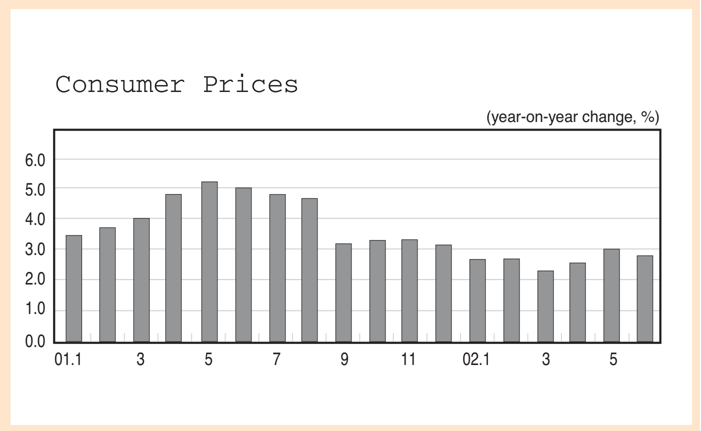
Moreover, worrisome signs have emerged that private consumption may decline, with cautious consumer sentiment due to a decrease in asset income following the slide in stock prices, fears of further terrorist attacks, etc. In fact, the Michigan Consumer Confidence Index dropped to 86.5 in July from 96.9 in May.

Meanwhile, the recent declines in the won-dollar exchange rate and semiconductor prices are likely to have a negative effect on future exports. The won-dollar exchange rate fell below 1,180 won per U.S. dollar recently, a level far below the 1,318 won at the end of 2001. Semiconductor prices have undergone an adjustment since March, with the spot price of 128DRAM plummeting to the US$2 level in May from US$4.28 in March.

Prices

Consumer Price Increase to Stabilize at Below 3%

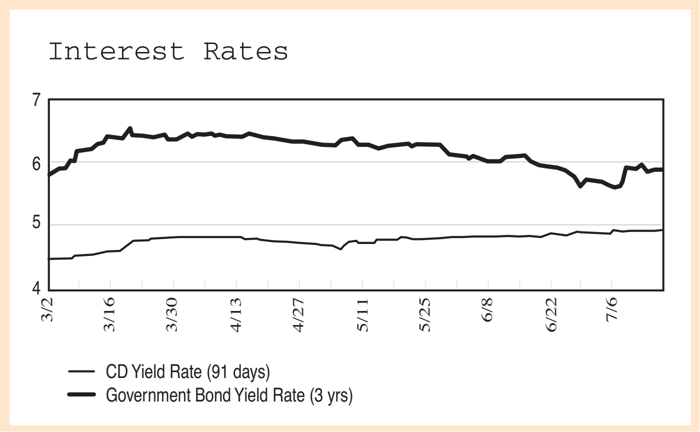
Except May, in which the CPI increased by 3.0% year-on-year due to the prices of farm, livestock and fishery products, this year's consumer prices have remained stable, increasing less than 3% year-on-year.



Interest Rates and Exchange Rates

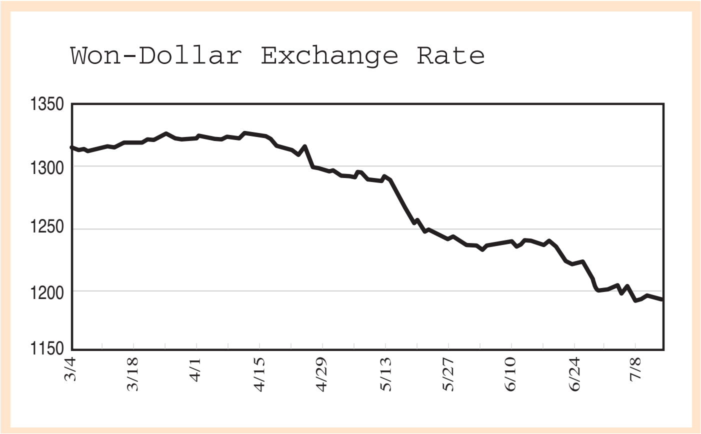
Gap between Long-Term and Short-Term Rates Narrowing

Long-term interest rates fell in the second quarter, while short-term rates increased slightly, thus narrowing the gap between the two. Long-term interest rates had declined somewhat before the May hike in call interest in part due to a reduced supply of long-term debentures as well as an expected price stabilization on the heels of the sharp drop in the won-dollar exchange rate.



Won Appreciation Affected by A Weakening U.S. Dollar

Since mid-April, the won-dollar exchange rate has declined sharply from the 1,330 level seen in the first quarter. A combination of factors continues to push up the won value: a continued current account surplus, upgrades of the nation's sovereign credit rating as well as the weakening U.S. dollar stemming from concerns about the U.S. economic recovery and volatile stock markets.



Outlook for 2002

Korea's economic growth, presently enjoying a rapid recovery, is expected to slow somewhat in the second half to stand at an annual rate of 5.7%. The main reasons behind this forecast include:

A strong possibility that key components of domestic demand, such as consumption and construction investment, that have lead the recent economic recovery will grow at a slower pace in the second half of the year.

With a full-fledged export recovery in the second half appearing all the more unlikely due to a possible delay in the U.S. economic recovery as well as declines in the exchange rate and semiconductor prices, this year's export growth is likely to remain at the technical rebound level after experiencing a sharp drop in 2001.

Facility investment also is projected to remain at an annual 4% level of recovery as businesses remain cautious in light of excess capacity in such conventional industries as steel and chemicals, completion of large-scale investments in information and telecommunications sectors, and sluggish exports.

Widespread adoption of the five-day workweek system from July 1 is expected to put a drag on the pace of economic recovery as well as affect production activities in the near-term.

Consumer prices will likely remain in the range targeted by the Bank of Korea. A 3%-3.5% level is projected for the second half, bringing the annual total increase to 3.2%. Although some concern has been voiced that the current recovery might spark inflation, slower domestic demand and the won appreciation will contribute positively to future price stability.

The current account surplus is expected to shrink to the US$5.7 billion level this year from US$8.6 billion in 2001 as imports are expected to outpace exports.

Interest rates may move upward in the event of a continued economic recovery in the second half. However, a limited increase is forecast as facility investment growth is expected to be slow and capital demands by enterprises will not be great due to improved internal liquidity conditions.

The won-dollar exchange rate is projected to fall to 1,180 won/US$ by the end of this year, mainly attributable to weakness in the U.S dollar. The U.S. dollar is expected to weaken further, affected by an increase in the U.S. current account deficit, the possibility of a delayed U.S. recovery, threats of additional terrorist attacks, loss of confidence in the accounting system, etc.

Prospects for 2002 Domestic Economy

(Unit: year-on-year change, %, US$100 million for international balance of payments)

	2001	2002						
	Year	1/4	2/4	1st half	3/4	4/4	2nd half	Year
GDP	3.0	5.7	6.2	6.0	6.1	5.5	5.8	5.9
(Manufacturing)	1.7	3.5	7.1	5.4	8.9	8.6	8.8	7.1
Total consumption	3.7	8.1	6.9	7.5	5.5	5.1	5.3	6.3
Private consumption	4.3	8.4	7.6	8.0	6.0	5.4	5.7	6.8
Fixed capital formation	-1.6	6.5	3.4	4.9	4.8	2.5	3.6	4.2
Facility investment	-9.7	3.2	3.5	3.3	7.9	5.0	6.4	4.8
Construction investment	5.8	10.1	3.4	6.3	2.6	0.9	1.7	3.6
Total exports	0.9	2.1	5.4	3.7	8.8	8.3	8.6	6.2
Total imports	-2.8	6.3	13.0	9.5	13.1	12.8	12.9	11.3
Producer price	1.9	-0.1	1.1	0.5	2.5	3.0	2.7	1.6
Consumer price	4.3	2.5	2.7	2.6	3.4	3.6	3.5	3.1
Current account	86.4	17.1	26.9	44.0	8.8	4.0	12.8	56.8
Commodity account	133.9	32.7	42.4	75.0	24.1	16.0	40.1	115.1
Exports	1513.7	361.3	411.4	772.7	409.8	411.2	821.0	1593.7
Change (%)	-14.0	-11.1	6.5	-2.5	13.1	14.7	13.9	5.3
Imports	1379.8	328.6	369.0	697.7	385.7	395.2	780.9	1478.6
Change (%)	-13.3	-12.1	9.8	-1.7	15.8	17.3	16.6	7.2
Service, income & transfer	-47.8	-15.5	-15.5	-31.0	-15.2	-12.1	-27.3	-58.3
Won/$ (end of period)	1326.1	1326.4	1205.0	1205.0	1190.0	1180.0	1180.0	1180.0
3-yr corporate bond (Avg.,%)	7.0	7.3	7.1	7.2	7.5	7.7	7.6	7.4

Sources: The Bank of Korea, National Statistical Office

Current Macroeconomic Policy Stance Should be Maintained

Regarding policy direction, the present macroeconomic policy stance should be maintained to foster a stable economic recovery. If necessary, small adjustments are recommended to enhance the efficiency and credibility of the policy. Only minor adjustments are advisable unless circumstances shift drastically.

While conditions of economic uncertainty persist, monetary policy makers should maintain the present interest rate level to ensure a stable economic recovery. Nevertheless, an increase in interest rates should be considered if domestic demand expands further and exports and facility investment recover fully, which would trigger substantial price-push pressure. Strengthening the won's value should help mitigate price pressure for the remainder of this year.

Considerations related to cyclical factors do not raise the need for changes in the government spending plan as this year's budget is not viewed as particularly expansionary.

Turning to taxes, a boost in tax revenues is anticipated due to the economic recovery. Any revisions in tax codes should be based strictly on merit as well as long-term repercussions of the proposed changes and not on the short-term implication of tax revenues.

Although the won's recent rapid pace of appreciation might justify the FX authority's exercise of smoothing operations, attempts to reverse the trend would likely have but limited effect. The current scenario is a good reminder to businesses with large foreign exchange transactions of the importance of hedging the FX risk. As the scope of the government's influence on the exchange rate will be scaled down in the future, businesses are well advised to take more proactive measures to deal with FX risks.

Maintain Policy Consistency and Expand Growth Potential

As the potential for demands from interest groups and social conflicts is amplified due to the "lame-duck" phenomenon, political influence on the economy should be minimized and confusing policy signals should be avoided.

Consistency of economic policies promoted by the government should be maintained in accordance with existing laws and market principles. Rational opinions should be considered, but caution should be taken concerning excessive assertions.

Policies to expand growth potential as well as enhance productivity are preferable from a long-term perspective over emphasis on short-term economic goals.

Long-term macroeconomic policies need to be deeply rooted to guide a smooth transition to a knowledge-based economy, secure self-generating power for economic recovery and build a foundation for stable growth.

Regarding labor policy, active efforts are required to increase flexibility in the labor market and to establish a balanced labor-management relationship based on the legal system rather than on populism or politically driven policymaking.

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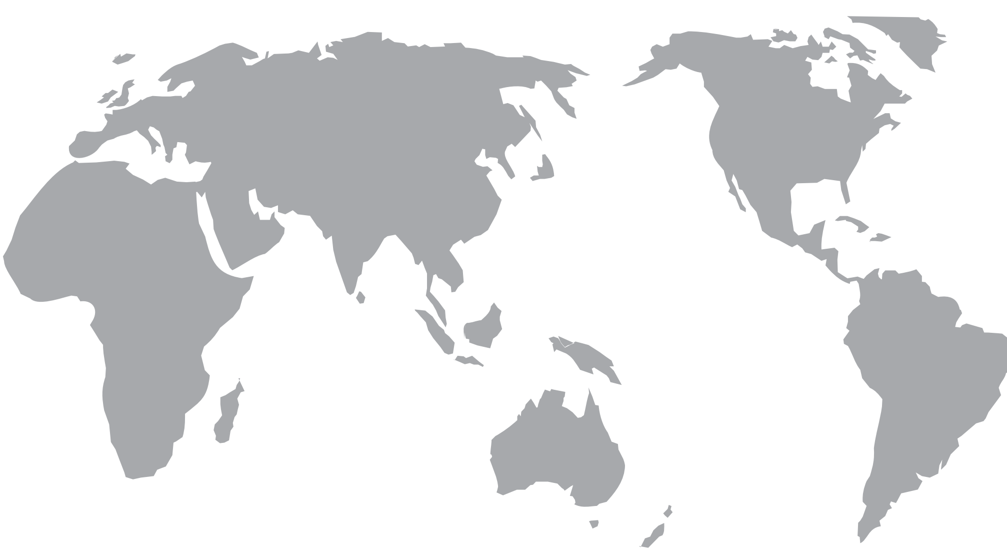

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