

## KOREA

## 2002: SLOWDOWN DESPITE ROBUST EXPORT GROWTH

The Korean economy is in the downward phase of its business cycle, with subdued growth of industrial production and service activities due to sluggish consumption growth and stagnation in equipment investment in 2002. Slowdown has occurred despite continued robust growth of exports (supported by the strong increase in exports of IT products, especially to China). Construction investment also increased. Equipment investment estimates, however, turned from mild growth to a sharp decrease in January 2003.

Another consequence of economic slowdown caused by sluggish domestic demand is the slower growth of employment. Weak domestic demand is dampening activities of the service sector, which usually has a high capacity to absorb labour shed from other sectors.

The rapid slowdown in private consumption is caused by

- slower real income growth induced by worsening terms of trade
- reduced access to consumer credits resulting from strengthened prudential regulations on consumer credits
- the wealth effect from stabilised asset prices, especially real estate prices
- increased uncertainties from domestic and external sources.

Prudential regulations on consumer credits were strengthened in October 2002, subduing consumer credit growth. Consumer credit offered by banks

decreased from the previous month for the first time in two years, with part of the decline attributed to seasonal factors, although consumer credit grew again in February 2003.

On top of these factors, the North Korean nuclear threat, the war with Iraq, and inauguration of a new government, are adding to uncertainties about the economy's prospects. Together, these uncertainties are curtailing economic activity. Reflecting the rising uncertainties, facility investment, which has maintained a mild upward trend, declined sharply in January and February 2003.

Despite concern over delayed economic recovery of the advanced economies, exports maintained their strong upward trend, aided by a robust increase in exports of IT products and exports to the Chinese economy. The trade balance on a customs clearance basis showed a small deficit throughout January–March 2003.

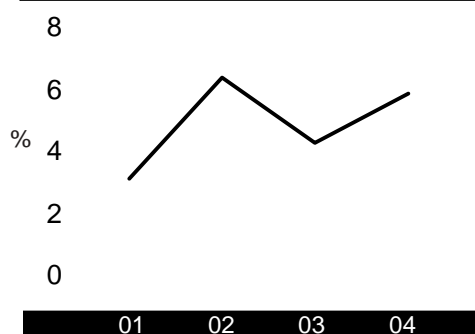
SARS may adversely affect Korea's export volumes, particularly to China and other Asian economies. Korea's export growth will be affected predominantly by the downward adjustment of mobile phone exports following a rapid increase.

In first-quarter 2003, consumer price rises accelerated due to the oil price hike, but the core inflation index was stable at an annual rate of around 3 per cent. Although consumer price increases caused by the oil price hikes do lead to lower consumer purchasing power, the oil price hike is unlikely to contribute to inflationary pressures in the medium

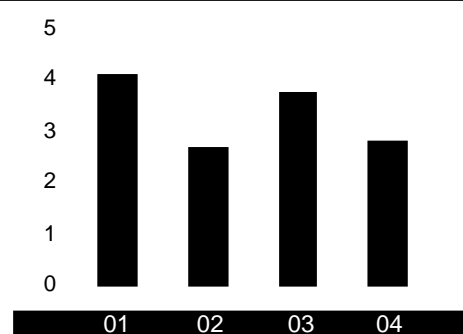
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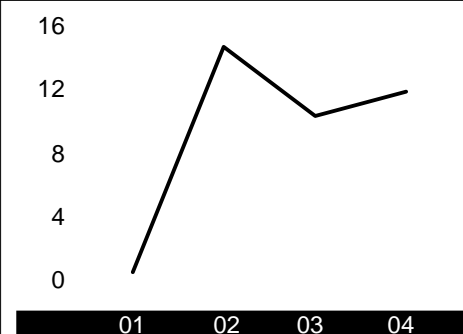
GDP growth



CPI inflation



Export growth



term. In fact, housing prices and service prices have been stabilising in recent times and will have a beneficial impact on medium-term price stability, though offset by the price instability prompted by wage increases of around 12 per cent during 2002.

Although a slowdown in the growth of domestic demand, and therefore the slowdown in overall growth, was expected to some extent, the pace of the slowdown has been somewhat faster than expected as a consequence of a series of adverse developments in internal and external conditions.

Some of the slowdown in private consumption and in economic growth is due to the natural adjustment of the expansion in household credit during the past few years. Worsening economic conditions were, however, also exacerbated by the fall of semi-conductor prices, uncertainties associated with the nuclear threat of North Korea, the SK Global incident, and the rapid erosion of the financial soundness of credit card companies.

Falls in semi-conductor prices are expected to have a similar effect on the South Korean economy to a rise in oil prices—namely, a worsening in the terms of trade. The North Korean nuclear standoff, which erupted at the end of 2002, emerged as a major risk factor for the South Korean economy, prompting a downward adjustment of South Korea's sovereign credit rating outlook by Moody's. The exposure of accounting fraud at a major Korean company, SK Global, greatly eroded the country's credibility on corporate transparency, amplifying instability in the domestic financial market. Also, the deteriorating soundness of South Korean

credit card companies has prompted a large-scale redemption of money market mutual funds, adding to economic unease. As a result, the Korean stockmarket has suffered the largest fall among the major markets since the beginning of 2003.

There are favourable factors in the South Korean economy compared with the pre-crisis period: large foreign reserve holdings, improved profitability of corporate and banking sectors, enhanced exchange rate flexibility, and more room for stabilisation policies. However, prolonged economic downturn and/or mismanagement of the financial and corporate distress could lead to more serious economic turbulence. Given the openness of the capital market, the possibility of gradual capital outflow cannot be ruled out if domestic economic conditions become seriously destabilised. Thus, it is important to identify factors that require domestic policy responses and take appropriate actions in order to prevent prolonged economic instability. For example, attention has to be paid primarily to moderating the steep decline in business conditions with flexible macroeconomic policy, by stabilising financial markets, and by pushing forward restructuring policies related to the labour market and bank privatisation.

#### 2003–2004: OUTLOOK

The following outlook is based on an assumption that the North Korean situation will not be further aggravated. It is also assumed that the Bank of Korea, having cut its call rate by 25 basis points in May 2003, will not cut the call rate any further, and that the government

budget will be supplemented by 4 trillion won.

The economic growth rate in 2003 is projected to be around 3.5 per cent, reflecting a slowdown in private consumption growth and sluggish equipment investment. Private consumption is expected to grow more slowly than GDP at 1 per cent, reflecting the deterioration in the terms of trade, the decline in asset prices and weak consumer confidence. Equipment investment is expected to grow at around 2 per cent owing to increased uncertainty arising from geographical risks, financial market instability, and worsened business sentiment. Construction investment is expected to slow down in second-half 2003, but will record 6 per cent growth for the year overall. Export volumes are expected to increase at approximately 10 per cent in 2003, although the rate of growth will fall significantly after the second quarter on a year-on-year basis. The unemployment rate is forecast to register 3.5 per cent—slightly higher than in 2002 (3.1 per cent)—as a consequence of the growth slowdown.

The current account is expected to shrink to a US\$1.5 billion dollar surplus compared in 2003, down from the 2002 figure (US\$6.1 billion surplus) because of the oil price rise in the first part of 2003.

CPI inflation is expected to be higher than in 2002 (2.7 per cent) at 3.8 per cent, and the core inflation rate is also expected to rise from 3.0 per cent in 2002 to 3.3 per cent in 2003

The GDP growth rate is projected to rise to 5.8 per cent in 2004, driven for the most part by a modest recovery in domestic demand and exports. As geopolitical risks recede and the domestic financial market stabilises, consumption and investment growth is projected to rise. Higher world economic growth is expected to give a mild boost to Korea's export growth as well.

#### Interest rate margins in selected East Asian economies

Korea's sovereign risk rating was adjusted downward at the end of 2002. The spread is from the yields on 5-year Treasury bonds. The margin of interest rates on Korean sovereign bonds over US Treasury bonds in the first part of 2003, is compared to other selected East Asian economies. The spread came down to 83 basis points at the end of May as financial markets stabilised.

