

KOREA

2003: DOWNTURN AND UPTURN

The Korean economy achieved low GDP growth of only 3.1% in 2003. In the first half of 2003, the Korean economy was hit by many negative external and internal shocks, including deterioration in the terms of trade (higher oil prices and lower semiconductor prices), financial market unrest caused by the SK Global incident and rapid erosion of the financial soundness of credit card companies, the North Korean nuclear issue, the outbreak of SARS and labour unrest. Private consumption and facility investment turned downward, decreasing sharply in the first half of 2003, and the Korean economy recorded negative quarter-to-quarter growth rates in the first half of 2003. The economy stabilised gradually in the second half of 2003, with the first positive quarter-to-quarter growth of 2003 recorded in the third quarter.

Private consumption decreased by 1.4% in 2003 mainly due to rapid adjustment of consumer credit. Under these circumstances, the terms of trade rapidly deteriorated, negatively affecting income. While oil prices rose due to the Iraq war, the price of semiconductors, one of Korea's main export items, began to plummet. Also, increased tensions regarding North Korea's nuclear program contributed to a fall in stock prices, and this might have affected consumption through the wealth effect.

Stagnant equipment and facility investment were affected by uncertainty surrounding the economic recovery

and a general lack of confidence in the economy. Government policy directions under the newly elected president were unclear to many market participants on a range of issues—such as, external relations, and welfare and labour relations—thus raising policy risks. Interest groups became increasingly vocal, and there was a sense of uneasiness that rule of law might be compromised in the government's response. Despite low interest rates and a rising capacity utilisation ratio, firms chose to increase cash holdings rather than equipment investment.

In contrast to domestic demand, exports continued to grow strongly, recording an annual increase of 15.7%. Though the rapid spread of SARS through China, Hong Kong and East Asia in April sharply reduced exports to this region, the adverse effects were assessed to be temporary. The growth rate of exports in US dollar terms of dropped to 7.1% in May, but jumped to 18.5% in June and continued to accelerate towards the end of 2003.

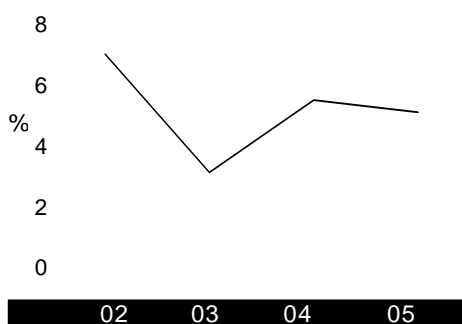
With withered domestic demand and solid export performance, the current account surplus increased to US\$12.3 billion in 2003 from US\$5.4 billion in 2002. Since ongoing stagnation in private consumption is driving the slump in service industries, employment conditions did not greatly improve despite the strong growth of exports. The unemployment rate rose by 3.4% in 2003 from 3.1% in 2002.

The consumer price index rose by 3.6% in 2003, higher than the 2.7%

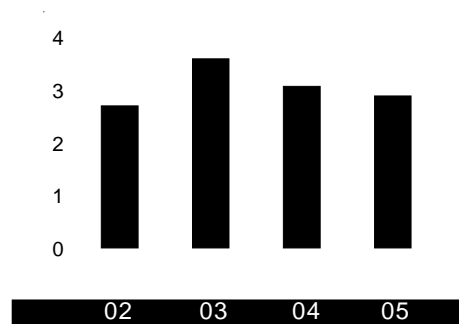
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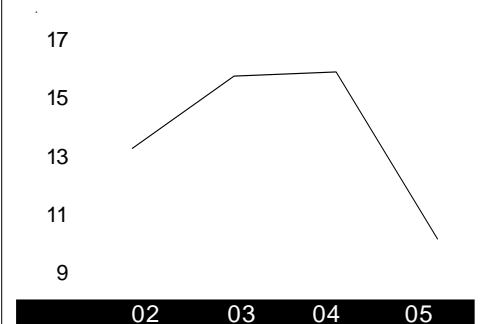
GDP growth



CPI inflation



Export growth



recorded in 2002. Over the course of 2003, however, the pace of inflation gradually stabilised as the economy entered a recession. In particular, the core inflation rate (excluding agricultural and petroleum product prices) was 3.1%, similar to the 3% recorded in 2002, implying that the relatively high consumer price inflation in 2003 was largely attributable to the hike in oil prices and capricious climate conditions.

2004–2005: ECONOMIC OUTLOOK

The economic outlook for 2004 is based on the assumptions that the robust recovery of the world economy continues and that the oil price falls slightly. It is also assumed that the real effective exchange rate of the won appreciates by 3–5%.

The economic growth rate for 2004 is projected to be around 5.5%, with a recovery in equipment and facility investment and private consumption. In the first half of 2004, GDP growth should be driven by strong export growth while, in the second half, it will rely more on domestic demand, such as equipment and facility investment and private consumption.

Although private consumption, less affected by the adjustment in consumer credit, is expected to recover gradually with income growth, its growth rate is expected to be around 4.2% in 2004, lower than the GDP growth rate. The pace of credit reduction by credit companies had already decreased significantly in the fourth quarter of 2003. Credit card loans decreased by 0.7 trillion won in the fourth quarter of 2003—far less than the 7.6 trillion

won in the second quarter and 4.8 trillion won in the third quarter. The amount of outstanding credit card loans at the end of 2003, 30.5 trillion won, was comparable to the level at the end of 2000 before the credit expansion. Wholesale and retail sales indices exhibit some signs of a modest recovery in private consumption, the month-to-month growth rate of which (after seasonal adjustment) rose from –1.8% in November 2003 to 0.5% in December and 1.8% in January 2004.

Equipment and facility investment is expected to grow by 7% in 2004, reflecting a technical rebound, export growth and a rise in the capacity utilisation ratio, though it remained stagnant until January 2004. The monthly equipment and facility investment estimates have recorded negative growth rates (on a year-on-year basis), ranging from 8.3% in November 2003 to –1.6% in December and –3.1% in January 2004. Meanwhile, the capacity utilisation ratio has risen quite high, to 80.5 in January, mainly due to rapid increase of exports.

Growth in construction investment will slow substantially, reflecting tightened regulation of the real estate market, to growth of around 2% per annum in 2004. The year-on-year growth rate of the value of completed construction has already begun to decline, dropping to 7.4% in January 2004 from 24.4% in December 2003.

Although the unemployment rate in the first half of 2004 is expected to be high, the rate should gradually decrease over the second half with a recovery in domestic demand,

recording 3.4% for the year as a whole. The seasonally-adjusted unemployment rate has been on a downward trend since last December, recording 3.6% in November, 3.5% in December, and 3.3% in January.

The US dollar value of exports is expected to increase by 18–19% as the world economy recovers, and imports are expected to grow by around 21% as domestic demand recovers and the won appreciates. In January and February 2004, exports increased by 39.1% on a year-on-year basis while imports increased by 18.3%. With recovery of domestic demand and appreciation of the won, the current account is expected to record a surplus of US\$10.1 billion in 2004, which is slightly smaller than the surplus in 2003. The consumer price inflation rate in 2004 is expected to be 3.1%, which is lower than the figure in 2003. The core inflation rate in 2004 is also expected to stabilise in the upper 2% range.

With lower-than-potential growth in 2003 followed by higher-than-potential growth in 2004, the Korean economy is expected to be back to its potential growth path, which is estimated to be around 4.5–5.5%. While export growth is expected to decelerate gradually, private consumption growth should accelerate to a rate close to that of GDP growth. Furthermore, equipment and facility investment growth should decline gradually, reflecting its mild long-term downward trend. Construction investment should increase by 3–4% in 2005, which seems to be a sustainable level after the three-year adjustment period following a construction freeze during the financial crisis of 1997.

There are several risk factors for the outlook—higher oil and commodity prices, continuing adjustment of consumer credit under high household debt, political instability, exchange rate instability against major currencies, and a slowdown of the Chinese economy.

Consumer credit by credit card companies

Consumer credit by credit card companies has decreased drastically since the fourth quarter of 2002, and this decrease is regarded as one of the key contributing factors in the contraction of private consumption in 2003. The pace of credit reduction decelerated significantly in the fourth quarter of 2003.

