8 KOREA, REPUBLIC OF

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2004: DOWNTURN AND UPTURN

The South Korean economy achieved modest GDP growth of 4.6% in 2004. Despite a number of external shocks such as oil price hikes in mid-2004 and a rapid depreciation of the US currency since October, GDP growth was mostly driven, surprisingly, by strong exports. Domestic demand, especially private consumption and construction investment, continued to be stagnant throughout 2004. The adjustment in consumer credit was thought to have been the biggest factor in explaining the negative growth in private consumption since 2003. Among other important factors discouraging domestic demand were such basic policy stances of the ruling party as an anti-speculation measure on real estate and political uncertainty stemming from the impeachment of the President and the debate surrounding the relocation of the national capital. Private consumption decreased by 0.5% in 2004 mainly due to an ongoing adjustment in consumer credit. In addition, the low growth of disposable income seems to have hindered recovery in consumption during 2003-2004. The growth rate of individuals' disposable income undershot the growth rate of GDP over 1999-2004 by about 5%, which seems to reflect low productivity among self-employed workers and rapidly growing social pension contributions: the nominal operating surplus of self-employed workers grew only by 2.1% per annum between 1999-2002, compared with a growth rate of 8.9% in wage income. Such a structural trend is expected to slow the recovery in consumption. Stagnant equipment and facility investment were also affected by the political and economic uncertainty. Even with a record operating surplus and low interest rates, a general lack of confidence in the economy drove firms to increase cash holdings rather than invest in equipment.

In contrast to the slump in domestic demand, exports continued to be surprisingly strong, recording a 31% increase. This was partly helped by the government's policy of maintaining a weak won. Despite skyrocketing oil prices in mid-2004 and a rapid appreciation of the currency near the end of 2004, the high growth rate of exports did not slow. The current-account surplus jumped to US$27 billion in 2004 from US$12.3 billion in 2003. However, a component analysis of the current account shows important structural changes in Korean industry: a huge trade surplus of US$38.5 billion was mostly driven by IT- and automobile-related firms, while contributions from SMEs to exports dwindled. The expanding gap between the large firms, and SMEs and self-employed workers worsened employment conditions and, consequently, the unemployment rate rose to 3.5% in 2004 from 3.4% in 2003. The balance in services, income and transfers marked a deficit of US$11.3 billion, implying that the service industry is losing its relative competitiveness to manufacturing.

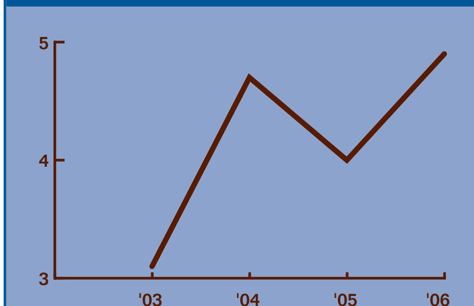
The consumer price index recorded a modest growth rate of 3.6% in 2004 partly due to weak domestic demand. The core inflation rate (excluding prices for agricultural and petroleum products) was 2.6%, implying that the inflation of consumer prices in 2004 was largely attributable to rises in oil and other commodity prices.

OUTLOOK FOR 2005 AND 2006

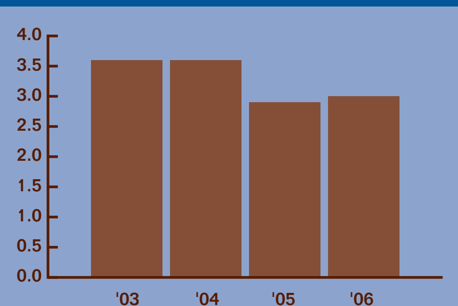
The economic outlook for 2005 is based on the assumptions that the robust recovery of the world economy will continue and oil prices will drop slightly from the level in 2004. It is also assumed that the real effective exchange rate (REER) of the won will remain at the current level. South Korea's economic growth rate is projected to be around 4% in 2005, lower than the 4.6% recorded in 2004, owing to a slow-down in export growth. As domestic demand is expected to recover gradually, the growth rate in the second half of 2005 is forecast to be in the upper 4% range, higher than the 3% in the first half.

Private consumption is expected to slowly recover to the mid 2% range, still lower than the growth rates for GDP and disposable income in 2005. While private consumption will be less affected by the adjustment in

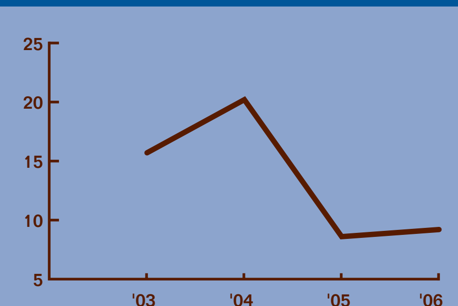
GDP GROWTH (%)



CPI INFLATION (%)



EXPORT GROWTH (%)



consumer credit, the pace of recovery hinges on how fast disposable income will grow in the long run. Equipment and facility investment is expected to grow by 8.3% in 2005 due to a gradual pickup in domestic demand and the appreciation of the won. Construction investment is projected to have increased in the low 2% range in 2004, and in the upper 2% range in 2005 as the government's "Comprehensive Investment Plan for Economic Vitality" takes effect.

The growth rate of export volume is projected to fall to 9% in 2005 from 21% in 2004 due to the expected slowdown in the world economy and the appreciation of the local currency. The growth rate of import volume will be in the 12% range in 2005 thanks to a recovery in domestic demand and the appreciation of the won. The current-account surplus is forecast to narrow to US$19-20 billion in 2005 from US$27 billion in 2004. The trade balance of goods in 2005 is expected to mark a surplus of US$34 billion, down from the surplus of US$38 billion in 2004, due to a slight letdown in world economic growth, the appreciation of the won, and the recovery of domestic consumption.

The CPI inflation rate is projected to be 2.9%, lower than the 3.6% rate of 2004, while the core inflation rate is projected to be 2.7% in 2005, similar to 2.9% registered in 2004. Unemployment is expected to increase slightly to 3.6% in 2005 from 3.5% in 2004.

RISKS AND UNCERTAINTIES

There are several risk factors to consider — higher oil and commodity prices; fluctuations in major exchange rates triggered by the rapid adjustment of the increasing US current-account deficit; an abrupt decline in housing prices in the wake of an increase in US interest rate in response to a weak dollar and inflationary pressure; and finally delayed recovery in domestic demand, provided that the Comprehensive Investment Plan announced by the government is less effective than expected or that low confidence in the national pension system leads to greater households savings.

According to a recent analysis by the Korea Development Institute, the appreciation of the REER, potentially driven by the weak US dollar, will reduce the South Korean GDP in the short run but its effect will fade away within two years. Specifically, a 5% fall in REER (an appreciation of the won) is expected to raise equipment and facility investment by 2-3% and private consumption by 0.3-0.6% in the first year, reflecting "cheaper" imported goods. It is also expected to shrink the current-account balance by US$5-7 billion. Consequently, the negative effect on the current account outweighs the positive effect on domestic demand, resulting in a fall in GDP by 0.2-0.5%. In addition, the consumer price index is expected to fall by 0.5%.

The South Korean government has been accumulating its reserves to support a weak Korean currency. With ammunition to support the won depleted and criticism about the appropriate level of the reserve, the government is not expected to increase its reserves as fast as previously. Although its stock is large enough and mismanagement of the reserve may result in serious capital loss, the government is not expected to change its portfolio drastically in favour of the Euro or other currencies by selling US dollars in the short run.