

REPUBLIC OF KOREA

Having decelerated sharply in the first half of 2001, GDP growth is expected to remain weak in the second half of the year. Considerable uncertainty exists about the duration of the slowdown and the ability of the economy to quickly resume long-run trend growth above 7 percent.

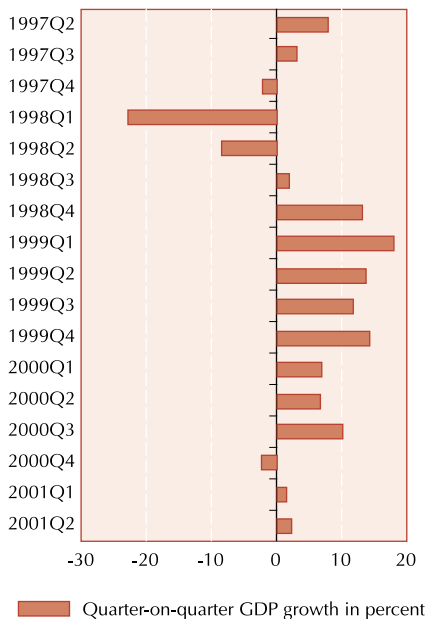
| Economic Indicator (percent) | 1998 | 1999 | 2000 | 2001 | | 2002 | |
|------------------------------|------|------|------|---------|----------|---------|----------|
| | | | | Current | ADO 2001 | Current | ADO 2001 |
| GDP growth | -6.7 | 10.9 | 8.8 | 2.0 | 3.9 | 3.6 | 5.5 |
| Inflation rate | 7.5 | 0.8 | 2.3 | 4.2 | 3.0 | 3.0 | 2.5 |
| Current account/GDP | 12.7 | 6.0 | 2.4 | 2.7 | 1.9 | 1.7 | 1.1 |

Economic Assessment. Following the collapse of global ICT demand in the fourth quarter of 2000, the economy grew at rates below 2.0 percent in the first two quarters of 2001. This sluggish performance is in sharp contrast to the two-year recovery boom from the fourth quarter of 1998 to the third quarter of 2000, when exports expanded rapidly to over 50 percent of GDP. With export demand declining by 22.0 percent in the second quarter of 2001 (and imports by 29.0 percent), investment stabilizing, and consumption growing robustly, this quarter was the first one since before the Asian financial crisis in which domestic demand (having contracted in four of the previous five quarters) was the sole engine of growth.

With the plunge in external demand, manufacturing activity faltered. Following nine consecutive quarters of growth averaging 20.0 percent, real value added in manufacturing contracted by 10.5 percent in the fourth quarter of 2000, and averaged a 0.7 percent contraction over the first two quarters of 2001. In contrast, reemerging strength in domestic demand growth revived nonmanufacturing activity. Construction, which shrank in 11 of the 12 previous quarters, averaged 7.1 percent growth over the first two quarters of 2001. Similarly services, which accounted for around 57 percent of 2000 GDP and which grew by 4.0 percent at the most over the last three quarters of 2000, accelerated to an average of 7.2 percent growth over the first two quarters of 2001.

In addition to boosting nonmanufacturing activities, higher domestic demand contributed to a fall in unemployment. While the unionized manufacturing sector shed jobs only slowly, services sector jobs were being added quickly with the net effect that almost 900,000 jobs were created in the first half of 2001, lowering the seasonally adjusted unemployment rate from 3.9 percent in December 2000 to 3.6 percent in June 2001 and further to 3.3 percent in September. Reflecting this, the consumer expectations index rose from 82.2 to 100.3 over the same period, despite rising inflation and slow nominal wage growth. Consumer price inflation rose from 3.2 percent to 5.2 percent over this period because of rising energy prices and a

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Source: Bank of Korea

depreciating won (which fell by 2.9 percent against the dollar during this period), but it fell back to 3.2 percent in September 2001 as energy prices eased.

The most striking feature in 2001 thus far has been the unexpectedly sharp drop in exports. The decline has been seen in nearly all sectors, reflecting the breadth of the global slowdown. The drop in electronics exports, which began in October 2000, was the steepest, accounting for 75 percent of the fall in export value between the second half of 2000 and the first half of 2001. The value of semiconductor exports in June 2001 was half the level of September 2000. Despite a significant rise in volume, semiconductors dropped from 13.0 percent of exports to less than 8 percent during this period because of an 80 percent drop in the semiconductor export unit price over the same period. Total merchandise exports were not as hard hit as the electronics component: in the first six months of 2001 their value contracted by about 5 percent compared to the first half of 2000, and by about 12 percent compared to the second half. Merchandise exports continued to weaken in the third quarter of 2001 and were down by about 10 percent through the first nine months of the year compared to a year earlier.

Despite the slump in exports, the current account remained in surplus in the first half of 2001, rising significantly from the level of a year earlier, though falling slightly compared to the second half of 2000. With a shift away from import-reliant exports and investment demand, there was a sharp decline in imports of 11.4 percent in the first half of 2001 compared to the second half of 2000, particularly in electronics (down 21.8 percent) and capital goods (down 18.4 percent). Total external reserves declined to \$94.3 billion by end-June 2001 from \$96 billion at the end of 2000. This was mainly due to a sharp increase in net loan repayments, including a prepayment of \$3.4 billion to IMF, which significantly reduced total external debt.

In the financial markets, the Korea Composite Stock Price Index (KOSPI) bucked the global trend, rising by 17.8 percent through June 2001, after a 50.1 percent drop in 2000. However, after falling by 8.4 percent in July and August and by another 12.0 percent in September, the KOSPI was down by 5.0 percent from its end-December 2000 level at the end of September. In addition, average daily trading values and volumes, new corporate stock issues, and foreign net purchases ebbed through much of 2001 as declining interest from global investors in emerging market equities combined with falling interest rates to shift corporate fund-raising activities to the bond markets. With the yield on three-year corporate bonds declining from 8.1 percent in December 2000 to 6.6 percent in August 2001, corporate bonds outstanding rose by 4.3 percent over the period.

Economic Management Issues. As global economic conditions continued to deteriorate in the third quarter of 2001, particularly after the 11 September attacks on the US, external demand, economic growth, and financial market conditions worsened; the Government countered with a mix of monetary and fiscal stimulus. Despite inflation running higher than its target of 4.0 percent, the central bank cut the overnight call rate by 125 basis points through 19 September. Through the first quarter of 2001, fiscal revenues

were above, and fiscal expenditures below, target, resulting in an increase in the fiscal budget surplus from 1.0 percent to 2.0 percent of GDP rather than the planned small fiscal budget deficit. The Government took some modest steps in the third quarter to provide fiscal stimulus by cutting taxes and accelerating planned expenditures, as well as pushing through a \$3.9 billion supplementary budget.

The Government's most significant steps to sustain economic activity have involved attempts to avoid capital market turmoil while working out high-profile corporate restructuring deals in an increasingly difficult economic environment. It made efforts to ensure the smooth functioning of capital markets both by guaranteeing new bond issues through its Quick Underwriting Program and its Korea Credit Guarantee Fund (KCGF) and by helping large creditors broker debt workout deals through the provisions of the Corporate Restructuring Promotion Law. These efforts have been successful in heading off a looming crisis in the bond and credit markets resulting from a large volume of total corporate debt reaching maturity this year. In addition, the KCGF and state pension funds will channel over \$5 billion into efforts to boost demand for equities.

With elections due in 2002 and a slowing economy increasing labor resistance to job-cutting reforms, the Government is making some progress on major corporate restructuring deals such as those involving Hynix Semiconductor, Daewoo Motors, and Hyundai Securities. This is important since, over the medium term, weaknesses in the corporate and finance sectors could remain a drag on domestic investment. Although investment may have been unsustainable at 38 percent of GDP in 1996, it has since declined to 26 percent in 2000 and to less than 24 percent in the first half of 2001. In addition, debt-equity ratios, on the decline since 1997, have begun to rise again while corporate profits have started to deteriorate.

Forecast. The Republic of Korea, with a strong external position, is not particularly vulnerable to adverse effects from the 11 September attacks. However, consumer and investor sentiment worsened in the third quarter of 2001, reflecting concern over a sharply deteriorating global economy, rising uncertainty in the wake of the attacks, and disappointment about the pace of corporate restructuring. The Government's efforts to stimulate domestic demand are expected to sustain real GDP growth of around 2 percent in 2001. Growth will improve modestly in 2002, as the global recovery remains subdued in the first half of the year. However, relatively robust export demand and GDP growth are expected in the second half. With inflation expected to continue falling through the second half of this year and 2002, the central bank may consider further rate cuts, but there is concern that low interest rates, already at 1998 levels, are feeding a real estate boom. The current account surplus is expected to be marginally wider overall in 2001 than in 2000, because imports are contracting faster than exports, but to narrow with economic recovery in 2002.