HERE COMES THE RECOVERY?

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With first quarter GDP recording relatively stable growth of 3.7% compared to early estimates of 2.5%, a few institutions predict an economic recovery in the second quarter. However, the characteristics of the first quarter's growth do not support such a rosy prospect.

Domestic demand will remain stagnant

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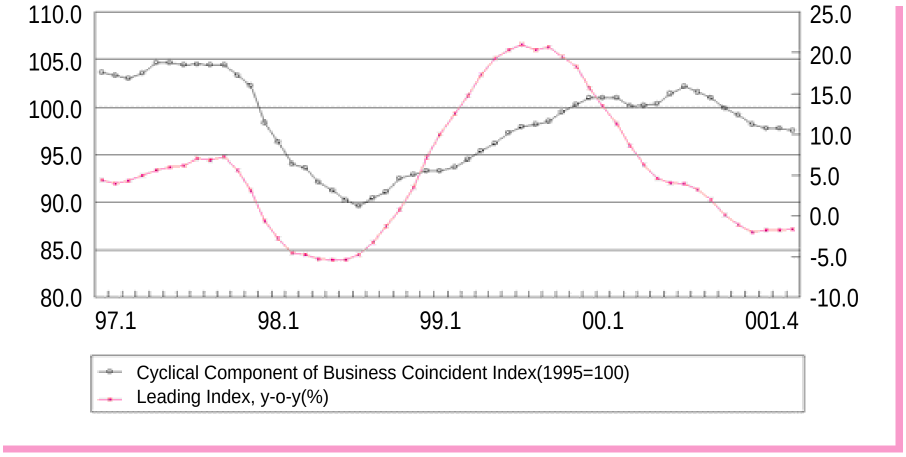
Meanwhile, private consumption (which accounts for 55% of GDP) shrank 1.0% from the previous quarter. Even though the 6-month leading index for consumption improved considerably since January, an economic upturn will not occur unless consumer income also increases.

Figure 1. Recent Trends of Business Cycle



Production cutback

April's production data demonstrates that current business conditions remain in a downturn. First of all, industrial production turned to negative growth from the previous month, while inventory in the manufacturing sector increased sharply, implying that an inventory correction still remains in the future. The recent sluggish production was caused by the continued deterioration of the export sector since the first quarter. Reflecting these features, the cyclical component of the business coincident index has continuously declined for 8 months.

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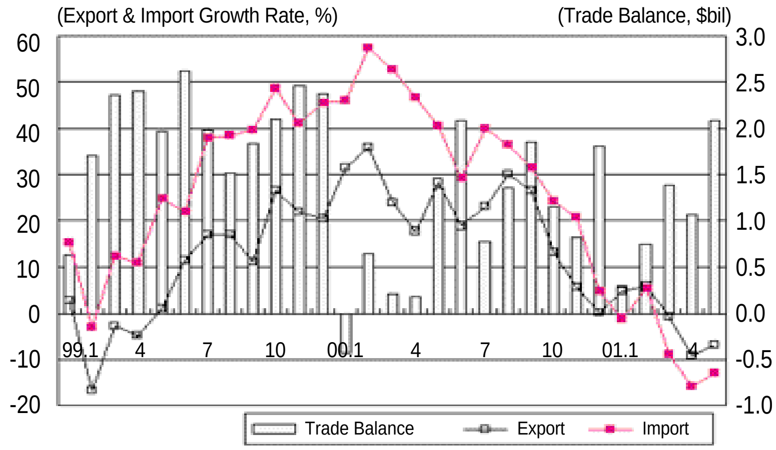
Exports led growth, but are faltering

The first quarter's growth depended heavily on exports- the contribution rate of exports to final demand was 130.4%. This growth pattern resembled that of the second half of 2000. However, the rate of export growth dropped from 16.4% in the fourth quarter to 8.4%, and the export decline became prominent since March.

Figure 2. Export, Import and Trade Balance



More worrisome, total exports, which led the first quarter's growth, seem to have fallen into a slump. Exports fell by 9.9% y-o-y in April and by 6.6% in May. In addition to price weakness, export volume also began to decrease. With continued stagnation of private consumption, the slowdown of exports makes stagnation in the second quarter probable, and growth in the second quarter is predicted at about 3.0%.

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Continued fall of business sentiment

Until recently, economic sentiment has surpassed performance. Although the business sentiment index and consumer confidence index haveimproved during early 2001, economic performance has not kept pace.

In June, business sentiment faltered from its improving trend since January. The Business Sentiment Index (BSI) of the Federation of Korean Industries (FKI), a representative indicator of current business sentiment, reported 114.3, a slight fall from May's 115.5. There are still more firms that are optimistic about future business conditions than pessimistic. However, worries of flagging sentiment are building up with the first decline in five consecutive months and other weakened sentiment indicators from the previous quarter.

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The recent BSI weakness was caused by sluggish exports since March. In fact, the BSI index on export prospects worsened for two straight months, although business prospects on future domestic demand were positive and reached 120.

Because external conditions are not expected to improve in the short run, firms' sentiments on investment seem to have shrunken further. Furthermore, the won's recent appreciation has frustrated Korean firms, who were counting on the won to decline, and their perceptions of current business conditions have been scaled back.

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More weight on the fourth quarter's recovery

Despite the gloomy factors above, however, the fact that business leading index has risen for four consecutive months since February means the current business cycle is nearing bottomed out. Since 1980, the business leading index has never declined after a three-month rise except in 1997, during the foreign exchange crisis. Additionally, the overall business cycle is expected to demonstrate a few positive signs after the third quarter such as recovery in exports of semiconductors, transportation and machinery equipment, a rebound in facility investment, and improved factory utilization.

So far, the most important hindrance to economic recovery has been the slowdown of the U.S. economy. If U.S. import demand is reduced by 1%, Korea's export volume to the U.S. will decline 1.7% in the long term. However, strong private consumption is supporting the U.S. economy despite significant cutbacks of capital expenditure and production in IT industries. As the Fed's successive rate cuts stimulate investment demand and mortgage refinancing, private demand is expected to recover in the third quarter. If income levels in Korea's biggest trading partners' do not slow, exports are expected to recover in the second half.

Reflecting these factors, economic conditions are expected to recover from the fourth quarter unless the economy is hit by internal or external shocks. More weight is laid on the upside potential of Korean economic growth.

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