RECENT ISSUES IN THE DOMESTIC ECONOMY

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1. Is the economy overheating?

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Some observers are concerned that the Korean economy is overheating for a number of reasons. First, the real estate market is experiencing a partial overheating. In 2001, domestic apartment prices nationwide rose by 14.5% year-over-year, the biggest increase since 1991, and in Seoul, prices rose by 19.3%. With the rapid increase in bank loans to households, funds are being concentrated into the real estate and asset market. In February 2002, in the first sale of housing lots, the application rate reached a record high of 44 to 1.

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The steeply rising domestic stock market is also cited as an indicator of overheating. On September 17, 2001, the Korea Stock Price Index was only 468.8, but by March this year, it exceeded the 900 level. Meanwhile, the bourses of advanced countries or emerging markets are either falling or rising slowly. Liquidity is also excessive, due to stimulus measures in 2001. The quarterly growth rates of M3 in 2001 were 8.2%, 8.2%, 10.3%, and 11.5%, which far outpaced economic growth.

Another cause for concern is the rapid increase of the Business Sentiment Index and consumer sentiment indexes. In March, the BSI rose by 31.2 points to 141.9, the largest increase ever. The consumer sentiment index recorded 55.7 in the first quarter, the highest figure since the fourth quarter of 1991.

The Ministry of Finance and Economy, as well as the Bank of Korea, think that a pre-emptive hike in the call rate is not necessary. Considering that export and investment have not started to recover in earnest, and the lack of inflationary pressure, they see little need to raise call rates. It is possible that this position will be adjusted when the growth forecast is revised upward in late April or early May.

The Department of Planning and Budget announced that it is possible that the early execution of the budget may be adjusted depending on economic conditions. While Morgan Stanley proposed that call rates be raised by 0.5% in light of a possible economic bubble, ABN Amro and Reuters have denied the possibility of economic overheating.

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Concerns of overheating are premature

Looking at a number of factors, one can see that the concerns of overheating are not substantiated. Coincident indicators that reflect current economic conditions, as well as leading indicators are showing signs of recovery rather than overheating. In particular, the cyclical fluctuation of the coincident index recorded 99.2, a level that merely shows an escape from the trough of the business cycle. Since 1980, the cyclical component of the coincident index has peaked at around 104, and bottomed out at around 97.

The manufacturing sector's operation rate is also showing only a slight recovery. The average operation rates in January and February were 76.6 and 76.5, showing that the excess facility and supply problem still exists throughout the economy. The recovery of the construction market has also been limited. The scale of the construction industry is smaller than before the financial crisis, and only a few areas in the capital are showing signs of overheating. The share of construction investment and housing construction in GDP in 2001 were 15.8% and 4.5%, far lower than the figures of 1997 (22.2%, 6.6%) or 1998 (20.9%, 6.4%).

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The upturn in facility investment and exports has also been weak. The export growth rate has been negative in January (-8.9%) and February (-16.8%), and facility investment is continuing to decrease or show weak gains.

In the financial sector, stock market trends are currently being led by foreigners and are based on economic fundamentals. The stock market boom that arose after late 2001 was not due to domestic buying, but investment by foreigners who expected a recovery in the Korean economy. The increase in foreign buying was based on several factors: first, Korea had better macroeconomic performance in 2001 than other Asian countries. Second, if the world economy enters a recovery in 2002, the Korean economy may possibly see the largest and fastest gains. Third, corporate restructuring efforts are improving management transparency, as well as profitability and financial structure. Fourth, stocks have relatively low price to earnings ratio and are still relatively undervalued compared to the company°Øs value. Therefore, the recent stock market boom in Korea is not based on a bubble mentality but on improvement in fundamentals and expectation for continued progress.

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Policy Tasks

Fine-tuning through policy mix and monitoring of economic conditions is needed more than ever. In fiscal policy, while the front-loading of the budget in the first half should be maintained, spending should focus on human resources and expansion of infrastructure. In monetary policy, measures to restrict the free increase of market interest rates should be abandoned, and an increase in call rates should be considered only when exports begin to show a definite recovery. Meanwhile, measures to prevent foreign capital flight should be installed as foreign investors wield heavy influence in the domestic stock market.

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Microeconomic policy should be used to resolve sectoral problems, and the emphasis should be on raising the stability of the overall economy. For example, overheated real estate markets in some areas should be moderated without causing the whole real estate market to contract. Stability also needs to be improved by resolving labor conflicts in public corporations and other factors of social tension. In addition, corruption should be rooted out and restructuring efforts continued to improve corporate transparency.

2. Likelihood of export recovery

Since March 2001, exports have shown a continued downtrend, although the decline tapered this March at -5.2%.

Since March 2001, exports have shown a continued downtrend, although the decline tapered this March at -5.2%. In February 2002, all main industries saw decreased exports except for autos and wireless telecom devices. Semiconductors fell by 34.3%, iron and steel products by 15.8%, petrochemicals by 12.4%, machinery by 14.2%, computers by 0.3%, and shipbuilding by 36.7%. Exports also decreased for all regions except for China.

The cause of the export slump includes the world economic recession, as well as tighter trade restrictions by the US and EU. The structural reason is that Korean exports depend excessively on price competitiveness, and because Korea focuses on a few strategic industries for its main exports, it is sensitive to fluctuations in the world economy.

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Most observers expected exports to show an upturn in the second quarter, and begin to recover in earnest in the third quarter. The decline rate of exports has moderated in 2002compared to the second half of 2001, due to a technical rebound from the second quarter of 2001 as well as expectations for improved export conditions. In particular, the high possibility of economic recovery in key export markets such as the US and EU will be a positive factor for exports.

It is unclear whether a major export recovery will occur however. Export growth rates are not expected to exceed 10% due to the need for improved competitiveness of Korean export products. As a result, overall exports in 2002 are not expected to exceed that of 2000.

Policy Tasks

First, stable management of exchange rates and interest rates is needed. An appropriate won rate should be maintained considering factors such as the yen rate. In addition, the price competitiveness of export companies should be protected from events such as a rapid hike in interest rates.

Another task is to improve the financial conditions of export companies. Insurance for exchange rate fluctuation should be expanded, and trade financing guarantees should also be expanded for small and medium sized companies and venture companies. In addition, an expansion of support for project finance for infrastructure projects in developing countries is needed.

Some industry bottlenecks still remain unresolved. Export insurance should be expanded to countries that have difficulty establishing letters of credit. Tariffs should be removed for raw materials such as iron and steel and IT components. Also, support needs to be broadened for development of industrial technology.

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In the mid- to long term, companies should try to diversify exports and increase the value-added of their products. The existing emphasis on export volume should be discarded, and research and development should be actively promoted to develop new products with high value-added. Measures should also be taken to build export industries in the bio and nanotechnology sectors.

Non-price competitiveness, such as brand and design, should be improved. Diverse products with unique functions should be developed. Companies should also gradually diversify their export markets from the US, Japan and Southeast Asia to include the Middle and South America, the Middle East, Eastern Europe, and Africa. VIP