

POST WORLD CUP MACRO ECONOMIC ISSUES AND OUTLOOK

Department of Macroeconomic Analysis

Background information for changes in economic outlook

Korean economy's upturning trend is expected to continue during second half of this year. By recording the first-half growth rate of high 5% and mid 6% for the second half, the overall GDP growth rate for the year 2002 is expected to be approximately 6.2%.

Korean economy's upturning trend is expected to continue during second half of this year.

Originally, the 2002 GDP growth rate was expected to be at a low 5%. There have been, however, several changes to the original assumptions. Therefore, corrections in economic outlook that reflect these changes are in order.

First, the economic recovery have gained elasticity. Private consumption and construction investment have led an overall economical growth from the fourth quarter of 2001 until the first half of this year. While private consumption and construction investments are showing signs of slight weaknesses, facility investments and exports are showing signs of recovery, causing overall growth to gain elasticity. Even though the Won/dollar rate is in a decline, this elasticity is expected to increase because of increased exports.

Second, a weak US dollar and strong Korean Won are expected to continue. A continued strength of the US dollar was originally expected but both current account and balance of payment problems in the US have caused a worldwide weakening of the US dollar. Furthermore, Korean Won's value is rapidly increasing due to the fact that the value of domestic fundamentals has increased favorably. This movement is expected to slow down somewhat, but appreciation of Won will continue.

Third, major economic bodies are sensing the improvement in business. Past and upcoming elections and/or new regulations (5day work week, PL law, etc.) were expected to slow down this upward trend. On a contrary, the economic outlook, from both businesses and consumers, is unexpectedly very positive.

Fourth, there is a very little possibility of the US economy's 'double dip' and Japanese economy is unexpectedly showing a positive signs. Japanese economy has grown by 1.4%(annually 5.7%) in the first quarter, which is a very positive sign that shows a rapid slowdown of stagnation. Despite presence of a few uncertainties, the US economy is expected to grow by 2%. If IT industries show signs of recovery, this will amplify the trend of global economic recovery.

Basic assumptions of corrected economic outlook

Domestic and international economic conditions are expected to stabilize.

Despite a few uncertainties, both domestic and international economic conditions are expected to stabilize.

First, the worldwide economic recovery will be sustained. The US economy will not show a 'Double dip' phenomenon, IT industries will slowly recover at the second half of this year and both Japanese and European economy will likely to maintain a recent positive economic progress.

Second, international oil prices are likely to decline and stabilize. A downward trend in international oil prices, primarily due to the political stability in Middle East, will likely overpower the pressure to increase oil prices due to an increased demand cause by the worldwide economic recovery.

Third, uncertainties that are hovering international money market are expected to ease back a little. Deficits in the US current and fiscal account have caused an outflow of foreign investment from the US. In turn, this may have caused current slippage in the US dollar. This slippage, however, will eventually loose momentum and if the US economy somehow avoids showing a 'Double dip' phenomenon and regain international trust, the US stock market will not likely show a drastic drop.

There are several uncertainties and risks that may threaten the economic stability.

There are several uncertainties and risks present along with positive signs that are mentioned above. First, worldwide economic recovery cannot gain any momentum unless recovery from IT industries becomes more prevalent. Furthermore, if situation in the Middle East worsens, prices for oil and raw material will soar, causing a contraction of international trade.

Second, there is a possibility of disturbance in domestic money market. Domestic money market's stability will be under constant threat as long as there are a rapid appreciation of Korean Won and constant influence exerted by movement in the US stock markets and foreign investors.

Third, there are several domestic factors that may disturb the economy such as: Economic policy's loss of independence and consistency due to government's election-oriented political influences, the five-day work week regulation, a possible labor trouble stemmed from privatization of public enterprises and a mass-egoism caused by the upcoming election.

The importance of policy makers' abilities to address these uncertainties and risks cannot be over emphasized.

Features of the second half economy of year 2002

First, growth will be led by the infrastructure investments and exports in the second half of this year, compared to the first half's private consumption and construction investment led growth.

Even though private consumption is current showing a slight downward trend, it will likely to stabilize primarily due to the upcoming election and five-day workweek regulation. On a contrary, investments from business will increase because the worldwide economy is showing positive economic signs.

Second, growth rate of the economy for year 2002 will be around 6.2%(in mid-

6% in second half) but a chance for the overheated economy is very slim. First reason why there is very little chance of the overheated economy is a limited growth in exports. Secondly, there will be very little investments in infrastructure because of the political change at the end of this year. Lastly, domestic businesses' investment mind is shifting from focusing on the scale of operation to focusing on productivity and profitability

Moreover, a pressure to raise price level will not likely be significant and demand does not appear to recover quickly either. The price level will not rapidly increase if current downward trend of Won/dollar rate continues, prices of oil and raw material stabilize, and worker's wage rate stays relatively stable. Increased money supply due to the upcoming election, and a five-day workweek regulation, however, will become factors that increase the price level of year 2003.

Macroeconomic policy directions and issues

There are several uncertainties remain in both cash-oriented sectors and banking sectors despite a positive outlook on the second half of this year's economic recovery. Policy makers should consider following factors in order to increase the economic stability.

First of all, macro economic policy has to maintain neutral(i.e. stable) position. Reacting too hastily on a temporary overheated economy by utilizing contractionary policies will result in a premature stoppage of the economic recovery. Fiscal policies must be able to maintain both neutral(stable) and low interest rate basis while bolstering the ability to finely tune and influence the economy.

The maintenance of a low-interest rate basis is especially important. There is a very little possibility of an interest rate hike in order to stabilize the price level because price level for the second half of this year is expected to be relatively stable. An excess interest rate hike can cause investment to dry up and this may limit both short and long term economic recovery, and it may weaken the expansion of growth potential. Therefore, while maintaining a low-interest rate basis, considering both international and domestic macro economic environment and short and long term interest rate spread, an increase in call rate for the second half of the year should be around 0.25%.

Policy makers should focus on carrying out several pressing matters in the second half of this year. First, the economic policies have to minimize uncertainties and achieve a definitive economic recovery. This can be done by recognizing factors that can cause uncertainties, either domestic or otherwise, and making them visible so these uncertainties can be quickly addressed and solved in advance. Maintaining consistency in economic policies can be another important contributing factor in alleviation of uncertainties. Also, in order to achieve a definite economic recovery, 'growth-inducing capacity' of each sector (e.g. consumption, investment, export) has to grow.

Second, the economic policies must be able to minimize shock from external sources, such as a rapid decline of Won/dollar rate or trade disputes. Actually, this minimization of external shock is closely related to problems in domestic economy.

Therefore, it is more of a mid-to-long term policy problem. In other words, banking sector's competitiveness has to increase via maintaining the structural adjustment while encouraging direct banking market. At the same time, parts and materials industry's growth has to be encouraged so foreign dependence of the object economy can be decreased. Nevertheless, several short-term policy actions, such as tight regulation of monetary speculators and preparation for a possible trade disputes, should not be overlooked.

Third, factors that can disturb domestic policy actions must be eliminated in advance. The economic policy action must remain free of any unnecessary political influences. Maintaining consistent economic policies can minimize the possible occurrence of a social discord. Also, any collective egoism must be quashed swiftly.

The second half of year 2002 is a very important time for Korean economy. In other words, whether Korean economy can maintain a stable growth will be decided during this time period. Policy makers must steadily carry out policy actions that will overhaul Korean economic system, strengthen growth potential and minimize any foreign or domestic economic disturbances

Macroeconomic Outlook

The economy will show a steady growth during the second half of this year.

The GDP growth rate will be around 6.2%, showing an improving economic trend. Even though both private spending and construction investments, that were leading the growth since third quarter of year 2001, are likely to show a little contraction, consumption, investments and exports are expected to fill the void.

The current account surplus will continue, but the size of surplus is likely going to decrease due to a growing amount of imports.

In the first half of this year, weak US dollar and domestic economic recovery have caused the Won/dollar rate to drop significantly. Won/dollar rate is expected to be stabilize around 1,210~1230 Won/dollar due to an inflow of foreign investment in Korean stock markets.

Unless there is a sudden shock, (Oil & raw material prices etc.) price level will remain relatively stable. The economic upturn trend and increased demand in the service sector due to a five-day workweek regulation may put an pressure on the price level.

The economic upturning trend, hosting of the World Cup and Asian Games, and upcoming election will likely decrease the unemployment rate to approximately 3.1%, a lower figure compared to the year 2001.

Primarily due to the positive economic trend and increased demand in cash for financing, interest rate will steadily rise from current level of 5.8% (based on the government bond earning rate) to about 6.0% by the end of this year. **VIP**