

Country Brief : South Korea

President Roh Moo-hyun faces the difficult task of not only tackling foreign policy issues, particularly North-South tensions, but also domestic concerns encompassing corporate reform, labour issues and putting the economy back on a strong growth track. The economy is facing its steepest downturn since the Asian crisis, slipping into recession in the first half of this year but a strong rebound is expected in the second half, putting growth for the year at around 3¼% with a sharp pick-up to around 6% in 2004.

No honeymoon for new leadership

President Roh Moo-hyun assumed office on 25 February 2003 and his first 100 days have been fraught with challenges. Three years after the historical peace summit in June 2000, North-South relations are at a low, undermined by North Korea's nuclear ambitions. Tensions remain high as a diplomatic resolution, working with China, Japan, the US and possibly Russia, is sought. However, multilateral talks with North Korea continue to meet with resistance from the North, suggesting a long road ahead to a possible breakthrough in resolving the nuclear dispute. President Roh has also had to maintain a delicate balance between reaffirming ties with the US, which have come under strain due to policy differences and anti-US sentiment, and developing a more balanced alliance.

At home, the economic downturn, labour unrest, a US\$1 bn accounting fraud involving the trading arm of South Korea's third largest conglomerate as well as fulfilling a pledge for further corporate sector reform are providing early challenges to the President who has faced a loss of popular support.

Economy slips into recession in H1 2003

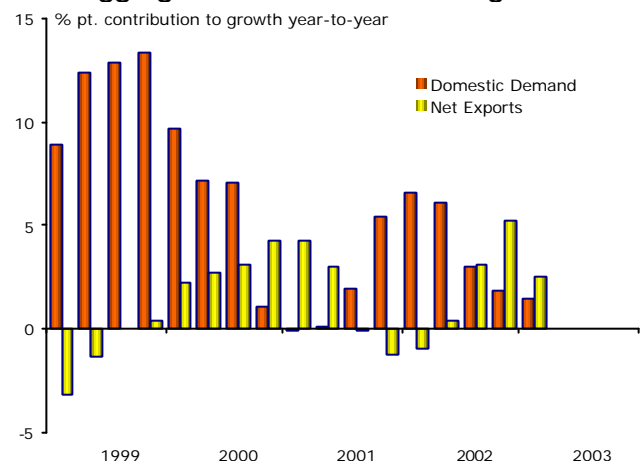
The Bank of Korea has estimated that real GDP fell 0.7% in the June quarter after contracting 0.4% in Q1 2003, putting the economy in technical recession for the first time since the Asian crisis. Private consumption fell 2.1% in the March quarter as spending was dampened by high oil prices, uncertainties over the Iraq war and renewed tensions with the North. In addition, the rapid acceleration of consumer debt and subsequent tightening of credit regulations have curtailed household spending. Credit to households has ballooned from KRW184 tn at end-1998 to KRW439.3 tn as at March this year. However, credit growth has slowed quickly, from 8% in the June quarter 2002 to 0.1% in the March quarter 2003.

Consumer demand remained soft in the second quarter, tempered by fears associated with the outbreak of Severe Acute Respiratory Syndrome in the region. Retail sales were weak in April and May, declining by an average of 3.8% compared with the same period in 2002. The seasonally-adjusted

unemployment rate has edged up from 2.8% at end-2002 to 3.4% in May 2003.

Production has been hit by industrial strikes and capital spending has been weak. The Business Survey Index compiled by the Korea Chamber of Commerce and Industry has been below 100 since Q4 2002 reflecting a more pessimistic outlook on the economy.

Flagging domestic demand hits growth



... but a rebound is expected in H2 2003

Flagging domestic demand has prompted a more accommodative fiscal and monetary stance. The overnight call rate was cut by ¼ point to 4% in May and a fall in consumer prices in June compared to May as well as weak economic activity prompted another rate cut, in July, bringing it to 3.75% - a record low. Parliament recently approved a US\$3.8 bn fiscal stimulus package to help lift domestic demand. Nevertheless, given concerns of the depth of the slowdown in economic activity, a second supplementary budget cannot be ruled out.

Economic activity is expected to gain momentum in the second half as private consumption picks up, helped by lower oil prices, and supportive macroeconomic policies. In addition, improving external demand should help to lift business investment and exports. Real GDP is forecast to grow by around 3¼% in 2003 but expand at a sharply higher rate of around 6% in 2004.

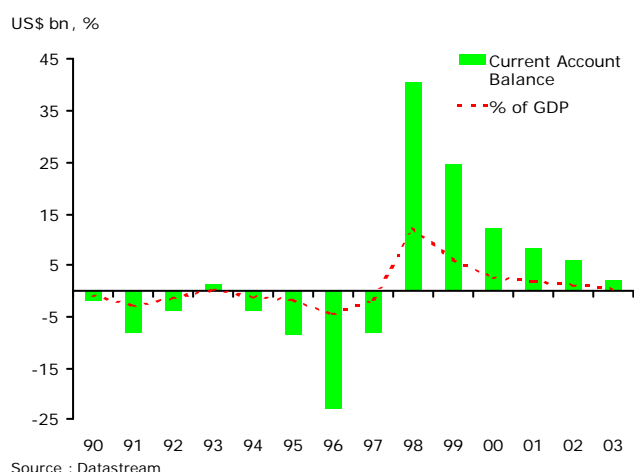
Due largely to higher oil prices earlier in the year, average annual inflation, at 3.7% for January-June 2003, is a full percentage point higher than for the same period in 2002. However, there are signs that inflation is easing thanks to the more recent fall in oil prices and lower food prices: the CPI grew by a lower 3% over the year to June 2003 compared with 4.5% in March, the highest rate since August 2001.

External position remains healthy although trade surpluses have been reduced

In June, the merchandise trade balance (customs-cleared basis) posted its biggest surplus since December 1999 of US\$2.4 bn. This was more a reflection of softer domestic demand rather than robust export performance. For the first six months of this year, the trade surplus was US\$3.4 bn, down 32% from the same period in 2002. Export growth has slowed markedly, from around 25% over the year to Q4 2002 to 15% over the year to Q2 2003. Korea's top two markets – the US and China – account for around 35% of total exports. Sluggish demand in the US and the SARS outbreak in China have severely curtailed export growth to these markets.

Imports have also grown at a slower pace reflecting a softening in consumer demand as well as demand for intermediate goods in response to weaker export growth. In addition, lower oil prices have improved the import bill (mineral fuels account for about 20% of imports). Imports, however, are expected to pick up in the second half of the year to meet the anticipated demand from export-oriented industries as external demand gains momentum.

Current account surplus narrows



The current account surplus has been steadily eroded over the past few years. For the first five months of this year, the current account shortfall stood at US\$903 mn. A narrower trade surplus has made it more difficult to cover the large deficit in the services balance. However, a surplus of around

US\$2 bn (0.4% of GDP) is projected for the year as a whole as export growth outpaces import expansion.

South Korea's external balance remains in a much stronger position than in the lead-up to the Asian crisis. International reserves stood at US\$123.6 bn as at April 2003, compared with US\$20.4 bn at end-1997. They were sufficient for close to 8 months of imports against only 1.4 months in 1997. The ratio of short-term debt to reserves has dropped from over 300% in 1997 to around 34% in 2002. External debt was estimated at US\$124 bn as at 2002 (24% of GDP).

Business reform and labour relations prime issues in corporate sector

Foreign direct investment for the first half of this year was US\$2.7bn, down from US\$4.8 bn for the same period in 2002 (US\$9.1 bn for the full year). The government's forecast of US\$6-7 bn for the year appears optimistic. Labour-management relations, transparency issues and North-South tensions together with weak global economic prospects have slowed the momentum of investment flows. The government recently extended tax breaks to encompass a wider industrial base to help attract investment but corporate sector reform and reducing the threat from the North will remain key factors in drawing larger long-term foreign commitments.

Concerns over corporate sector reform, particularly governance standards and transparency issues, have been reinforced by the handling of the troubled SK Global, the trading arm of the third largest chaebol, SK Group. The likely bail-out of SK Global by the Group despite strong opposition from foreign stakeholders underscores the difficulties faced by foreign investors in South Korea's family-controlled businesses or chaebols. However, the drawn-out debate over the outcome of SK Global contrasts sharply with what would have been an automatic move prior to the Asian crisis.

The escalation of labour strikes has seriously undermined the economy as unions call for reduced work hours and express concerns over the government's proposed privatisation and its impact on the workforce. The government has taken a tough stance on cracking down on strike activity in a bid to stave off criticism that it has been too soft with the workers earlier in the year. For instance, the privatisation of Chohung Bank went ahead but employees' strike action was ended by a compromise deal, which included job guarantees and wage hikes.

There is increasing concern that labour unrest will spread and remain a major obstacle to foreign

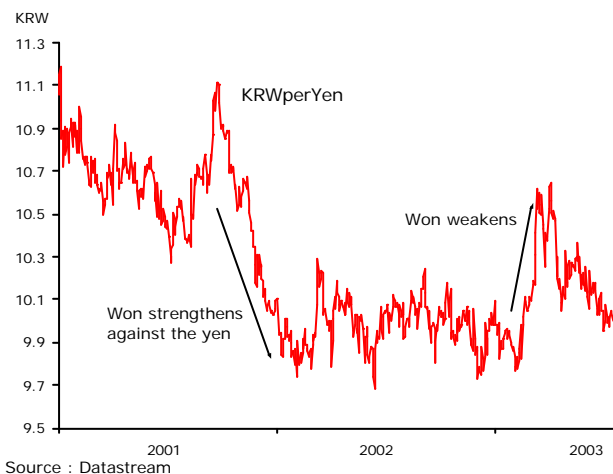
investment. In the World Competitiveness Yearbook 2003, South Korea's labour market was ranked the least competitive among 30 countries surveyed by the Institute of Management Development.

Within the financial sector, the pick-up in performance of the banking sector since the Asian crisis has lost momentum. Higher provisioning for debt exposure in the corporate sector and rising credit card delinquencies are likely to have dampened banks' performance in the first half of this year. The combined net income of 19 local banks was KRW46.5 bn in the first quarter of 2003 compared with KRW200 bn in the previous quarter. There has been a significant rise in non-performing loans (NPLs), which increased by 24% from December 2002 to March 2003 but the ratio of NPLs to total loans remains low at 2.7% compared with 11.3% as at end-1999. However, efforts to improve credit quality through tighter lending procedures should help to strengthen banks' performance in the long run.

Financial markets weighed by domestic concerns

The Korean won came under some downward pressure in March as tensions with North Korea escalated and concerns over the health of SK Group intensified. The won moved from KRW1186 per US dollar at the start of the year to KRW1261/USD on 28 March before regaining ground to around KRW1180/USD on 16 July.

Won's movement closely tied to the Yen

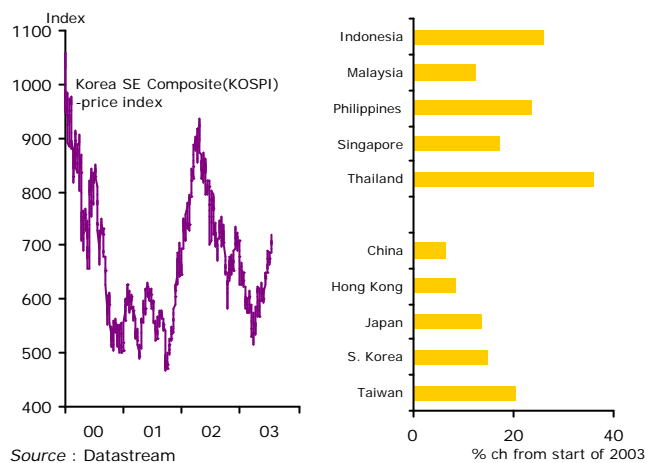


For the most part, the won's movement mainly reflects fluctuations in the yen given that South Korean exports closely compete with Japanese goods, particularly in industries such as automobiles, telecommunication equipment,

petrochemicals and shipbuilding. Apart from the period earlier in the year where sentiment took a decidedly adverse turn and led to a weakness in the won, the KRW/Yen rate has moved in a tight range, highlighting the importance of maintaining the won's competitiveness against the yen. Economics@ANZ expects the yen to remain relatively steady against the US dollar over the next few months with a downward bias in 2004. This, in turn, is likely to put downward pressure on the won against the US dollar.

The Korean stockmarket was similarly impacted with the KOSPI down 15% between end-December and end-March. It has, however, picked up by 34% since the low in March. Compared with its Northeast Asian neighbours, the stockmarket has performed relatively well but has grown at a much slower rate than its Southeast Asian counterparts.

Stockmarket shows signs of recovery



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