

KOREA

Following a GDP growth of 3 percent in 2001, the Korean economy rebounded strongly in 2002, despite a sluggish global economy. In the last three quarters of 2002, GDP grew year-on-year by 6.4 percent, 6.0 percent and 7.0 percent (seasonally adjusted), respectively. For the year as whole, growth averaged 6.3 percent.

Much of this recovery was driven by growth in private consumption and a very strong export performance. However, recent data suggest a deceleration in private consumption growth. While the deceleration in consumption growth has in part been due to measures taken to curb the rapid growth in consumer borrowing that took place during much of 2000 and 2001, it also reflects consumer uncertainty about domestic economic prospects over the coming months. The consumer sentiment index, which gauges how consumers feel about domestic economic prospects over the next six months, has remained below 100 since October 2002. Data capturing investment trends in January and February 2003 also suggest a slowdown.

The Korean economy may be more sensitive to downside risks in the global environment than other countries in the region due to the combination of Korea's dependence on oil imports, high level of exports and relatively strong linkage to international equity markets. Based on the current global environment and associated uncertainties—including developments with respect to DPRK—our growth forecast for 2003 is now 4.9 percent. However, while Korea's GDP growth rate is likely to slow in the near term, Korea's ample reserves and relatively low public and external debt levels should limit its vulnerability to external shocks.

Over the longer term, the progress made in corporate and financial sector restructuring and towards establishing a system based on greater market discipline should put Korea on a good footing to sustain productivity-driven growth.

Recent Macroeconomic Developments

Output, wages and inflation

The Korean economy performed strongly in 2002, despite a sluggish global economy, primarily reflecting strong growth in two of the major components of final demand: private consumption and exports (Figure 1).

- Private consumption growth, which had been a key driver during most of 2001, remained robust in 2002, although it tapered somewhat in the fourth quarter of 2002. Following growth of 8.9 percent year-on-year in the first quarter of 2002, household spending grew by 7.6 percent, 6.5 percent and 4.4 percent year-on-year in the second, third and fourth quarters respectively. Of the 9.5 percent average growth in final demand in 2002, private consumption

contributed about 3 percent (Figure 2), sustained by steady growth of household income, ample credit to households, and low real interest rates. However, since the end of the year, the momentum of private consumption has waned—January 2003 data on retail and wholesale sales (seasonally adjusted) show a month-on-month decline of 2.0 percent.

Figure 1. Real GDP and expenditures
(Index 1998 Q2 = 1.00)

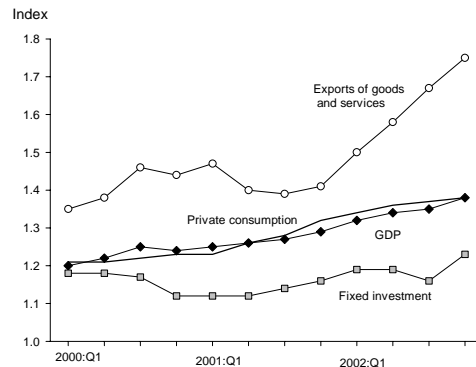
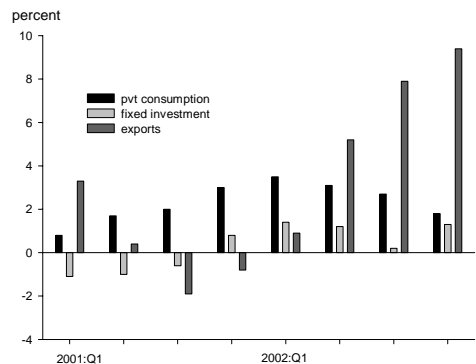


Figure 2. Contribution to year-on-year growth in final demand
(percent)



Gross fixed investment, which picked up in the last quarter of 2001, grew by an average of 6 percent year-on-year in first half of 2002, before slowing down significantly to a year-on-year growth rate of 1.1 percent in the third quarter. However, it picked up sharply again in the last quarter of 2002, when it grew by 6.1 percent year-on-year. The contribution of fixed investment to the 9.5 percent average year-on-year growth in 2002 was 1.0 percent (Figure 2). Much of the growth was driven by equipment investment and construction. The contraction in equipment investment seen since early 2000 (in tandem with the contraction of the high-tech sector) reversed in the first quarter of 2002 and strengthened further throughout the rest of 2002, when it grew by an average of almost 8 percent year-on-year. Construction investment, which picked up in 2001, reversing three years of decline, continued to show strong growth during the first quarter of 2002. And although growth slowed in the second quarter and investment in

construction actually declined by almost 4 percent year-on-year in the third quarter, it picked up again in the fourth quarter, growing over 5 percent year-on-year. However, more recent data on capital goods and machinery imports, suggest a sizable slowdown in investment growth again—capital goods imports declined by 8 percent month-on-month in January 2003, while growth in machinery imports declined by as much as 16 percent month-on-month.

- The pick-up of exports in goods and services began towards the end of the first quarter of 2002, and accelerated through the rest of the year—growing by 13 percent, 20 percent and 24 percent year-on-year in the second, third and fourth quarters respectively. This performance was led by a resumption of growth in high-tech exports (semi-conductors and information and communications manufactures). At the same time, other parts (autos and ships) of Korea's diversified export structure continued to fare relatively well. Thus exports, which had made a negative contribution to the growth in final demand in the last half of 2001, contributed almost 6 percent of the 9.5 percent average year-on-year growth in final demand during 2002. Unlike the other components of final demand, exports continued to perform strongly through January 2003.

- On the supply side, the services sector delivered a strong performance, growing at 10.8 percent year on year in the first two quarters of 2002, 11.3 percent year-on-year in the third quarter and 9.1 percent year-on-year in the last quarter. This strong outturn reflected consumer optimism in general and rapid growth in areas such as credit cards in the first three quarters of 2002. The strongest growth however was in electricity, water and gas, which received a boost from the recent high level of public works: average year-on-year growth during 2002 was over 13 percent. There are indications, however, that the momentum of service sector growth may be waning, as indicated by a weaker growth more recently in retail sales, hotel and restaurant, and transportation and communication.

Reflecting the strong GDP growth—especially in the services sector—the year-on-year unemployment rate (seasonally-adjusted) declined from 3.7 percent in 2001 to 3 percent in 2002. As of February 2003, it has remained at 3 percent (seasonally adjusted). Thus, the unemployment rate is now comparable the pre-crisis period, although labor force participation remains below the pre-crisis peaks. At the same time, wage rises have been matched by productivity increases: while average monthly earnings rose by 10.5 percent year-on-year in the first three quarters of 2002 (an increase from 6 percent year-on-year in 2001), manufacturing productivity also accelerated to 9.4 percent year-on-year in the first half of 2002.

Year-on-year consumer price inflation averaged 2.8 percent in 2002. More recently, there has been some upward pressure—with year-on-year inflation in January and February 2003 rising to 3.7 percent and 3.8 percent respectively. However, this has been mainly due to supply

side factors such as higher oil prices, seasonal increases in agricultural prices and public utility charges. Core consumer prices, which exclude energy and food costs, have remained relatively stable, averaging 3 percent year-on-year during January and February 2003, thus continuing to be at the center of the Bank of Korea's target range of 2-4 percent.

External sector

Current account developments

In 2002, exports in US dollar terms surged to \$162.5 billion—a 7.5 percent increase from the previous year. Nominal export growth was particularly robust in the third and fourth quarters of 2002, when it grew by 13 and 26 percent year-on-year respectively. The growth in dollar exports reflects a rebound in export volume growth in the second half of 2002, driven largely by a pickup in exports of automobile, heavy and chemical goods and high-tech goods (semi-conductors, computers and info-communications equipment). China was the second most important destination of Korean exports (after the US) in 2002. Imports of goods and services also rose by a similar magnitude (7.7 percent) and stood at \$148.3 billion at the end of 2002 (Figure 3). Although Korea's terms of trade improved in the first quarter of 2002, it declined from April onwards and by December 2002 the deterioration was over 7 percent year-on-year (Figure 4). As a result, the trade surplus, which had eased from \$16.9 billion in 2000 to \$13.4 billion in 2001, declined further to \$8.6 billion in 2002, and the current account surplus, which was \$8.6 billion at the end of 2001, narrowed to around \$6 billion in 2002. More recently, with the higher oil prices that have fed into higher import costs, the trade and current account have both turned negative (the trade deficit during January-February 2003 amounted to US\$ 0.6 billion and the current account deficit was US\$ 0.37, as compared to surpluses in the trade balance and in the current account of US\$ 0.16 billion and US\$0.6 billion respectively in the first two months of 2002).

Figure 3. Exports and Imports of goods (US \$ billion)

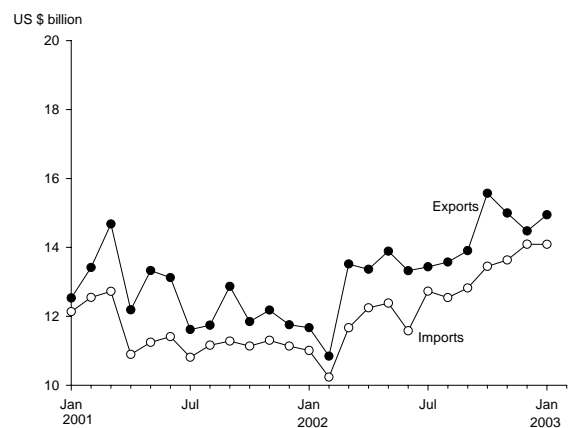


Figure 4. Trade Indices

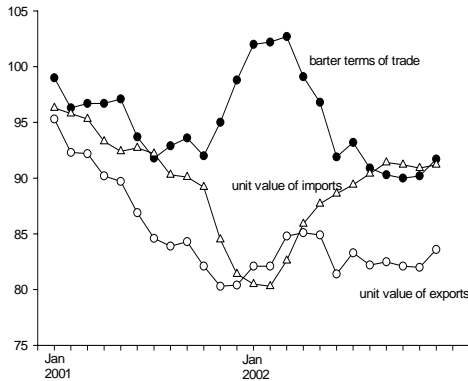
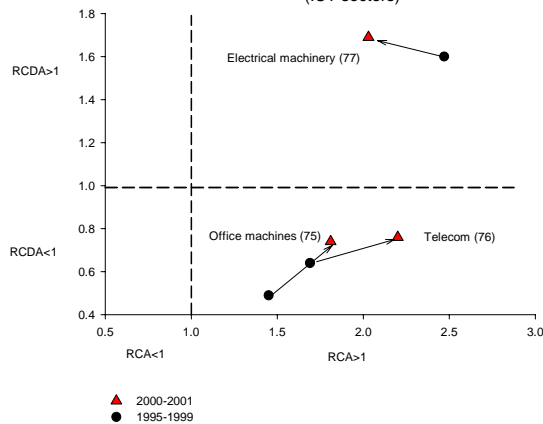


Figure 5. Revealed Comparative Advantage Positions (ICT sectors)



Underpinning the strong export performance in 2002 has been a longer-term trend improvement in Korea's competitiveness in some key products, as measured by Revealed Comparative Advantage (RCA) indices. In the information, communications and technology sectors (ICT) for instance, Korea has a significant revealed comparative advantage in exports. (A country's RCA in a certain product captures the extent to which the country exports a higher proportion of the product than the average country, and is measured as the ratio of the share of the product category in that country's exports to the share of that product category in overall world exports). Thus in 2000-2001, Korea's RCA in exports was 1.8, 2.2 and 2.0 in office machinery (SITC 75), telecommunications (SITC 76) and electrical machinery and electronics (SITC 77) respectively¹. Indeed, Korea appears to be increasingly participating in the regional production sharing process in these sectors—a process that is generally associated with both higher exports and imports. (Production sharing involves the breaking up of the production process—facilitated by reduction in transport costs and improved logistics—that allows firms in different countries to take part in those stages of production in which they have a comparative advantage. This in turn, leads to greater trade

¹ An index of 1 or higher indicates a revealed comparative advantage in exports.

and can enhance efficiency). In particular, Korea already appears to be engaged in production sharing in the electrical machinery sector, as evidenced by both a revealed comparative advantage in exports and a revealed comparative disadvantage in imports (higher than average imports in this sector) and a high intra-industry trade index², and is moving towards production sharing in both office machinery (SITC 75) and telecommunications (SITC 76) (Figure 5).

Not surprisingly therefore, Korea's exports of parts and components in these sectors have increased dramatically since the mid-1990s. For instance, Korea's share in China's total imports of parts and components in the telecommunications sector has increased from 4.3 percent in 1995 to 8.0 percent in 2001. Similarly Korea's share of China's total imports of parts and components in the electrical machinery sector has increased from 4.2 percent in 1995 to 9.3 percent in 2001. There have also been significant increases in Korea's share of ICT parts and components imports of other East Asian countries, including Indonesia, Thailand, Malaysia and the Philippines.

Capital account developments

The capital account showed a net inflow of \$1.5 billion during 2002. Much of the inflows were on account of short-term loans and trade credits, which increased in line with the pickup in economic activity, and were facilitated by improvements in Korea's credit rating. FDI inflows amounted to \$1.9 billion during the year—much lower than the \$3.5 billion recorded the previous year, both due to the weak global environment as well as a decline in the number of mergers and acquisitions of Korean companies. With Korean foreign direct investment abroad (at US\$2.6 billion) exceeding these inflows, net FDI flows were a negative \$0.7 billion. While net outflows from the stock market amounted to \$1.6 billion, this was made up in net inflows of debt securities, so that net portfolio investment showed a modest positive balance of \$0.18 billion. With net outflows of both FDI and portfolio investment during January-February 2003, the capital account surplus narrowed to US\$0.8 billion—compared to a surplus of US\$ 1.3 billion during January-February 2002.

External assets, liabilities and exchange rate developments

With both the current and capital account recording large surpluses in 2002, Korea continued to accumulate foreign reserves. At end-January 2003, official reserves amounted to \$122.9 billion—almost twice the short-term external liabilities on a remaining maturity basis. (And total external assets at \$187.6 billion exceeded total external liabilities at \$132.3 billion as of January 2003).

² The Grubel-Lloyd index in electrical machinery was 0.86 in 2000-2001. The higher the index, the greater the intra-industry trade. In general, 0.5 or higher is taken to indicate high intra-industry trade.

The Won appreciated by about 7 percent against the US dollar in nominal terms in 2002. Against the Japanese Yen however, the Won was relatively stable, appreciating by only 2.5 percent in nominal terms in 2002. However, reflecting growing uncertainty about the external environment, as well as adverse market reaction to the SK Group scandal (the trading unit of SK, Korea's third largest chaebol, has recently admitted to misrepresenting its level of debt), the nominal exchange rate depreciated by about 3.5 percent against the US dollar at the end of March 2003 (from the end 2002 level).

Monetary and Fiscal Developments

In May 2002, following a rapid growth in monetary aggregates that reflected a surge in lending to households, BOK raised the target call rate by 25 basis points. Household credit rose at an annual rate of 34 percent in the first three quarters of 2002, following strong growth in 2000-2001. Most household borrowing has been used to purchase housing, and almost two thirds of bank loans are collateralized. Although delinquency rates on bank loans are relatively low and have declined since 2000, credit card delinquency ratios have continued to rise sharply since 2000—reaching some 12 percent at the end of 2002. Accordingly, the authorities undertook a series of actions during the course of 2002 related to household lending and provisioning. Effective May 2002 the FSS/FSC increased minimum provisioning for household loans, and strengthened the asset classification criteria by requiring that loans overdue by three months or longer be classified as substandard if they exceeded 60 percent of collateral value. Although the pace of household lending slowed after May 2002, it picked up strongly again in August and September. In September 2002, therefore, the FSC/FSS lowered the guideline for the ceiling on loan to value (LTV) ratios for apartments in Seoul and parts of neighboring Kyonggi Province from 70-80 percent to 60 percent as part of a package to curb real estate speculation. And another package was announced in October 2002, comprising a) further increases in required provisioning, effective January 2003, with the increase also applying to insurance and finance companies; b) the requirement that credit evaluation be conducted for real estate secured loans in a manner similar to unsecured loans, taking into account borrower income and ability to pay; c) an increase in BIS risk weighting for some real estate secured loans; and d) a lowering in the LTV guideline to 60 percent throughout the country. These measures appear to be having an effect: household lending slowed at the end of the year.

Increasing uncertainties in the external environment and the recent slowdown in growth of private consumption and household debt, as well as weaker investor confidence, have discouraged BOK from raising the target call rate further, in spite of some indication of potential inflationary pressures and relatively strong industrial production and export data. Given the current set of mixed developments, BOK is expected to maintain a cautious stance in the first

half of 2003 and to monitor the situation as the various uncertainties unfold.

After reaching highs of just under 900 points in April 2002 on expectations of a faster-than-anticipated economic recovery, the Korea Composite Index slipped below the 650 points range in December 2002 and has continued to show weak performance through March 2003 due to uncertainties regarding the external environment, including concerns about North Korea, as well as repercussions from the SK episode. The spread on foreign exchange stabilization bonds which mature in 2008 fell to 7 basis points over US Treasury bonds as of end December 2002. This was much lower than the 28 basis points at the end of September 2002 and the 82 basis points at the end of 2001. The sovereign credit rating was maintained at "A-", (indicating "high" credit quality) by all three of the major credit ratings agencies—Moody's, Standard and Poors, and Fitch through the year. However, Moody's recently downgraded the outlook on Korea's long-term ratings from positive to negative, citing the "increasing uncertainty regarding North Korea actions and possible responses from the international community" as the reason.

The fiscal position for 2002 is expected to be sizably higher than the original budget. Excluding both privatization receipts and the National Pension Fund, a small deficit of 0.5 percent of GDP is expected, as compared to a budgeted deficit of 2.4 percent of GDP. (Inclusive of the national pension fund but excluding privatization revenues it is expected to reach a surplus of 2 percent of GDP, as compared to a surplus 0.1 percent of GDP in the budget). Reflecting the buoyant economy, total revenues are likely to exceed budget projections while current expenditures are anticipated to be 1 percent of GDP lower than budgeted.

In view of the anticipated longer-term pressures for public sector spending in financial sector restructuring, healthcare, public pension system, and North Korea cooperation, the Government has announced that the current conservative stance of fiscal policy will be maintained and that no deficit-covering bonds will be issued this year. (Such bonds had been issued since the financial crisis). Accordingly, the budget for 2003 (excluding SSF and privatization receipts) envisages an almost balanced fiscal position. (Including SSF, but excluding privatization receipts, the budget has been set at a surplus of 2.9 percent of GDP).

Financial and Corporate Sector Developments

The performance of the banking sector

The non-performing loans (NPLs) of commercial and specialized banks fell to 2.3 percent in December 2002 from 7.3 percent in September 2001 and 12.3 percent in September 2000 (Table 1). The average profitability of the Korean banking system also strengthened further. The average rate of return on assets in the commercial banking sector, which turned positive in 2001—at 0.76 percent—rose

to 0.87 percent as of the first half of 2002, and the rate of return on equity, which recorded 16.3 percent at end 2001, rose to 17.4 percent (Table 2). Data as of September 2002 indicate that average bank capital stood at 11.4 percent of risk-weighted assets. There remains some concern in the market, though, that a few of the state-owned banks with

substantial corporate exposures have sometimes been unwilling to move on large problem borrowers and accept reductions in their claims. In addition, provisioning levels may still not be adequate in the case of some of these large problem companies.

Table 1. Non-performing loans to total loans in the financial sector in 2002
(in percent)

Banks		Non-bank Deposit		Insurance		Securities		NBFi		All FIs		All FIs incl KAMCO	
Sep 2.4	Dec 2.3	Sep 11.8	Dec 12.3	Sep 4.4	Dec 4.1	Sep 46.0	Dec 38.2	Sep 11.1	Dec 10.0	Sep 4.3	Dec 3.9	Sep 9.4	Dec 8.9

Table 2. Indicators of profitability in commercial banks
(in percent)

	1997	1998	1999	2000	2001	2002 ^{a/}
Interest margins	1.13	1.53	1.79	1.05	2.16	2.89
Rate of return on assets	-0.93	-3.25	-1.31	-0.57	0.76	0.87
Rate of return on equity	-14.1	-48.6	-24.7	-10.8	16.3	17.3
CAR	6.6	8.2	10.9	10.5	10.8	11.4 ^{b/}

^{a/} As of June 2002 unless otherwise indicated. ^{b/} As of September 2002

The performance of the non-bank sector

In contrast to the banking sector, progress in the non-bank sector has been relatively slow, and NPLs in the non-bank sector remain quite high at 10-12 percent of total loans as of December 2002. Consequently the NPL ratio for the financial system as a whole still stood at 3.9 percent as of December 2002.

In the insurance industry, the combined net profits of 23 local life insurance companies of Won 3.8 trillion for the first three quarters of the fiscal year that ended in December 2002, were not sufficient to make up for the accumulated losses of Won 5.2 trillion over the past five years (ending March 2002). In fact, a number of insurance companies, as well as ITCs, remain undercapitalized and there are concerns about the financial strength of the non-bank deposit taking institutions. Among the latter, the weaker institutions are credit unions and mutual savings banks. As of end-June 2002, almost 30 percent of credit unions were insolvent and as a group credit unions have suffered losses for several years. The FSC/FSS suspended operations of 122 credit unions towards the end of last year and has recently announced that 107 are to be liquidated.

Nine credit-card firms also recorded a combined net losses of W262 billion (\$218 million) last year, from a net profit of W2.5 trillion in 2001—due both to increased provisions on extended loans and rising defaults on credit card payments. The delinquency rate for payments in arrears for more than 30 days was estimated to be 8.8 percent at the end of 2002, soaring from 3.8 percent a year earlier and the

outstanding loan-loss provisions also increased sharply from W1.6 trillion in 2001 to W4.1 trillion as of the end-December 2002. Only four companies managed to remain in the black last year. As noted above, a series of measures were introduced last year to curb the rapid increase in credit-card debt, and further measures will be launched to encourage credit-card companies to write-off credit card receivables turning sour.

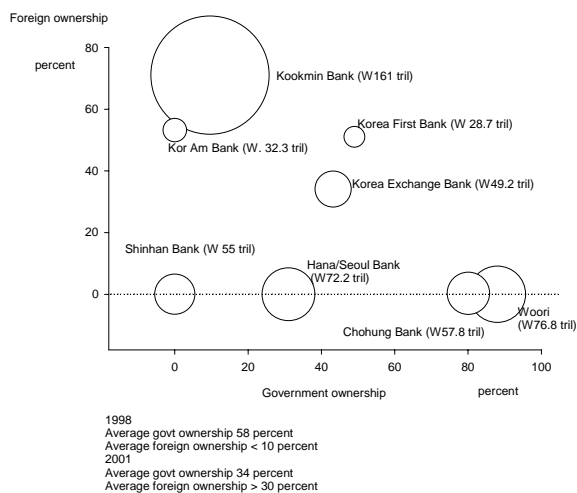
Restructuring and re-privatization of financial institutions

The need to press ahead with the sale of the government's shares in nationalized banks (Figure 6) has been a key issue in the restructuring and consolidation agenda and with improvements in banks' profitability, further progress has been seen in the re-privatization of banks³. Hana Bank, officially selected as the preferred bidder for the sale of Seoul Bank in August 2002, finally signed a merger agreement with the Seoul Bank in December 2002. Agreement has reportedly been reached on the timing and method for the sale of 60 percent of the remaining government shares in the merged bank; the other 40 percent is to be sold within the 18-month price guarantee period extended by Hana Bank. Shinhan Financial Holding Company has been chosen as the preferred bidder to purchase the nearly 80 percent government stake in

³ Following the onset of the crisis, recapitalization with public funds had raised the average government ownership in commercial banks (weighted by banks' assets) from 17 percent at end 1996 to 58 percent at end 1998.

Chohung Bank. A due diligence audit of Chohung Bank by independent accounting firms began in mid-February 2003, aimed at reappraising the value of the bank. The results of the due diligence are expected to determine the sale price of the bank to Shinhan FHC. Woori Financial Holdings Company, Korea's second-largest banking group, is accelerating its plans to lower the government-held stakes in Woori Bank to less than 50 percent by floating \$1 billion in overseas depository receipts (DR) in the transition to a privatized bank. The timing and size of the planned DR issue is to be discussed soon. The Government has also indicated that it will sell its minority stakes in other banks after its stake in Chohung Bank and Woori Bank have been reduced to less than 50 percent.

Figure 6. Ownership and Asset Size in Major Commercial Banks
(as of June 2002)



The Government has also made some progress with respect to the re-privatization of non-bank financial institutions. In particular, its 51 percent share of Korea Life was sold to a consortium led by the Hanwa group in October 2002. A buyer is now being sought for two Hyundai Group financial units: Hyundai Investment Trust and Securities and Hyundai Investment Trust and Management.

Use of public funds

Significant progress has been made in recovering the W157 trillion of public funds (amounting to 32 percent of average GDP in 1998-2000) that was used for restructuring since the financial crisis. As of end-June 2002, the Government had recovered 32 percent or Won 50 trillion through the sale of acquired government shareholdings, collection of NPLs and the sale of assets. The Government estimates that over the medium term, it will be able to

recover an additional W37 trillion (to make a total of W87 trillion or 56 percent of GDP in recovered funds). For the unrecoverable W69 trillion of public funds, a burden-sharing plan has been adopted: about 70 percent is to be borne by the budget by converting previous KDIC and KAMCO bonds into government bonds, and the remaining 30 percent will be covered by a 0.1 percentage point surcharge in the deposit insurance premium which went into effect in early 2003. This decision should reduce any uncertainty regarding the government's contingent liability arising from financial sector restructuring.

Corporate sector performance

Indicators of corporate sector health in the manufacturing sector improved significantly in 2002. Average debt/equity ratios declined further from 182 percent at end 2001, to 130 percent in the third quarter of 2002. Similar improvements were seen in debt to assets and debt to sales ratios (Table 3).

With the strong economic growth and continued progress in corporate restructuring (see below), profitability in the manufacturing sector also showed substantial improvement. The average operating income-to-sales ratio rose from 5.5 in 2001 to 8.1, which, together with the decline in debt levels and financial expenses, led to a significant improvement in the ratio of ordinary income-to-sales (Table 4).

However while *average* corporate sector performance improved significantly in 2002, the proportion of firms in very poor health also increased—with the share of corporates whose operating income was below their interest payments (i.e. with ICR less than 100 percent) rising to 34 percent in the third quarter of 2002 from 29 percent at end-2001 (Figure 7). Thus, although the average ICR in the third quarter of 2002—at 254 percent—was very much higher than the average ICR of 96 percent at end-1999 (Figure 8), the proportion of firms with interest coverage less than 100 percent in the third quarter of 2002 (at 34 percent) was actually comparable to that at the end of 1999 (at 33 percent). There has, therefore, been an increasing divergence in the performance among firms—a trend already evident in 2001—with the performance of the weakest firms having deteriorated further in 2002, despite the robust growth of the economy. (The ICR of the weakest quartile of firms fell by 44 percentage points to only 8 percent in the third quarter of 2002).

Table 3. Indicators of debt in the manufacturing sector
(average, in percent)

	1997	1998	1999	2000	2001	2002 Q3
Debt/equity	396	303	215	211	182	130
Debt/assets	54	51	43	41	40	33
Debt/sales	66	63	53	43	43	40

Table 4. Indicators of corporate profitability in manufacturing
(average, ratio)

	1997	1998	1999	2000	2001	2002 Q3
Operating income/sales	8.3	6.1	6.6	7.4	5.5	8.1
Financial expenses/sales	6.4	9.0	6.9	4.7	4.2	3.2
Ordinary income to sales	-0.3	-1.8	1.7	1.3	0.4	7.6

Figure 7. Interest Coverage Ratios
(percent)

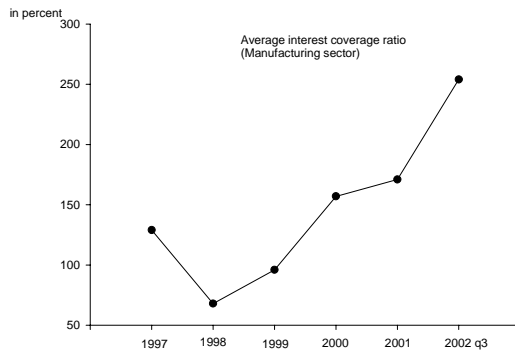
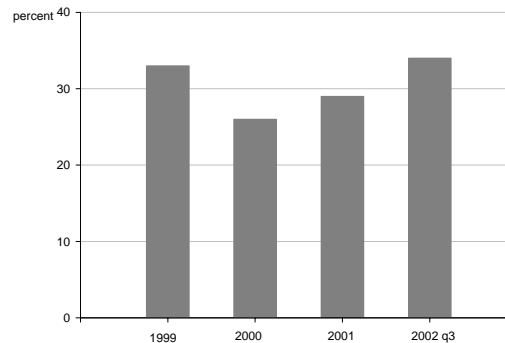


Figure 8. Corporates with interest coverage less than 100 percent



Corporate sector restructuring

Since the introduction of the formal out-of-court workout program in June 1998, two-thirds of a total of 83 companies—that is to say 55 companies—have successfully graduated as a result of rehabilitation, sell-offs and liquidations, while 6 companies have been required to exit. Consequently, the number of companies in formal out-of-court workout programs fell to 12 at end-2002 from 22 at end-2001 and 38 at end-2000. To ensure that the credit risk posed by corporate borrowers is continuously monitored and to encourage out-of-court workouts by creditor banks, the Government had introduced the “Continuous Credit Risk Assessment System” in March 2001. As of December 2002, there had been four rounds of assessment under this system and a total of 243 companies were required to exit. More recently, following the biannual assessment that was completed in January 2003 a further 27 companies out of 992 companies were required to exit.

One of the most important pending issues in corporate restructuring has been the restructuring of Hynix. Its sale to Micron Technology, promoted in the creditors’ rescue plan of October 2001, failed in April 2002 due to objections by the board of shareholders. However, in early

2003 creditors finally reached agreement on a new restructuring plan that includes additional conversion of W 1.9 trillion of debt into equity, rescheduling of W 3 trillion in debt, and the sale of assets. Despite strong opposition from minority shareholders, the 20-to-1 capital reduction was approved at a regular meeting in an attempt to normalize business—and about 50 executives tendered their resignation, taking responsibility for the several trillions of Won of accumulated deficits in recent years. With the capital reduction, Hynix’s paid-in capital will shrink from W26.2 trillion to W1.27 trillion and its number of outstanding shares will be reduced from 5.23 billion shares to about 250 million. A final signing for the takeover of Hanbo Steel by A.K. Capital and the main contract for the sale of Daewoo Motors were also made last year. At the end of September 2002, a \$12 billion debt restructuring plan was approved for Daewoo Motors, paving the way for General Motors to take control. The new joint venture firm, GM Daewoo Auto and Technology was launched in October 2002.

The SK group scandal has raised some concerns in the market about accounting standards and has highlighted the need to continue to strengthen corporate governance.

Nonetheless, Korea has made substantial progress in the area of corporate governance since the onset of the crisis. One of the most important recent developments has been the submission of a unified and comprehensive corporate insolvency law to the National Assembly. The new Insolvency Act will consolidate three existing insolvency-related acts: the Reorganization Act, the Composition Act and the Bankruptcy Act, and is expected to be effective as of July 1, 2003. Once enacted, it should contribute to the resolution of the remaining segment of distressed companies.

Macroeconomic Outlook

On the macroeconomic front, the level of usable reserves has continued to rise, and while external debt also rose in 2002, Korea's level of reserves provides substantial insulation against potential shocks. Korea has also pursued a steady fiscal consolidation as the economy has recovered, giving it considerable flexibility to respond to future macroeconomic developments. At the same time, Korea has continued to make progress in financial and corporate restructuring and in moving towards an economy based on greater market discipline, both of which are important for sustaining productivity-driven growth over the longer term.

In the near term however, the external environment—and the associated uncertainties—are likely to affect Korea's GDP growth adversely.

Equity markets in the US, Europe and Japan saw heavy declines during the second half of 2002 on the back of declines in 2001, oil prices have risen through 2002 and OECD growth is now expected to be about 0.1 percentage points lower than the already modest previous forecasts for 2003 and 2004.

Korean stock markets are quite closely linked with international stock markets, and the Korean stock market has also declined—particularly in the last few months—in large part due to net selling by local investors. Analysis also points to private consumption in Korea being highly responsive (through wealth effects) by developments in the Korean stock market. Indeed, as mentioned earlier, recent trends already suggest a waning of private consumption growth. Furthermore, both the consumers' evaluation and expectations index remain below 100 (indicating negative expectations for the economy over the next six months). The Korean economy is also more sensitive to oil price increases than many other countries in the region—given its energy-intensive manufacturing economy and heavy dependence on imported oil (oil imports amount to 5 percent of GDP). And, given Korea's high level of exports, the Korean economy is also sensitive to fluctuations in global demand.

Overall, with the combination of weak performance in international stock markets, higher oil prices, a sluggish global economy and major uncertainties with regard to international tensions with DPRK and Iraq, our growth forecast for the Korean economy is now 4.9 percent for 2003.

Policy Issues

Much progress has been made in strengthening the financial sector since the crisis. However—although they do not pose any immediate risks—weaknesses remain. First, while the banking sector as a whole is in a relatively strong position, some banks may be inadequately provisioned against those corporates that have exhibited persistently weak performance. Second, segments of the non-bank sector (including the non-bank deposit taking institutions and the insurance sector) remain weak and need to be addressed. Third, continued progress is needed with respect to prudential supervision, especially in enhancing the regulator's ability to supervise risks such as the rapidly growing off-balance sheet activities of banks and the derivative activities of securities firms, as well as to be able to respond to new challenges.

With respect to the corporate sector—while profitability of corporates has increased very significantly on average—a sizable proportion remains unprofitable and highly leveraged. Continued improvements in corporate governance and disclosure should help in resolving this remaining segment of corporates. Further measures to enhance such market-based discipline include: the continued strengthening of shareholder rights—such as the introduction of class action suites for securities law violations and the encouragement of cumulative voting; the requirement that at least two thirds of the members of an outside director's nomination committee consist of independent directors; the codification of the fiduciary duty of corporate directors to shareholders; more effective audit committees, and improved corporate disclosure, particularly those related to third party transactions.