

# Analysis of Factors Determining the Current Account

There are growing concerns over the Korean economy, as Korea's current account, having registered a surplus for the past ten years following the financial crisis in 1997, is expected to shift into deficit this year. Since a current account deficit may cause instability in the foreign exchange market and consequently affect the entire economy negatively, it is an urgent task for the central bank to analyze the factors determining the current account and come up with appropriate measures to improving the account position.

A new analytical method is adopted in this paper to identify structural problems of the current account, given that the recent current account deficit is attributable not only to changes in external conditions, including a rise in global raw material prices but also to a decrease in goods account surplus resulting from the widening the bilateral deficit with Japan and the narrowing bilateral surplus with import-export gap with China along with the increase in the services account deficit. In other words, in order to reflect structural aspects of the current account as well as domestic and overseas demand, trade terms and foreign exchange rates, which all have a significant influence on it, an empirical analysis is conducted adopting a new current account model with the weights of trade with China and Japan, those of exports of high-quality, competitive goods and those of service goods trade set as explanatory variables.

The empirical analysis results show that, from the perspective of economic fundamentals, the current account improves in cases when real GDP decreases following the contraction of domestic demand; when global import volume grows in response to the expansion of

overseas demand; when trade terms improve, influenced by drops in import price indexes, including that of crude oil; and when the won/dollar exchange rate rises. Meanwhile, from the perspective of trade structure, the current account improves in cases when the weight of trade with China and Japan in total Korean trade grows; when the share of exports of high-quality products with a competitive edge increases; and when the weight of trade in services goes down.

The results of developments in elasticity over time from a reduced form regression estimation based on the current account model reveal that the elasticity of the current account with respect to the won/dollar exchange rate and the share of trade in services shows sustained downward movements, while its elasticity with respect to overseas demand, trade terms, weight of trade with China and Japan in total Korean trade and the share of exports of high-quality products with a competitive edge exhibits a sharp increase. Meanwhile, the results also show that the elasticity with respect to domestic demand continued to rise following the outbreak of the Asian financial crisis, but has slightly declined since the year 2004.

The following suggestions can be drawn on ways to improve the current account, based on the results of this paper. First, in order to make improvements in the import-inducing industrial structure in which imports are greatly influenced by domestic demand, factors giving rise to imports need to be reduced by securing and maintaining a technological competitive edge for core items, including parts and components. Second, efforts need to be made to seek the stable growth of exports through quality improvement, to strengthen resource diplomacy and to make a structural transition to an energy-efficient economy. Third, attempts need to be made to further expand Korean trade with Japan and China, which has a great influence on the current account. Last, competitiveness in the service-related industry needs to be boosted by improving English skills for people in the service industry.