

# **K**ERI **E**CONOMIC **B**ULLETIN

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Korea Economic Research Institute

# I Economic Trends and Outlook

## Executive Summary

There is widespread concern that Korea may face, in the second half of 2008, stagflation - economic slowdown coupled with rising prices. Led by rises in import prices, consumer prices in the second half are expected to increase by 5.6%, the sharpest jump since the second half of 1998. The dramatic rise in the overall price level is likely to further erode consumer sentiment and limit economic growth to 3.3% in the second half of this year.

Accordingly, the top policy priority now should be to maintain or manage price stability. If the current trends continue, inflationary expectations would inevitably come to the fore and set in motion the vicious cycle where higher price levels prompt a rise in wage, which in turn increases the inflationary pressure. In order to avoid this situation, the authorities should firmly commit to stabilizing foreign exchange rates and freeze the policy interest rate. That would send a strong message to the market and help tame inflationary expectations. Furthermore, short-term support measures are needed for the economically disadvantaged class to cushion the blow of the declining real economy.

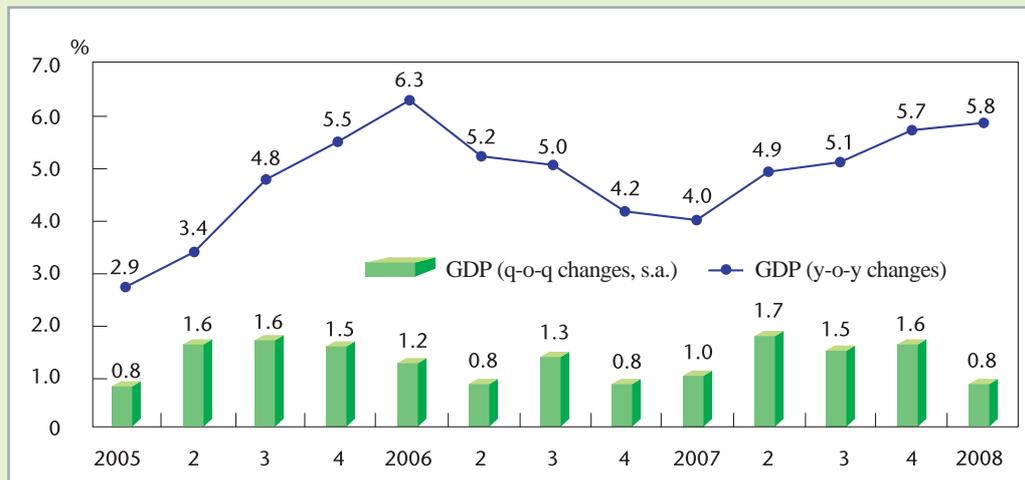
As difficult as it might be, current economic conditions cannot be an excuse to delay implementing the reform measures President Lee had promised during his campaign last year. Regulatory reforms and privatization of public enterprises should continue as planned to enhance efficiency of the overall economy. Furthermore, creating an investment-inducive environment and improving labor market flexibility remain urgent policy initiatives. It is also crucial to firmly establish the rule of law as a prerequisite for sound and efficient functioning of the market economy. Only when all these problems are resolved will the nation be able to expect a favorable turn of the economy in the future.

## Recent Developments

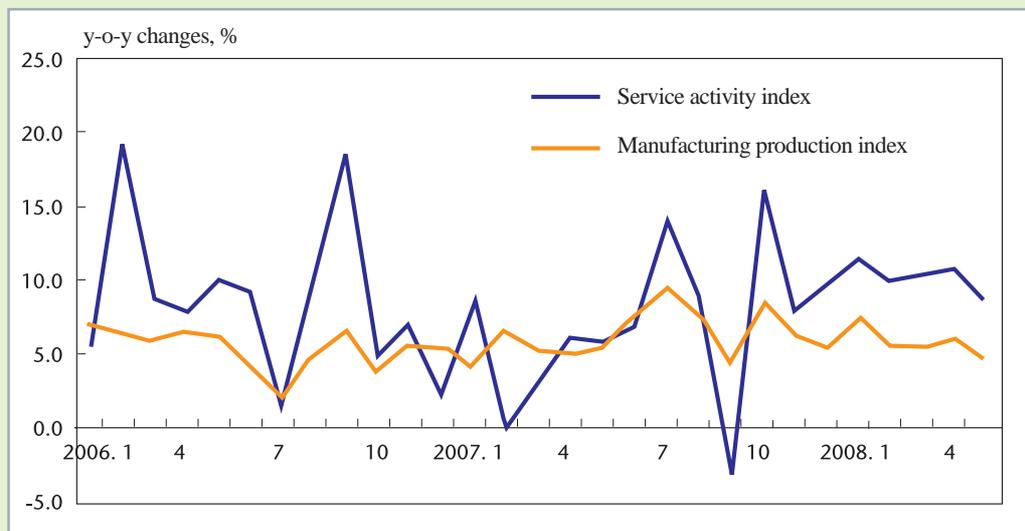
GDP in the first quarter of 2008 grew only 0.8% from the preceding quarter, largely due to slowdowns in consumption growth rate and decline in investment. It was the lowest rate of growth since the second quarter of 2006.

The economic slowdown became apparent with declining output growth in the manufacturing and service sectors between April and May. The service output grew 5% compared with 6.4% in the first quarter, and the manufacturing output also lost steam, recording 9.8% growth compared with 10.7% in the first quarter.

### Quarterly GDP Growth



### Manufacturing Production Index and Service Activity Index



Recovery in domestic demand remains weak. Consumer goods sales grew only 3.9% in the first quarter of this year after recording 7.1% and 4.5% growth in the third quarter and the fourth quarter of last year respectively. In May, growth further slowed significantly to 3.1%. Facility and construction investments are also on the decline since the fourth quarter of last year.

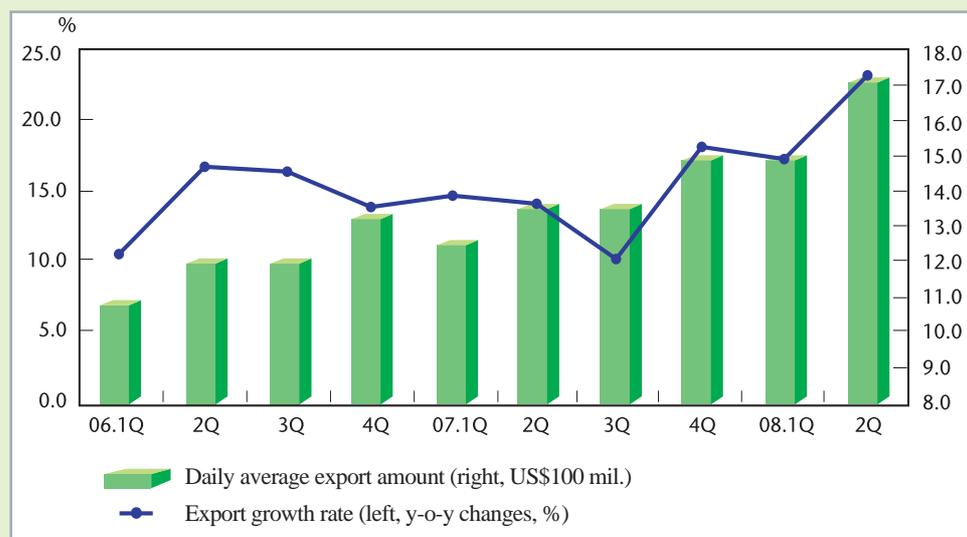
### Trends in Domestic Demand

(Unit: y-o-y changes, %)

	2007					2008		
	1/4	2/4	3/4	4/4	Year	1/4	April	May
Consumer Goods Sales	5.7	4.2	7.1	4.5	5.3	3.9	5.7	3.1
Facility Investment (constant)	12.8	11.9	0.7	9.2	8.6	-0.9	-1.7	-2.5
Domestic Machinery Orders (constant)	16.1	7.4	14.7	30.0	17.0	19.3	15.4	-1.1
Construction Completed (current)	7.9	6.0	4.4	8.0	6.6	5.8	4.0	8.0
Construction Orders Received (current)	26.3	26.3	-5.6	29.5	19.3	-3.9	-2.5	18.8

On the other hand, the export sector has fared well and grew 17.3% and 23.3% in the first and second quarters, thanks largely to brisk performances in key industries such as petroleum products and wireless communication equipment. The daily average export amount rose sharply to US\$1.7 billion in the second quarter from US\$1.49 billion in the first quarter.

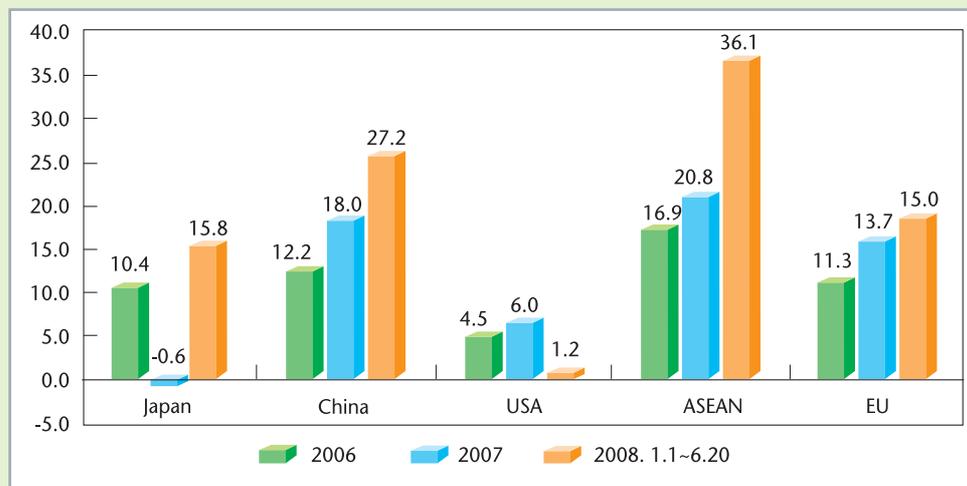
### Export Growth Rates & Daily Average Exports



In terms of export destinations by region in the January-June period, exports to China, the EU, ASEAN and Japan continued to remain strong.

### Export Growth Rates by Region

(Unit: y-o-y changes, %)



Due to worsening external environments, the current account balance has been suffering deficits since December last year, and recorded a US\$5.21 billion deficit in the first quarter of this year and US\$2 billion deficit in the April-May period. The persistent deficit is attributed to significant rises in imports, which grew 29% in the first half of this year. The surge in imports was due to dramatic rises in the prices of oil and raw materials.

### Current Account Balance

(Unit: US\$100 million)

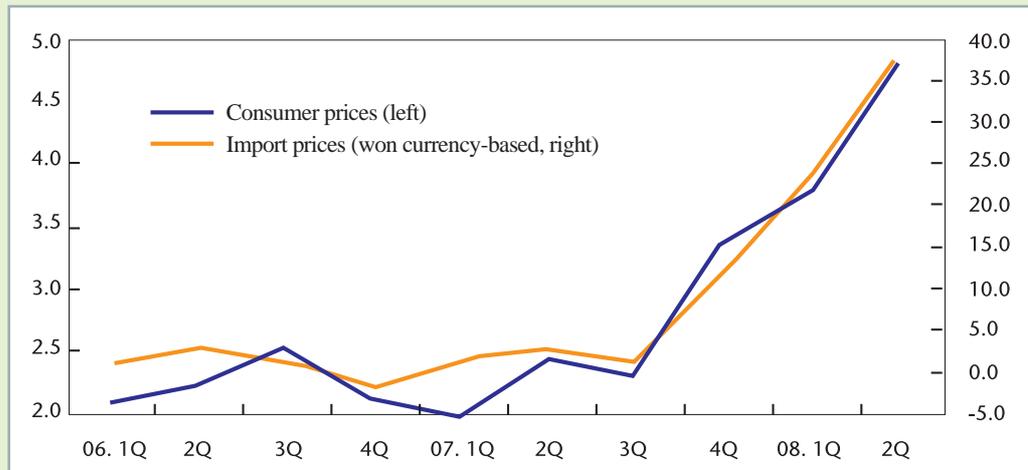
	2007					2008	
	1/4	2/4	3/4	4/4	Year	1/4	April-May
Current Account Balance (=A+B+C+D)	-16.6	0.3	44.3	31.5	59.5	-52.1	-19.6
A. Goods Balance	60.4	69.7	96.8	67.3	294.1	-12.2	22.4
B. Services Balance	-61.8	-44.0	-58.8	-41.2	-205.7	-50.7	-21.5
Travel Balance	-36.1	-36.6	-43.6	-34.7	-150.9	-30.2	-17.0
Service Business Balance	-22.6	-17.1	-19.1	-25.1	-83.8	-29.1	-17.3
C. Income Balance	-6.9	-15.4	16.6	13.4	7.7	16.9	-14.7
D. Current Transfers Balance	-8.3	-10.0	-10.3	-8.0	-36.5	-6.1	-5.8

The consumer prices have been on an ever-rising trend, marking a 3.4% increase for the fourth quarter of 2007 and in 2008, 3.8% jump for the first quarter and 4.8% rise for the second quarter.

The main cause behind this consecutive upward trend was the rise in import costs valued in won terms (12.3% for the fourth quarter of 2007, 23.8% for the first quarter of this year and 38.0% for the period between April and May) on account of a weaker Korean won coupled with hikes in international commodities prices and crude oil prices.

### Consumer Prices and Import Prices

(Unit: y-o-y changes, % )



Market interest rates have reversed course to an upward trend since May this year due to mounting fears of inflation in line with high oil prices. Affected by international financial instability, the economic slowdown in the United States, and Korea's continued current account deficits, among other factors, the Korean won has depreciated against the U.S. dollar since November last year.

**Corporate Bond Yield Rates and Exchange Rates**



## Outlook for the 2nd Half of 2008

### *External Environment*

Because of uncertain international financial market conditions and instability in the commodities markets, the global economy is expected to slow further compared to last year. Accordingly, the IMF projects that the world economy will grow at 3.7%, 1.2 percentage point lower than the 4.9% in 2007.

As there are some recent signs that the oil price would stabilize, albeit at a higher level than in the past, in the second half of this year, we expect future oil price rises to be somewhat limited. China's effort to suppress its oil consumption as the world's second-largest oil consumer, Saudi Arabia's declared commitment to a more stable oil price, the increased probability of a stronger dollar and the U.S. Congress' deliberation on regulating speculative capital will serve to improve oil market conditions. Based on this assessment, our forecast for the price of Dubai oil, Korea's benchmark, for 2008 is around US\$100/barrel.

### *Internal Environment*

The government's policy direction has now turned to promoting economic stability. The policy of stimulating exports with a cheaper Korean won seems now replaced with that of containing import price shocks. The target rate of economic growth is also adjusted downward from 6% to the 4% level.

Efforts to ease the domestic demand slowdown following higher oil prices are likely to continue. The government intends to move up the investment schedules of public enterprises, and provide oil tax refunds. It also plans to invest about 5 trillion won in advance this year, which had been previously set aside for next year's SOC projects. In the second half of this year, it intends to disburse about 3 trillion won in oil tax refunds.

Social and political instability that has been ignited by the mad cow controversy has forced the government to postpone, at least temporarily, implementation of structural reform measures.

### *Prospects for the 2nd Half of 2008*

Due to slowdowns in private consumption, facility investment and export growth, economic growth is expected to fall to 3.3% in the second half, which is a significant retreat compared with 5.2% in the first half.

Private consumption is expected to record low growth of 3.2% in the second half and 3.4% in the first half consecutively due to weaker consumer sentiment caused by hikes in the prices of raw materials and oil and worsening labor market conditions.

Construction investment is expected to continue its downward trend due to tight housing market conditions. But it is likely to improve slightly compared with -0.8% growth in the first half and record 1.5% growth owing to several public construction projects and the early execution of investment plans of public enterprises.

Facility investment is projected to recover to high growth of 5.6% in the second half, far higher than 1.1% in the first half, as slowdowns in related indicators, such as receipt of machinery orders, projected facility investment BSI and facility investment adjustment pressures, are expected to be less significant.

Exports (based on international balance of payments and the U.S. dollar) are likely to slow due to the deepening of the U.S. economic woes and the subsequent global economic slowdown becoming more apparent. However, as the export sector has steadily improved its non-price competitiveness while diversifying export markets over the years, it is expected to manage double-digit growth of 11.5% in the second half.

With a deficit of about US\$2.6 billion in the second half, the current account balance is expected to record a deficit of about US\$7 billion for the whole year. This is attributed to the worsened goods balance due to increases in crude oil import amount amid continuing service balance deficits. The current account balance for the entire year is projected to be in the red, for the first time in 11 years since 1997.

With international price shocks expected to be transmitted fully to the domestic market, consumer prices are likely to increase 5.6% in the second half of this year. Producer prices rose 10.6% during April and May, which will be reflected into consumer prices with the time lag of several months.

Reflecting stronger inflationary pressures, market interest rates are projected to rise at the 5% level, and the corporate bond yield rate will be around 6.6%.

The Korean won is expected to appreciate gradually due to changes in government policy stance and improvement of the current account balance. However, suspension of interest rate cuts by the Federal Reserve and the strong-dollar policy will limit the magnitude of appreciation of the Korean won against the U.S. dollar. We expect the won-dollar exchange rate to be around 1,000 won in the third quarter and 990 won in the fourth quarter.

### Economic Outlook for 2008

(Unit: y-o-y changes %, US\$100 million)

	2007	2008						
	Year	1Q	2Q	3Q	4Q	1st H	2nd H	Year
GDP	5.0	5.8	4.6	3.7	3.0	5.2	3.3	4.2
(SA, q-o-q, %)		0.8	0.7	0.6	1.1			
Private Consumption	4.5	3.4	3.4	3.1	2.9	3.4	3.0	3.2
Construction Investment	1.2	-1.1	-0.6	-0.9	1.9	-0.8	1.5	0.4
Equipment Investment *	7.4	2.0	0.3	6.5	4.9	1.1	5.6	3.4
Consumer Prices	2.5	3.8	4.6	5.5	5.6	4.2	5.6	4.9
Current Account	59.5	-52.1	8.2	-8.5	-17.4	-43.9	-25.9	-69.8
Commodity	294.1	-12.2	64.4	45.7	13.9	52.2	59.6	111.9
Exports	3789.8	1028.8	1167.7	1071.8	1153.9	2196.4	2225.7	4422.1
Growth (%)	14.2	19.0	25.7	14.2	9.1	22.5	11.5	16.7
Imports	3495.7	1041.0	1103.3	1026.1	1140.0	2144.2	2166.1	4310.3
Growth (%)	15.5	29.4	28.4	21.9	15.1	28.9	18.2	23.3
Service & Others	-234.6	-39.9	-56.2	-54.1	-31.4	-96.1	-85.5	-181.6
Ex Rate (Avg., KRW/USD)	929	956	1021	1001	996	989	999	994
Corp. Bonds Yield (3-year, AA-)	5.7	6.4	6.3	6.6	6.5	6.3	6.6	6.4

\* Including intangible asset investment

# | Issue Focus

## Understanding the Current Situation and Future Policy Tasks

### 1. Understanding the Current Situation

To understand the current situation of our economy correctly and prepare countermeasures, it is necessary to have a good grasp of the overall trends of the world economy. The trend of growing price instability amid a worsening real economy is a global phenomenon, which has a significant correlation with the imbalance in the world economy over the past 10 years.

In the period of 2003-2007, the global economy recorded unprecedented robust growth thanks to the rapid progress of the newly industrialized countries (NICs). At the same time, however, the 'seed of uncertainty' was growing larger.

The world's economic growth rate was 3.3% annually on average in the 1999-2002 period and rose to 4.6% in the 2003-2007 period. A subsequent sharp increase in total demand brought price hikes on international oil and raw materials, causing a global price rise phase. Raw materials prices, excluding crude oil, sharply increased 12.9% annually on average during the years between 2003 and 2007, and international oil prices skyrocketed as much as 23.8% in the same period. The raw materials prices decreased at the annual rate of -1.8% on average during the period of 1999-2002. The weakening U.S. dollar, following the deepened trade imbalance of the United States, served as a push factor for crude oil and raw materials prices. Also, increased inflow of capital from China, the Middle East, etc. led to a fund supply excess situation in the U.S. financial market, and provided the grounds for an international financial market crisis through overheating of the U.S. housing market.

### Major Indicators of World Economy and Korean Economy

	World			Korea			
	Growth Rate	Raw Materials Price Increase*	Average Crude Oil Price Increase	Growth Rate	Domestic Demand Growth	Export Growth	Ratio of Exports vs Domestic Demand
1999	3.5	-8.3	37.5	9.5	10.4	8.6	44.2
2000	4.7	4.2	57.0	8.5	9.8	19.9	48.0
2001	2.2	-4.8	-13.8	3.8	3.1	-12.7	45.3
1999~2000	3.3	-1.8	20.8	7.2	7.7	6.0	46.3
2003	3.3	5.9	15.8	3.1	0.6	19.3	54.9
2004	4.9	15.2	30.7	4.7	0.5	31.0	65.3
2005	4.4	6.1	41.3	4.2	3.2	12.0	68.6
2006	5.0	23.2	20.5	5.1	4.1	14.4	73.7
2007	4.9	14.0	10.7	5.0	4.3	14.1	79.2
2003~2007	4.6	12.9	23.8	4.4	2.6	18.2	68.3

\* Excluding crude oil.

In the Korean economy, flagging domestic consumption has continued for the past 10 years. Domestic demand growth, combining private consumption and fixed investment, sharply declined to the annual rate of 2.5% in 2003-2007 from 7.7% in 1999-2002. Amid such an environment, the unmitigated repercussions of deepened world economic imbalance and global price increases were felt in Korea without filtering. In the course of this process, the won-U.S. dollar exchange rate increased sharply early this year, and this played a role in amplifying the external price shock.

## 2. Policy Tasks

As price instability caused by the recent increase in cost factors emerged as the most critical task, Korea's economic policy for the second half of this year should focus on price stabilization. Price increases should be prevented from weakening household purchasing power, contracting the real economy and bringing about a vicious price increase cycle featuring wage hikes and production cost rises,

### (1) Short-Term Tasks

The most important task is to ward off the public sentiment for further inflation. Therefore, the government must show firm resolve for price stabilization through timely operation of foreign exchange rates, money interest rate freeze, stabilization of public utility prices, etc. In the case of public utility prices, imposing restriction on price push factors is not

desirable, but the government needs to encourage public corporations' cost reduction efforts through efficiency enhancements which must precede increases in public utility fees.

Worsening of the real economy will cause an employment adjustment centering on vulnerable classes. This implies that a short-term employment policy is necessary, including subsidies for stabilization of the living standards of vulnerable classes, in addition to the mid and long-term employment policy.

As for policy interest rates, maintaining the current level is desirable. Lowering interest rates when price instability is heightening may give the wrong signal to economic entities. Raising interest rates is not appropriate either, as it may have the effect of curbing total demand amid a situation in which the domestic demand slowdown is already feared to deepen.

## (2) Mid and Long-Term Tasks

Regulatory reform should be put into a full-fledged implementation stage. To facilitate recovery of economic conditions, the government needs to ease corporate-related regulations first on a step-by-step basis in accordance with an established priority. In this regard, the government should lift regulations on investment and manufacturing activities in the capital region, particularly for areas that can contribute to strengthening corporate competitiveness and expanding new growth engines.

The government should suggest objective criteria, principles and schedules to privatize public enterprises. Privatization of public enterprises should be promoted actively to enhance the productivity of our economy and the vitality of the private sector.

The principle of rule of law and basic social order should be established. The rule of law is an essential prerequisite for democracy and the market economy. In the process of implementing policies, communicating with the public and coordinating public opinion is absolutely necessary, but the methods and procedures should be guided by the law. Collapse of the rule of law and basic social order will depress the economy through social turmoil.

# Recent Publications

## Research Monograph

### **Ownership Structure and Corporate Governance for Firm Profitability - Evidence from Korea after the IMF Economic Crisis -**

Research Monograph 08-08

Dong Keun Cho, Min-Sik Byun

The purpose of the study is to analyze the effects of ownership structure and corporate governance upon firm value using firm level data from the post-IMF crisis in Korea.

The results of the study can be summarized as follows. First, a firm's profitability in terms of various ROA measures such as ROA1, ROA2, ROA3 is higher when the ownership of controlling shareholders is higher for firm and industry specific effects. The relationship between ownership and profitability could be characterized as the "Inverse U shape." Therefore, 'the hypothesis of convergence of interests' could be applied after the period of post-IMF crisis. This result contrasts with Choi's study (2003) showing the validity of the 'hypothesis of entrenchment' during the IMF crisis, 1996~2000.

Second, this study cannot find any obvious empirical evidence that firms with disparity of ownership and control rights suffer from low profitability. This implies that the tunneling of controlling shareholders is not prevalent after the period of IMF crisis by virtue of autonomous regulation inertia of market forces. This result contrasts with Joh's study (2003) showing the negative effects of the discrepancies of ownership and control rights on profitability.

Third, this study finds reliable positive effects of controlling shareholders' influence on profitability, and also reliable negative effects of the independent director ratio on profitability. It implies that performance depends on the speed of decision making and the entrepreneurship of the controlling shareholders. The sentiment for 'democratic management' turns out to be just invented illusion.

## **Prospects & Effects of Chinese Yuan Appreciation and Policy Implications for Korea**

Research Monograph 08-09

Chan-Guk Huh, Bonghan Kim and Soojung Nam

In this report, the Chinese yuan in 2008 is projected to appreciate less than 10% through only gradual foreign exchange rate adjustments despite its domestic price push pressures and the U.S. pressure for the currency's appreciation. Notwithstanding its high growth, China will avoid a drastic change in foreign exchange rate management because it could lead to a major shock to the country, which is not equipped with a market economy infrastructure such as an efficient financial system.

Although the yuan appreciation may not be as great as expected, the rise in yuan currency value would become a more pressing factor for Korean won appreciation, and consequently affect negatively Korea's proper management of trade balance objectives.

Also the correlation between Korea's exports and China's exports is high, particularly in the export of capital goods. This is raising concerns that a significant slowdown in China's exports, which may happen as a result from the worsening economic situations, can have a significant negative effect on our exports to China as well.

Furthermore, it is emphasized that the trend of FDI in China and in Korea is moving in the same direction, and so the crowding out effect to each other is not so big. It means that the yuan appreciation would have a negative effect on the inflow of FDI into China but Korea would not benefit from such situation.

## **A Study on Consumption Tax Reform in Korea**

Research Monograph 08-10

Sang Kyum Kim

The tax system of the twentieth century could be summarized as taxation based on income, which increasingly reveals its weakness in terms of efficiency as globalization is intensified. However, many public economists point out that these problems could be overcome with a consumption tax, which is a growth-friendly system. Some leading countries began to

reform their tax systems with a consumption-based model. In this sense, a consumption-based tax system is seriously considered as an alternative to the current income-based tax system that encompasses double taxation.

This study reviews the current consumption tax system in Korea, and tries to determine desirable directions for tax reform, based on four major principles in tax reform of Korea - efficiency, simplicity, global standard, and responsibility. This study covers all consumption taxes, both national and local government level, such as VAT, special consumption tax, transportation-energy-environmental tax (formerly known as transportation tax), and liquor tax. For local taxes, this study also reviews tobacco tax, leisure tax, and butchery tax. The major conclusions of this study are that for VAT, in order to keep a broad tax base, exceptions to taxation, such as tax exemption and zero rate taxation, should be substantially reduced; for other taxes, the tax rates should actively reflect the external costs of consumption, to internalize the consumption externality.

## Policy Report

### **Assessment and Tasks of Price Stabilization Measures**

Policy Report 08-03

Seung-Rok Park

This report suggests diverse implications and improvement methods for the government's 'Action Plan to Check Daily Necessities to Stabilize the Livelihood of Low-Income Households,' where 52 basic items were selected for intensive management as these items are frequently purchased by subject classes and account for a great part of household expenditure.

This study argues that fewer items should be subject to price management focusing on oil, education and housing expenses to effectively counter inflationary pressures that directly affect the lives of low-income households.

The government's current price countermeasures deal with too many items and there is a danger of conflicting with its growth-oriented macroeconomic policies. If price stability is overemphasized, there is also a possibility that it may have negative side effects, such as a decline in job creation opportunities following economic growth slowdown and discrimination between SMEs and large enterprises.

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