

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

## Contents

**Economic Trends and Outlook** ..... 02

Executive Summary

Recent Developments

Outlook for 2008

**Issue Focus** ..... 10

Improving the Current Account Balance Through the  
Service Sector Reform

**Recent Publications** ..... 13



Korea Economic Research Institute

# I Economic Trends and Outlook

## Executive Summary

The Korean economy is expected to grow at 4.5% in 2008. The growth projection is revised down 0.6 percentage point since December last year to reflect the worsening external environments. Favorable developments in the foreign exchange markets and revision of the national taxation system are likely to be dominated by the global economic slowdown and rising international commodity prices including oil.

Due to stronger Korean won and rising international oil and commodity prices, the rate of consumer inflation is likely to reach 4% level this year for the first time in seven years since 2001. The current account is expected to record US\$8.6 billion in deficit as the service account deficit continues to grow while the goods trade is beginning to suffer. To reflect these recent developments, our current projections for the consumer inflation and the current account balance are 1.1 percentage point higher and US\$7.4 billion lower respectively relative to our earlier projections in December.

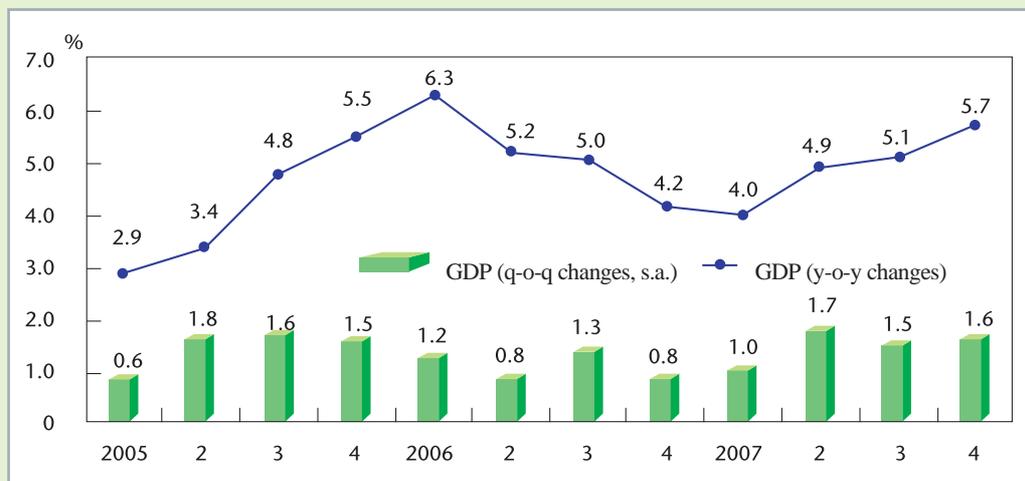
Active policies to stimulate domestic demand are needed to offset the negative effects of deteriorating external conditions. Moreover if investment plans of the big 30 business conglomerates, whose sales amount to 9.28 billion Korean won are actually realized, achieving an economic growth rate of 5% might be feasible. If the economic conditions get worse, the monetary authority should seriously consider interest rate cuts. Given that the annual inflation rate for 2007 was 2.5% and that the Bank of Korea's target rate of inflation for 2007~2009 is 3.5%, there should be some room left, at least temporarily, for adaptive monetary policies.

Enhancing the efficiency of supply side, through such means as improvement in the efficiency of distribution networks, regulation reforms, tax cuts, moderate wage increases along with enhancement of labor productivity, will be more effective in curbing rising inflationary pressures than suppressing the demand side with higher interest rates. To tackle the current account deficit problem, more emphasis should be placed on improving the service sector's international competitiveness than on attempting to manipulate the exchange rate through government interventions.

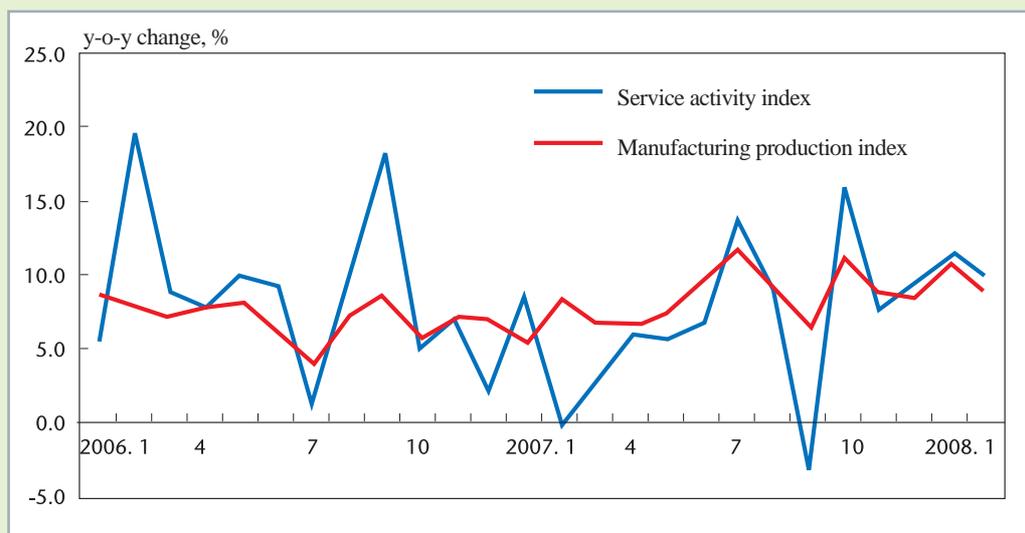
## Recent Developments

Economic growth in the fourth quarter of 2007 expanded to 5.7%, higher than the 5.2% of the third quarter. However, the economy is showing some signs of slowing down with activities in both manufacturing and service sectors stagnating.

### Economic Growth Rates by Quarter



### Manufacturing Production Index and Service Activity Index



Domestic demand is also getting weaker. The growth of consumer goods sales has continued to decline from 7.1% in the third quarter to 4.5% in the fourth quarter of last year and further down to 3.8% in the January-February period of this year. Facility investment declined as well in the same period after a brief rebound in the fourth quarter of last year. On the other hand, construction investment has been robust since the fourth quarter of last year. However the outlook is rather dim with construction orders, a leading indicator, falling to 9.7% in January-February.

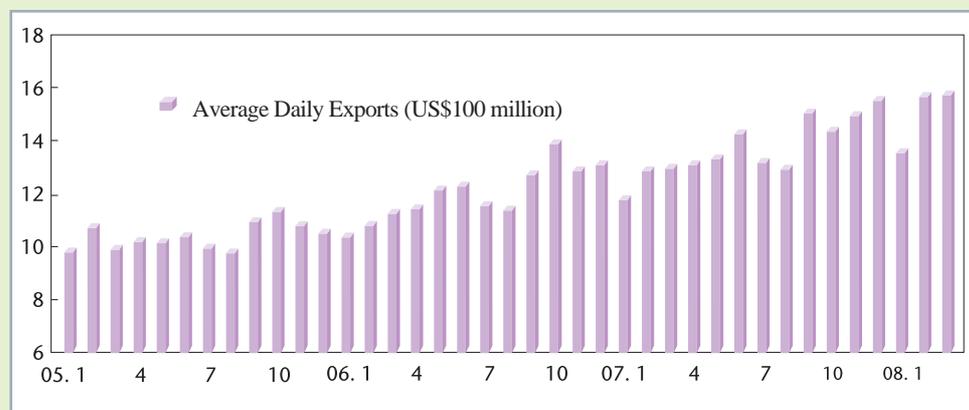
**Trends of Key Domestic Demand Indicators**

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

	2006	2007				2008	
	Annual	1/4	2/4	3/4	4/4	Annual	1/4
Sale of Consumer Goods	4.1	5.7	4.2	7.1	4.5	5.3	3.8
Estimated Facility Investment (constant)	8.9	12.7	11.7	0.6	9.2	8.5	-2.1
Domestic Machinery Orders Received (constant)	18.9	16.1	7.4	14.7	30.0	17.0	19.0
Construction Progress Payments (current)	2.6	7.9	6.0	4.4	8.0	6.6	7.2
Construction Orders Received (current)	9.0	26.3	26.3	-5.6	29.5	19.3	-9.7

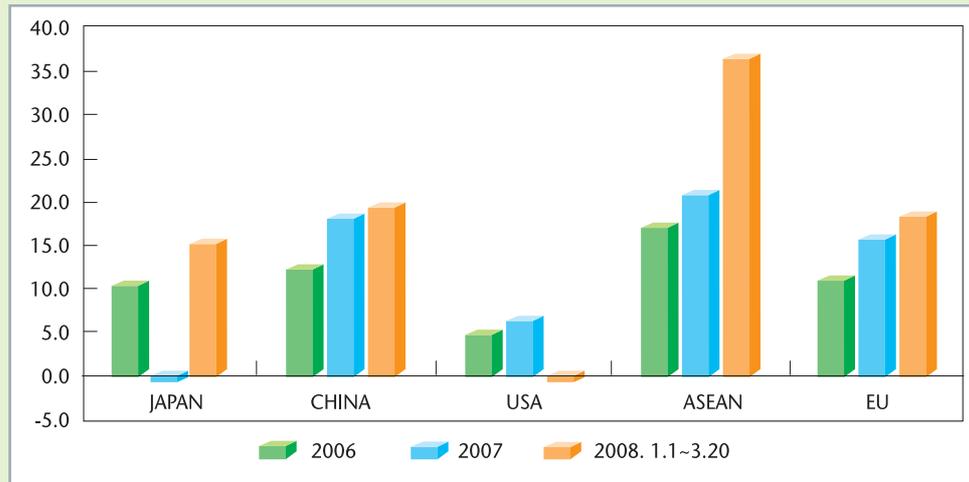
The export sector remains brisk in 2008. Following 18.2% growth in the fourth quarter of last year, exports expanded 17.6% in the January-March period of this year. The daily average export amount is on the rise as well, recording US\$1.35 billion in January, US\$1.56 billion in February and US\$1.57 billion in March. With respect to this year's exports by destinations, exports to China, the EU and Japan have expanded compared to last year, whileas exports to the United States have posted a downward trend due to the U.S. economy's slowdown.

**Daily Average Export Amount by Month**



**Export Growth Rates by Region**

(y-o-y changes %)



Reflecting the worsening external conditions, the current account balance is continuing to record deficits since December last year, posting about a US\$5 billion deficit in January-February this year. Rising international commodity prices including oil, causing imports to grow 28.1% in January-February, is blamed for the deficits despite the robust export sector performance.

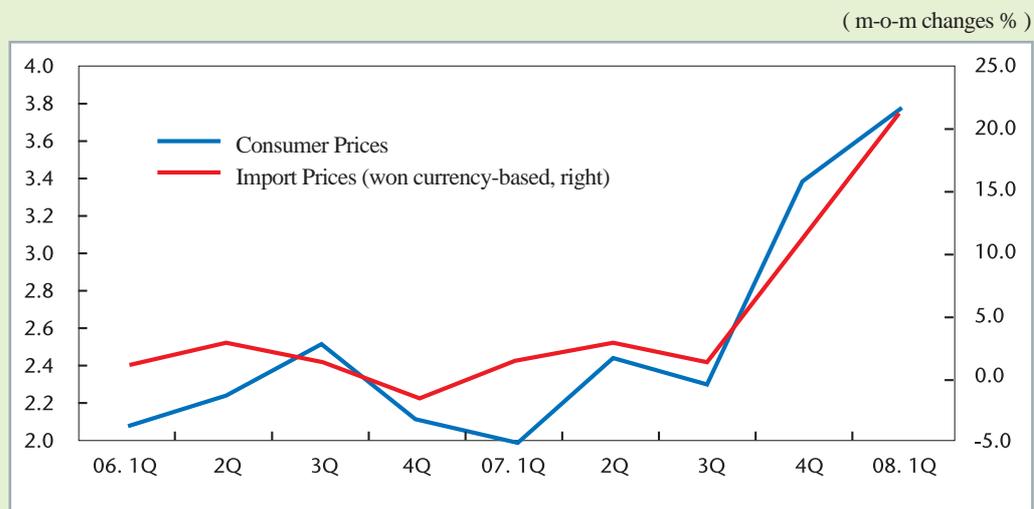
**Current Account Balance**

(Unit: US\$100 million)

	2006				2007	
	1/4	2/4	3/4	4/4	Year	1~2
Current Account Balance (=A+B+C+D)	-16.6	0.3	44.3	31.5	59.5	-51.0
Commodity Balance	60.4	69.7	96.8	67.3	294.1	-16.9
Service Balance	-61.8	-44.0	-58.8	-41.2	-205.7	-43.9
Travel Balance	-36.1	-36.6	-43.6	-34.7	-150.9	-24.5
Service Business Balance	-22.6	-17.1	-19.1	-25.1	-83.8	-21.1
Income Balance	-6.9	-15.4	16.6	13.4	7.7	14.7
Current Transfer Balance	-8.3	-10.0	-10.3	-8.0	-36.5	-4.9

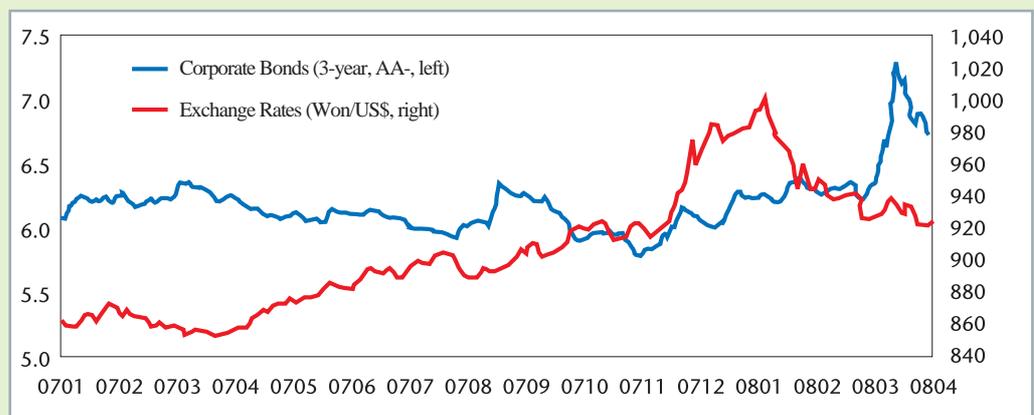
Consumer prices rose sharply at 3.8% in the first quarter of this year. It rose 2.3% in the third quarter and 3.4% in the fourth quarter of last year. Inflation of this magnitude was last seen in May, 2005. This is attributed to the sharp growth in import prices, which rose from 12.3% in the fourth quarter of last year to 21.7% in the first quarter of this year, led mainly by crude oil and international raw materials price hikes.

**Consumer Prices and Import Prices**



Market interest rates are showing a downward trend as expectations of economic slowdown and interest rate cuts mount. The Korean won has depreciated consistently against the U.S. dollar as fears of further financial instability and recession of the U.S. economy linger.

**Corporate Bond Yield Rates and Exchange Rates**



## Outlook for 2008

### External & Internal Environment

Both external and internal environments are changing rapidly

- With U.S. economic stagnation becoming apparent, the IMF adjusted its growth projection for the U.S. economy downward in 2008 to 0.5% from the previous forecast of 1.9% in October 2007. A slowdown of China's export growth is also more rapid than expected. China's export growth declined from 25.7% in 2007 to 16.5% in January-February this year.
- The rising price of oil (Korea's benchmark Dubai oil price) is showing no signs of slowing down. It averaged US\$91/barrel in January-February this year from the US\$80 level at the end of last year. International raw material prices are increasing sharply as well, as evidenced by increases in the IMF's commodity non-fuel price index from 14.4% in 2007 to 17.5% on average in January-February this year.
- Exchange rates are moving in unexpected directions as well. The Korean won-U.S. dollar exchange rate has depreciated, contrary to expectations, to 956 won in January-March this year and further to 991.0 won as of March 31. On the other hand, the Japanese yen has appreciated against the globally weak U.S. dollar. The Japanese yen-U.S. dollar exchange rate has declined from 105 yen in January-March this year to 99.8 yen as of March 31.
- As the global economy slows down and domestic demand weakens, the government is expected to implement various economic stimulus packages. The government contends that revision of the national tax system in 2007 will reduce the tax burden by about 1.705 trillion won.

Reflecting these changes, our projection of the economic prospects for 2008 is revised as follows.

### Exogenous Variables used in the forecast model for 2008

Projection Time	Assumed Values of Exogenous Variables for 2008						
	Economic Growth & Exports of Major Countries		Cost Factors		Exchange Rates		Tax Cut
	U.S. Economic Growth	China's Exports	Dubai Oil	Raw Materials Prices	Won/ U.S. Dollar	Yen/ U.S. Dollar	
Dec. '07	2.0%	20%	85 (US)	15%	910	105	-
Apr. '08	0.5%	15%	90 (US)	20%	980	100	1,705 trillion
Basis	IMF's Downward Adjustment 1.9% → 0.5%	China's Export Slowdown 25.7%('07) → 16%(Jan.-Feb. '08)	CERA's Upward Adjustment 81\$ → 90\$	IMF's Increase of Raw Materials Price Index 14.4%('07) → 17.5%(Jan.-Feb. '08)	956 (Jan.-Mar.) → 991.0 (Mar. 31)	105 (Jan.-Mar.) → 99.8 (Mar. 31)	Gov't, Revision of the National Tax System

## Prospects for 2008

- The Korean economy is projected to grow 4.5% in 2008. The forecast is revised down 0.5% point from the previous one in December 2007 to reflect changes in international as well as domestic economic environments as described above.
  - Private consumption growth is expected to slow to 4.4% in 2008 from 4.5% in 2007.
    - Consumer sentiment is likely to weaken due to economic slowdown in the U.S., increasing inflationary pressures resulting from rising international commodity prices, and prolonged instability of the international financial markets.
  - Construction investment is expected to show slight improvement and grow 2.0% in 2008 compared to 1.2% in 2007.
    - A host of public projects such as Multifunctional Administrative City, Innovation Cities and Enterprise Cities are expected to lead a recovery of construction investment. However, the government's efforts to stabilize housing prices coupled with the accumulation of unsold housing units will make the recovery less than robust.
  - Facility investment growth is expected to slow to 6.7% in 2008 from 7.4% in 2007.
    - Despite the high operating ratio in the manufacturing sector and the government's attempts to stimulate investment, facility investment growth will be restricted as the global economy and the international financial markets continue to struggle.
- Consumer prices are expected to rise 4.3%, about 1.8 percentage point higher compared with 2.5% in 2007.
  - This is attributed to weakening of the Korean won amid strong international inflationary pressures due to rises in international prices of crude oil and grains.
- The current account balance is expected to reverse course to a deficit of US\$8.8 billion in 2008 from a surplus of US\$6 billion in 2007. The deficit will be the first in 11 years since 1997.
  - Influenced by the slowdown of the U.S. economy and China's stronger contractionary policy stance, export growth (BOP basis) is likely to decrease to 11.7% in 2008 from 14.2% in 2007.
  - Import growth (BOP basis) is expected to expand to 17.2% in 2008 from 15.5% in 2007 due to increases in international oil and raw materials prices.

- The Korean won-U.S. dollar exchange rate is expected to depreciate to 980 won in 2008 from 930 won in 2007 mainly as a result of the current account balance deficit and instability of the global financial market.
- The Korean won is expected gain some strength over the U.S. dollar in the second half of 2008 as the uncertainties in the international financial markets are resolved.

### Prospects for Domestic Economy in 2008

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

	2007	2008				
	Year	1Q	2Q	3Q	4Q	Year
GDP	5.0	5.0	4.1	4.2	4.6	4.5
(S.A. q-o-q, %)	.	0.1	0.9	1.7	1.7	-
Private Consumption	4.5	4.5	4.3	4.2	4.5	4.4
Construction Investment	1.2	1.8	1.3	2.0	2.6	2.0
Facility Investment	7.4	4.0	4.6	9.7	8.5	6.7
Consumer Prices	2.5	3.8	4.5	4.4	4.3	4.3
Current Account	59.5	-79.5	-46.0	9.4	27.9	-88.2
Commodity	294.1	-5.7	11.7	68.2	59.8	134.1
Exports	3789.8	1001.3	1049.7	1037.1	1143.3	4231.4
Growth (%)	14.2	15.8	13.0	10.5	8.1	11.7
Imports	3495.7	1007.0	1038.0	968.8	1083.5	4097.3
Growth (%)	15.5	25.2	20.8	15.1	9.4	17.2
Service & Others	-234.6	-73.8	-57.7	-58.8	-31.9	-222.3
Ex-rate (Ave. KRW/USD)	929.3	956.0	996.0	989.0	980.0	980.3
Corp. Bonds Yield (3yr. AA-)	5.7	6.4	6.0	5.7	5.9	6.0

\* Including intangible asset investment

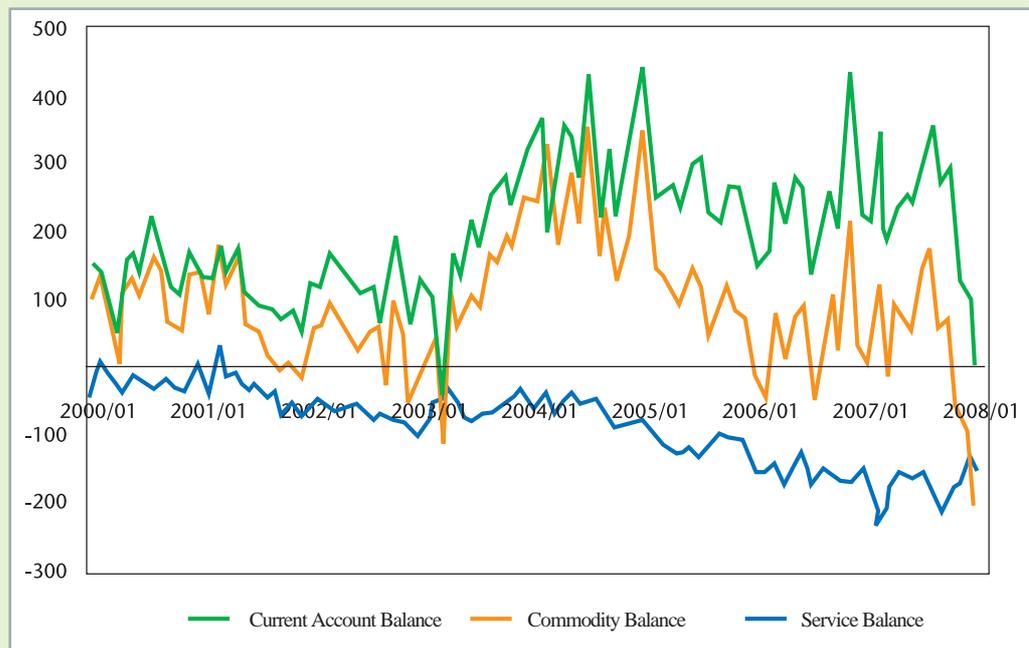
# Issue Focus

## Improving the Current Account Balance Through the Service Sector Reform

Korea's current account balance is expected to shift to a deficit in 2008 after 11 years in the black. The short term cause of the reversal to a deficit is the deterioration in goods account balance. However the fundamental long term factor is the chronically widening service account deficit since 2000. Its persistent nature suggests that the service account deficit may not be a short-term phenomenon but a result of structural problems in the service sector.

○ Current Account Balance, Commodity Balance and Service Balance

(Unit: US\$10 million)



Source: The Bank of Korea

- The current trend of expanding service account deficit, if not checked in time, may become a destabilizing force to the Korean economy
  - Depreciating the Korean won might be a quick solution as it would most certainly enhance the service sector's price competitiveness. However manipulating the exchange rate is a double-edged sword. Cheaper currency improves the current account balance, but it also raises the prices of imports on which the Korean economy is heavily dependent upon. According to our estimates, lowering the Korean won-U.S. dollar exchange rate from 1,000 to 980 won improves the current account balance by about US\$800 million. But it also raises the consumer prices by around 0.2% point. When the spectre of global inflation is looming over our collective head, any policy that aggravates the inflationary pressure should be carefully scrutinized.
- Rather than attempting to manipulate the market-determined foreign exchange rates, the government should implement measures to enhance competitiveness of the service sector.
  - The government needs to introduce measures to improve competitiveness of the Korean educational system. Educational outlays abroad are making up an increasingly large part of the service account deficits. Considering that most overseas study and training are primarily for the purpose of learning English, it is necessary to improve the quality of English education at public schools and expand such programs as English villages. Improvement of inferior educational infrastructure and diversification of educational opportunities would also help reduce the demand for overseas study and training.
  - Boosting the competitiveness of our tourism industry is also required. First, the government could allow more foreign workers in the service sector. It would alleviate the shortage of supply of qualified labor in the sector. It would also help address the language-related communication difficulties, which is the most frequently cited cause of inconvenience by foreign visitors. Second, easier access to a wide variety of travel Information should be pursued. More one-stop services should be made available which offer necessary information to visitors with just a few clicks. Third, custom-tailored tourist products should be developed. The Hallyu-focused customized tourist goods developed in 2005 are cited as a successful example. There is also a need to develop food-related tourist items, which are highly rated by foreign visitors. In this regard, stimulating leisure-city development projects that reflect the locations' competitive edges through revision of related regulations will be a step toward the right direction.
  - The competitiveness of business service should be enhanced as well. As business

services are closely related to manufacturing productivity and require comparatively specialized high-end manpower, it is necessary to take a structural approach with a long-term view in mind. There is a need to pursue division and specialization of the labor. Outsourcing parts of production processes, through mutual cooperation between the business service sector and the manufacturing sector can be considered in this regard. Furthermore, securing specialized high-quality manpower by introducing more rigorous competition in post-graduate educational institutions is needed

- Regulatory barriers that make it difficult for large businesses to enter the service sector should be removed. More active M&As between firms in the service sector should be encouraged. These policy changes would make possible exploitation of scale economies, which the service sector, mostly comprised of SMEs, badly needs. To stimulate investment in the service sector, systematic tax incentives should be offered, and more funds should be made readily available to deserving part of the service sector that has a comparatively low ratio of tangible assets.

# | Recent Publications

## Research Monograph

### **Pro-business Policy and Institutional Change of Japan**

Research Monograph 07-11

Yong-Yul Kim

The Japanese economy had failed to see its recovery during and past so-called 'lost decade' since 1990s and the country recently started to see signs of its economic turnaround and competitiveness improvement. Despite critics of sluggish progress in its structural reform in the past that prevented the economy from getting out of recession phase, robust efforts by the Koizumi government to push for structural reform and deregulation paved the way for bringing economic revitalization to the nation.

Following the introduction part (chapter one), the second chapter endeavored to look at the country's attainment of economic recovery through enhancing corporate vitality in corporate activities. The third chapter looked at ownership structure of Japanese enterprises and regulation over equity investment to other businesses. The fourth chapter focused attention on executive officer system that the Japanese firms have pursued as part of efforts to bring a restructuring into the mechanism of board of directors. The fifth chapter focused on the change in Japanese policies related to promoting M&A markets and defending the managerial control of companies.

Defenses against hostile takeover bids and regulatory standards to prevent abuse of such tools should run in parallel as a kind of package. Just like the Japanese case, Korea needs to have such preventive measures in place, which are designed to play an act in case of urgency. Guidelines on preventing abuse of management protection measures are prerequisite to introducing them and such guidelines should take root as a social norm after being given adequate consideration.

### **Optimal Size and Roles of the Public Sector**

Research Monograph 07-12

Gyeong Lyeob Cho et al.

Unlike the trends in other countries, Korea has suffered unnecessary budget drains over the past five years due to enlargement of the public sector, increase in the number of public servants, expansion of administrative organizations, suspension of privatization, etc. The

negative effect of larger government that has been a result should be overcome with government re-organization, manpower adjustment, privatization of public corporations and establishment of a new governance system through easing of restrictions, realization of a small but efficient government and achievement of a market economy.

Due to the government policy intended to achieve equal distribution or equity through government intervention, the growth slowed and bipolarization worsened to a degree. Under the government-led welfare and job creation initiatives, there were a number of similar or duplicate projects pursued by different ministries, accompanied by inefficiencies and serious waste of budget, and most of the jobs created were temporary and low-wage ones.

Therefore, the next government must focus on the management of national debt and recovery of financial health through establishment of financial rules and restrictions on discretionary fiscal expenditures. Korea's tax burden is already higher than that of the United States or Japan. When considering quasi-taxes, mandatory service system, enormous amount of private spendings on education and per capita income level, the effective tax burden is even more excessive.

As the labor supply is declining sharply due to an aging society and freer international capital movement also are expected from the acceleration of world market openings, the government should concentrate on expanding growth potential by lowering the marginal tax rates, including corporate tax, personal income tax, inheritance tax, etc.

Korea's tax system is also so complicated that tax payment and administration expenses are high. Therefore, reform is required to abolish the multiple tax imposition-type tax items and eliminate unnecessary non-taxable and tax reduction/exemption items aggressively in order to simplify the system and broaden the tax base. Regarding the integrated real estate tax, this paper suggests reduction of taxation scope, downward adjustment of the tax rate and separation of the property tax and the integrated real estate tax.

As provincial governments are inclined to depend on the central government transfers rather than on their own budget due to structural problems associated with local taxes and share taxes, waste of financial resources sources has reached a serious level. Therefore, the central government should pursue self-reliant-type decentralization by reducing its transfers and improve a system that infringes on autonomous tax imposition rights.

## Government Policy Toward Large Enterprises

Research Monograph 07-13

Zu-Sun Rhee et al.

This paper analyzed empirically the weight of Korea's top 30 business groups in the national economy and the trend of the weight for the past 11 years(1995-2005) according to the classification into financial and non-financial companies and again non-financial companies into manufacturing business, service business, etc.

According to the analysis, although there are some differences by business type and measured indices, the weight of the 30 business groups appeared to have declined significantly. In 1995, the weight of the 30 business groups in the non-financial business sector accounted for 34.1% of the nation's total assets, 59.7% of sales and 40.3% of employment. However, in 2005 after 10 years had passed, their weight fell to 19.2%, 35.6% and 25.6%, respectively.

An analysis of the survey on the trend in the weights of the four largest business groups and the top 30 business groups for the past 10 years, respectively, found that the weight of the four largest groups decreased furthest. This was because these four groups reorganized business structures, reduced manpower, etc. in the wake of the foreign exchange crisis.

The government is emphasizing the growth of the national economy through facilitation of global enterprises. In contrast, however, the growth of Korea's large enterprises has instead been limited, being classified as targets for restrictions.

There was contradiction in that the government curbed investment by the large enterprises, designating large business groups every year with the goal of restricting concentration of economic power.

In the process, the so-called large business groups have suffered identity crisis as they are designated for restrictions that bar their subsidiaries from investing in affiliates or other companies, and furthermore, there are also considerable differences among the designated large business groups.

Therefore, specific questions arise such as whether the application of the same restrictions to them all is really desirable or not, etc. This paper suggests that the government abolish the designation system of large business groups.

## **KERI 2007 - Long-Horizon Macroeconomic Model and Forecasting Results for Korean Economy**

Research Monograph 08-01

Hag-Soo Kim

In this report, an annual macroeconomic model is constructed that is suitable for forecasting long-horizon Korean economy and the forecasting results for Korean economy until 2030 are also presented according to scenarios for the annual growth rate of total factor productivity (TFP). The model presented in this report emphasizes the role of total factor productivity since it plays an important role in an innovation-driven economy and its role becomes more important in an economy as the economy becomes characterized as innovation-driven one. In addition the model also includes the government sector to analyze the effect of government expenditures and the nominal GDP share of corporate tax revenue on the long-run economic growth path.

The forecasting is performed from 2007 to 2030 with three different scenarios for the growth rate of total factor productivity. The baseline for the growth rate of total factor productivity is 1.8% per annum that is the historical growth rate of total productivity over the period of 1971~2006. With this baseline scenario, GDP is expected to grow at the rate of 3.14% per annum.

The best scenario assumes that TFP grows at the rate of 2.7% per annum, which is the annual growth rate of TFP for the period of 1981~1997. With this best scenario, it is expected for GDP to grow at the rate of 4.17% per annum. The worst scenario assumes that Korea fails to improve total factor productivity and ends up with the growth rate of only 0.7%, the annual growth rate over 1970's. For this case, the annual growth rate of GDP will be only 1.88%.

Based on the policy simulation results and the forecasting results with three different scenarios, we could sum up our findings into three major implications. The first one is that the improvement of total factor productivity has the most persistent and strong effect on the overall economic growth among other policy variables.

The second is that the increase in total factor productivity has a negative effect on the economy, which happens in the labor hours. The demand for labor is substituted by the increase in total factor productivity, which possibly explains the problem known as 'jobless

growth' in Korea after the crisis. The last implication is that 1% point decrease in the nominal GDP share of corporate tax revenue increase GDP more than 1% point increase in the share of government expenditures.

## **An Empirical Analysis on the Collusion**

Research Monograph 08-02

In Kwon Lee

This study shows how to systematically and statistically detect the presence of collusive bidding behavior in auctions and properly estimate damages to consumers or taxpayers. The antitrust agency can not easily obtain the solid evidence of bid rigging. Therefore, the detection of bid rigging is not an easy task. The antitrust agency needs to distinguish between collusive behavior and noncooperative behavior, both of which lead to supracompetitive profits since some statistical indicators generally associated with collusion may arise in an equilibrium of noncooperative game.

The appropriate methods for the detection of explicit bid rigging and noncooperative tacit collusion require the detailed statistical analyses of strategic behaviors and market environments in addition to simple regression-based analysis. This paper illustrates the effects of limits of current legal enforcement in relation with collusion inference at the levels of Fair Trade Commission and Courts. This research strongly suggest that competition agency delete the unfair collusion inference code of Antitrust Law and adopt the actual inference based on solid circumstantial evidence. And Also, It provides that reasonable approach for the relevant refusal of collusion inference.

The accurate assessment of damages is a key issue in litigation involving a bid rigging. The assessment of damages is often a principal issue in litigation because the interests of plaintiff and defendant directly conflict. Primary objective of the plaintiff is usually to collect as much as possible and that of the dependant is to pay as little as possible. In order to recover antitrust damages, the plaintiff in a bid rigging case must be able to prove the amount of the price change suffered as a result of a conspiracy.

Even if the proof of damages is obviously critical to plaintiffs and defendants alike, there are very few empirical studies on this subject. Three alternative techniques can be

successfully used for preparing damage cases. The first is cost method approach looking at the relationship between winning bid and professional's estimates of competitive bid on the basis of sketch cost data. The second is dummy variable approach estimating over the pooled sample of rigged and unrigged contracts with a dummy variable which is equal to one if the job is rigged and equal to zero if it is unrigged.

The third is a forecasting approach using only unrigged bids as a control group to estimate the model and then plugging the data points for each rigged bid into estimated model. However, it should be noted that these estimates are poor substitutes for estimates based on reliable cost data. This study investigates the effect of the regulation change on the formation of cartel, antitrust damage suit, and the imposition of administrative fine.

This study suggests that the government agency should assess the basic fine on the basis of proper damage estimation, not on the basis of the certain percentage of gross sales. This legal approach may help the consistency, the stability, and predictability of legal enforcement. This study also suggests that at the stage of active antitrust damage suit, the financial remedy rely on damage suit and the fine focus on administrative regulation reflecting dead weight loss and enforcement cost due to the collusion in oligopoly market. The punitive compensation system needs to be introduced restrictively in hard-core cartels.

## **A Study on the Political Economy of Trade Policy in Korea**

Research Monograph 08-03

Wongun Song

This study examines the applicability of endogenous protection theory, especially "Protection for Sale" model by Grossman and Helpman(1994) for the determination of trade policy in Korea. First, in this study, the basic model based on G-H is developed and examines the effects of labor-related variables on the determination of trade policy by extending the basic model which considers the lobbying by labor unions and labor market rigidities. It is theoretically derived that the labor market rigidity of one sector increase the trade protection level for that sector if the labor suppliers of that sector is politically organized.

Second, in this study, the econometric models based on the basic model, the modified basic

model with dummy variables for agriculture, and the extended model with labor market rigidities are developed and estimated using the SITC 2-digit level data for Korea. The estimation results do not support the hypotheses of political economy of trade policy. That is, the political economy of trade policy that the trade protection level is high for the sector in which the relatively more gains from protection and the less cost of protection will be expected because of low import penetration ratio and inelastic import demand is proved not to be working for the determination of trade policy in Korea.

The estimation results of this study are mainly due to the fact that Korea has reduced trade barriers substantially since 1990s and the differences in tariff rates between industries has been declined due to the policy of equivalent tariff structure. The other important characteristic of the estimation results is that whether the sector belongs to agriculture is very critical to the trade protection level of that sector. This characteristic shows that the determination process of trade policy in Korea is very influenced by populism. The estimation results of this study have important implications for the strategy that minimize the internal political opposition to trade liberalization such as trade adjustment assistance program. On the contrary, for sustaining more trade liberalization, it is imperative to overcome the influence of opinions of opposition groups on the sentiment of median-voters.

### **An Empirical Study on Competitive Edge of Korean-Made Products in China - A Case for Home Appliance and Cellular Phone**

Research Monograph 08-04

Chang-Ho Cho, Paik-Hyun Suh, Eun-Young Kim

The aim of this study is to test competitive advantage of Korean home appliances and cellular phones in China. To achieve the aim, this study examines three major subjects. that is: What criteria is applicable to Chinese consumer in purchase decision? What's the difference of evaluation between purchase group and non purchase group of Korean products? Is there any the causal relationships among several national images (country image, people image, and the general product image) and its impact on quality evaluation and purchase intention on Korean products?

This study has used the questionnaire which has been collected through Chinese consumers

survey. The samples of this study are 307 Chinese consumers who are above 18 years old and residents at Beijing.

The findings could be summarized as follows. Firstly, Chinese consumers set more value on product quality than price. Secondly, Chinese consumers purchases Korean product due to high technical level, superior design and long durability. Finally, National images and general product images has less influence than functional quality on purchase intention. In conclusion, the product quality factor will give Korean home alliance and cellular phone an edge over the competition.

## **Economic Impacts of Developing Enterprise Cities**

Research Monograph 08-05

Gyeong Lyeob Cho

An enterprise city is initially proposed by the Federation of Korean Industries with the purpose of hosting economic activities including manufacturing and tourism industries. In addition to its main function of hosting industrial, research and tourism activities, an enterprise city will contribute to the investment promotion, creation of employment, and balanced national development. According to their main function, enterprise cities are classified into four types of cities such as industry-trade type, knowledge-based type, tourism-leisure type, innovative hub type. Currently 6 areas are selected for sites of enterprise cities, Wonju and Chunju as cities of knowledge-based type, Muan as city for industry-trade type, Taean, Muju, and Yeongam-Haenam as cities of tourism-leisure type.

On the contrary to our expectation, however, this national project is very slowly progressing due to the low economic feasibility. Politically biased emphasis on the balanced territorial development, the capital area is excluded from the location of an enterprise cities. Thus, major companies and foreign investors hesitate to invest on this projects. The success of enterprise cities highly depends on effectively inducing the foreign and domestic investment.

Under the scenario of portion of foreign investment to total investment, this study investigates the effect of developing enterprise cities on both regional and national economics. This study uses the Multi-Regional Dynamic Computable General Equilibrium

model which consists of 8 regions and 17 industries. The analysis shows that increasing FDI and/or inducing potential domestic investment is an important factor to effectively develop enterprise cities. To this end, the government removes institutional obstacles of investment and also constructs road, railroad and other transportation infrastructure in the initial stage of developing enterprise city.

## **Global Patterns of M&A Activity and their Implications to Korea**

Research Monograph 08-06

Seung-Rok Park

As the world economy becomes more global, the boundaries of capital movement vanish, and the Chinese economy is developing, there has been a global trend of M&A drive. However, Korean businesses have failed to pay close attention to this trend, failing to make the most of lucrative foreign investment opportunities.

There have been numerous restrictions on foreign investment by the Korean businesses for M&A in outside markets of the country. There have also been restrictions against investment of private equity fund in global markets, which serves as a source of significant financing for corporate M&As. Likewise, foreign investments by Korean financial institutions have been subject to governmental regulations. With few large players in the international M&A market, performances of the Korean financial institutions have been disappointing.

The purpose of the study is to examine these situations Korean businesses face in the global M&A market. This study looks at M&A efforts among world businesses(IN-IN) everywhere in the global market during the past decade, cases of M&A between foreign enterprises and domestic enterprises(OUT-IN). It takes a look not only at roughly 340,000 cases of M&A by years, nations, regions and industries, but deal types of M&As, financing of the M&A deals and global enterprises who have played a significant role in the international M&A market.

## Policy Report

### **Change in U.S. Supreme Court's Assessment Criteria for Resale Price Maintenance Behavior and Policy Implications**

Policy Report 07-07

Zu-Sun Rhee and Seuk Hun Sin

This paper analyzes the U.S. Supreme Court's ruling on June 28, 2007, reversing the previous principle held for 100 years on minimum resale price maintenance agreement. The agreement restricted distributors to the resale of goods at prices higher than the minimum price established by manufacturers, and the Court found this practice per se illegal. The recent ruling would have policy implications for Korea in that it will affect the government's competition policy.

Addressing diverse vertical restrictions commonly used by distribution channels, including resale price maintenance behavior, not from the perspective of protecting 'competition' for the enhancement of consumer welfare, the original intent of the Competition Act, but from the perspective of protecting 'competitors' of the transacting parties, this paper explains that the U.S. Supreme Court's ruling will provide momentum to resolve fundamental problems in operating the Fair Trade Act of Korea, which has treated such behavior as per se illegal.

Furthermore, the paper suggests that the government adopt the changed viewpoint in the ruling regarding the essence of corporations and competition as momentum to change the government's overall corporate policy, which has been focusing from the aspects of 'monopoly and regulation'.

### **Evaluation of Korea-U.S. FTA Negotiation Results by Sector and Implications for Korean Enterprises**

Policy Report 07-08

Inkyo Cheong et al.

Under the proposed Korea-U.S.(KORUS) FTA, the Korean economy is expected to advance into a de-facto full open market system. This paper evaluated the KORUS FTA negotiation results and reviewed implications for Korean enterprises with classification into six themes.

The six themes are ▲ the commodity sector, ▲ the service sector and investment, ▲ regulations, ▲ trade remedy, ▲ government procurement and ▲ damaged industries.

### **Korea-U.S. FTA and Regulation and Policy Reform in Sectors: Comparisons between Korea and the U.S.**

Policy Report 07-09

Sung Bong Cho et al.

In order to realize the benefits of economic integration following conclusion of the Korea-U.S.(KORUS) FTA, it is necessary to create the same regulatory environment to promote competition between the two countries.

This report suggests policy tasks in five themes: ▲ corporate policies, ▲ land regulations, ▲ policies on the financial sector ▲ tax policies and ▲ labor market and labor relations between two countries.

### **The Costs of Compulsory-Purchase Bonds and Policy Implications**

Policy Report 07-10

Taekyu Lee

The system of compulsory-purchase bonds is distorting the market and creating an economic burden for the private sector. The normal bond issue process, that is, attraction of capital through market, is desirable. Considering the stable demand for government bonds at present, it appears that issuing the bonds as government bonds through the market is feasible.

In the case of municipal bonds, however, conversion to attraction of capital through markets will not be easy, since the municipal bond-issuing markets target a market focused on borrowing of indebtedness certificates utilizing public funds. As the best alternative, policy efforts to stimulate municipal bond-issuing markets are necessary while recognizing the need to issue compulsory-purchase municipal bonds but rationalizing the interest rate and

pursuing improvements to reduce the targets for compulsory purchase.

### **Implications of France's CPE System - Centering on Flexibility of Labor Market and Job Creation**

Policy Report 08-01

Yanggyu Byun

This paper analyzed the employment creation effect of the First Job Contract (CPE: Contrat Premiere Embauché) system introduced by France in 2006 to resolve its youth unemployment problem.

The analysis found that the employment creation effect of a flexibility policy limited to part of the labor market was not very large. This means that an overall labor market flexibility policy, involving regular workers, is important in order to achieve the task of job creation.

A flexibility policy limited only to the part of the labor market, like the Non-Regular Workers Protection Act in Korea, would likely deepen the dual structure of the labor market and bring negative effects, such as sharp increase in the number of non-regular workers. Therefore, a flexibility policy that includes the regular labor market should be implemented in parallel. Such a policy would introduce healthy competition between regular and non-regular labor markets and enhance the efficiency of the entire labor market.

### **Unstable Factors in International Financial Markets and Future Prospects**

Policy Report 08-02

Soon-Kwon Ahn

There is a good possibility that international financial instability will continue into the second half of this year.

First, when considering the estimated size of the variable interest-based subprime

mortgages and prospects for U.S. housing market conditions, delinquency of subprime mortgage loans is highly likely to worsen until the end of this year.

Second, despite the economy-boosting policies initiated by the U.S. government and the Federal Reserve Board(FRB), considerable adjustment time will be required in light of the characteristics of the housing and subprime mortgage markets.

Third, if delinquency of subprime mortgages worsens, the sentiment driving financial uncertainty will continue to negatively affect related banking institutions and exacerbate the subsequent loss scale.

**Working Paper****Nonlinear Mean-Reversion in Southeast Asian Real Exchange Rates**

Working Paper 07-01

Bonghan Kim, Doo-Yull Choi, Seewon Kim

We found nonlinear mean-reverting tendencies in Southeast Asian currencies by applying the newly developed nonlinear unit root test by Park and Shintani(2005). First, with the U.S. dollar as the numeraire currency, we found that 63% of the real exchange rates of Southeast Asian currencies turned out to be stationary. However, with the Japanese yen as the numeraire currency, we found no evidence in favor of purchasing power parity for most currencies in Southeast Asia, except for the Korean won and Taiwanese dollar.

These findings imply that Southeast Asian currencies may not form a yen-dominated Asian exchange rate system. Second, when the dollar-based real exchange rates of Southeast Asian countries were nonlinear mean-reverting, we found that the mean-reverting process could be well described by the ESTAR model, rather than the DTAR or DLSTAR model. As the ESTAR model shows smooth nonlinear movement toward its equilibrium value, this finding may imply that the dollar-based Southeast Asian real exchange rates move with smooth nonlinear mean-reverting behavior toward their equilibrium values.

**Unemployment of College Graduates - No Problem in Themselves?**

Working Paper 07-02

Sung-Joon Park

The unemployment of the highly-educated young adults is perceived as a result of a lack of opportunities to work, so job creation is seen as the only appropriate solution. But can just the rash creation of new jobs solve the problem? Even if new jobs are created, would it solve the problem if the highly-educated youth are not interested in them?

There is some suspicion that attitude is contributing to the unemployment of the highly educated. As a result of their expectations being high and growing higher year by year without finding a job at a satisfactory level, unemployment is becoming long-term and even when they are employed, the trend of quitting jobs voluntarily is prevailing.

As the youth of today take longer to get their first jobs and they also quit jobs easily, the unemployment rate is bound to be naturally high. Therefore, creation of jobs suited to their tastes and skill level, not just any jobs, is important. No less important, however, adjustment of their high expectations regarding employment is considered absolutely necessary.

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