August 2010 No.61

KERI ECONOMIC BULLETIN

Contents

Korea Economic Research Institute

Executive Summary

Korean Economic Growth for 2nd Half Projected at 4.6%, Down from 7.6% in 1st Half

Korean economic growth is expected to slow from 7.6% in the first half of this year to 4.6% in the second half. The major factors in the slowdown are a set-back of the recovery trend in the global economy following financial instability in Europe, the recent decline of economic indicators in China and the United States, normalization of domestic macroeconomic policy, and base effects from the growth trend of last year, which was high in the first and low in the second half.

In the second half, private consumption is expected to grow 3%, with interest rate hikes, decline of real estate business conditions and employment growth slowdown. Facility investment, which posted strong 29% growth in the first half, may slacken to the 12% level in the second half, affected by stagnation of economic recovery trends in major countries, domestic interest rate hikes, full-fledged implementation of corporate restructuring, and other factors. Meanwhile, sluggishness of construction investment is likely to deepen further in the second half.

Current Account Surplus May Decline to US$8.4 Bil. in 2nd Half from US$11.6 Bil. in 1st Half

Influenced by a decrease in total demand following the financial instability in advanced countries, economic slowdown in China, the appreciation of Korea's currency against the U.S. dollar and base effects, export growth (U.S. dollar basis) is expected to slow to 16.5% in the second half from 33.5% in the first half. The scale of the current account surplus also is expected to decline to US$8.4 billion in the second half from US$11.6 billion in the first half due to faster growth in imports than exports, expansion of overseas service demand, etc.

Consumer Prices to Grow 3.2% and Won/USD Fx-Rate to Appreciate to 1,130 Won in 2nd Half

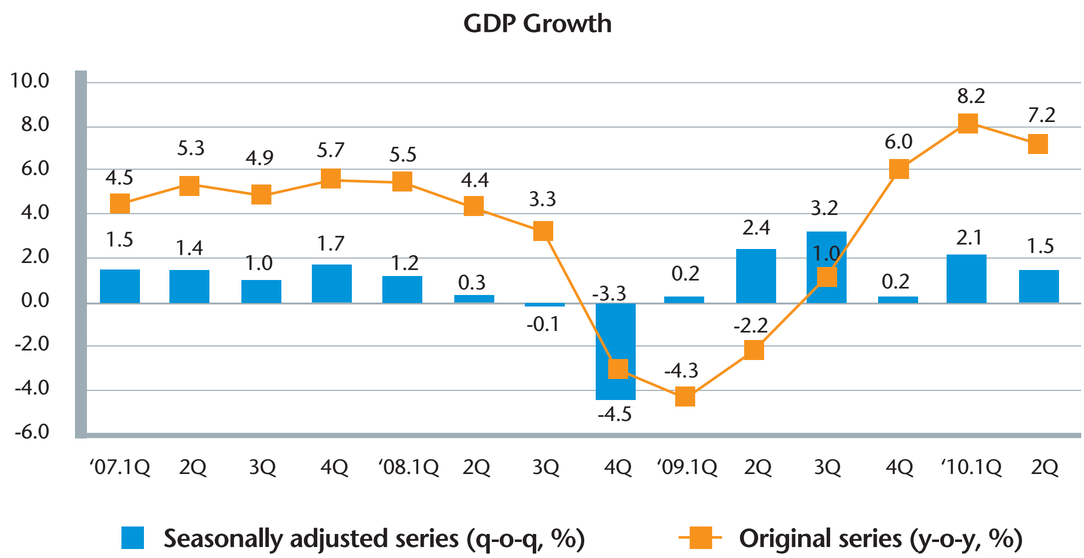
In the second half, consumer prices may increase due to stronger total demand, public utility rate hikes, and base effects. With the won currency also showing an appreciation trend in addition to relatively stable prices of import raw materials, including crude oil, consumer price growth is expected to remain below 3.5%. Affected by easing of the financial crisis in Europe and the U.S. economic slowdown, etc., the U.S. dollar-based foreign exchange rate is expected to appreciate gradually and attain the 1,130-won level on average in the second half.

Economic Trends and Outlook

Recent Developments

GDP Grew 1.2% in 2nd Qtr. '10

GDP growth in the second quarter of 2010 posted a lower 1.2% compared with 2.1% in the first quarter. The growth slowdown is attributable to the fact that, whereas growth in facility investment and exports & imports expanded significantly, private and government consumption did not keep pace and also construction investment returned to a declining trend.



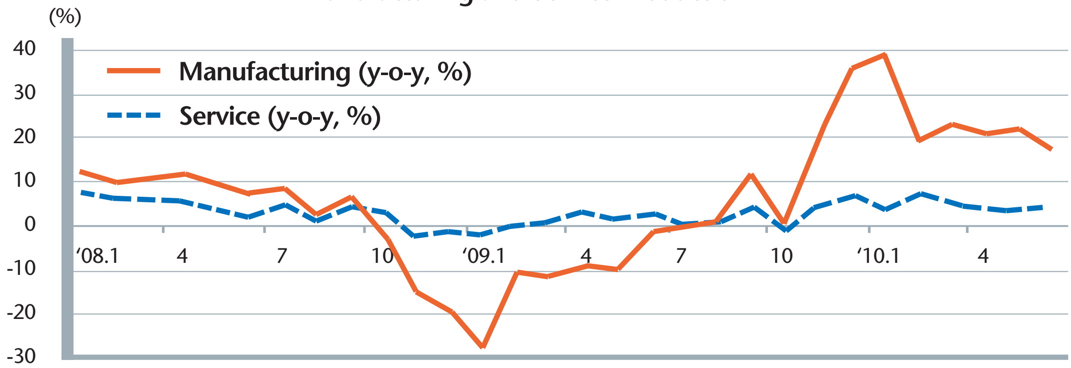
(Unit: q-o-q changes, %)

	2009	2010	
	4/4	1/4	2/4
GDP	0.2	2.1	1.5
Private Consumption	0.4	0.7	0.8
Government Consimption	-2.4	5.8	0.1
Construction Investment	-0.1	1.3	-3.4
Equipment Investment	5.3	2.4	8.1
Exports	-1.0	2.9	7.0
Imports	0.1	4.4	7.1

Manufacturing Production and Service Business Production Grew 20.1% and 4.0%, Respectively, in 2nd Qtr.

In the second quarter, manufacturing production continued a high year-on-year growth of 20.1% following 26.9% growth in the first quarter. On the other hand, service business production growth slowed to 4.0% from 5.9% in the first quarter.

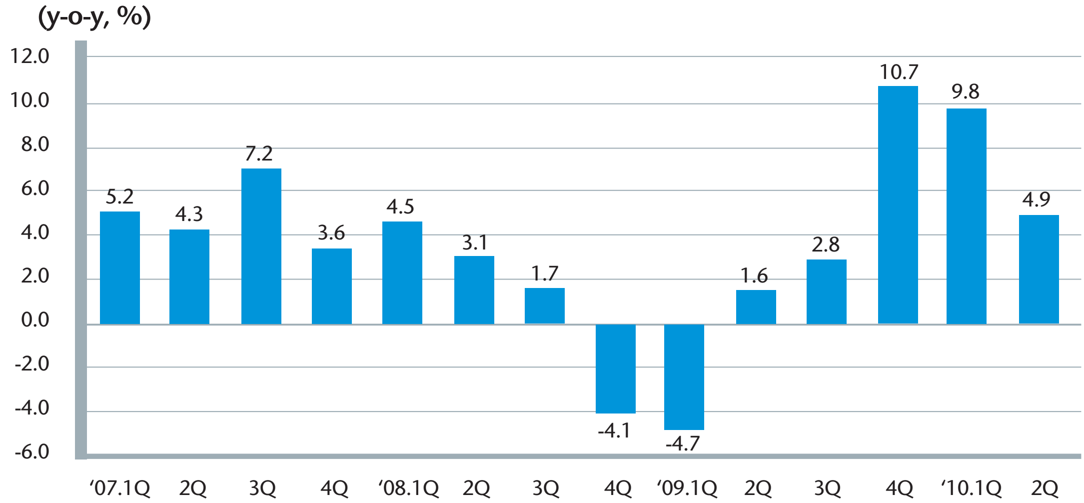
Manufacturing and Service Production

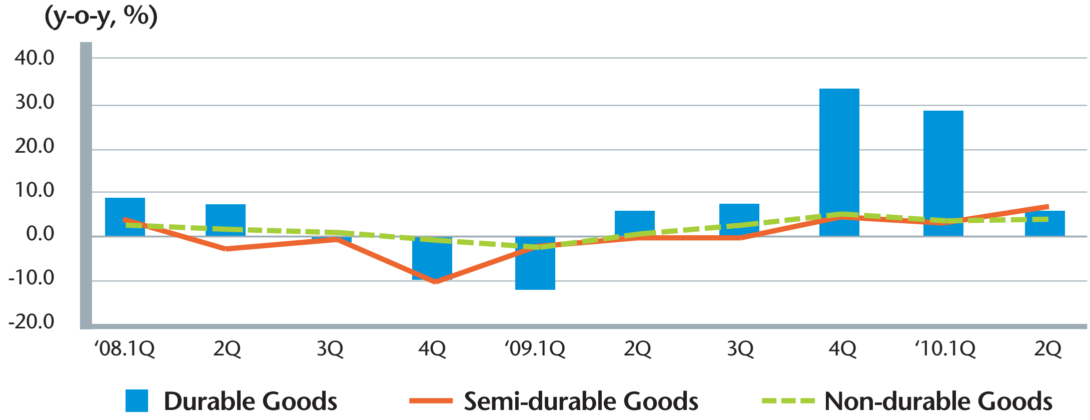


Consumer Goods Sales Grew 4.9% in 2nd Qtr.

The growth of consumer goods sales slowed significantly to 4.9% in the second quarter from 9.8% growth in the first quarter due to a sharp drop in sales of durable goods, such as passenger cars and electrical home appliances despite expanded sales of semi-durable goods.

Consumer Goods Sales

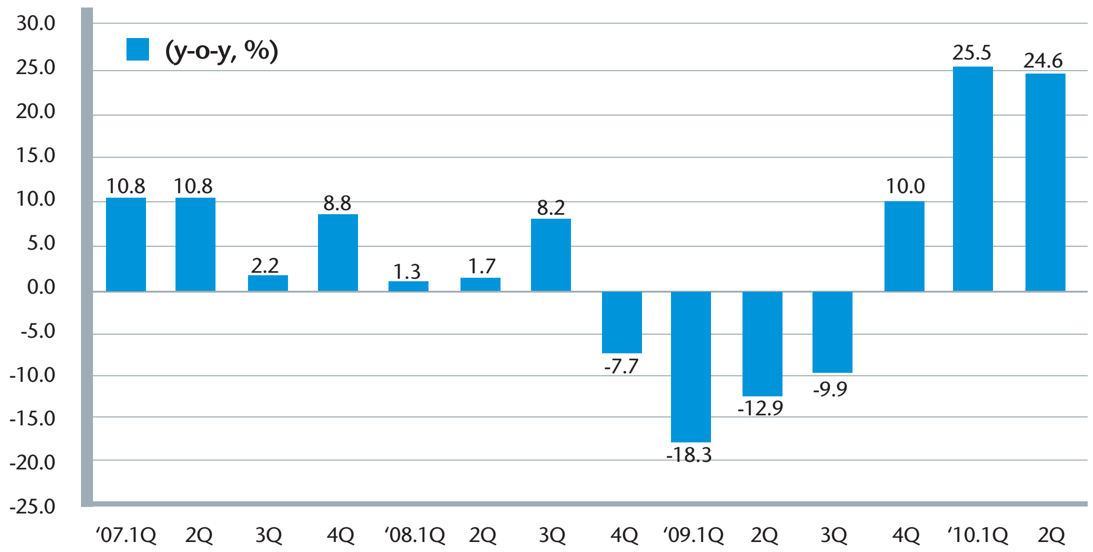


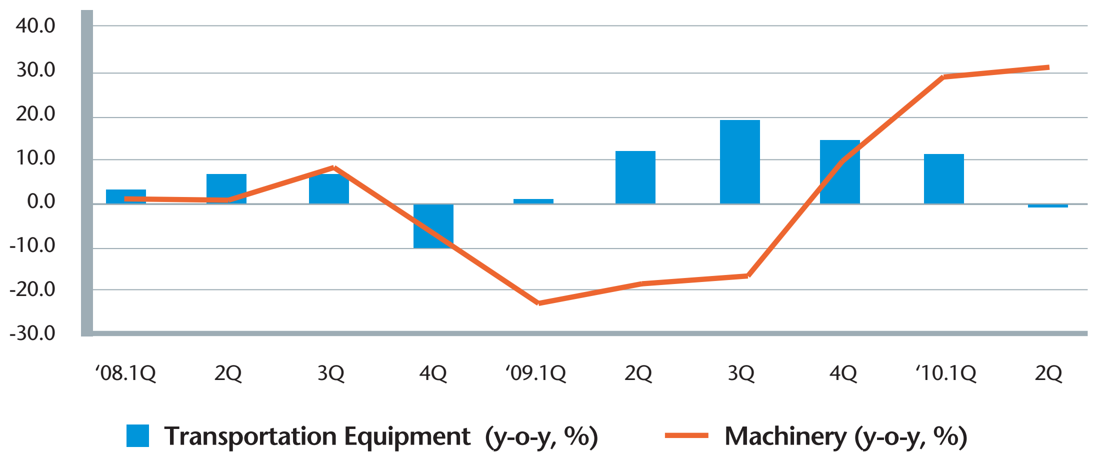


Facility Investment Increased 24.6% in 2nd Qtr.

Facility investment continued strong year-on-year growth of 24.6% in the second quarter following 25.54% in the first quarter. While machinery investment posted brisk growth, transportation equipment investment was sluggish.

Equipment Investment

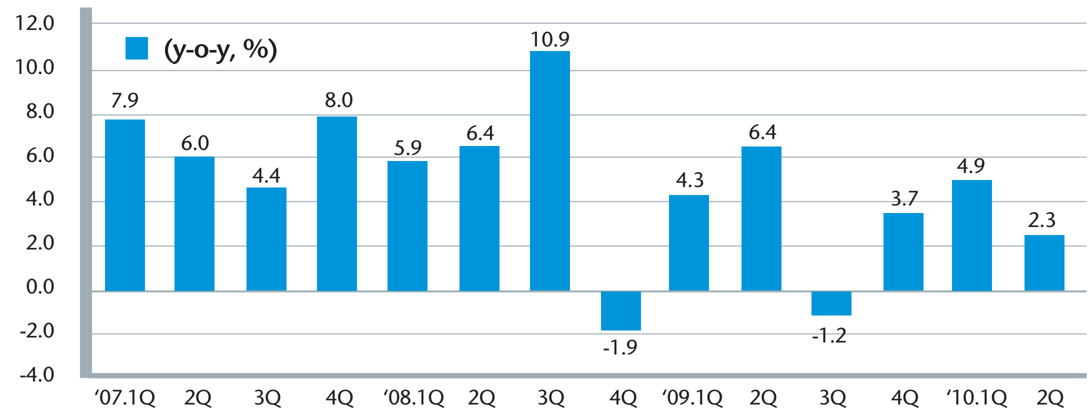


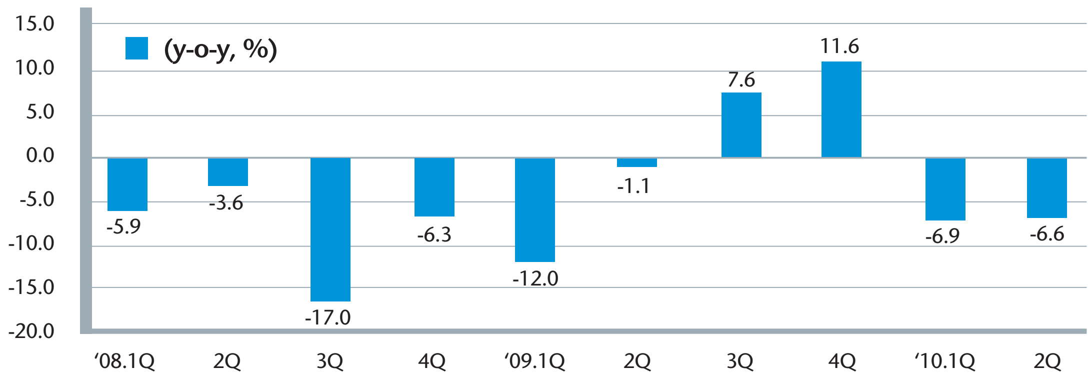


Construction Investment Increased 2.3% in 2nd Qtr.

Compared with the first quarter (4.9%), the growth of construction investment slowed to 2.3% in the second quarter. The growth in receipt of construction orders, a leading indicator, declined to 6.6% in the second quarter after falling to 6.9% in the first quarter.

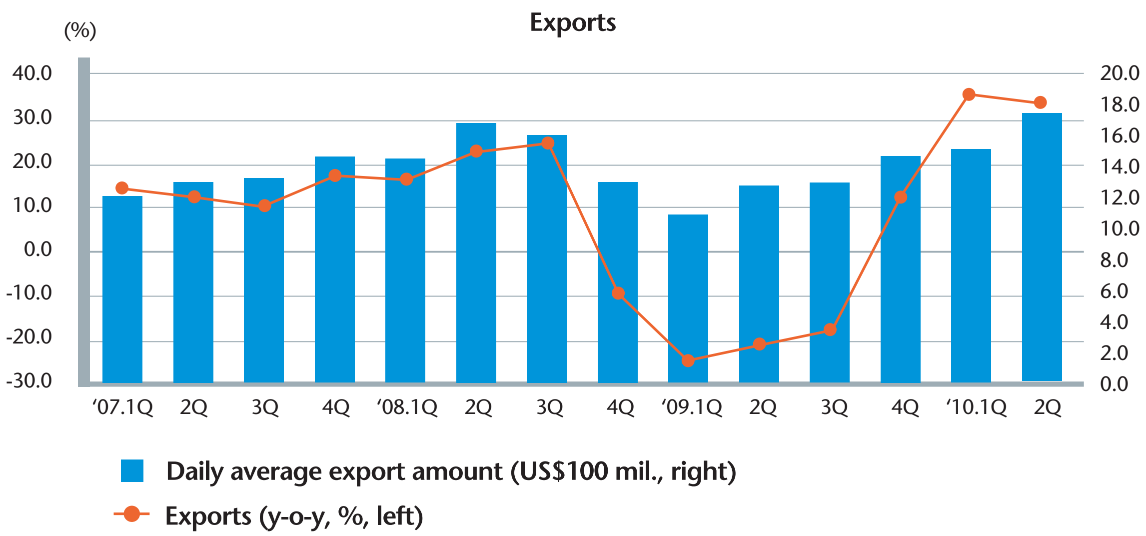
Construction Investment

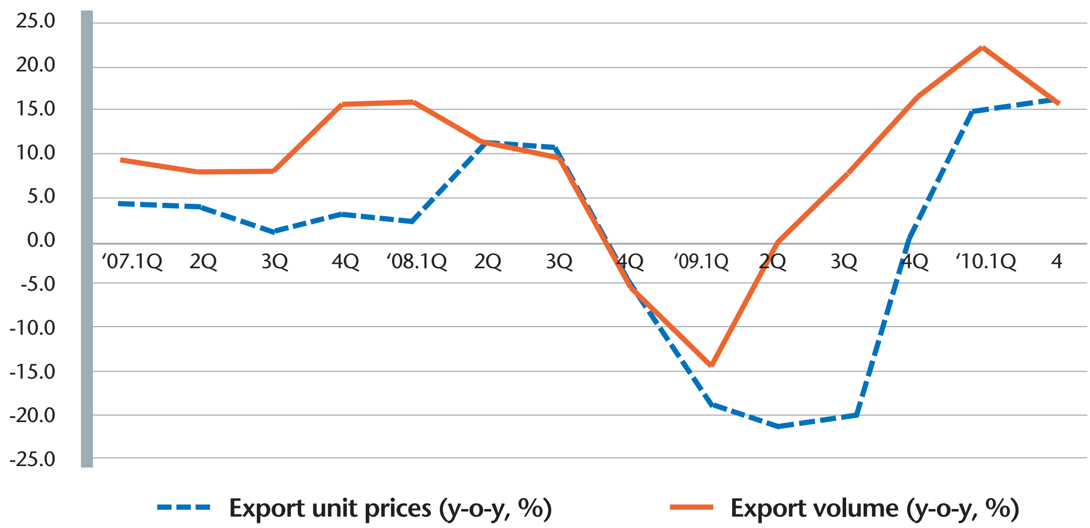




Exports (Customs Clearance Basis) Grew 35.% in 2nd Qtr.

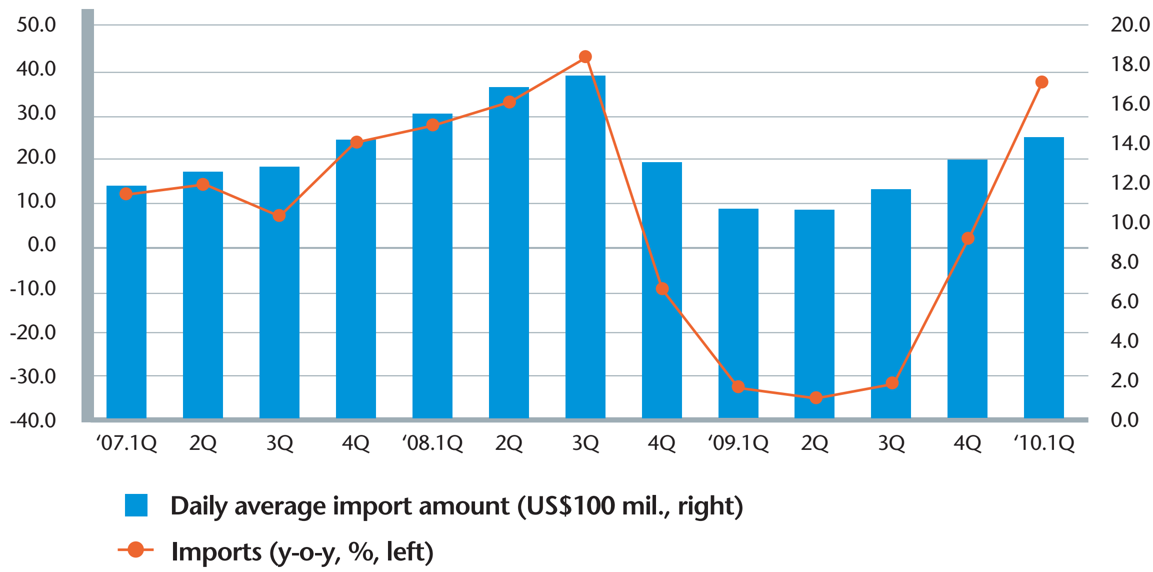
Owing to a double-digit increase rate in export unit prices as well as expanded export volume, exports (customs clearance basis) continued strong growth of 34.0% in the second quarter after posting a 36.2% gain in the first quarter. Semiconductors (97.3%) automobiles (89.6%) led the growth trend.





Imports (Customs Clearance Basis) Expanded 40.0% in 2nd Qtr.

Since the first quarter of 2010, imports have continued a high growth trend, outpacing export growth, and recorded a 40.0% increase in the second quarter. By usage, imports of raw materials, including crude oil, led the growth, accounted for about 60% of total imports.



	2010 (Jan. 1 ~ June 20)		
	Amount (US$100 mil.)	Increase Rate (y-o-y, %)	Ratio (%)
Total Imports	1,909	38.7	100.0
Raw Materials	1,140	44.0	59.7
Capital Goods	583	32.0	30.5
Consumer Goods	184	28.7	9.6

Current Account Surplus in 1st Half: US$11.6 Bil.

Compared with US$21.72 billion in the fist half of last year, the current account surplus was significantly lower in the first half of 2010 at US$11.6 billion due to a reduction in the commodity balance surplus and an expansion of the service balance deficit.

Current Account Balance

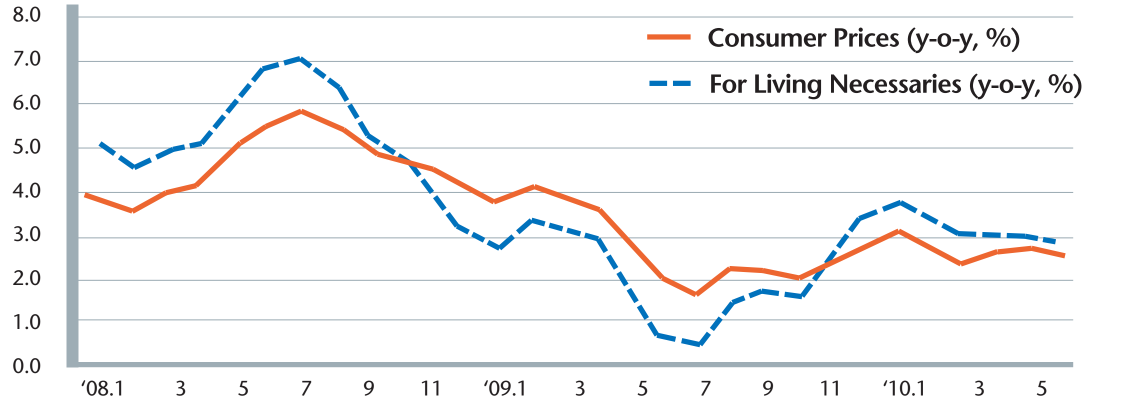
(Unit: US$100 mil.)

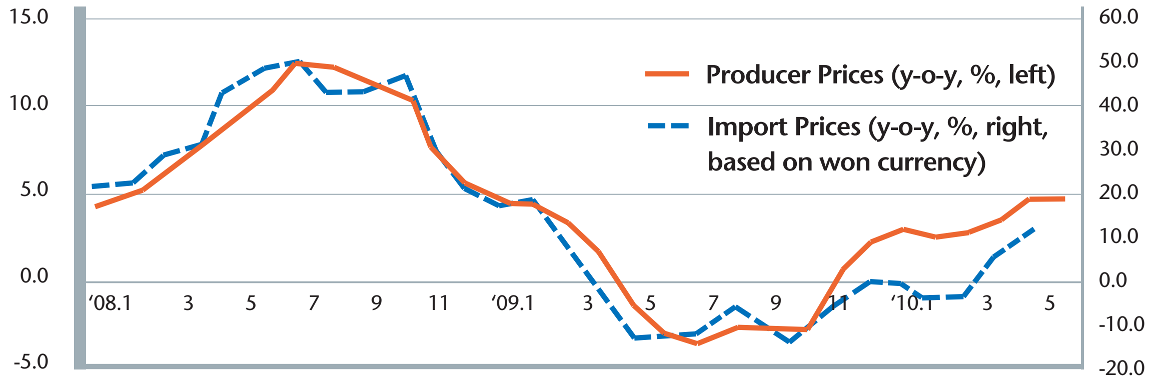
	2009	2010		Comparisor	
	year	1/4	2/4	2010	2009
Current Account Balance (= A+B+C+D)	426.7	13.4	102.8	116.1	217.2
A. Commodity Balance	561.3	74.3	156.5	230.8	258.8
B. Service Balance	-172.0	-60.4	-41.7	-102.0	-60.9
Travel Balance	-38.9	-19.9	-13.6	-33.5	-5.5
C. Income Balance	45.5	7.6	-7.5	0.0	12.2
D. Current Transfer Balance	-8.1	-8.1	-4.5	-12.7	7.1

Consumer Prices Increased 2.6% in 2nd Qtr.

The growth of consumer prices declined mildly to 2.6% in the second quarter from 2.7% in the first quarter, owning to foreign exchange rate appreciation, oil price stabilization, etc. Since advancing to a 3% level in April, however, producer prices rose 4.6% in both May and June. Import prices also surged 11.3% in May.

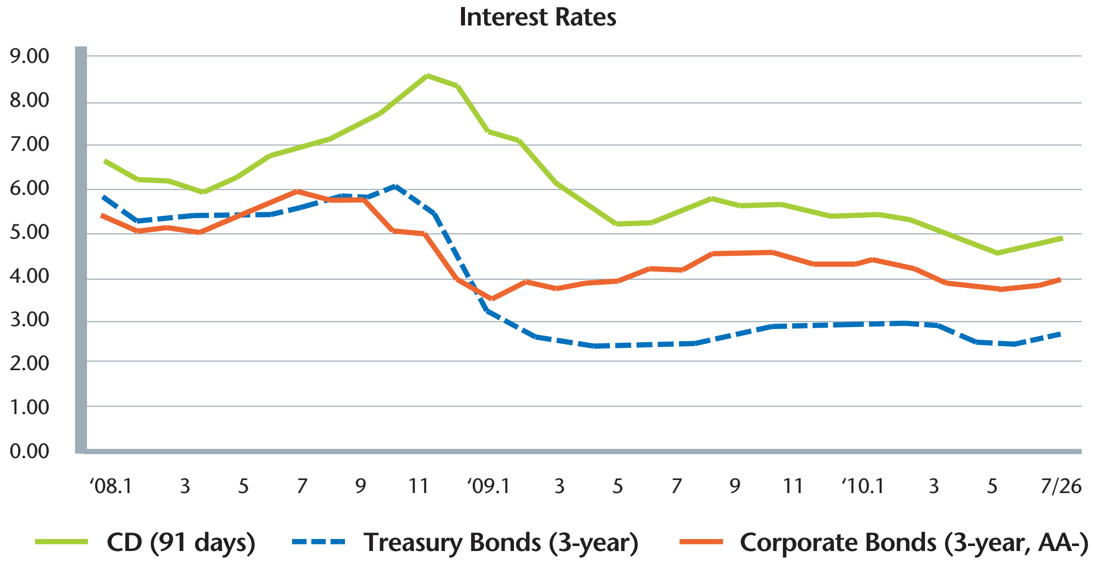
Prices





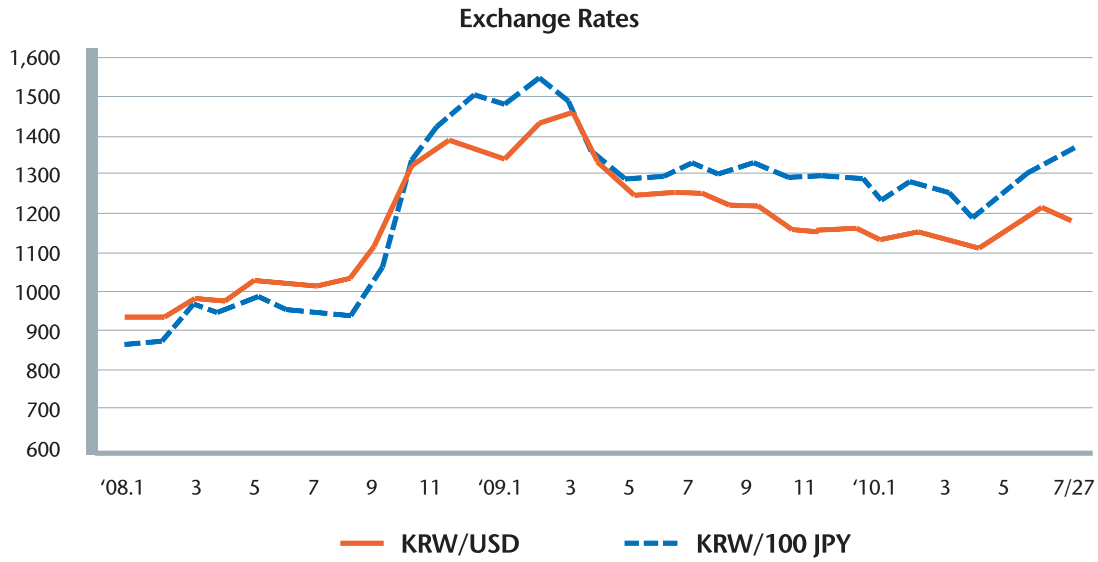
Market Interest Rates on the Rise Since May

Market interest rates, which had declined due to the financial crisis in Europe, rebounded to an increasing trend in expectation of a policy rate hike (0.25 percentage point on July 8) with the month of May as the lowest point.



Won-U.S. Dollar Fx-Rate Fall Below 1,200 Won

The won-U.S. dollar exchange rate dropped below 1,200 won due to such factors as signs of the financial crisis in Europe easing, appreciation of China's yuan currency, increases in domestic policy interest rate and the trade balance surplus.


Exchange Rates
1,600
1500
1400
1300
1200
1100
1000
900
800
700
600
'08.1
3
5
7
9
11
'09.1
3
5
7
9
11
'10.1
3
5
7/27
KRW/USD
KRW/100 JPY

Outlook for 2nd Half of 2010

1. Internal and External Environments

Recovery Trend of World Economy to Slip in 2nd Half

Amid the exit strategies in major countries, global economic growth is expected to slow down in the second half of 2010 due to such factors as signs of a slowdown in the Chinese economy, fears of delay in consumption recovery from employment instability and uncertainty of the housing business in the United States, and economic stagnation in the EU affected by financial retrenchment.

International Oil Prices to Increase Slightly

A structural change in oil demand caused by retrenchment in Europe due to financial problems, gradual rollback of economic boosting policies in China and other nations, reduction in revenues from oil products following a weaker dollar, high oil inventories in major countries, enhanced energy efficiency and increases in utilization of substitute energies in advanced country markets, etc. are likely to be factors restraining oil price hike trends in the second half.

International Financial Market Uncertainties to Continue

With the IMF helping to prevent the spread of the European financial crisis, the financial sector in Europe may find stability on a gradual basis. When considering the weak tax revenue infrastructure and inefficient public sector, etc. in related countries, however, there is always the possibility that market instability may reappear.

Internal Environment Too Weak to Boost Economy

Emergency measures taken to respond to the global financial crisis are normalizing, and an exit strategy is already being implemented with a reduction of the fiscal scale for 2010 compared with 2009.

Key Assumptions for Projections

Exogenous Variables	Unit	2009	2010
China's Growth	%	9.2	10.5
Japan's Growth	%	-5.2	2.4
U.S. Growth	%	-2.5	3.3
Dubai Oil Price	US$/bbl.	61.8	75.0
RP Interest Rate (end of year)	%	2.00	2.75

2. Outlook for Korean Economy (2nd Half of 2010)

Growth: 7.6% (1st half) →4.6% (2nd half)

In the second half of 2010, economic growth is projected to slow due to contraction of domestic demand following the implementation of measures to normalize fiscal and monetary policies, the European financial crisis, China's retrenchment policy, export slowdown caused by increased foreign exchange rate volatility and weakened base effect, compared with -3.2% (y-o-y, 1st half of 2009) → 3.5% (y-o-y, 2nd half of 2009).

Private Consumption: 5.0% (1st half) → 3.4% (2nd half)

Affected by an increase in the household debt burden and weakening of real estate conditions in the wake of interest rate hikes, private consumption is expected to slow in the second half of 2010. Furthermore, the employment recovery trend, which is expected to worsen again with 'The Hope and Work Project' ending in August, is likely to be a negative factor for consumption.

Construction Investment: -0.6% (1st half) →-1.1% (2nd half)

Influenced by reduced fiscal spending, slowdown of real estate business conditions, expanded policy risks, etc., construction investment may decline further in the second half.

Facility Investment: 29.4% (1st half) → 12.8% (2nd half)

Facility investment may rise owing to improvement in corporate performance results and foreign exchange rate appreciation, but growth may be slow due to stagnation of economic recovery trends caused by uncertainties in external environments and implementation of an internal exit strategy, increases in raw materials price and interest rate hikes and full-fledged restructuring of small and medium enterprises (SMEs) following that of large enterprises in July.

Current Account Balance: US$11.6 Bil. Surplus (1st half) → US$8.4 Bil. Surplus (2nd half)

Due to expansion of the gap between import growth and the export growth and an increase in the service balance deficit, the current account surplus is expected to decrease in the second half compared with the first half. Export growth will slow to around 17%, caused by demand declines following financial retrenchment policies in advanced countries, economic slowdown in China, won-U.S. dollar exchange rate decline, base effects, etc. However, imports are expected to post 25% growth, due to import demand increases and unit price hikes following economic recovery. Meanwhile, the service balance is likely to continue posting deficits due to low productivity of the domestic service industry and impacts from foreign exchange rate appreciation.

Consumer Prices: 2.6% (1st half) → 3.2% (2nd half)

Led by an increase in total demand pressure, base effects, and other factors, consumer prices are expected to post 3%-level growth in the second half. However, since price increase rates of imported raw materials, including crude oil, will not be significant and the won currency will see an appreciating trend, consumer price growth is projected to be limited.

Market Interest Rates: 4.9% (1st half) → 5.1% (2nd half)

Affected by policy rate increases and economic recovery, market interest rates are expected to rise gradually to the 5% level in the second half. Nevertheless, the expansion is unlikely to be sharp, due mainly to concerns over economic uncertainties and easing of inflationary pressure.

Won-U.S. Dollar Fx-Rate: KRW1,154/USD (1st half) → KRW1,133 /USD (2nd half)

Due to signs of an easing European financial crisis and slowdown in the growth of the U.S. economy, the won-U.S. dollar exchange rate is expected to decline. Internally, continuation of the current account surplus, foreign currency liquidity improvement at domestic banks, and increase in the inflow of foreign capital are likely to be factors supporting an appreciation of the won currency value from the perspective of supply and demand.

Outlook for Korean Economy (2nd Half of 2010)

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

	2009	2010						
	Year	1Q	2Q	3Q	4Q	1st H	2nd H	Year
GDP	0.2	8.1	7.2	4.4	4.9	7.6	4.6	6.1
(SA, q-o-q, %)		2.1	1.5	0.6	0.7	3.0	1.7	
Private Consumption	0.2	6.3	3.7	3.2	3.6	5.0	3.4	4.2
Construction Investment	4.4	2.3	-2.7	-1.9	-0.4	-0.6	-1.1	-0.9
Facility Investment	-9.1	29.9	29.0	15.7	10.0	29.4	12.8	20.3
Consumer Prices	2.8	2.7	2.6	2.9	3.5	2.6	3.2	2.9
Producer Prices	-0.2	2.6	4.2	4.1	4.5	3.4	4.3	3.9
Current Account	426.7	13.4	102.8	35.9	47.7	116.1	83.6	199.8
Commodity	561.3	74.3	156.5	94.7	100.5	230.8	195.2	426.0
Exports (BOP Base)	3735.8	1036.3	1206.8	1199.0	1196.7	2243.1	2395.7	4638.9
Growth (%)	-13.8	32.6	34.6	21.5	11.8	33.6	16.5	24.2
Imports (BOP Base)	3174.6	962.0	1050.3	1104.4	1096.2	2012.3	2200.6	4212.8
Growth (%)	-25.7	37.7	45.7	31.5	19.8	41.7	25.4	32.7
Service & Others	-134.6	-61.0	-53.7	-52.9	-114.7	-111.6	-226.3	
Fx Rate (Avg. KRW/USD)	1278.4	1144.1	1163.5	1145.0	1120.0	1153.8	1132.5	1143.1
Corp. Bonds Yield (3-year, AA-)	5.8	5.3	4.6	4.9	5.2	4.9	5.1	5.0
Unemployment Rate (%)	3.6	4.7	3.5	3.4	3.4	4.1	3.4	3.8

Policy Issue:

Resolving Local Governments' Fiscal Problems

Discussion Background

With Seongnam City Government's recent declaration of a moratorium related to construction of its new city hall, fears of wasteful fiscal management are spreading. It seems that lack of an appropriate system, including a bankruptcy procedure for provincial governments, weak internal controls, the central government's low level of supervision, unpreparedness of the early warning system to detect a financial crisis and poor response capability, etc. are major factors in poor fiscal administration.

Preparation of countermeasures are urgently needed from the perspective that a worsening of fiscal adminstration in provincial governments may lead to stagnation of regional economies and contraction of the national economy.

Current Status of Provincial Fiscal Administration and Problem Areas

1. The financial independence level of provincial governments, which reached 63.8% in 1998, fell 10 percentage points to 53.6% in 2007 and again to 52.25% in 2010.

2. As of the end of 2009, the total debt of provincial governments surged 32.9% year-on-year to 25.6 trillion won.

3. The debt of public corporations in provinces, the potential debt of provincial governments, increased 22.1% on annual average over the past five years.

4. Provincial governments' high dependence level on financial resources transferred from the central government is causing problems related to autonomy, responsibility and efficiency.

5. Heads of local autonomous bodies do not intend to utilize their autonomous rights to increase taxes in expectation of public resistance.

6. Pre & post management of tax expenditures is weak.

Policy Alternatives

1. Strengthen pre and post management, including introduction of a bankruptcy procedure for provincial governments, reinforcement of the citizens' recall system, introduction of a citizens' voting system on key policy items requiring fiscal expenditure. strengthening of an early warning system for provincial financial administration, mandatory implementation of citizen participation in the budget system, etc.

2. Provincial governments should increase the supply ratio of their own financial resources through reinforcement of autonomous rights to tax and reduce the transfer ratio of financial resources from the central government.

3. The central government must manage the debts of provincial public corporations by including them in the debts of provincial governments. Also, it should implement intensive restructuring, such as sale of their real estate and disposal of their equity and inventory assets for provincial public corporations that continue to post deficits.

Employment Protection Legislation and Corporate Investment: Empirical Analysis and Case Studies

Research Monograph 10-03
Byoungki Lee

The purposes of this study are as follows: First, among factors affecting the change in corporate investment, the effect of employment protection is going to be empirically analyzed. The analysis of how employment protection influences corporate investment requires dynamic panel analysis using data by countries rather than analyses of individual countries due to the nature of employment protection legislation index. Second, major countries which have relaxed their employment protection are selected to analyze such specific institutions and their effects. Based on empirical analysis and results from case studies, this research produces several important findings.

The finding from this analysis is that stronger employment protection leads to decrease in corporate investment. Second, when employment is more strongly protected, firms confront greater financial constraints. Third, tighter protection of employment in each country is negatively related to corporate investment. Fourth, Korea has very high firing costs in the World Bank's Doing Business, ranking 28th out of thirty OECD countries. Firing costs amount to 91 weeks of wages, and prove to have a damaging effect on creating a corporate-friendly environment as well as to push Korea's ranking in the labor regulation area down to a lower level.

A Study on the Effects of Populistic Ideology on the Determination of Economic Policies

Research Monograph 10-04
Wongun Song

The hypothesis that as income inequality grows, the policies for income redistribution are more prevailed under democracy is a generally accepted one among the fields of political economy and public choice. This study proposes the political economy of populism and based on this theory of political economy of populism the effects of the degree of populistic ideology prevailed on the adoption of redistribution policies in Korea are analyzed using several empirical methods. This study finds that as the government's position is closer to the leftist, the government expenditure for redistribution is increased by estimating econometric models using Korean data. The results of the estimations show that the above hypothesis can be applied to the case of Korea. In Korea, the populistic ideology such as socialism has been spread very fast and deeply into the people due to the influences of the left-leaning governments and teachers'union. The wide spread acceptance of socialism among the public will have along-term effect such as the expansion of redistribution programs in Korea. However, the expansion of redistribution programs towards the universal social welfare system will have a deadly effect on the long-term sustainable growth of economy because these programs will restrict incentives for work, save, and invest that will lead to limit the economic growth

Do Large Retailers Harm Competition?: A Competition Policy Analysis on the Regulation of Large Retailers

Research Monograph 10-05
Sung-Bong Cho

The competition authorities are regulating large retail stores based on tenuous grounds. The poorly-established transaction order is the often cited reason for restricting the business activities of large retail stores to protect suppliers and small and medium sized companies. But what is protected from this measure is not competition but competitors damaging the raison-d' ȇtre and the dignity of the competition authorities. The Notification on the Unfair Trading Practices of Large Retail Stores as an ad hoc regulation on large retail stores not business firm in general should be repealed in this sense. The standards of reviewing unfair trading needs to be changed as well. It should focus on the competition and consumer welfare not the relationship between firms.

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