August 2012 No.69

KERI ECONOMIC BULLETIN

Contents

Korea Economic Research Institute

Executive Summary

Korea's 2012 Growth Downwardly Adjusted to 2.6% and 2013 Growth Projected at 3.3%

A downward adjustment of the national economic growth for 2012 was made to 2.6%, 0.6 percentage point lower than 3.2% announced in May this year. This is because amid worsening export environment caused by a prolonged recession in the European economy, delay in the U.S. economic recovery, decline in the Chinese economy, etc., improvement in the domestic demand environment also is difficult due to employment slowdown and limitations of policy space.

Affected by the fall in the price of assets, household debt burden, employment recovery slowdown, etc., private consumption growth is likely to reduce to 1.4% from 2.2% and facility investment growth is expected to slow significantly to 1.4% from 6.0% as well in consideration of a declining trend in the export growth and shrinkage of corporate investment sentiment and others. Construction investment growth was revised to 0.3% from the previous 2.0% after taking into account the continuation of a stagnation in housing business conditions.

Consumer Price Forecast at 2.6%, Current Account Balance at US$30.3 Billion, Won-U.S. Dollar Ex-Rate at 1,140 Won

The consumer price growth for 2012 is projected at 2.6%, a 0.5 percentage point lowered figure than the previous 3.1%. Influenced by the slowdown of imports outstripping that of exports, improvement in the service balance, etc., current account balance is expected to expand to US$30.3 billion from US$15.9 billion forecasted earlier. The won-U.S. dollar exchange rate is predicted to hover around 1,140 won without direction according to alleviation or recurrence of the European economic crisis.

Growth for 2013 Projected at 3.3% - Below Potential Growth Rate Despite Slight Improvement

The growth is expected to improve slightly in 2013 to 3.3%, which can not reach the level of potential growth rate. Consumer price growth is projected at 2.6%, similar to this year. The current account surplus scale in 2013 is expected to reduce to US$24.6 billion and won-U.S. dollar exchange rate to appreciate mildly and post an annual average of 1,106 won.

Need for Soft Landing of Household Debt & Blocking of Sharp Drop in Real Estate Prices

When considering the moves of the related indicators, such as assets price, currency multiplier and overdue loan payment rate, it appears that a possibility of deflation is not high but is still on the rise. As policy tasks required to ease deflation possibility, reinforcement of policy responses for a soft landing of household debts and pursuit of activation of transactions in the real estate market through adverse mortgage and total equity investment ceiling system are needed.

Economic Trends and Outlook

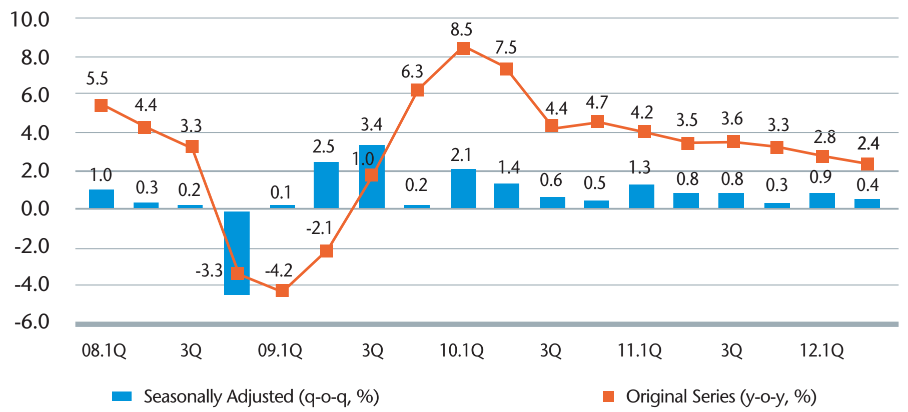
Recent Developments

Growth in 2nd Qtr. of 2012 Stayed at 2.4% Year-on-Year, the Lowest Level Since 3rd Qtr. of 2009

The low growth in the second quarter of this year is attributed to a slowdown in domestic growth, including declines in private consumption, facility investment and construction investment. Owing to consumption growth of durable and semi-durable goods, consumption maintained a 1.2%-level growth in the second quarter, but slowed compared with 1.6% in the first quarter.

Facility investment in the second quarter decreased 2.9% year-on-year and dropped as much as about 11.5 percentage points from 8.6% in the first quarter, affected by a steep fall in the investment for machinery. Construction investment also rebounded to a negative growth of -1.4% in the second quarter from 1.5% in the first quarter. On the contrary, net exports soared 16.1% in the second quarter from 6.4% in the first quarter, due to the slowdown of imports outpacing that of exports.

GDP Growth



Growth by Final Demand Items & Growth Contribution Rates

(Unit: %, % point)

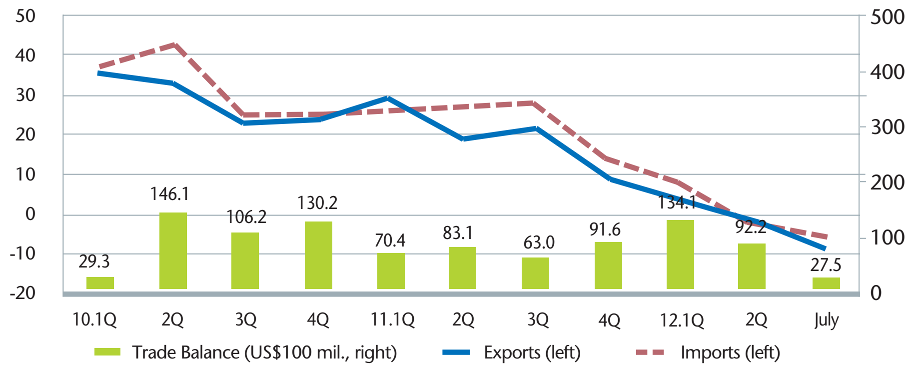
Contribution Rate (%)		Private Consumption	Equipment Investment	Construction Investment	Exports	Private Consumption	Equipment Investment	Construction Investment	Exports
		(Original Series, y-o-y)				(Seasonally Adjusted Series, q-o-q)			
Growth (%)	2011 1/4	2.9	10.3	-11	81.7	0.6	-1.6	-4.4	10.6
	2/4	3	7.7	-4.2	11.8	0.8	4.7	3.5	-5.3
	3/4	2.1	1.2	-4	29.4	0.2	-1.8	-0.5	13.5
	4/4	1.1	-3.3	-2.1	18.9	-0.4	-4.3	0.1	1.2
	2012.1/4	1.6	8.6	1.5	6.4	1	10.3	-1.2	-3.1
	2/4	1.2	-2.9	-1.4	16.1	0.5	-6.4	0.3	4.9
Contribution Rate (% p)	2011 1/4	1.6	1	-1.6	3	0.3	-0.2	-0.7	0.8
	2/4	1.5	0.8	-0.7	0.6	0.4	0.5	0.5	-0.6
	3/4	1.1	0.1	-0.7	2	0.1	-0.2	-0.1	1
	4/4	0.6	-0.3	-0.4	1.5	-0.2	-0.4	0	0.3
	2012 1/4	0.9	0.8	0.1	0	0.5	1	-0.2	-0.5
	2/4	0.6	-0.3	-0.2	1.4	0.3	-0.7	0	0.6

Accompanied Declines in Exports & Imports ? Recession-Type Trade Surplus

The declining trends of exports and imports expanded further in July with exports to -8.8% in July from -1.6% in the second quarter and imports to -5.5% from -2.4% in the same period. With import decline appearing larger than export decline, trade balance surplus continues.

Exports, Imports and Trade Balance

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



Total Current Account Surplus Surged to US$11.1 Bil. in 2nd Qtr. from US$2.6 Bil. in 1st Qtr.

The whopping current account surplus increase in the second quarter is attributed to the conversion of service balance into a surplus in addition to the expanded commodity balance surplus. Commodity balance jumped to US$8.5 billion in the second quarter from US$2.6 billion in the first quarter and service balance rebounded to a surplus of US$2.3 billion from a deficit of -US$70 million.

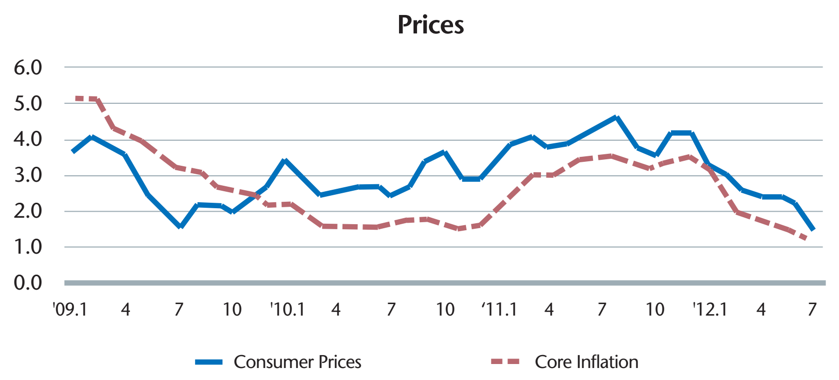
Current Account Balance

(Unit: US$100 mil.)

	2010	2011	2012	
	Year	Year	1/4	2/4
Current Account	293.9	276.6	25.6	111.4
Balance of Goods	400.8	321.0	26.1	84.8
Balance of Service	-86.3	-43.8	-0.65	23.1
Balance of Primary Income	10.2	24.6	14.9	8.2
Balance of Secondary Income	-30.8	-25.2	-8.9	-4.7

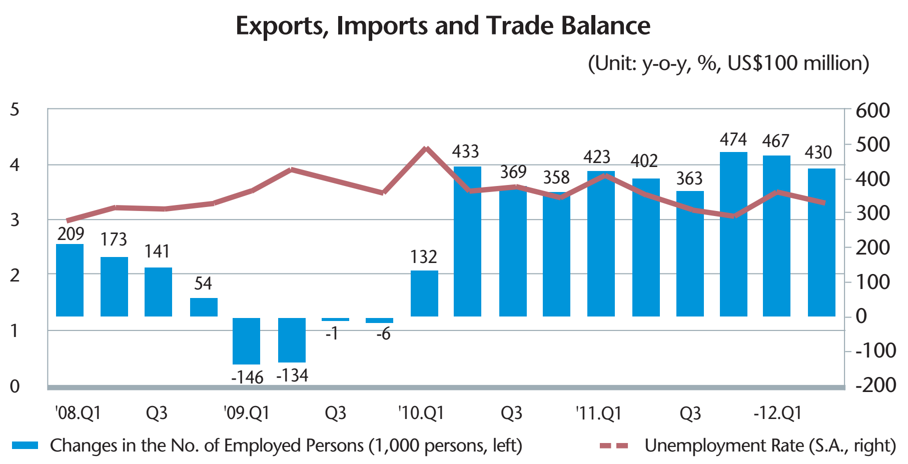
Consumer Prices on Downward Stabilization

Due to a decline in import prices following the demand contraction and falls in raw materials prices due to economic depression, growth of most of the items except rents and utility bills (electricity, gas and water) falls to 1% level.



Employment Also Slowing Quantitative Recovery

Employment appears to be also slowing a quantitative recovery, including a decline in its growth trend to the 300,000-person level in June. In terms of year-on-year, the number of employed persons reduced to 370,000 from 450,000 in April and 470,000 in May. Unemployment rate increased 0.1 percentage point to 3.2% in June as well.



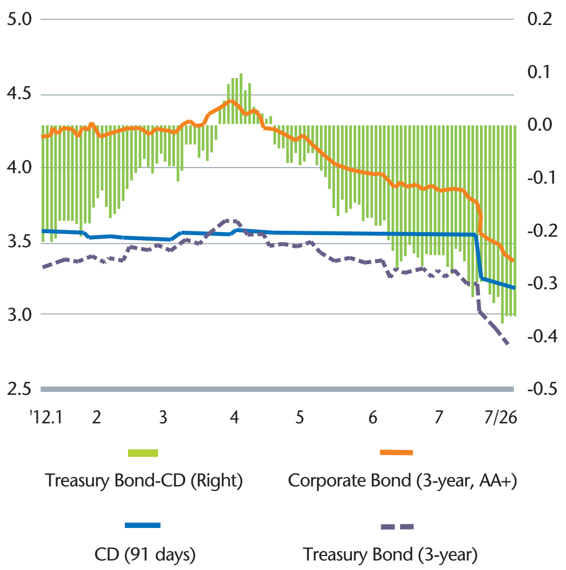
Market Interest Rate Continuing to Fall due to the preference of riskless asset

Affected by the recent base rate decrease (June 11) and preference of safe assets, short & long-term market interest rates continued to fall additionally. Accordingly, a reversing phenomenon between short-term and long-term interest rates is expanding further. The short & long-term interest spread increased to 0.01 percentage point (treasury bond - CD, %p) on April 5 and 0.59 percentage point on August 10.

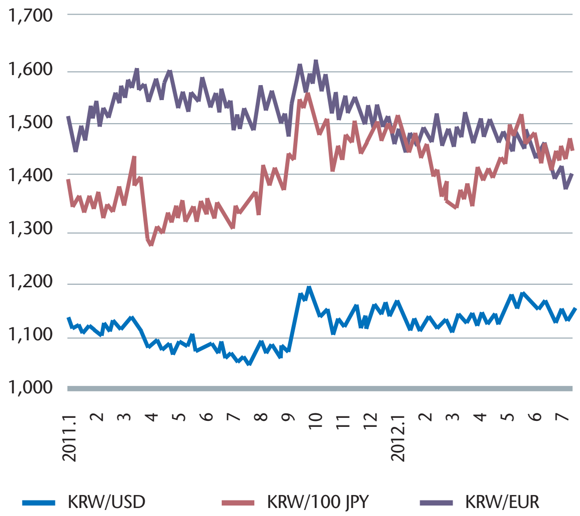
Won-U.S. Dollar Ex-Rate Rises in 2nd Qtr. due to the global economic depression, etc.

The won-U.S. dollar exchange rate recorded 1,152 won in the second quarter, the highest since the third quarter of 2010 when it reached 1,186won. Since the EU Summit at the end of June, however, the exchange rate slightly decreased in expectations of the mitigation of the Eurozone crisis.

Interest Rates



Exchange Rates



Outlook for 2012 ~ 2013

1. External Environments

Global Economy Expected to Maintain Low Growth

The Eurozone economy is likely to stay at a 0.7% growth in 2013 continuously from a negative growth (-0.3%) of this year due to the region's fiscal contraction. With a possibility of recovery appearing in housing business conditions, the U.S. economy is expected to realize a mild growth in the second half of this year and the first half of 2013. Negotiations to prevent 'fiscal cliff' are projected to proceed after the U.S. presidential election. Owing to its active measures to boost its domestic demand, including fiscal and currency expansion policies, China is expected to realize recovery starting in the 4th quarter of this year. Japan may maintain a recovery trend owing to its economic stimulus and restoration from earthquakes. However, excessive government's debts, eurozone's economic slowdown and yen currency strength, etc. are likely to become the restricting factors for recovery.

Int'l Oil Prices May Continue to Decline Thru 1st Half of 2013

As the Middle East democratization movement ends the first phase, the direction of international oil prices is highlighting the demand factor associated with the global economic recession all the more. Although there exist fears of a delay in the supply following the Iran-related geopolitical risks, the response potential is expected to be sufficient.

Policy Responses of Major Countries to Resolve Eurozone Crisis to Become the Key for Exchange Rate Direction

U.S. dollar is expected to strengthen until the first half of 2013, with the demand for the greenback, safe asset, being maintained. Nevertheless, the changeability of U.S. dollar is likely to expand due to such factors as whether to implement QE3 or not, U.S. presidential election and fiscal cliff. When considering its retreat from safe asset and the Japanese government's implementation of monetary easing policy, the yen currency is expected to continue a weakening trend. With fears of economic depression and the ECB's base interest rate cut measures expected, the falling trend of Euro currency is likely to continue. In the short term, a fall of Chinese yuan currency is expected for export expansion but in the medium term, yuan is projected to maintain a mild appreciation, affected by the international community's pressure on the currency's appreciation.

Major Assumptions for Projections

The forecast for global economic growth for 2012 and 2013 was adjusted to 3.3% and 3.5% respectively. Adjustment of international oil prices (Dubai oil basis) also were made to an annual average of US$100 a barrel for 2012 and US$90 a barrel for 2013.

2. Outlook for Korean Economy (2012~2013)

Growth: 2.6% for 2012 (2nd Half: 2.5%) → 3.3% for 2013

The growth in the second half of this year is expected to stay at 2.5%, slightly lower than the growth in the first half. This is attributed to significant export slowdown, stagnation of employment recovery and restrictions on domestic demand recovery following the weakening in the growth policy potential. The growth is likely to improve slightly in 2013 but projected at about 3.3%, below the potential growth rate. This is not only because of the limited recovery of external demand due to the continuation of deleveraging in major advanced economies, like Europe and USA, but also because of a high possibility of promoting normalization of the base interest rate and balanced fiscal administration.

Private Consumption: 1.4% for 2012 (2nd Half: 1.4%), 2.5% for 2013

Private consumption growth in the second half of this year is expected to stay at a weak 1% level. Those factors to restrict consumption will be fall in the prices of assets, such as real estates and stocks, household debt burden, employment recovery slowdown, etc. Private consumption is expected to recover slightly in 2013 with slight improvement of substantial purchasing power thanks to alleviation of economic depression and decreases in international oil prices and exchange rates.

Facility Investment: 1.4% for 2012 (2nd Half: 0.3%), 4.0% for 2013

Facility investment growth is forecast to slow significantly to 0.3% in the second half of this year compared with 2.5% in the first half. Affected by export slowdown, the situation is that facility investment contraction by related industries is unavoidable and corporate facility investment projections are also negative. However, facility investment growth is expected to recover about 4% level in 2013 along with export recovery. Falls in the expenses associated with imports of capital goods, etc. following won currency value increases may also become recovery factors.

Construction Investment: 0.3% for 2012 (2nd Half: 0.7%), 2.0% for 2013

Construction investment is expected to continue a low growth trend also in the second half of this year continuously from the first half, due to reduced roles of the public sector amid continuation of poor progress for housing business conditions. Affected by contraction of SOC-related budget, prolongation of slowdown in housing business conditions, the growth is likely to stay at an annual recovery of about 2.0%.

Current Account Surplus: US$30.3 Bil. for 2012 (2nd Half: US$16.6 Bil.), US$24.6 Bil. for 2013

Current account surplus is expected to expand to US$16.6 billion in the second half of this year from US$13.7 billion in the first half. It is a depression-type surplus that appears due to import growth becoming more significant than export growth. In 2013, current account surplus scale may reduce because if economic recession is eased, commodity balance surplus (depression-type surplus) will decrease and service balance surplus will expand again.

Consumer Prices: 2.6% for 2012 (1st Half: 2.4%), 2.6% for 2013

Consumer prices are expected to slow to a 2.4% growth in the second half of this year owing to stagnation of import unit price increases with price falls in raw materials, including crude oil, caused by domestic economic slowdown. Consumer price growth for 2013 is projected at 2.6% to be same as that in 2012. This is attributed to the fact that despite the factors to lower prices are expected from the supply side, such as oil price drop, won-U.S. dollar exchange rate declines, etc., there will also exist price pushing factors from the demand side, including a slight improvement of economic growth.

Corporate Bond Yield Rate (3-year, AA-): 3.7% for 2012 (2nd Half: 3.2%), 3.9% for 2013

With an additional decrease of the base interest rate being expected amid preference of safe assets maintained following the uncertainty of external environment, market interest rates are expected to continue also in the second half of this year. In 2013, however, market interest rates are likely to show a gradually rising trend with increases in the domestic economic growth and prices increase rates due to rebound attempt of the global economy.

Won-USD Ex-Rate: 1,140 Won for 2012 (2nd Half: 1,138 Won), 1,106 Won for 2013

Won-U.S. dollar exchange rates are expected to fluctuate higher or lower than 1,140 won in the second half of this year directionlessly in accordance with ease or recurrence of the European financial crisis. In 2013, with policy following the resolution of the European crisis making progress gradually, the exchange rate is likely to fall mildly due to a high possibility of the rate lowering factors being highlighted, including weakening of confidence in U.S. dollar, continuation of Korea's current account balance, etc.

Outlook for Korean Economy

(Unit: y-o-y, %, US$100 million (int'l balance of payments))

	2011	2012			2013		
	Year	1st Half	2nd Half	Year	1st Half	2nd Half	Year
GDP	3.6	2.6	2.5	2.6	2.7	3.8	3.3
(SA, q-o-q, %)		1.2	1.3		1.4	2.4	
Private Consumption	2.3	1.4	1.4	1.4	1.9	3.1	2.5
Construction Investment	-5.0	-0.2	0.7	0.3	1.5	2.4	2.0
Equipment Investment	3.7	2.5	0.3	1.4	3.3	4.8	4.0
Exports (Goods & Service)	9.5	3.9	3.5	3.7	4.0	6.3	5.2
Imports (Goods & Service)	6.5	2.5	1.5	2.0	3.0	5.8	4.4
Consumer Prices	4.0	2.7	2.4	2.6	2.5	2.8	2.6
Current Account Balance (US$100 mil.)	265.1	137.0	165.5	302.6	85.9	159.6	245.5
Commodity	309.5	110.9	190.2	301.1	96.8	171.3	268.1
Exports (BOP Base)	5525.6	2734.6	2845.3	5579.9	2852.7	3056.5	5909.2
Growth (%)	19.7	1.1	0.8	1.0	4.3	7.4	5.9
Imports (BOP Base)	5216.1	2623.7	2655.1	5278.7	2755.9	2885.2	5641.1
Growth (%)	23.8	2.1	0.3	1.2	5.0	8.7	6.9
Service & Others	-44.5	26.1	-24.7	1.4	-10.9	-11.7	-22.6
Ex Rate (Avg. KRW/USD)	1108.0	1141.7	1137.5	1139.6	1122.5	1090.0	1106.3
Corp. Bonds Yield (3-year, AA-)	4.4	4.2	3.2	3.7	3.5	4.1	3.8
Unemployment Rate (%)	3.4	3.6	3.4	3.5	3.7	3.3	3.5

Policy Issue:

Check of Deflation Possibility & Implications

Recent Trends of Major Indicators Imply Rising Deflation Possibility

Overdue interest payment rates for household loans are increasing due to weakened household debt repayment ability following the decline in assets value. KOSPI Composite Index exceed 2,000 in early this year but dropped to about 1,800 recently. The growth rate of housing sales prices nationwide also fell to 3.0% in June from 6.5% in early this year. Overdue interest payment rates rose to 1.37% in May this year from 0.89% at the end of last year.

Together with signs of credit crunch, liquidity and facility investment contraction phenomena are appearing. The monetary multiplier (M2) in May this year dropped 22-fold, the lowest level in the 2000s, and the daily average stock trading value also fell to less than four trillion won for the first time since March 2007. Due to duplication of credit crunch signs and economic recession, facility investment growth decreased significantly to -6.4% in the second quarter of this year as well.

Calculation Results of IMF's Deflation Vulnerability Index Show Deflation Possibility Is More or Less on the Rise

As a result of calculation after revising IMF's deflation vulnerability index according to the suggestion from Decressin & Laxton (2009), the index, which had maintained 0.15 (extremely low) since the fourth quarter of 2009, appeared to have risen to 0.31 since the second quarter of 2011. Although one can not say that deflation possibility became greater from an absolute aspect, it is interpreted that deflation possibility became more or less greater due to depression of the global economy and housing market.

Need for Soft Landing of Household Debts and Prevention of Sharp Drop in Real Estate Prices

Financing system improvement and continuous monitoring of the soundness of financial institutions are necessary and there is a need to strengthen the existing policy financing system for the low-income class.

To prevent credit crunch, temporary measures of reducing debtors' burden through extension of due dates or adjustment of interests are required.

It is necessary to prevent excessive sales of houses and sharp price declines by enhancing reverse mortgage utilization, including alleviation of restrictions on public sector reverse mortgage entry qualifications and target houses.

Spread of the total equity ceiling system is expected to bring such effects as preventing steep price drops of large-scale houses and accelerating the consumption of the middle-aged class.

Recent Publications

Discussion and Analysis of Taxation on Investment in Affiliates

Research Monograph 12-03

Sanghyun Hwang and Hyun Jong Kim

This paper examines the discussions related to taxation on investment in affiliates and numerically estimates the impacts of introducing this system on corporate finance and investment. The taxation on investment in affiliates means a tax policy for large-size business groups that excludes the deduction of dividend incomes between affiliates and interest expenses on debt for investment in affiliates. First, this paper compares the current tax system of Korea internationally, reviews academic discussions, and also investigates changes on corporate finance due to the introduction of taxation applicable.

This paper estimates the effects on capital cost and investment of abolishing the exclusion of dividend income from gross revenue and the deduction of interest expense for forty domestic major firms in numerical analysis. On the assumption that funds for investing in affiliates are proportional to debt ratio for forty firms except holding companies that the taxation are applicable to, the result from policy simulation is that the cost of capital increases by 0.64%, and the capital for production decreases by 1.07% due to the taxation.

To say it another way, the amount of investment reduction becomes ₩ 2740.1 billion in tangible asset and ₩ 2548.2 billion in net tangible asset. The analysis shows that the effect of abolishing the exclusion of dividend income from gross revenue is 10 times less than that of abolishing the deduction of interest expense. This is why the exclusion rate of dividend income itself is currently very low, so that dividend payout ratio and equity share of affiliate are low.

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Publisher: Byung-il Choi
Editor: Chang-Bae Kim, Jayne Jungsun Yoo

Designed by Blue-Ribbon Communication System (BCS.com)
Phone: (82-2) 6258-7870/3 Fax: (82-2) 6258-7877

KERI Economic Bulletin
is published by Korea Economic Research Institute,
8th Fl., Hana Daetoo Bldg., 27-3, Yeouido-dong,
Yeongdeungpo-gu, 150-705 Seoul, Korea.
Tel : (82-2)3771-0001, FAX : (82-2)785-0270/1