

KERI **E**CONOMIC **B**ULLETIN

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Editors' Note

Beginning in this issue, two new features are added to KERI Economic Bulletin: 'Issue Focus' and 'Recent Publications'. 'Recent Publications' lists brief summaries of recently published works by researchers at KERI. 'Issue Focus' features a more thorough description of a selected work, based on relevance and importance of a certain subject, for interested readers. The purpose of adding these new additional features is not only to enrich the contents of the Bulletin but also to help foster constructive and lively exchange of ideas on the Korean economy among professional economists and policy-makers worldwide. The editors wish that the readers would enjoy the new format of the Bulletin as much as the old.



I Economic Trends and Outlook

Executive Summary

The internal and external economic environments for 2007 do not bode well for Korea due to uncertainties in several areas. External factors such as unstable international oil prices, a global economic slowdown, interest rate hikes, and weakening of the dollar pose difficult challenges to overcome. Domestically, upcoming presidential election is likely to heighten the already intense social conflicts and uncertainties about economic policies which tend to be guided by political, rather than sound economic, motives during the election cycle. Moreover, the government's economic stimulus packages do not seem to be having the intended impact on the nation's economy. Consequently, the nation's economic growth in 2007 is projected to slow down to 4.1% from 5.0% in 2006.

A heavier tax burden for homeowners, stagnant job growth, precipitous growth of household debt, among other things, are likely to hamper a robust recovery of private consumption. Equipment investment is also not expected to reach a desirable level due to uncertain economic prospects, insufficient improvement in corporate investment climate and election-related policy confusion. Signs of economic slowdown are already popping up in some areas. The construction industry is bracing itself for difficult times ahead as the number of unsold apartments in the local provinces grows and the leading industry indicators are showing worrisome signs. All these make the forecast of weaker domestic demand more credible.

The current account balance is expected to revert to a deficit for the first time since the financial crisis in 1997. The service sector is sustaining expanding account deficits which is largely due to its weak international competitiveness. In addition, imports are growing at a faster rate than exports. Yet, the upside is that inflation is expected to stay low largely due to stabilizing oil prices, economic slowdown, and appreciating of won.

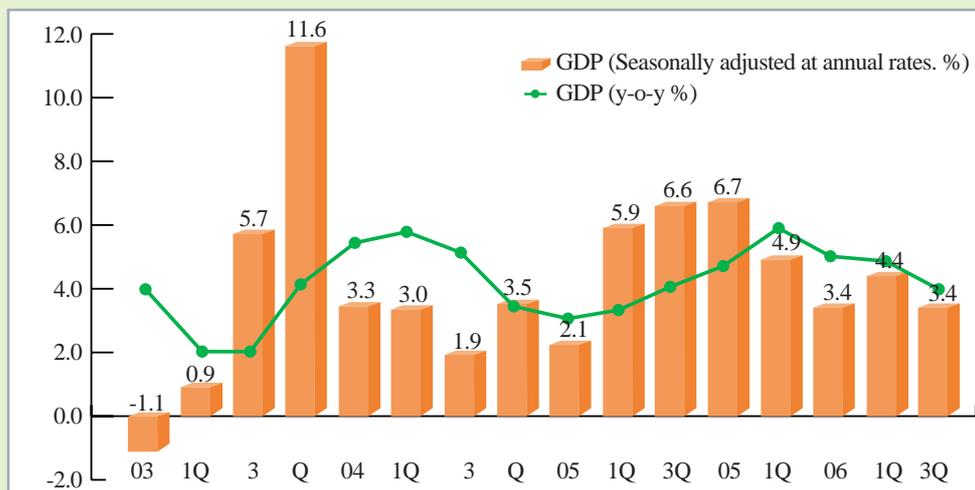
Reflecting economic recession and price stabilization trends, market interest rates are expected to decrease gradually. Still the won-dollar exchange rate is expected to continue its march downward as the weakening dollar is not likely to reverse its course in the near future. Additionally, revaluation of Chinese yuan will further strengthen the Korean currency. However, these downward pressures are likely to be partially countered by the expectation of deficits in the current account balance, an increase in the volume of outward investment in foreign stocks by Korean nationals, and the government's easing of restrictions on direct investment abroad.

An unexpected setback in negotiations with North Korea on its nuclear capabilities and a sharp decline in housing prices are two notable risky factors that could further exacerbate Korea's growth prospects for 2007.

Recent Developments

Real GDP growth in the fourth quarter of 2006 was 3.4% (seasonally adjusted annual rates) down slightly from 4.4% in the third quarter. The decline is attributed to a significant slow-down in equipment investment growth (14.7% → 0.4%) and a decline in export growth (8.6% → -1.0%). Despite the disappointing recent performances, the annual rate of GDP growth in 2006 reached 5%, one percentage point higher than in 2005 (4%), due to the economy's robust growth in the first half of the year.

Real GDP



Manufacturing production growth had recorded a double-digit rate since the fourth quarter of 2005, but declined dramatically in the fourth quarter of 2006 and January, 2007. The growth rate of the service sector activity fell gradually from 5.7% in the first half of 2006 to 4.7% in the second half of 2006, and further to 4.6% in January 2007.

A decline in consumption growth is continuing. Growth of sales of consumer goods, a representative consumption indicator, had dropped to a 3.7% level in the second half of 2006 from 5.6% in the first half of 2006 and fell further to 3.1% in January 2007.

Equipment investment, posting growth rates of 6.4% in the first half of 2006, climbed to a 8.4% growth rate in the second half of 2006. Construction investment, which had been sluggish, also showed some signs of a recovery centering on general civil engineering pro-

jects from public and private construction. Equipment and construction investment growth in January 2007 climbed further to 16.0% and 13.3% respectively.

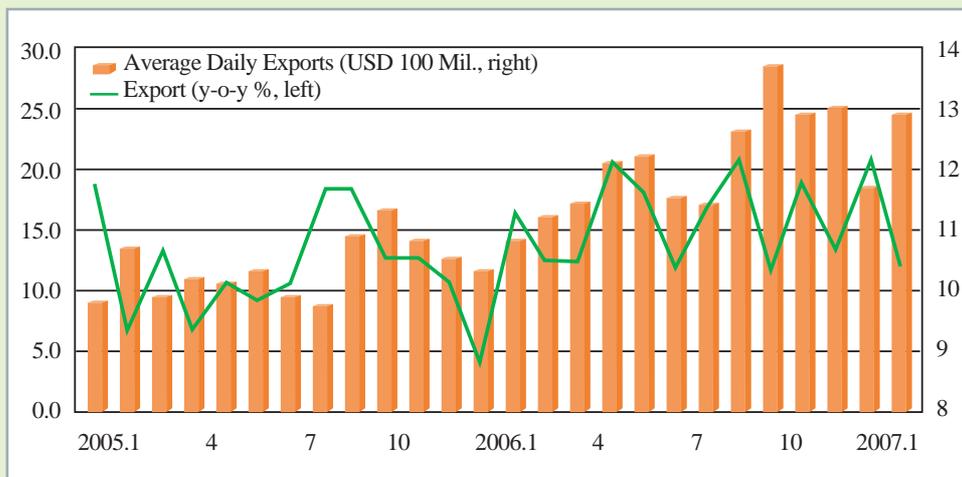
Industrial Output, Consumption and Investment

(Unit: y-o-y,%)

	2005	2006					2007
	Year	1/4	2/4	3/4	4/4	Year	Jan.
Manufacturing Production	6.2	13.4	12.0	11.8	5.5	10.5	7.6
Services Activity	3.6	6.1	5.3	4.5	4.8	5.1	4.6
Wholesale & Retail sales	2.9	4.0	4.5	4.4	4.0	4.2	5.2
Consumer Products Sales	4.1	5.3	6.1	2.9	4.5	4.7	3.1
Estimate of Equipment Investment	6.4	6.2	6.6	11.7	5.1	7.3	16.0
Domestic Construction Completed	4.1	4.2	-0.3	4.8	6.0	3.7	13.3

Export growth in January~February period expanded 16.1%. By export category, semiconductors, steel(39.9%) and shipbuilding(56.1%) enjoyed faster growth while wireless communication equipment(2.8%), automobile(4.9%) and computer(-4.5%) have experienced a slowdown in their growth rates during the period from January 1st to February 20th.

Exports



The current account balance reduced to a surplus of USD6.1 billion in 2006 from a surplus of USD15 billion. It reduced even further to record deficit in January 2007. The decline was, in large part, due to poor performances of the service sector with its expanding deficits that more than offset the surplus in the goods account. The service account recorded deficit at USD18.8 billion last year which was about USD5 billion worse than the deficit of USD13.7 billion in 2005.

Balance of Payments

(Unit: USD Bil.)

	2005	2006					2007	
	Year	1/4	2/4	3/4	4/4	Year	Jan.	
Current Account	15.0	-1.1	0.7	0.4	6.1	6.1	-0.5	
Goods Account	32.7	5.2	7.4	6.2	10.3	29.2	1.2	
Service Account	-13.7	-5.0	-3.9	-5.4	-4.5	-18.8	-1.9	

Stabilizing oil prices and exchange rate appreciation contributed to easing inflationary pressures. CPI(consumer price index) was up 1.9% in the January~February period of 2007, down by 0.2%p compared to 2.1% in the fourth quarter. PPI(producer price index) growth rate also declined to 1.5% in January 2007 from 2.0% in the fourth quarter.

Prices

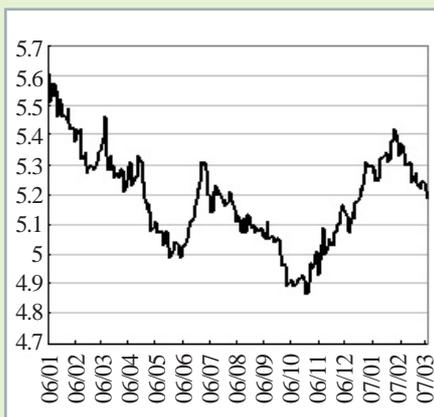
(Unit: y-o-y,%)

	2005	2006					2007	
	Year	1/4	2/4	3/4	4/4	Year	Jan.	Feb.
Consumer Prices	2.8	2.1	2.2	2.5	2.1	2.2	1.7	2.2
Producer Prices	2.2	1.7	2.4	3.1	2.0	2.3	1.5	

Long-term interest rates turned to a downward trend in February 2007, until when the rates had risen steadily since October 2006. The recent downward trend is due to weakened expectation on the recovery of economy, decrease in the US long-term interest rates which is caused by the comment on lessened inflationary pressures by the chairman of the FRB, and a net sale of foreigners' government bond futures.

The won-dollar exchange rate has been rising recently, recording above 950 in March. The recent upward trend is attributed to a dollar appreciation factor which is due to a freeze in market interest rates both in Euro area and in Japan, and to a won depreciation factor which is due to the current account deficit(USD 0.5 bil.), and due to the net outflow of foreigners' stock investment in January. The increase in the target call rates from 0.25% to 0.5% in Japan last February and the attempt to rewind the yen-carry trades also attribute to the rise of won-dollar exchange rate.

Corporate Bonds(3yr, AA-)



KRW/USD



Outlook for 2007

External Environment

Due to global interest rate hikes and economic downturns of leading economies, growth of the world economy is expected to slow somewhat in 2007. A group of major advanced countries, weary of excess liquidity and inflation, has increased interest rates several times in 2006, and the trend is likely to continue in 2007. The Federal Reserve and European Central Bank (ECB) increased the interest rates five times in 2006 alone. Bank of Japan also raised its call rate to 0.5% from 0.25% in February 2007. Meanwhile, China is working to stabilize its red hot economy by hiking the basic interest rate and raising the reserve ratio. Global contraction is now underway and will become a major factor in the slowdown of the world economic growth in 2007.

Dollar's downward spiral is likely to continue in 2007. It might as well be unavoidable given the difficult task ahead of resolving the U.S. current account deficit and the U.S. losing its edge over its main competitors, Japan and EU, in terms of economic growth. Narrowing interest rate gaps between the U.S. and these economies provides an additional reason to expect further depreciation of the U.S. dollar. Amid the expectation of weaker dollar, the major countries are maneuvering to diversify foreign exchange holdings by reducing their dollar reserves.

International oil prices are expected to further decline and stabilize at a lower rate in 2007. Contraction of international liquidity, slowdown of the global economy, and increased crude oil production by non-OPEC countries will reduce the likelihood of high oil prices as observed in 2006. However, it should also be noted that the geopolitical risk factors in the Middle East remains significant and hence poses a great deal of uncertainty for international policy-makers.

Internal Environment

Korea faces a myriad number of difficult issues and uncertainties in 2007. For starters, the presidential election, slated for December, could bring out social conflicts, economic policy confusion and a predominance of politically motivated policies as it typically has in the past. Given the current political environment which is ripe with ideological conflicts, it is highly probable that presidential candidates will try to attract voter attention by making populist campaign pledges or invoking socially divisive issues, which adversely affect the national economy. The upside of this story is that various economic stimulus packages will be introduced by the incumbent government to increase its chance of election victory. However, whether these packages would be of substance remains to be seen.

Another difficult issue Korea faces in 2007 is whether it can successfully conclude free trade agreement talks with the U.S., its largest trading partner. Korea stands to benefit a great deal from the agreement, first of which is a rise in the nation's credit ratings. However, under the highly charged current political environment, the possibility that special interest groups objecting to the Korea-U.S. FTA gain undue influences over the negotiation process cannot be easily dismissed. The failure of establishing free trade ties with the U.S. will create an additional burden on the already weary Korean economy.

In addition to these political issues, anti-corporate stance of the current government such as reinforcement of the strong protective measures for part-time employees will act to discourage corporate investment. Household consumption is not expected to improve either due to increases in various real estate-related taxes and rapidly growing household debts.

Prospects for 2007

Projections for the Korean economy in 2007 based on the above internal and external environments are summarized below:

The economy is expected to grow at a low 4% range in 2007, below the level of 2006(5.0%). The decline in the projected growth rate is attributed mainly to the slowdown of export growth due to worsening external environments.

Domestic demand is also expected to remain sluggish. A slowdown in private consumption is unavoidable due to increased tax burden on homeowners, stagnating job growth, and growing household debts. Equipment investment by businesses is also unlikely to reach a desired level due to uncertain business outlook, a lack of improvement in the corporate investment climate, and policy confusion related to the presidential election.

The service sector shows no sign of improvement in its international competitiveness, and import growth is expected to outpace export growth. Due to a continued expansion of the service account deficit and poor export growth, the current account balance is likely to reverse course to a deficit in 2007.

Fortunately, consumer prices are expected to stabilize in 2007 in the low 2% range, similar to 2006. The accumulated upward pressures on the price level from high oil and real estate prices will be partially countered by the appreciation of won and overall slowdown of the economy.

Owing to economic slowdown and stable prices, market interest rates are expected to exhibit a downward trend. In addition, the government may cut the interest rate before the presidential election if the economic slowdown persists. won will continue to appreciate if dollar and Chinese yuan continue their current trends. On the other hand, such factors as possible current account deficits, expansion of overseas investment, and easing of regulations on foreign direct investment are expected to mitigate the appreciation of won.

Prospects for Domestic Economy in 2007

(Unit: y-o-y, %)

	2005	2006		2007			
	Year	1st H.	2nd H.	Year	1st H.	2nd H.	Year
GDP	4.0	5.7	4.4	5.0	3.9	4.3	4.1
(S.A. at annual rate %)		4.9	3.9		3.9	4.8	
Private consumption	3.2	4.6	3.8	4.2	3.6	4.0	3.8
Construction investment	0.4	-1.9	1.3	-0.1	0.5	1.4	1.0
Equipment investment*	4.9	7.1	8.2	7.7	5.5	6.4	5.9
Consumer Prices	2.8	2.2	2.3	2.2	2.2	2.4	2.3
Current Account(USD Bil.)	15.0	-0.4	6.5	6.1	-1.2	-1.5	-2.7
Commodity(USD Bil.)	32.7	12.6	16.6	29.2	18.3	11.7	25.0
Exports(USD Bil.)	289.0	157.9	178.9	331.8	175.2	189.3	364.4
growth(%)	12.1	13.9	15.7	14.8	10.9	8.8	9.8
Imports(USD Bil.)	256.3	145.3	157.3	302.1	161.8	177.6	339.5
growth(%)	16.4	19.6	16.7	18.1	11.4	12.9	12.2
Service & Others(USD Bil.)	-17.7	-13.1	-10.1	-23.1	-14.5	-13.1	-27.7
Ex rate(Ave, KRW/USD)	1024.1	963.1	946.5	955.1	937.5	920.0	928.8
Corp. Bond Yield Rate(3yrs. AA-)	4.7	5.3	5.1	5.2	5.2	5.0	5.1

* Including intangible asset investment

Downside Risks

In the economic projection for 2007, North Korea's nuclear experiments and domestic real estate prices are expected to serve as downside risks. An unexpected North Korean nuclear test would have a negative impact on the economy such as cooling of consumption and investment sentiment, greater instability in financial variables, including stock prices, foreign exchange rates and capital outflow. The conditions of the real estate market, particularly the possibility of sharp declines in housing prices, could become a big burden to the overall state of the economy through losses in household assets, delinquent repayment of loans to banking institutions, and contraction of construction investment.

Issue Focus

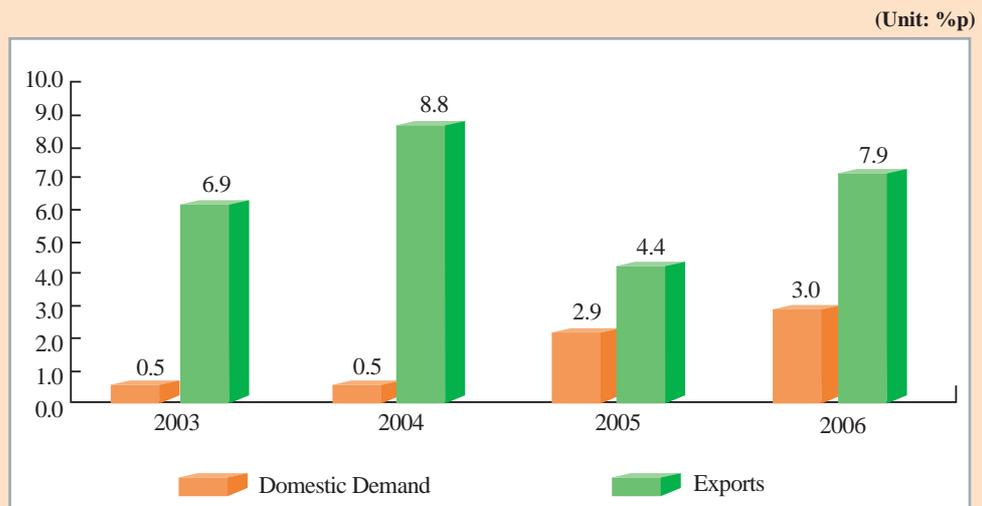
Outlook 2007 and Key Issues of Korea's Economy

Chan-guk Huh
Director of Economic Research Division
Korea Economic Research Institute

A look back at 2006

The 2006 Korean economy was a repeat performance of the past three years. Namely, robust export growth was accompanied by weak domestic demand, as can be seen in the figure below. This time last year, most forecasters saw a very different picture in their crystal balls in which recovered domestic demand playing a much more important and balanced role than exports. Well, the actual pan-out of the economy in 2006 made fools out of the forecasters yet again. Strong export growth was all the more noticeable in light of the sharp appreciation of the Korean won since late 2005.

Contribution of Domestic Demand & Exports to GDP Growth



The exchange rate of the won against the US dollar went up about 6.7% in 2006. Unexpectedly strong demand for Korean exports resulted from a robust global economy that has been supported by a tripod of steady improvements in advanced economies, break-neck paced growth of newly developing giants (China and India), and an enduring economic boom in resource rich countries. On the other hand, domestic demand had lagged behind external demand. Private consumption that makes up about 55% of GDP showed some signs of recovery in the second half of 2005 after contracting on year-on-year basis for two years running until 2005. However, sluggish job and income growth has limited the bounce-back in consumption.

Patterns in construction investment and facility investment spending, which make up most of capital formation, diverged in 2006. Construction spending sagged while facility investment spending rose somewhat noticeably in 2006. This might be a troubling signal as construction spending was the only vibrant component while consumption and facility investment had been weak.

External factors ...

Key global institutions such as IMF, OECD, and ADB seem to have reached a consensus that there would be a slight deceleration of global growth in 2007. Also the value of the US dollar is expected to continue to weaken. The depreciation of the US dollar against major currencies such as Euro and Japanese yen continued throughout 2006. Furthermore, as a Japanese short term policy interest rate is likely to be raised, the expectation of further weakening of the US dollar is gaining stronger grounds. The Korean won's exchange value seems to have fallen enough so far. However, many foreign exchange experts expect continued appreciation of the Chinese Renminbi. At the same time, arguments that the US will put further pressure on Asian currencies as it tries to rectify gaping trade imbalances are abound. In such an environment, anything could happen to the won as there are plentiful examples of short-term overshooting of exchange rates. Such developments are likely to impart somewhat negative tone to Korea's external demand in 2007.

Global interest rate hikes, high oil and commodity prices have burdened the global as well as Korean economy in 2006. The international oil price (Dubai crude) is expected to remain in the neighborhood of US\$60/barrel. Weaker demand for oil due to decelerating global growth and increases in crude oil production by non-OPEC countries would give the world a moment of relief. But heightened geopolitical risks in the Middle East with OPEC reducing oil production to battle declining oil prices may make the relief a rather short one.

... and internal factors that blur visibility

Turning to domestic scene, 2007 is going to be a highly charged year of politics as a presidential election is scheduled in December. Already a split up of the ruling party sometime in early 2007 is a fait accompli. Korean politicians, like in other countries, are not known for their fiscal discipline or principled resistance to populist agendas. Heavy political season means that mundane issues like economy will be getting less attention by politicians and political appointees in the government. Chances of the government coming up with timely and appropriate responses to developments that may have adverse consequences to the national economy will get slimmer.

The North Korean nuclear test has rightfully drawn an international outcry and harsh criticisms around the globe. Many experts worried that already sagging Korean economy would be further damaged by it. Although a lot depends on how North Korea will respond

to such criticisms, it may be instructive to note that it is in the interests of both North Korea and the United States to maintain stability in this region. Recent talks between the two governments seem to be a good step toward achieving regional stability. Negotiations over the Korea-US Free Trade Agreement have been a thorn in the government's side and stirred the public's nationalistic emotions. However, despite the fear-mongering of some politicians and special interest groups, the Agreement is expected to be finalized in the near future.

Then again, nuclear North Korea and a trade agreement with the U.S. are highly controversial political issues. As such, there is still a possibility that things may go awry, which will further weaken the consumer confidence and discourage businesses from investing.

In sum, prospects are somewhat better in 2007 with the relatively smooth sailing of talks between the U.S. and North Korea, a trade agreement with the U.S. nearing its finalization, and last but not the least, the presidential election done with by the end of 2007 lifting the thick political fog blocking the view forward at last.

Housing prices are going to be a tricky issue

In addition, an issue that has gathered tremendous attention in Korea so far and that has potentially powerful disruptive impact is housing prices. This issue has drawn disproportionately large attention since 2004. At the time, price increases were limited to only few areas in Seoul. As some predicted, the government's efforts to control prices of residential properties in the affluent parts of Seoul by relying on measures such as tax hikes and freeing of redevelopment projects in the target areas backfired. Increases in housing prices became more widespread and quickened in the greater Seoul metropolitan region until recently.

Prices have risen up so much so that bank regulators with concerns about banks' exposure to such booms through mortgage lending are worried about a possible sharp adjustment in the property prices. Measures to tighten the credit flow to the real estate sector have been implemented by Bank of Korea and Financial Supervisory Services. These measures seem to be taking effect slowly as the housing prices are seemingly being stabilized. However the government is walking on the extremely thin line. Were it to make false moves, the magnitude of ill effects it would cause is considerable.

The housing market could collapse as it did in Japan in the 1980s, and it would send debilitating shockwaves through the entire economy by undermining financial stability and consumer confidence. The fact that the property prices are dropping, slowly but surely, under the weights of heavy tax policies and restricted supply of collateral loans may be a sign of the market finally regaining its rational equilibrium. However, many are feeling that the apparent calm in the property markets might be a prelude to a huge economic storm afterwards. Without anybody noticing, a top priority for policymakers may already be shifting from managing housing prices to avoiding what Japan went through in the 1980s.

Encumbered Korean economy in 2007

Just as the global economy is expected to decelerate in 2007, Korean economy is also expected to slow down a bit. In terms of GDP growth rate, it is expected to slow to low 4% range from 5% in 2006. Growth in external demand is expected to slow due to the expected global deceleration as well as much strengthened Korean won. Consequently, the current account is expected to turn red in 2007. Slowing exports and the ever increasing services account deficits are the main reasons for this turnaround. Strong won has aided the rapidly surging trends in outbound travelers and high travel-related expenditures. The group includes not only tourists but also many students of various ages going abroad for education, and seekers of medical services. Many are worried that such a trend may be a symptom of a deeper problem. Korean providers of these services may simply be losing its competitive edge.

Rapid appreciation of the Korean won has significantly deteriorated exporting firms' profitabilities since late 2004. This has been a key reason why the domestic economy remained doldrums while the export sector continued to do well. Many observers have wondered why large businesses have not added jobs and increased capital spending when their export figures continued to break records. For example, employment in the manufacturing sector (i.e., exporters) has actually shrunk between 2002 and 2006 from 4.24 million to 4.18 million. An important reason for this seeming anomaly is that the average wage in the manufacturing sector has gone up only about 33% in local currency terms but approximately 58% in US dollar terms due to won appreciation during this period. For exporters' global competitiveness, dollar denominated wage is what matters. The wage hikes are simply making it impossible for the exporters to hire more.

The won-dollar exchange rate is going to be the key variable for both the government and the private sector. It fell steeply in November-December of 2006 threatening 900 won per dollar mark. Though it appears to be stabilizing for the moment, much volatility is expected in 2007. It could fall below 900 for a short period anytime if a massive dollar selling takes place in global foreign exchange markets. At the same time, it could surge towards 1000 won per dollar mark if a large-scale capital outflow were to take place in Korea due to some destabilizing developments. Based on economic fundamentals such as current account deficits, Korean won is not going to strengthen much more from the level seen recently. For the year, it is expected to average at about 930.

Based on such considerations, export growth is expected to provide only limited support to domestic demand in 2007. In turn, consumption and investment spending are expected to do better than in the past few years, but not strong enough to lead economic growth. Non-economic factors reviewed earlier are going to put downward pressures on economic senti-

ments and thus limit the extent of any recovery in consumption and corporate investment.

Fortunately, a lack-luster domestic demand and the strong Korean won's exchange value are going to limit any upward movement in prices in 2007. This is why price increases have been in check despite rapidly rising oil and commodity prices in the past several years. The CPI inflation is expected to remain at a low 2% range. Tame inflation is going to help interest rates to remain stable in 2007. Corporate sector's demand for funds is expected not to be strong and the government's efforts to limit the credit flow to the household sector that started in late 2006 will take effect in dampening the overall demand for funds. Market interest rate (corporate bond, 3-year, AA-) is expected to fall only slightly in 2007 to 5.1% from 5.2% in 2006.

Economic Outlook for 2007

(Unit: y-o-y, %)

	2006	2007
GDP	5.0	4.1
Private consumption	4.2	3.8
Construction investment	-0.1	1.0
Equipment investment*	7.7	5.9
CPI	2.2	2.3
Current account(USD Bil.)	6.1	-2.7
Export(%)	14.8	9.8
Imports(%)	18.1	12.2
Ex rate(Ave, KRW/USD)	955	929
Corp. Bond Yield Rate(3yrs. AA-)	5.2	5.1

* Including intangible asset investment

Regaining economic vigor, on-going challenge

Sluggish job growth is a crucial problem facing the Korean economy. The average unemployment rate of a mid 3% range might give a false sense of security when the unemployment rate for people in their twenties is over 8%, more than twice the average figure. Between 1997, the year of the financial crisis, and 2006, population belonging to age groups 20-64 has gone up by 2.81 million. In the same period, employment of all types has gone up by 2.24 million. Such a deficit does not take into account the deterioration in terms of quality of employment. Korea's overall employment rate (proportion of the employed to the working age population) is below the OECD average of 65% in 2005. In many industrialized countries, employment rates run over a 70% level. As 1% represents over 300 thousand workers in Korea, this is a serious indicator. Overcoming such a job deficit remains an urgent task.

Perhaps the most urgent task for the government is to maintain social stability in the presidential election year. Many have complained about near lawless protests of many interest groups such as labor unions and anti-FTA groups. They worry that rights to protest seem to outweigh rights of many ordinary citizens to conduct their daily businesses and make a living in an orderly environment. It is very important that presidential candidates realize that anxiety and lethargy of the Korean economy over the last several years have a lot to do with passive and lethargic business behaviors that resulted in part due to the atmosphere hostile to businesses. Regardless of candidates' individual ideological inclinations, recognizing the root causes of the job deficit and sluggish investment clearly appear to be the first step toward solving Korean economy's short term as well as long term challenges.

| Recent Publications

- Research Monograph: provides comprehensive medium- and long-term research results in both theoretical and empirical aspects on various economic issues.
- Policy Report: provides timely and current analysis on the economic policy issues and offers policy alternatives.
- Issue Paper: provides research results in a form of the series of related papers dealing with occasionally selected issues.
- Working Paper: provides preliminary research results on various economic issues.

This issue of KERI Economic Bulletin introduces 11 new research monographs, 4 new policy reports and 2 new issue papers published during 2006. Together with next issue of the Bulletin, it will introduce all reports published during 2006.

Research Monograph

Ten Years into NAFTA and Its Lessons to Korea

Research Monograph 06-06

Youngmin Kwon (Myong Ji University)

This study identifies the automobile and electronics industries as leading supporters of the NAFTA in the United States. They were the industries that had faced the fiercest competition from East Asian countries, such as China, Japan, and Korea. In light of the findings in this study, the current situation in Northeast Asia is very different from what North America faced ten years ago.

That is, there is no outstanding leader in Northeast Asia like the U.S. in North America. Considering the fact that Japan, Korea, and even China have been pursuing a similar economic development strategy and are now competing with each other in almost every industrial product category in the world export market, it seems implausible to come up with a trade agreement that everyone could agree on.

Therefore, it is much more practical to first discuss the possible steps to cool down competitive zeal among similar industries across these countries. This study also suggests some areas of possible collaboration among these countries and among industries in this regard.

Property Rights, Corporations, and Conglomerates

Research Monograph 06-08

Young-Yong Kim (Chonnam National University) / Kyung-Suk Park (Chonnam National University)

Corporations and conglomerates have developed as a form of property rights to internalize the external benefits from commercial activities. In order to successfully internalize the benefits, corporations and conglomerates must reduce both decision-making and external costs that are the most important part of the overall internalization costs.

The decision-making costs are reduced by concentrating decision-making authority in the hands of a small number of managers, and external costs that might be imposed on the shareholders are avoided or reduced through stock market transactions. In this regard, conglomerates that consist of affiliated firms have developed with a controlling shareholder whereas no controlling shareholder characterizes M-form conglomerates.

Documented empirical observations largely support these findings. Finally, advocates of corporate governance movement fail to understand the economic theory underlying the operations of corporations and conglomerates.

An Empirical Study on the Relationship between Firm Performances and Control-Ownership Disparity: Focus on State-governed Enterprises

Research Monograph 06-09

Hyun Jong Kim (KERI)

This study empirically tests how control-ownership disparity affects the firm's performance (profits and market values). For those private firms that belong to Chaebols, the control shareholder's control-ownership disparity indices do not have a statistically significant relationship with the firm's profits and market value, suggesting that the Tunneling hypothesis is not supported by the data.

To allow for the possibility of endogeneity bias, a reverse regression is conducted to see whether a firm's profits and market value affect control-ownership disparity indices in the next period. By and large, the results show that there is no statistically significant negative relationship between the two variables, and that the relationship turns out to be positive in some specifications.

Similarly, this study shows that the government's control-ownership disparity indices are not correlated with the state-owned enterprises' profits and market value, suggesting that the government does not abuse its control rights onto the state-owned enterprises.

Contrarily, it is found that increases in the government's control-ownership disparity indices are negatively correlated with the privatized enterprises' profits, suggesting that the government abuses its control rights onto the privatized enterprises.

Does Inheritance Tax Ensure Equal Economic Opportunity?

Research Monograph 06-10

Myung Keun Choe (Kangnam University) / Gyeong Lyeob Cho (KERI)

Imposition of inheritance tax may hurt international competitiveness of the financially liberalized economy by hampering the incentives to save and invest.

Using an overlapping generation model, this study analyzes the effects of inheritance tax on the individual welfare of different components of the social strata. The empirical results show that reducing the inheritance tax rate by 40% from its current level raises total social welfare by between 168.5 billion and 668.3 billion Korean won.

In an opposite scenario, strengthening the inheritance tax system results in a downward equalization where the welfare of both of those with and without expected inheritance is reduced due to economic inefficiency. The analysis also shows that an increase in inheritance tax rate raises the welfare of low-income class and improves equality of income distribution only if the intertemporal elasticity of substitution is abnormally high.

Although abolishing inheritance tax is economically efficient, it cannot be considered a practical policy alternative for the lack of a satisfactory alternative tax system and means to prevent potential tax evasion. Hence, until tax-related infrastructure is soundly established, the burden of the tax should be mitigated through lowering its rates and improving the underlying institutional infrastructure.

Furthermore, institutional conversion to a form of acquisition tax, in line with the ability-to-pay principle and the policy of suppressing concentration of wealth, is required.

A Study on Legislation of Taxpayer Advocate System

Research Monograph 06-11

Myung Keun Choe (Kangnam University)

Infringement of rights by tax administration authority is a major cause of taxpayer grievances. However, resolving them through conventional appeals or court procedures has become increasingly insufficient due to ever-expanding government bureaucracy in the modern welfare state.

Taxpayer advocate system can proactively prevent the accumulation of these grievances by dealing with them promptly and efficiently without imposing undue procedural costs.

After comparing taxpayer advocate systems in other countries, this report suggests that it would be best that we model our Taxpayer Advocate System after the American system. The policy recommendations listed in this report include legislating elevation of the current status of the Taxpayer Advocate implemented by the order of National Tax Service in 2000, installment of the National Taxpayer Advocate with a balanced administrative structure to ensure its independence, allowing the National Taxpayer Advocate to make public recommendations of remedies for maladministration to guarantee their effectiveness, and submission of annual reports by the National Taxpayer Advocate to the National Assembly and the general public. The report should include trends of taxpayer grievances or complaints occurrences, the results of examinations of those occurrences, implemented remedies, and a summary of expressed opinions.

Dividend Policy and R&D Investment Decisions of Korean Firms: A Dynamic Panel Data Analysis

Research Monograph 06-12

Byoungki Lee (KERI)

This study analyzes the effect of foreign ownership on the dividend policy and the R&D investment decision of the Korean firms during the period of 1990 to 2005. In order to trace down the relations between the foreign ownership and the dividends and R&D investment, it employs the Generalized Method of Moments (GMM).

The basic framework is the Error Correction Model (ECM), which specifies a long-run or target level of the stock accumulated in the R&D investment, but which allows a flexible specification of the adjustment dynamics.

This study shows that the foreign ownership is positively related to dividend policy; that is, the higher foreign ownership is associated with a firm, the greater dividend payout the firm practices.

It also shows that firms face the financial constraints in their investment behavior, and that the sensitivity of cash flow on R&D investment is larger for non-chaebol and high technology firms than chaebol and low-technology firms. The effect of foreign ownership on the R&D investment decision is found to be statistically insignificant.

Economic Effects of Value-Added Tax on Financial Services in Korea

Research Monograph 06-13

Yu-Chan Kim (Keimyung University) / Guangsug Hahn (KERI)

The purpose of this study is to examine the necessity of imposing value-added tax (VAT) on the financial services and to simulate its overall effects on the Korean economy. We begin by surveying the arguments in the literature and the problems caused by levying VAT on the financial services. In the empirical analysis, we employ a dynamic computable general equilibrium model to simulate possible effects.

Taking into account the tax burden, we simulate the effects for two scenarios. The first scenario is to levy VAT on the financial services while keeping the other taxes unchanged, and the second one is to levy VAT on the financial services while adjusting the consumption tax so that there is no change in total tax revenues. In other words, the second scenario is to implement the new tax in a revenue-neutral way.

In the first scenario, the negative effects on the households and the financial sector are dominated by the positive effects on non-financial firms and the government. In this case, the new tax has an overall positive effect on GDP and employment. In the second case, on the other hand, the financial sector benefits significantly from VAT taxation. Moreover, the households also benefit from the new tax in the long run while its effects on the other parts of the economy are positive as in the first case. Based on this analysis, we conclude that the revenue-neutral policy option is more desirable.

Cross-Country Comparison of Corporate Governance Determinants

Research Monograph 06-14

Yong-ki Kim (Samsung Economic Research Institute)

From the perspectives of path dependency and historical experiences, the governance practice among Anglo-American corporates is inadequate to be a model for Korean corporates.

The institutions on the basis of the Anglo-American corporates' practice, although recognized as global standards in Korea, are only specific results which are originated from US and UK historical experiences. The institutions reflect the specific ownership structure in the US and UK and the socio-political situation of the past.

This study argues that the Korean government and the policy makers should not blindly implement Anglo-American institutions without localizing them.

Firm Competitiveness of Korea, China and Japan

Research Monograph 06-15

Seung Rok Park (KERI)

To study competitiveness of Korea's leading firms, this study employs a non-parametric approach (based on Data Envelopment Analysis) with the panel data for 1,900 firms of Korea, China and Japan during the period of 2001~2004. Besides comparing the scales of sales and assets, profits, and factor productivity, this study measures the index of TFP (total factor productivity) growth and its three components of scale economies, technical efficiency and technical change for the firms.

The results of this study suggest some valuable points on the aspects of corporation such as the optimal size, investment practice, restructuring and enhancement of technology, and on the future target for change of industrial structure as a whole.

Comparison of Economic Performance of Korean Companies Before and After Merger

Research Monograph 06-16

Byoungki Lee (KERI)

This study compares performances of corporates before and after merger using 186 merging corporates from 1987 to 2004. For the analysis, we examine the companies' profitability, the output growth and the TFP (total factor productivity) growth. The analysis shows that there has been a significant improvement in post-merger performance after the financial crisis.

The government's flexible labor market policies and reduction of redundant machinery and equipments seem to have contributed to productivity improvement.

The Effect of IT Investments of Securities Companies on Their Profitability

Research Monograph 06-18

Myung Hoon Yi (Myong Ji University) / Jong-Kil An (Myong Ji University) / Changkyu Choi (Myong Ji University)

This study shows a positive effect of the IT investments of the securities companies on their profitability using data on the IT investments of 24 securities companies from 1992 to 2004.

The study employs a pooled OLS model, random effects model, and fixed effects model for estimation. The results are robust to estimation methods but sensitive to firm size.

The empirical results imply that the strategy of increasing IT investments by the securities companies has been desirable. However, small- and medium-sized securities companies may have to reconsider their IT investment strategies.

Policy Report

Impact of FX Rate Appreciation and Policy Tasks

Policy Report 06-04

Chan Guk Huh (KERI) / Chang Bae Kim (KERI) / Jeongseok Song (Chung-Ang University)

A recent drastic appreciation of Korean won is expected to hurt the export sector's international price competitiveness. Yet, its effects are not fully materialized thanks to the nation's brisk exports to China. Still, in terms of profitability and employment creation potential, the competitiveness of Korean export firms has already weakened.

To mitigate the negative impact, policy measures need to be implemented to narrow the exchange rate gaps with competitor countries. Also, measures to enhance employment flexibility need to be installed. Presently the Korean businesses are fully exposed to exchange rate risk and have few ways to deal with worsening profitability. One way to ease such a problem is to enhance employment flexibility so that businesses could lower production costs by adjusting their labor stock.

A Study on the Revision of Large-Scale Business Group Policies and Study on the Revision of Large Business Group Policies and Desirable Policy Direction

Policy Report 06-06

Chung-Gyu Choi (KERI)

In the global competition era, any policy restricting the concentration of economic power or requiring discriminative regulation against large-scale business groups based on purely domestic considerations should be eliminated.

Also, there is a need to shift policy focus from restriction of the economic power concentration per se to regulating the anti-competition activities. Furthermore, policy priority should be given to solidifying the existing regulatory framework to best suit actual corporate conditions before introducing a new regulation. Finally, M&A-related laws and systems should be overhauled to prevent unproductive M&As and to provide reasonable means of protecting managerial rights.

Assessment of the Roh Administration's Real Estate Policy and Countermeasures

Policy Report 06-07

Gyeong Lyeob Cho (KERI)

A disregard for fundamental market principles seems to be a main cause for failure of the Roh Administration's real estate policy. The Roh Administration has tried to stabilize housing prices relying solely on controlling demand while curbing the housing supply by private enterprises.

To remedy the housing problem, the comprehensive real estate holding tax, which infringes on constitution rights, needs to be lowered and converted into a provincial tax at the same time. As a means to increase the housing supply, real estate transactions should be boosted by lowering the real estate capital gains tax or delaying the tax payment date when the capital gains are used in the purchase of a new property. Above all, it is urgent to ease or abolish restrictions on land utilization and re-construction that undermine the flexible housing supply.

Korea-U.S. FTA Study: Intellectual Property Rights

Policy Report 06-09

Kiyoon Sohn (University of Incheon)

The report examines the policy stances of the U.S. and Korea on IPR that are embedded in their trade negotiations with other countries. After reviewing the basic positions of the two countries regarding the IPR field in the Korea-U.S. FTA negotiations, potential key issues in the IPR field centering on copyrights, patent rights and business secrets are analyzed and a negotiating strategy is suggested.

In the case of copyrights, major issues include extension of the protection period, protection of technical safeguards, temporary storage restriction and introduction of a legal loss compensation system. Key issues concerning patent rights are restriction on compulsory licensing and extension of patent period in the event of delay in administrative procedures.

Finally, items that Korea could demand of the U.S. with respect to IPRs are suggested. For example, with regard to Article 337 of the U.S. Tariff Act of 1930, Korea could ask the U.S. to introduce an expedited procedure system for Korean enterprises and also to change the present U.S. 'first invention' provision to 'first application.'

Issue Paper

The German Judicial Review of Property Tax Law and Its Implications to Recent Revision of Comprehensive Property Tax Law of Korea

Issue Paper 06-26

Myung Keun Choe (Kangnam University)

The Federal Constitutional Court of Germany (Bundesverfassungsgericht) in 1995 conducted a judicial review of the property tax law (vermogensteuergesetz) and declared it unconstitutional for the following reasons. First, assessing the values of the taxable properties is inconsistent within its own property tax law. When the values of properties are assessed, normally future yield prices calculated with the yield capitalization method are used as a standard. However, the values of some properties are measured, in practice, with the current market prices. And when taxed, a single tax rate is applied to those two different assessments, which is against the equity principle of tax laws. Second, taxation of the properties is essentially based on the yield from holding the properties, and the sum of taxes levied on all the properties cannot be more than 50% of the expected total yield. Therefore, the property tax law violates the principle of half taxation and consequently is affirmed unconstitutional.

The German judicial precedent has important implications for the recent revision of the comprehensive property tax law in Korea. The comprehensive property tax law adopts the current market price of owned properties as a tax base and takes no account of debt directly related to the owned properties. Under the progressive tax rate regime, the marginal tax rates for property tax and real estate tax reach up to 0.5% and 4%, respectively. If a household has several units of housing, this translates into the effective tax rate of over 3%, which is equivalent to 130% of income earned from holding the properties for a year.

Abolition of Cumulative Taxation in Major Countries and Its Implications for Korea

Issue Paper 06-27

Myung Keun Choe (Kangnam University)

The cumulative taxation system is not desirable for the Korean tax system for the following reasons. First, such a taxation system would not conform to the Constitution. Marriage and family life must be established and maintained based on individual dignity and gender equality, and the Constitution stipulates that the nation is obliged to guarantee these rights. A progressively-structured cumulative taxation on a married couple in the comprehensive real estate holding tax contains elements that are unconstitutional, giving an unjust discriminative disadvantage to marriage and family life. Major countries, including Germany, Japan, the United States, and others, also have either abolished the cumulative taxation on a married couple for income or asset or never adopted it.

Secondly, illegal behaviors like evasion of the comprehensive real estate holding tax through use of other persons' names can be prevented through inheritance tax or real estate capital gains tax. A fine of 30% of the real estate price is imposed for violations of name trust for real estate (false dispersion); the maximum 50% tax rate of the gift (donation) tax is applied to the transfer of real estate between lineal ascendants and descendants, considering it a donation; and the maximum 36% rate of real estate capital gains tax is imposed on transfer of real estate between family members.

Adopting the cumulative taxation system simply because families live together is unreasonable from all aspects of taxation theory.

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