

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

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I Economic Trends and Outlook

Executive Summary

Economic growth (GDP basis) for 2008 is projected at 5.1%, which is higher than the estimated growth rate of 4.8% for 2007. Although the external environment has deteriorated markedly, KERI remains cautiously optimistic about Korea's growth prospects for 2008 due to favorable developments in the domestic market. In contrast to the tumultuous international market conditions, domestic demand is showing healthy signs of recovery. The fact that the newly elected government is not shy about its growth-oriented and market-friendly stances serves as a key factor. On top of the recovery trend in domestic spending, the export sector remains strong as it has been successful in increasing market diversification and enhancing product competitiveness. Regional stability resulting from reduction of the North Korean nuclear risk is an additional factor that allows us to maintain guarded optimism.

Inflationary pressures will increase in 2008 as consumer prices are expected to grow around 3% due to robust domestic demand and rising prices of international commodities. The last time prices rose by this magnitude was in 2004 when they increased 3.6%. The current account balance is also projected to return to a deficit of about US\$1.4 billion, for the first time in 10 years, due to expanding domestic demand and the service account deficit.

Apart from the positive developments mentioned above, it is important not to ignore the potential risks posed by the international credit crunch and global inflationary pressures.

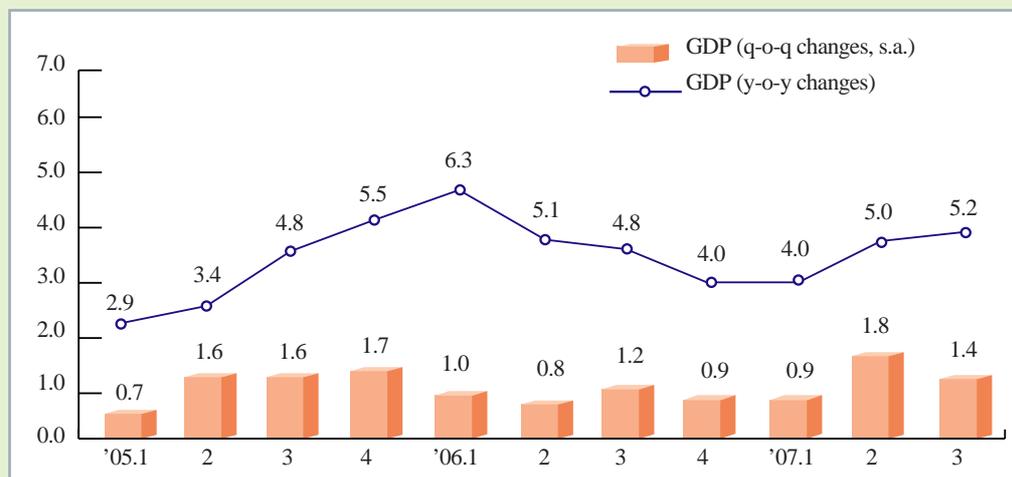
For starters, the new government needs to stabilize the domestic financial market by easing credit conditions. It also needs to put into place measures that can shield the Korean economy from global inflationary pressures. Current economic conditions provide little wiggle room for the government in terms of interest rate policies. As such, policy makers will have to be extremely careful not to throw the economy off track by taking an undue tightening stance. Implementing the tax relief measures pledged by the president-elect at the earliest possible time would provide some breathing space for the policy makers themselves as well as the recovering domestic market.

Domestically, the new government should initiate regulatory reforms to foster robust corporate investment at the earliest possible date. It also needs to firmly commit to upholding the principles of law and order in the process to ensure social stability. During the transition period, the newly elected government should cooperate with the current government and take necessary steps so as to ratify the Korea-US FTA in the early days of the new administration.

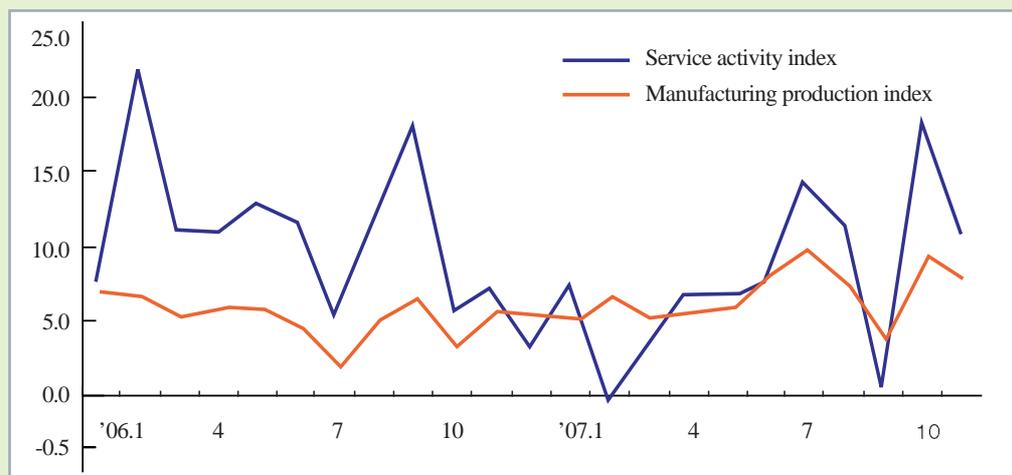
Recent Developments

Real GDP growth in 2007 rose to 5.0% in the second quarter and 5.2% in the third quarter, with 4.0% in the first quarter as the lowest level. In October-November, growth indices continued in a positive direction. Production in the manufacturing sector expanded 14.8% in October-November from 8.9% in the third quarter. Service sector output also increased to 8.6% in October-November from 7.0% in the third quarter.

Economic Growth Rates by Quarter

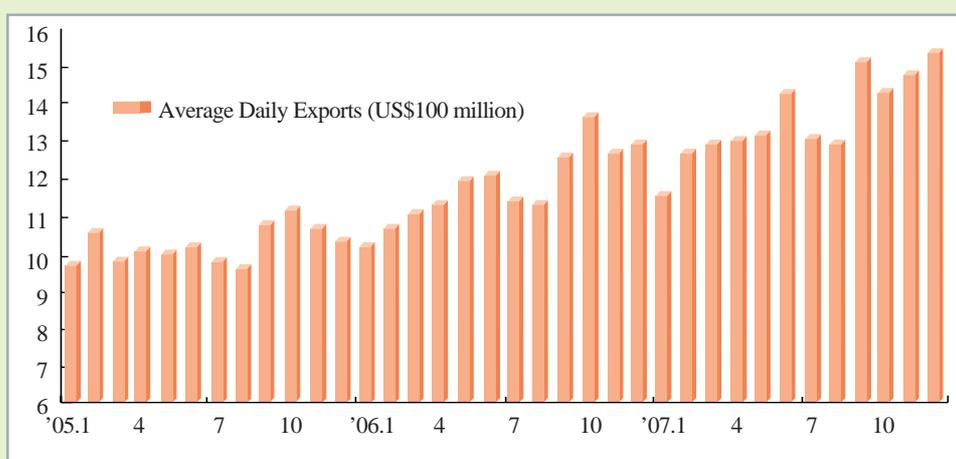


Manufacturing Production Index and Service Activity Index

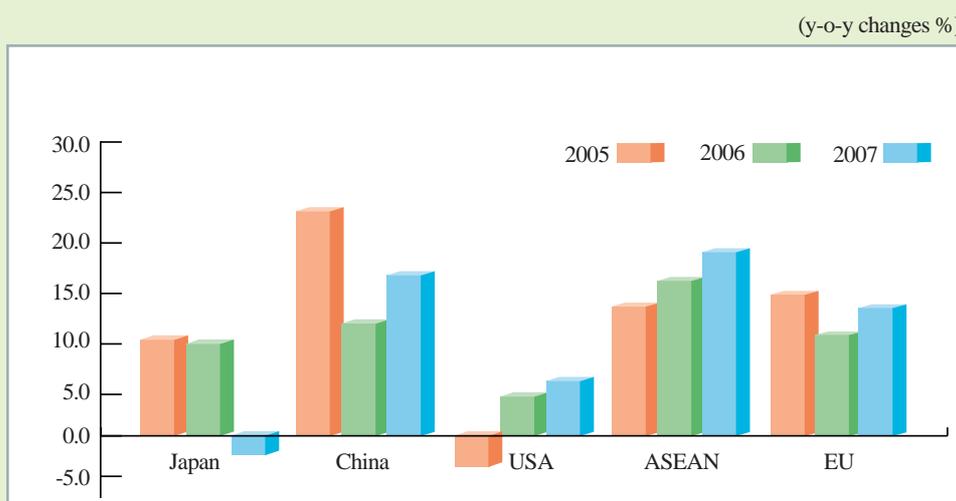


The brisk export trend continued in the second half from the first half. The daily average of exports has exceeded US\$1.3 billion each month since March. By region, the favorable trend of exports to China, the EU and ASEAN continued but exports to the United States and Japan were stagnant.

Daily Average Export Amount by Month



Export Growth Rates by Region



Domestic demand also recovered mildly centering on consumption. Sales of consumer goods increased at the rate of 7.1% in October-November, continuing from the 8.6% growth posted in the third quarter. Facility investment, which declined in the third quarter, also rebounded to growth in October-November and its leading indicator, receipt of domestic machinery orders, continued a high growth trend. Construction investment growth remained in a slight slowdown, however, but its leading indicator, receipt of construction orders, increased sharply in October-November.

Trends of Key Domestic Demand Indicators

(Unit: y-o-y changes %)

	2006				2007			
	2/4	3/4	4/4	year	1/4	2/4	3/4	10~11
Sale of Consumer Goods	6.1	2.9	4.5	4.7	7.1	5.3	8.6	7.1
Estimated Facility Investment (constant)	6.7	11.8	5.1	7.4	11.3	12.1	-1.9	3.6
Domestic Machinery Orders Received (constant)	24.4	21.0	16.7	18.8	15.3	7.4	14.8	32.1
Construction Progress Payments (current)	-0.3	4.8	6.0	3.7	6.5	5.2	3.4	5.5
Construction Orders Received (current)	-14.7	37.1	27.1	9.0	26.3	26.3	-5.6	61.4

Owing to brisk export performance, improvement of income balance, etc., the current account balance converted to a surplus in the July-November period from a deficit in the first half. The current account balance surplus was US\$8.64 billion in July-November, up about US\$10.2 billion from a deficit of US\$1.63 billion in the first half.

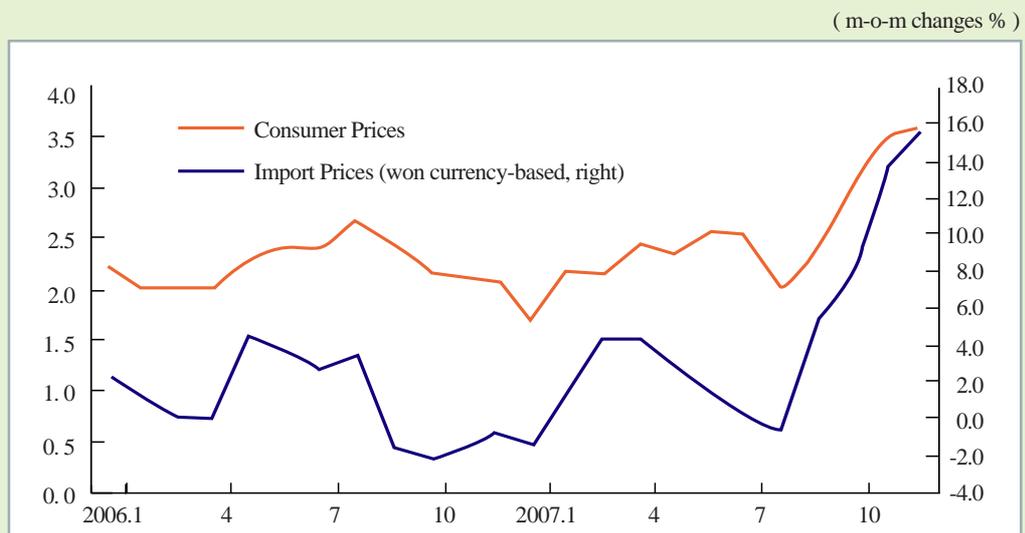
Current Account Balance

(Unit: US\$100 million)

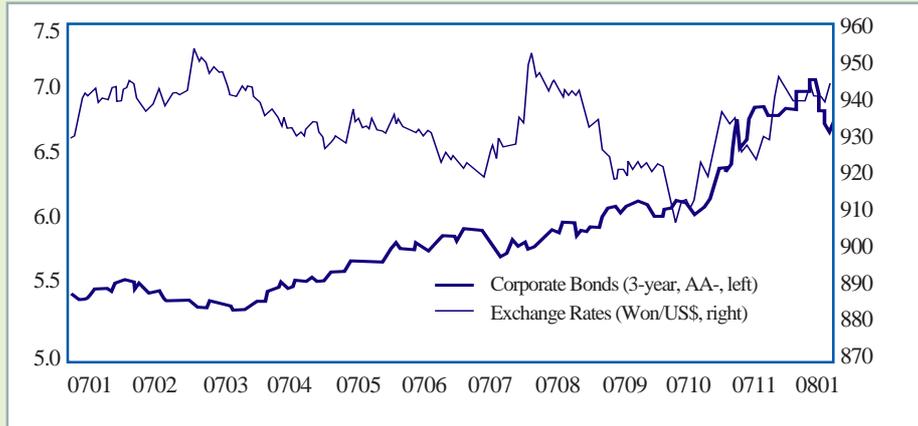
	2006					2007			
	1/4	2/4	3/4	4/4	Year	1/4	2/4	3/4	10~11
Current Account Balance (=A+B+C+D)	-11.2	6.9	3.7	61.4	60.9	-16.6	0.3	44.3	42.1
Commodity Balance	52.2	74.1	62.3	103.5	292.1	60.4	69.7	96.8	65.3
Service Balance	-50.0	-38.8	-53.8	-45.0	-187.6	-61.8	-44.0	-58.8	-28.8
Travel Balance	-29.5	-28.4	-37.8	-33.4	-129.2	-36.1	-36.6	-43.6	22.2
Service Business Balance	-15.1	-15.1	-18.5	-19.6	-68.3	-22.6	-17.1	-19.1	-16.9
Income Balance	-4.8	-16.5	6.1	9.8	-5.4	-6.9	-15.4	16.6	9.3
Current Transfer Balance	-8.6	-11.9	-10.8	-6.8	-38.2	-8.3	-10.0	-10.3	-3.7

The rate of increase in consumer prices became steeper on a gradual basis, growing 3.0% in October, 3.5% in November and 3.6% in December. These high rates of over 3% were reached for the first time since May 2005. This is attributed to sharp rises in import prices caused by increased crude oil and international raw materials prices. Won currency-based import prices jumped 15.0% in October-November from 2.0% in the third quarter.

Consumer Prices and Import Prices



Corporate Bond Yield Rates and Exchange Rates



Market interest rates are also recording a high growth trend due to tight global credit, a sharp increase in issuing short-term bonds, and other factors. The yield rate, which was 5.87% on September 3, fluctuated up and down around the 6% level through the end of December. Won-dollar exchange rates recorded an upward trend due to increased export payments and stock sale by foreigners after a sharp increase in mid-November caused by the aftereffects of instability in the global stock market.

Outlook for 2008

External Environment

Due to the aftermath of delinquency in U.S. subprime mortgages, concerns about global inflation, etc., the growth of the world economy is expected to slow to 4.8% in 2008 from 5.2% in 2007. Cited as key factors are stagnation of housing business conditions and an unstable financial market in the United States, sluggishness of the U.S. economy, contractionary policy and yuan currency appreciation in China, and impact of strong currencies and the slowdown of the U.S. economy for Japanese and European economies. Because of fears over global inflation, meanwhile, projections are that money interest rate cuts by major countries will not be easy.

International oil prices are expected to fluctuate around US\$80/barrel (based on Dubai oil) due to geopolitical risks, real asset investment following a weakening U.S. dollar, etc. Nevertheless, the band of additional price increases is likely to be narrow as demand for crude oil decreases due to the slowdown in global economic growth.

Instability in international financial markets is expected to increase with expanded losses of financial institutions following the delinquency of subprime mortgages, tight monetary policy on inflation concerns, etc.

Internal Environment

With the launch of a new government, promotion of aggressive economic stimulation policies is anticipated. As the new government emphasizes practicality, in particular, it is expected to play an active role in the substantial reinvigoration of the economy.

Geopolitical risk on the Korean Peninsula is also expected to ease. The six-party talks are making smooth progress by and large and the activities proceeding from the South-North Korea summit in October 2007 also will contribute to reducing the uncertainty of the political situation on the peninsula.

Monetary policy is likely to maintain a retrenchment tone. Amid the continuing economic recovery trend, the likelihood of an easing of monetary policy is not very high in view of the domestic fundamentals and monetary policy environment, including heightened fears regarding domestic liquidity and price instability in an economic recovery period. Due to uncertainty over the world economy, won currency appreciation, etc., money interest hikes are not likely either. For the time being, the present policy tone is expected to continue.

Prospects for 2008

Real Economy

Due to a slowdown in world economic growth and won currency appreciation, export growth is expected to slow to 8.4%. Owing to expansion in the domestic demand sector, construction and facility investment, private consumption, etc., however, real GDP in 2008 is expected to grow 5.1%, higher than the 4.8% achieved in 2007.

Private consumption in 2008 is expected to recover due to the government's revision of the taxation system, improvement of consumption sentiment, etc. Yet, private consumption growth is expected to be limited to 4.8% annually due to an increase in the burden of household debt, with the money interest rate serving as a factor in limiting the recovery trend of private consumption.

It will be difficult to realize a significant recovery in construction investment in the private sector in 2008. However, overall construction investment is expected to grow 2.8% annually, led by the public sector, including commencement of construction of administration-centric cities, innovative cities, corporate cities, etc.

In 2008, facility investment is expected to maintain the recovery tone of 2007, but its growth will be limited due to the export slowdown following stagnation of global economic expansion.

External Transactions

Affected by the slowdown in the U.S. economy, China's strengthened retrenchment policy, continued weakening of the dollar and strong international raw materials prices, export growth is expected to slow. With export diversification, enhancement of non-price competitiveness, etc. overcoming the worsened external environment to some extent, however, exports will be able to maintain double-digit growth.

Influenced by domestic demand recovery, won currency appreciation, strength of raw materials prices, etc., imports are expected to post high growth, outpacing export growth in 2008 in continuation from the second half of 2007.

For the first time in 10 years since 1998, the current account balance is expected to post a deficit of about US\$1.4 billion. This is attributed to a reduction of the surplus in the commodity balance and an increase in the demand for overseas services due to low competitiveness of the domestic service sector, won currency appreciation, etc.

Consumer Prices

The increase rate of consumer prices in 2008 is projected at 3.2%, higher than the 2.6% level posted in 2007. Price-push factors will include strong international raw materials prices, domestic demand recovery, aftereffects of inflation in China, etc.

Market Interest Rates

In 2008, market interest rates (based on corporate bond yield rate) are expected to post 6.5%, 0.8 percentage point higher than the 5.7% in 2007. The pressure factors to push interest rates higher are likely to be an increase in financial demand following domestic demand recovery, tight global credit, etc., which will continue at least through the first half of 2008.

Exchange Rates

The won-dollar exchange rate (annual average) in 2008 is expected to be 910, down from 928 in 2007. This is because the factors tending to strengthen the won will be greater than those to weaken the currency. The global dollar weakening phenomenon, resumption of foreigners' buying of stocks, an upward adjustment in the national credit rating following mitigation of tensions on the Korean Peninsula, etc. are strengthening factors, while the slowdown of the U.S. economy, conversion of Korea's current account balance to deficit, etc. are weakening factors.

Prospects for Domestic Economy in 2008

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

	2006	2007		2008			
	Year	1st H.	2nd H.	Year	1st H.	2nd H.	Year
GDP	5.0	4.5	5.1	4.8	5.3	5.0	5.1
Private Consumption	4.2	4.1	4.7	4.4	4.9	4.7	4.8
Construction Investment	-0.4	3.5	0.1	1.6	1.8	3.7	2.8
Equipment Investment*	7.8	10.5	3.6	7.0	6.3	9.7	8.0
Consumer Prices	2.2	2.3	2.8	2.6	3.4	3.0	3.2
Current Account	60.9	-16.3	89.8	73.5	-26.8	13.0	-13.9
Commodity	292.1	130.1	185.4	315.5	123.1	156.6	279.6
Exports	3318.4	1793.6	1986.2	3779.9	1986.9	2175.0	4161.9
Growth(%)	14.8	13.6	14.2	13.9	10.8	9.5	10.1
Imports	3026.3	1663.6	1800.8	3464.4	1863.8	2018.5	3882.3
Growth(%)	18.4	14.5	14.5	14.5	12.0	12.1	12.1
Service & Others	-231.2	-146.4	-95.6	-242.0	-149.9	-143.6	-293.5
Ex Rate(Ave, KRW/USD)	954.8	934.0	923.0	928.5	915.0	904.8	910.0
Corp. Bonds Yield(3yrs, AA-)	5.2	5.4	6.0	5.7	6.6	6.4	6.5

* Including intangible asset investment

Issue Focus

Policy Recommendations for the New Government in 2008

Financial Market and Macroeconomic Risks and Countermeasures

1. The Mortgage Crisis

Recent developments in the housing market are quite unsettling. Market interest rates, which remained relatively stable in the first half of 2007, have been rising sharply recently. The increases in interest rates, if not checked, could pose a significant burden on borrowers in the housing market. Higher interest rates can be a real headache especially for low-credit mortgage borrowers. They constitute 12% of all existing loans, and borrowers are finding it increasingly hard to keep up with loan payment schedules. As consumers struggle with higher interest rates, more and more newly-built apartments are failing to find buyers. As of the end of October 2007, the number of unsold apartments exceeded 100,000. It is expected that the problem is likely to get worse due to higher interest rates and the frigid housing market conditions. The housing market woes present a significant challenge to the financial sector that extended credits worth 80.5 trillion won to the real estate sector as of the end of September 2007. Judging from the current trends, it appears that the situation in Korea is following a path similar to that of the subprime mortgage crisis in the United States.

To nip the mortgage crisis in the bud, the new administration needs to devote efforts to stabilize the market interest rates at a lower level and to tackle the issue of delinquent PF and its assets. It also needs to address the unsold housing problem by revising real estate taxes and allowing normal market transactions to take place.

2. Global Inflation Following Steep Rises in Oil and Grain Prices

Increasing oil and grain prices are making global inflation a clear and present danger. Once in full bloom, it can wreak havoc on the Korean economy. Therefore the new administration should initiate countermeasures as soon as possible to minimize the adverse effects.

Lowering gas taxes should be on top of the list of policy initiatives. With the gas tax accounting for 57% of the gasoline price, the average driver in Korea is bearing a higher burden than those in Japan, Canada, and the United States. The new government needs to

be more flexible and lower the gas taxes, at least for a limited period, to mitigate the increasing burden of the higher oil price. Lower gas taxes would help to sustain the recovery of private consumption and investment by reducing costs on both consumers and producers. The new government should further ease inflationary pressures by enhancing efficiency of public companies and by limiting the rise of public utility costs. In addition to these domestic policy measures, international efforts such as securing raw materials through long-term contracts, diversification of import sources, strengthening overseas investment in resource projects, and building international information networks are necessary to secure longer-term stability.

3. Financial Market Instabilities and Monetary Policies

One of the major consequences of the U.S. credit crisis is that economic scenes, both domestic and international, are becoming extremely blurry. Hence consumers are becoming less confident about future prospects, and the Korean economy might stall as a result. The market-induced uncertainties coupled with global inflationary pressures present a difficult challenge to the monetary authorities. As noted previously, the policy makers have quite a narrow path to navigate in terms of interest rates. There is a possibility of economic slowdown on one side of the road, and on the other side lurks cost-driven inflation. Therefore, the monetary authorities will have to weigh very carefully their interest rate policies. Perhaps it will be instructive to note that despite the warning signs of inflation, central banks in major advanced countries are gradually opting for lower interest rates and liquidity injections where necessary to stabilize their financial markets and provide support for healthy economic activities.

Main Policy Points Concerning Other Pending Issues

1. Foster Corporate Investment with Early Indication of Direction and Schedule of Deregulation

In order to encourage solid corporate investment, the government should announce guidelines for measures to ease restrictions on development projects in the greater Seoul area and on the use of land at the earliest possible date.

Reducing these restrictions will go a long way as they have been a major impediment to sound corporate investment. More specifically, development projects in the capital area should be allowed in principle and prohibited only under exceptional cases. It would be best if this policy is implemented as quickly as possible because the new administration then will have cleared any uncertainties the private companies may have on the subject.

2. Establish a Firm Principle of Law and Order Early On

The hard-line labor organizations are likely to stage major protests to test the will of the new administration in the first half of 2008. In fact, it was precisely due to intensive and illegal activities of labor unions and interest groups that the economic stimulus package of the Participatory Government produced less than desired effects in 2003. The experiences of the Participatory Government illustrate that establishment of a strict principle of law and order is a precondition to successful economic policies. Any activity of interest groups that pursues their own private interests and inflicts social damage in the process should be strongly dealt with. Likewise, illegal and violent strikes by any organization should be strictly prohibited.

3. Pursue Early Ratification of Korea-U.S. FTA

During the transition period, the newly elected administration must promote the ratification of the Korea-U.S. FTA at the National Assembly in cooperation with the outgoing government. Timing is essential as the U.S. Congress is adopting increasingly protectionist stances. There is also a possibility that the United States may demand renegotiation. Early ratification of the agreement by our National Assembly will not only have the effect of pressuring the U.S. Congress to ratify the FTA, but also could strengthen our hand in other FTA negotiations like the ongoing Korea-EU FTA. Furthermore, delays in the ratification process until after the new administration is inaugurated will bring about similar delays in revisions of the related domestic laws. All in all, it is in the best interest of the new administration to promote early ratification of the Korea-US FTA.

I Recent Publications

Research Monograph

Choices for Advanced Korea: A Rich Nation, Happy People

Research Monograph 07-10

Korea Economic Research Institute

This report contains policy recommendations that are necessary for Korea to become a truly advanced nation by 2020. They include 60 key initiatives in four policy areas - strengthening growth potential, promoting and firmly establishing the market economy, enhancing the public sector competitiveness, strengthening national security and fortifying diplomatic ties.

This report reveals that the vision of 'Rich Nation, Happy People' can become a reality only when creative individuals, competitive enterprises, a harmonized society with minimal conflicts, and a small, efficient government are realized by enacting suggested policy alternatives and upgrading a free democracy and market economy-based national system.

This report also suggests regaining economic vitality through achieving a US\$30,000 per capita income, US\$1.5 trillion GDP, more than US\$1 trillion in trade volume, and establishment of a democratic paradigm that minimizes social conflict in the next five years. It also considers ways to achieve US\$50,000 per capita income and over US\$2.2 trillion GDP, and to becoming an advanced country by 2020 in such fields as politics, economy, society, and cultural infrastructure.

Policy Report

Changes in the U.S. Supreme Court's Appraisal Criteria Regarding Resale Price Maintenance Behavior and Their Implications

Policy Report 07-07

Zusun Rhee, Seuk Hun Sin

This report analyzes the U.S. Supreme Court ruling of June 28, 2007, which implies a change from its previous position that had stood for 100 years. The new ruling held that the minimum resale price maintenance agreement - in which a manufacturer establishes a certain constant price and prohibits its distributor to resell goods at a lower price - is inherently anti-competitive behavior. This has implications for Korea's competition policy.

Addressing diverse vertical restrictive actions, including the resale price maintenance covenant, that are being used generally in the distribution sector until now, not from the perspective of the original intent of the law to protect 'competition' to promote consumer welfare, but from the perspective of protecting 'competition' for the transacting parties, this report argues that momentum has been created to improve the basic problem in the application of Korea's Fair Trade Act that has treated these type of actions as illegal.

Furthermore, this report suggests that Korea change its point of view regarding the nature of enterprises and competition, which was addressed in the ruling. The impetus is now at hand to change the nation's basic corporate policy, which has viewed private corporate activities from the aspect of monopoly and restriction, as well as its competition policy.

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

working paper 07-01

Bonghan Kim, Doo-Yull Choi, Seewon Kim

This research found nonlinear mean-reversion tendencies in Southeast Asian currencies by applying the newly developed nonlinear unit root test by Park and Shintani (2005). First, with the U.S. dollar as the numeraire currency, we found that 63% of the real exchange rates of Southeast Asian currencies were stationary. However, with the Japanese yen as the numeraire currency, we found no evidence in favor of purchasing power parity for most currencies in Southeast Asia, except for the Korean won and Taiwanese dollar. These findings imply that Southeast Asian currencies may not form a yen-dominated Asian exchange rate system. Second, when the dollar-based real exchange rates of Southeast Asian countries were nonlinear mean-reverting, we found that the mean-reversion process could be well described by the ESTAR model, rather than the DTAR or DLSTAR model. As the ESTAR model shows smooth nonlinear movement toward its equilibrium value, this finding may imply that the dollar-based Southeast Asian real exchange rates move with smooth nonlinear mean-reversion behavior toward their equilibrium values

www.keri.org

Publisher: Jong-Seok Kim

Editor: Chan-Guk Huh

Co-Editor: Yun Ho Chung, Chang-Bae Kim, Pilhyun Kim

Designed by Blue-Ribbon Content & Strategy (BCS.Com)

Phone: (82-2) 6258-7870/3 Fax: (82-2) 6258-7877



KERI Economic Bulletin

is published by Korea Economic Research Institute,
FKI Building, 28-1 Yoido-dong, Yeongdungpo-ku,
150-756 Seoul, Korea.

Tel : (82-2) 3771-0001, FAX : (82-2) 785-0270/1