

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

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# Executive Summary

## **Korean Economic Growth for 2010 Projected at 4.6%**

The Korean economy is expected to grow 4.6% in 2010. Quarterly, year-on-year growth is projected at 0.2% in the first quarter, 1.2% in the second quarter, 1.6% in the third quarter and 1.8% in the fourth quarter. Affected by improvements in income and consumer sentiment, domestic demand recovery is likely to quicken amid a favorable export trend expected in line with the realization of the global economic recovery.

In 2010, private consumption is expected to grow 4.8%, owing to improvements in employment and income. Facility investment is also projected to rebound to 9.0% growth from a 9.1% decline last year in expectation of the economic recovery and the increased investment potential at large enterprises. However, construction investment growth is likely to slow to 0.2% in 2010 from a 4.4% expansion last year due to sluggish business conditions. Meanwhile, exports (U.S. dollar basis) are expected to grow about 15%, owing to the recovery trend in the global economy and base effects.

## **Current Account Surplus at US\$20 Bil., Inflation at 3.0%, Won/U.S. Dollar Fx Rate at 1,120 Won-Level**

Influenced by faster growth in imports than exports, greater overseas service demand, etc., the scale of the current account surplus is expected to reach about US\$20 billion in 2010, a sharp drop from US\$42.7 billion in 2009. Exports (U.S. dollar basis) are expected to grow about 15%, owing to a recovery trend in the global economy and base effects while imports are forecasted to grow about 20% due to the domestic economic recovery and import unit price increases.

Affected by the economic recovery and import unit price increases, inflation rate is expected to hit 3.0% in 2010, up slightly from 2.8% in 2009. The Won-U.S. dollar exchange rate is projected to average 1,120 won on an annual basis in 2010 to post a mild declining trend due to a weakening dollar, the current account surplus, etc.

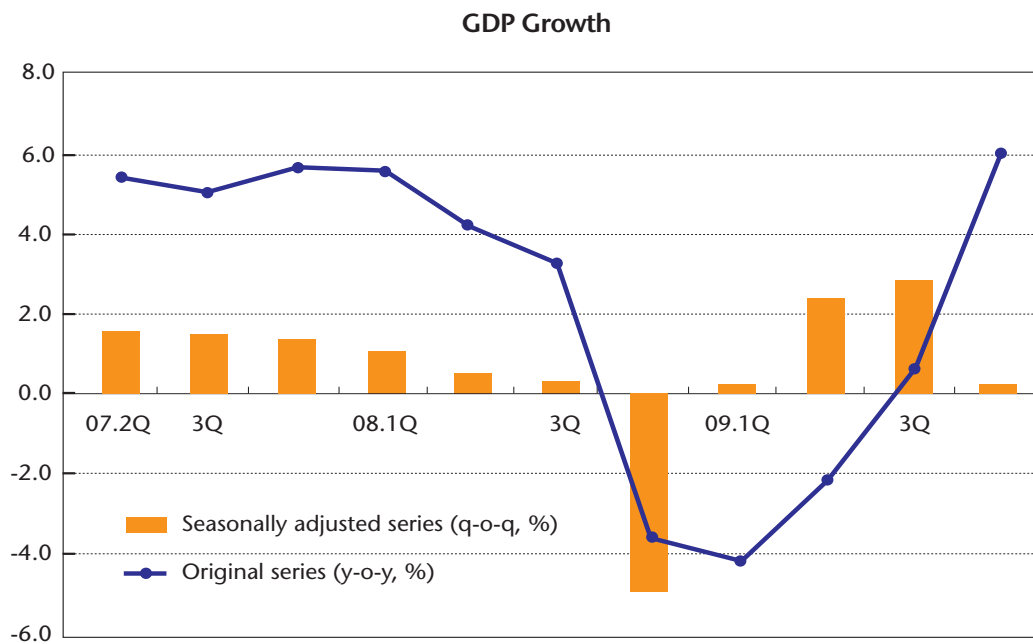
## **Need to Increase Policy Rate to Keep Pace With Economic Recovery**

As the economy is expected to grow faster than the potential growth rate in the second half of 2010, there is a need to advance the timing of a policy rate increase to the first half of 2010. Fiscal policy should expand the private sector's role through tax reduction and smaller government and move toward securing fiscal health.

## Recent Developments

### Slowdown in GDP Growth

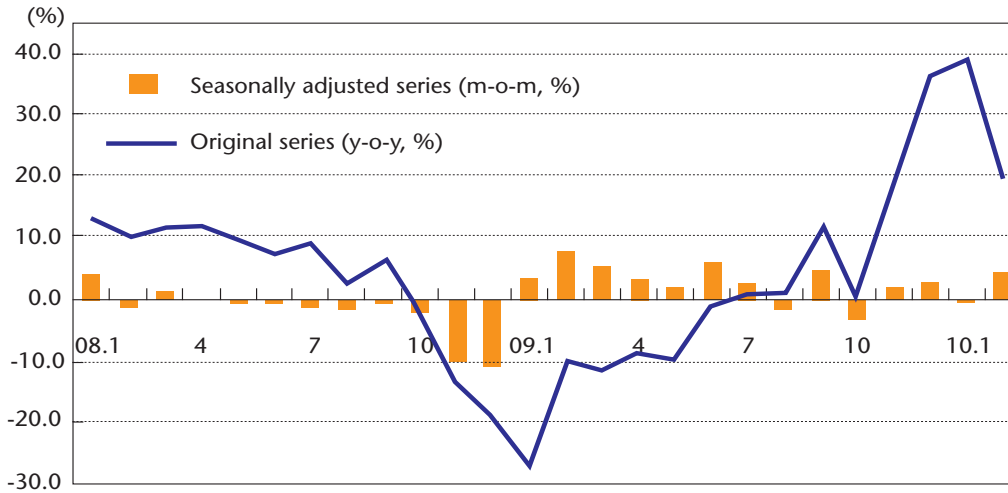
Real GDP, which grew 0.2% in the fourth quarter of 2009, entered an adjustment phase over the previous quarter's fast recovery. However, GDP grew 6.0% year-on-year due to base effects.



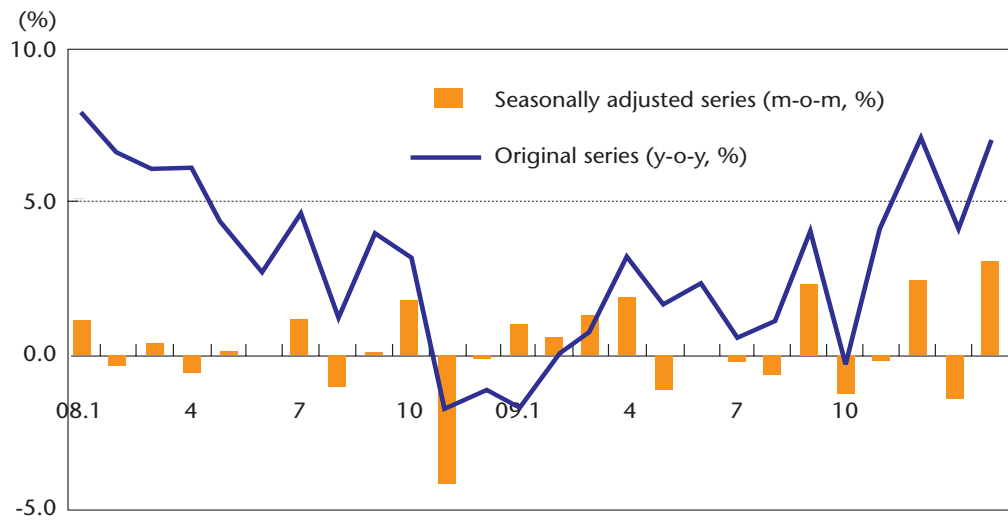
### Production Activities Continue to Recover

Compared with the same month of last year, manufacturing production in February 2010 recorded positive growth for the eighth consecutive month since July last year. Service production in January-February 2010 increased 5.7%, an expansion from 3.7% growth in the fourth quarter.

### Manufacturing Output



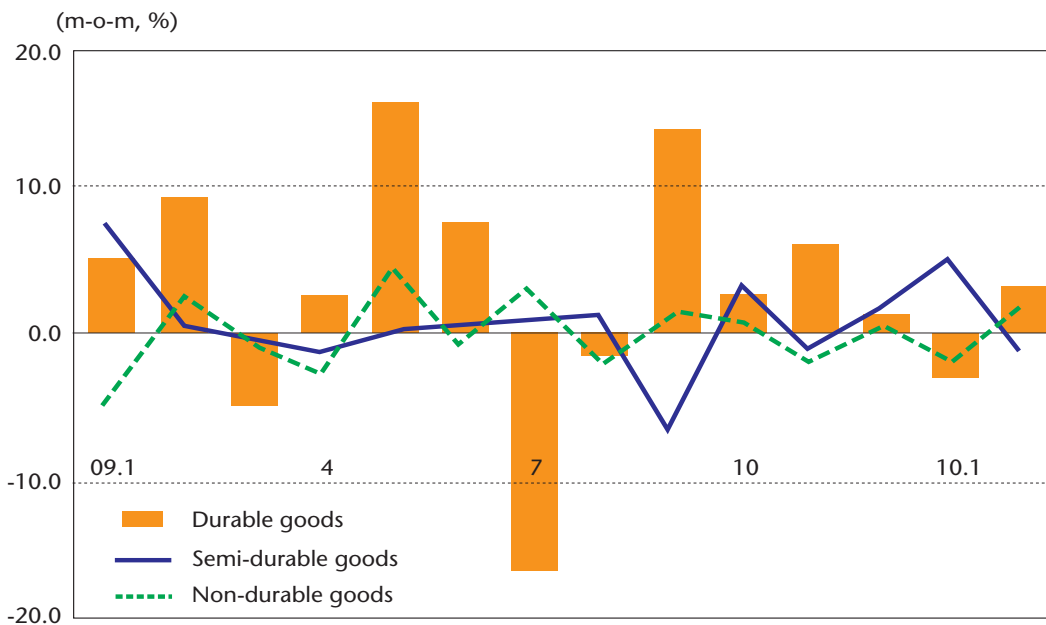
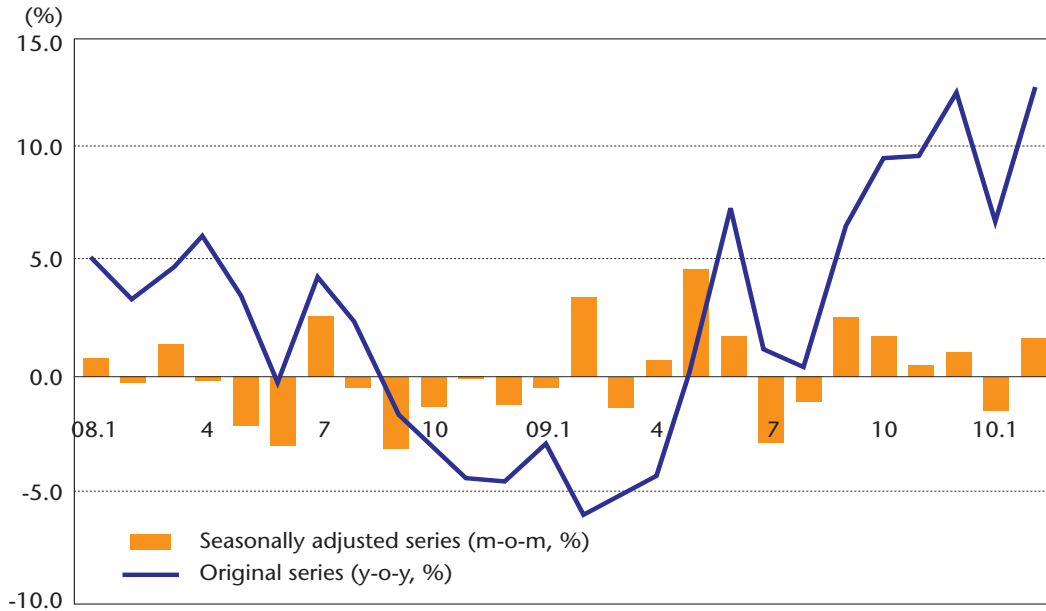
### Service Output



#### Consumer Goods Sales Slowed

The growth of consumer goods sales slowed year-on-year as a result of a sharp slowdown in the sales of durable consumer goods, automobiles, etc.

Consumer Goods Sales



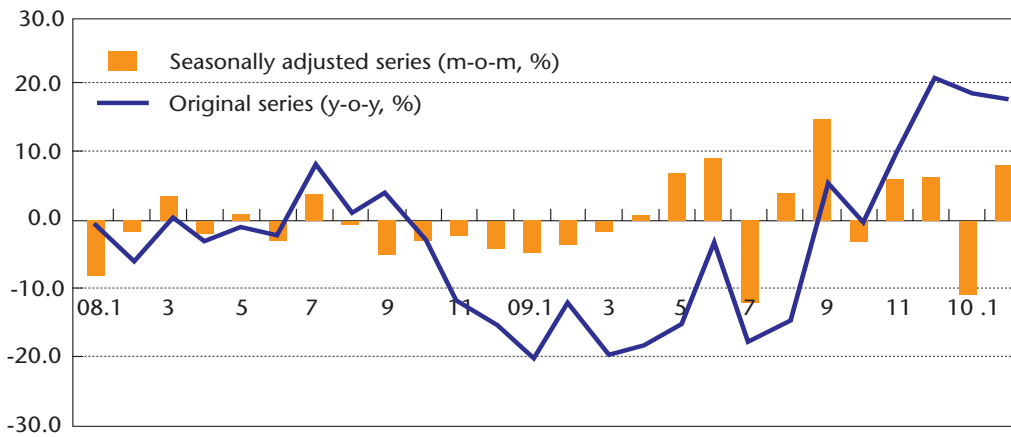
**Facility Investment Recovery  
Tone Slowed**

Due to base effects, facility investment growth in January-February 2010 increased significantly compared with the same period of last year, but returned to a year-on-year decline in March due to investment sluggishness in both machinery and transportation equipment.

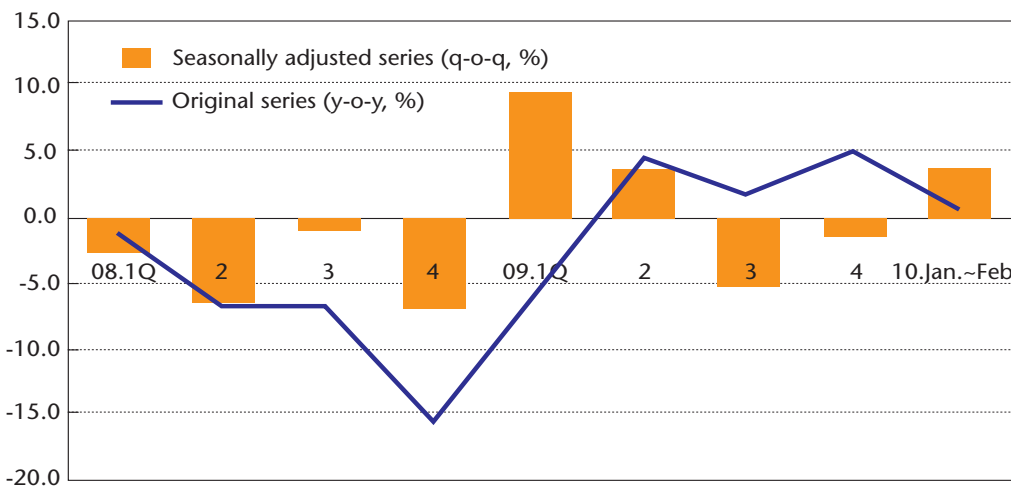
**Construction Investment Growth  
on the Decline**

Construction investment slowed in the public sector amid a lackluster recovery in the private sector.

**Equipment Investment**



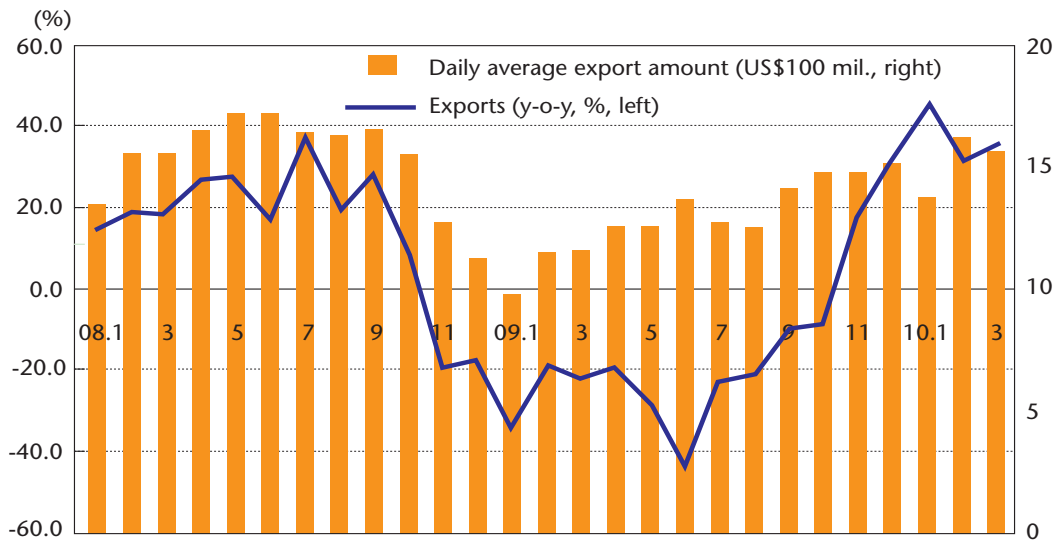
**Construction Investment**



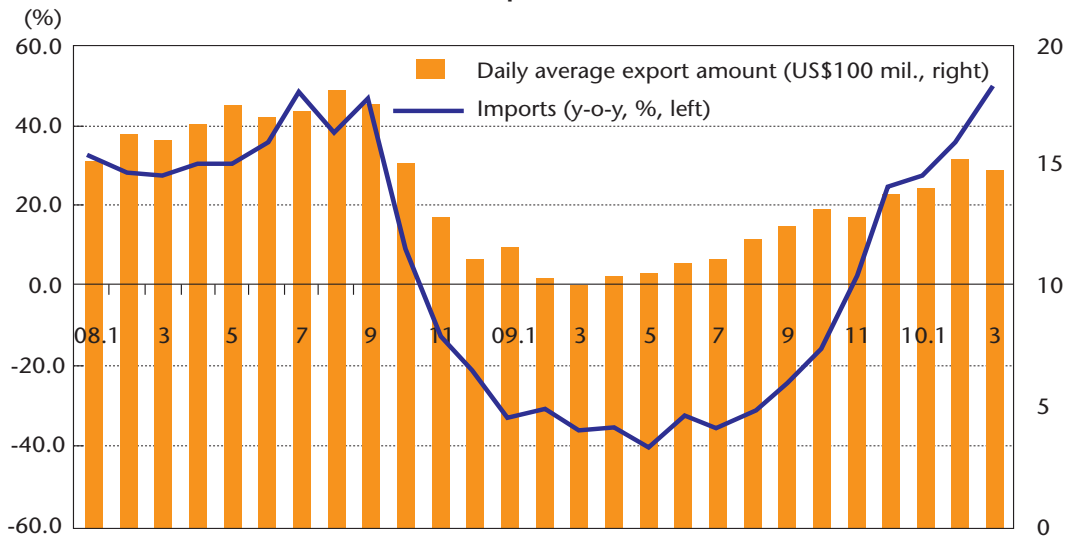
**Exports and Imports Showing Rapid Growth**

Influenced by recovery in the global economy, exports surged 36.6% in the first quarter of 2010 year-on-year, while imports also jumped 37.2% year-on-year due to exchange rate declines, oil price hikes, domestic demand improvement, etc.

**Exports**



**Imports**



## Economic Trends and Outlook

### Current Account Surplus in Jan.-Feb. Contracted to '10 US\$470 Mil.

The current account in January-February 2010 showed US\$470 million deficit due to sharp increases in imports with the continued service balance deficit and the reduced commodity balance surplus.

### Current Account Balance

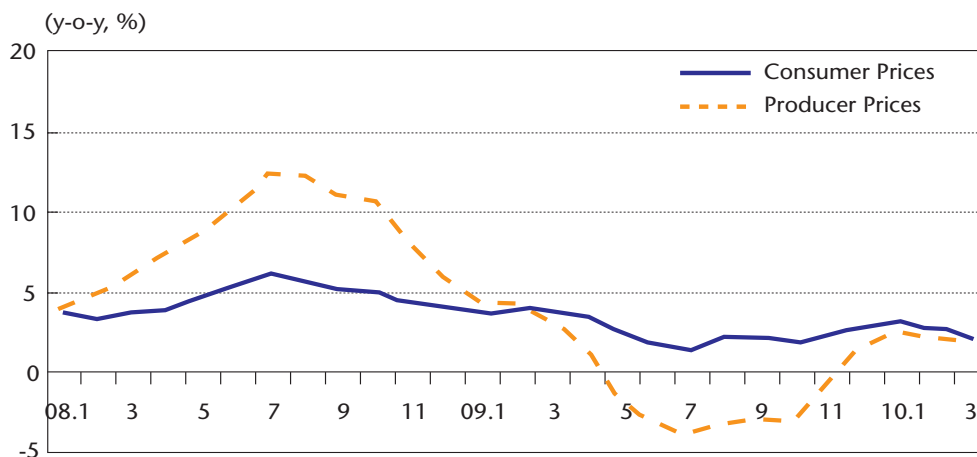
(Unit: US\$100 mil.)

	2009					2010
	1/4	2/4	3/4	4/4	year	1~2
Current Account Balance	86.2	131.0	104.0	105.6	426.7	-4.7
Commodity Balance	83.1	175.8	147.0	155.4	561.3	29.1
Service Balance	-19.3	-41.7	-53.3	-57.7	-172.0	-39.4
Travel Balance	5.2	-10.7	-20.7	-12.7	-38.9	-13.3
Business Service Balance	-32.1	-39.5	-37.2	-49.2	-157.9	-28.4
Income Balance	9.2	2.9	16.9	16.5	45.5	10.3
Current Transfer Balance	13.1	-6.0	-6.6	-8.6	-8.1	-4.7

### Prices Remain Stability

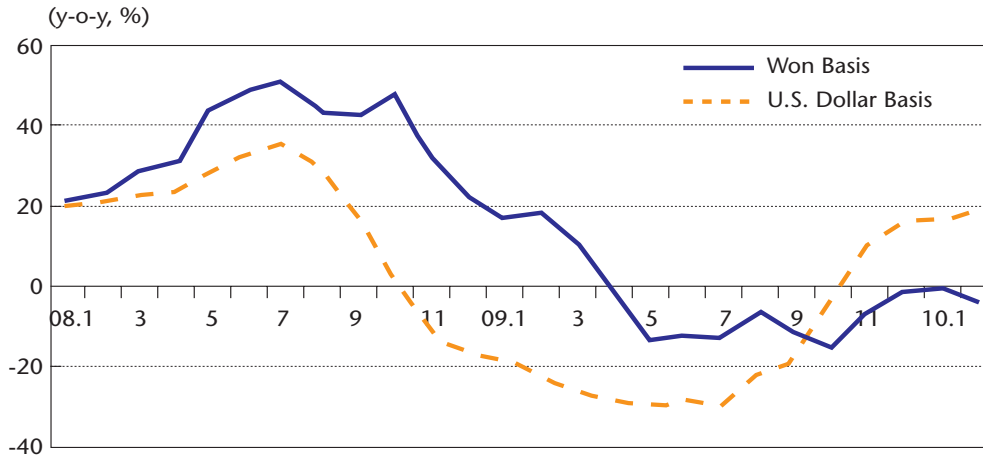
With overseas inflationary pressures being only partially offset by exchange rate declines amid a mild demand recovery trend, import prices (dollar basis) recorded double-digit growth since December last year. However, won currency-based import prices continued negative growth.

### Prices





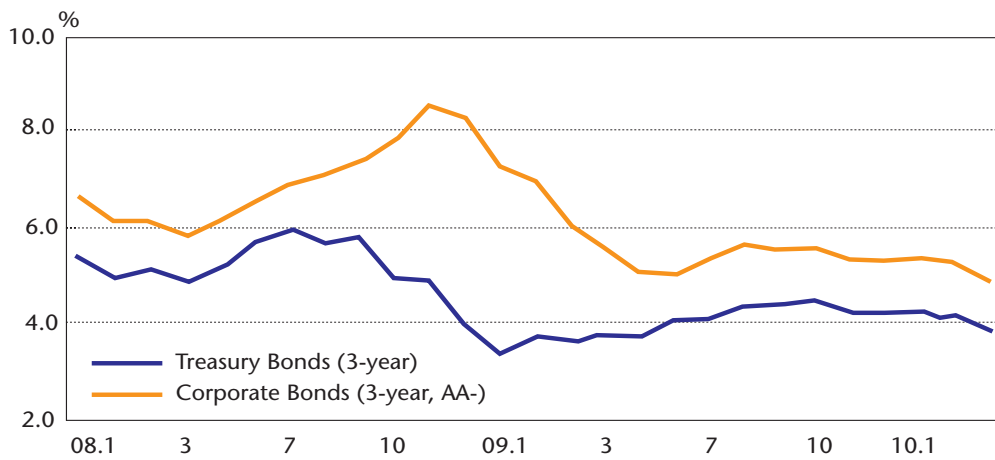
### Import Prices



### Market Interest Rates on Slight Decline

Market interest rates, after showing a rising trend at the end of last year in expectations of economic recovery, slightly declined entering this year as the government maintained expansive financial stance.

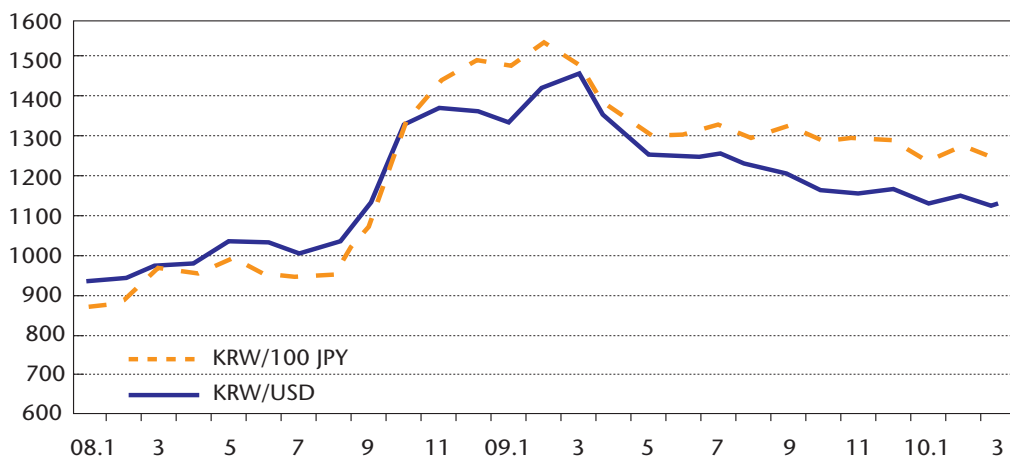
### Interest Rates



**Korean Won Appreciating Since March**

Influenced by robust economic fundamentals in domestic markets, such as the expanding current account surplus and improved environment for supply of foreign capital, the won-U.S. dollar exchange rate has declined.

Exchange Rates



# Outlook for 2010

## 1. Internal and External Environments

### World Economy in 2010 to Post Faster Recovery Than Earlier Expectations

Owing to active policy responses by major countries as international financial and foreign exchange markets show greater stability, a global economic recovery has materialized since the fourth quarter of last year centering on the United States and China. Reflecting this, the IMF made an upward adjustment in its projection for global economic growth this year to 3.9% from the previous 3.1%. Compared with the past, however, the recovery speed is expected to be mild due to the weakening of economic pump-priming, spread of trade protectionism, debt adjustments in advanced countries, etc.

### International Oil Prices to Increase Mildly

With demand for crude oil limited due to a milder global economic recovery trend than in the past, enhanced energy efficiency, etc., international oil prices are expected to rise only slightly to the US\$80/barrel level on the annual average.

### Gradual Increases in Policy Rate Expected

From the perspective of minimizing ill side effects (inflation, asset bubble) from low interest rates, policy rate increases are unavoidable. Considering uncertainty of a recovery in the 'private sector's self-survival power' and vulnerable areas for interest rate hikes, household economy, SMEs, etc., there is a possibility that the government may increase the policy rate gradually.

### Government Budget for 2010 Grew 2.6%

The government budget for 2010 (291.8 trillion won) increased 2.6% compared with 284.5 trillion won in 2009. The annual average budget increase rate for 2005~2009 was 7.9%.

### Major Assumptions for Projections

Exogenous Variables	Unit	2009	2010
China's Growth	%	8.7	10.0
Japan' Growth	%	-5.3	1.7
U.S. Growth	%	-2.5	2.7
Dubai Oil Price	US\$/bbl.	62.0	80.0
RP Interest Rate (end of year)	%	2.00	2.75

### 2. Outlook for Korean Economy

**Growth: 0.2% (2009) → 4.6% (2010)**

In 2010, the Korean economy is expected to continue the recovery trend due to the global economic recovery, base effects, etc. The fact that the expansionary policy tone, such as interest rates cut and expansion of fiscal expenditures, which contributed to improvement in the macroeconomy, is being normalized is serving as a factor restricting a rapid recovery.

**Private Consumption: 0.2% (2009) → 4.0% (2010)**

Despite limiting factors, such as household debt burden, disappearance of automobile purchase incentives and adjustment in asset prices rise, private consumption is likely to post a 4.0% recovery due to improvements in employment and wages, exchange rate decline, etc.

**Construction Investment: 4.4% (2009) → 0.2% (2010)**

Overall construction investment is likely to record a slight increase with the slowdown in the public sector's SOC budget in addition to the delay in private construction recovery caused by the construction business recession.

**Facility Investment: -9.1% (2009) → 9.0% (2010)**

Amid rises in investment pressure caused by the prior investment slowdown, facility investment is expected to achieve a strong rebound based on improvement in the business performance of large enterprises, exchange rate declines, etc.

**Current Account Balance: US\$42.7 Bil. Surplus (2009) → US\$19.9 Bil. Surplus (2010)**

Due to import growth and an expanded service balance deficit, the current account surplus is expected to be markedly lower compared with 2009.

**Export Growth: -13.8% (2009) → 15.1% (2010)**

Despite uncertainty in consumption recovery following household debt adjustments in advanced countries and exchange rate declines, exports are expected to grow around 15% owing to the global economic recovery and base effects.

**Import Growth: -25.7% (2009) → 21.5% (2010)**

Affected by the economic recovery and import unit price increases, imports are projected to grow over 20%.

**Consumer Prices: 2.8% (2009) → 3.0% (2010)**

Due to the influence of the economic recovery and import unit price increases, consumer prices are expected to rise 3.0%, up slightly compared with 2.8% in 2009. Considering deflation gap, mild economic recovery speed, exchange rate declines, etc., inflation is likely to be modest.

**Market Interest Rates: 5.8% (2009) → 5.8% (2010)**

Led by policy rate rises, the economic recovery and increases in the volume of corporate bonds issued, market interest rates are expected to rise gradually and reach 6% level (based on corporate bond yield rates) in the second half of the year.

**Won-U.S. Dollar Fx-Rate: KRW1,278/USD (2009) → KRW1,125/USD (2010)**

Affected by persistent current account surpluses amid a global dollar weakening trend and foreign currency liquidity improvement at domestic banks, the won-dollar exchange rate is expected to decline. With the U.S. economic recovery speed comparatively faster than in the Euro zone and Japan, however, the pace of the decline will be mild.

### Outlook for Korean Economy (2010)

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

	2009	2010						
	Year	1Q	2Q	3Q	4Q	1st H	2nd H	Year
GDP	0.2	6.2	4.7	3.0	4.7	5.5	3.9	4.6
(SA, q-o-q, %)		0.2	1.2	1.6	1.8	0.7	3.1	
Private Consumption	0.2	5.3	4.0	3.0	3.8	4.6	3.4	4.0
Construction Investment	4.4	1.7	-2.8	0.7	1.5	-0.9	1.1	0.2
Facility Investment	-9.1	13.2	10.8	7.3	5.9	11.9	6.6	9.0
Exports (Goods + Service)	-0.8	13.1	5.0	5.5	4.5	8.8	5.0	6.7
Imports (Goods + Service)	-8.2	18.7	16.2	14.8	10.6	17.4	12.6	14.9
Consumer Prices	2.8	2.9	2.7	2.9	3.4	2.8	3.2	3.0
Producer Prices	-0.2	2.7	2.9	2.6	3.0	2.8	2.8	2.8
Current Account	426.7	79.1	52.8	39.5	27.9	131.9	67.4	199.3
Commodity	561.3	117.5	142.7	100.8	80.2	260.2	180.9	441.2
Exports (BOP Base)	3735.8	1023.2	1065.2	1085.1	1124.7	2088.4	2209.8	4298.1
Growth (%)	-13.8	30.9	18.8	10.0	5.1	24.4	7.4	15.1
Imports (BOP Base)	3174.6	905.7	922.5	984.3	1044.5	1828.1	2028.8	3856.9
Growth (%)	-25.7	29.6	27.9	17.2	14.2	28.8	15.6	21.5
Service & Others	-134.6	-38.5	-89.9	-61.3	-52.3	-128.4	-113.5	-241.9
Fx Rate (Avg. KRW/USD)	1278.4	1140.0	1130.0	1120.0	1110.0	1135.0	1115.0	1125.0
Corp. Bonds Yield (3-year, AA-)	5.8	5.3	5.5	6.1	6.4	5.4	6.3	5.8
Unemployment Rate (%)	3.6	4.5	3.8	3.7	3.5	4.2	3.6	3.9

## Policies

### Need for Exit Strategy

'Financial stability,' the condition for implementing an exit strategy, has been achieved in general. Financial and foreign exchange market indicators are stable. The CDS premium has reached its pre-crisis level. And the exchange rate is stable at the 1,100 won level. The credit spread is also narrowing. Although unstable factors still exist, the recovery trend in the real economy is projected to gain momentum in the second half of the year.

The health of debt positions has been enhanced, including the ratio of financial assets to financial liabilities. And the impact of interest rate rises on household consumption is expected to be limited. The ratio of financial assets vs. financial liabilities rose to 219.5% in 2009, up from 197% in the preceding year.

### Fiscal Policy Should Focus on Normalization of Interest Rates in Line With Economic Recovery, Expansion of Growth Potential and Securing of Financial Health

The household debt burden following interest rate increases is not at a level to raise concerns. Increases in delinquent household loans and delays in restructuring of marginal firms that would occur if low interest rates continue are greater threats. Considering economic ripple effects from fiscal expenditures and tax reduction, strategies that pursue expansion of growth engines and financial health through a continuous tax reduction policy and restructuring of financial expenditures are required.

## **Strategies for Promoting Korea's Service Exports**

Research Monograph 09-12

Jang-Hee Yoo

Korea has to plan strategies for expanding exports. First, based on the WTO's principles of trade liberalization, Korea should press ahead with the creation of an environment more favorable to service exports. It is also crucial to be aware of Korea's conditions concerning service exports. As an intangible activity, the supply of services requires that consumers and suppliers meet either in person or via some form of communication, thereby necessitating personal contact. In this respect, suppliers (exporters) of services should be equipped with good character, high levels of knowledge and technology, and consideration for others.

The idea of developing services into an export-oriented industry does not mean disregarding major manufacturing industries, which now enjoy success as a result of the efforts to boost competitiveness. On the contrary, the key point in this argument is that we should learn a lesson from the success story of exporting manufactured goods in the selection of service industries with growth potential and turning them into the export industries.

## **The Permanent Income Hypothesis and Liquidity Constraint: Using Micro Household Data from Korea**

Research Monograph 09-13

Youn Seol

This study examines empirically the permanent income/life cycle hypothesis (PIH/LCH) using household-level data from Korean family surveys. We consider recent economic crises, including the 1997 Asian financial crisis and the 2003 "credit card crisis" and analyze samples split into two groups based on income risk and level.

Results from the split samples considering the two economic crises confirm the existence of excess sensitivity of consumption across different groups for a different sample period. For those in the high income bracket with highly secure jobs (Group 1), empirical results show that consumption does not respond to anticipated income changes after the crises between 1999 through 2004. Therefore, unlike an economic boom when similar patterns are observed among different risk groups in terms of consumer behavior, Group

I takes a rational decision regarding the consumption plan during a recession.

In conclusion, liquidity constraint is not the main cause of excess sensitivity of consumption for the Korean case. In an economic recession, the upper income group makes a rational consumption decision to maintain an optimal consumption plan.

## **AN INTERNATIONAL COMPARISON ON THE DETERMINANTS OF CORPORATE TAX BURDEN AND ITS IMPLICATIONS**

Research Monograph 09-14

Hag-Soo Kim

Korea maintains a corporate tax rate that is below the OECD average, while Korean firms' corporate tax burden slightly exceeds the OECD average. For Korea, the average top marginal tax rate in law since 2000 is 29%, including local taxes, which is the 7th lowest among 21 countries included in the analysis. However, the average ratio of corporate tax reduction for Korea is estimated as about 29%, while the OECD average is 35%, which seems to explain why the corporate tax burden for Korea measured as the ratio of corporate tax burden to nominal GDP is relatively high at the OECD average.

## **Climate Change: Threats or Opportunities?**

Research Monograph 09-15

Youngduk Kim, Gyeong Lyeob Cho

This study surveyed the status of climate change negotiations as well as climate change policies in major economies. Facing imminent threats from climate change policies, many countries and their business sectors seek strategies and policies to turn risks into the business opportunities in a changing environment as exemplified in the cases of GE and Goldman-Sachs. This study also surveyed the emerging green markets in Korea as well as around the world.

The priority of the business sector should on the establishment of a GHG inventory system for firms and in pursuing opportunities to save energy or improve energy efficiency economically. Next firms need to



investigate business opportunities in green product markets and to develop business strategies to enter those markets. The business sector as a unified body should involve itself in the climate change policy-making process in the public sector.

### **An Empirical Study on the Effect of Internal Governance Mechanisms on Management Efficiency**

Research Monograph 09-16

Hyun Jong Kim

Using Korean listed-company data from 2001 to 2008, we examine how corporate internal governance mechanisms such as ownership control structure, board structure and foreign stockholders affect agency costs like management efficiency. Our results show that the increased ratio of outside directors on the board of directors that is required by regulation does not reduce agency costs. These results imply that the role of outside directors does not work as an internal governance mechanism, and so the regulation on the outside director ratio needs to be modified. On the other hand, empirical work shows that management efficiency is not affected by ownership structure. This means that increases in controlling-shareholder ownership and control right disparity does not reduce management efficiency.

### **Government Failure and The Global Financial Crisis**

Research Monograph 09-17

Yoong-Deok Jeon and Hag-Soo Kim

In this paper, the Austrian Business Cycle Theory (ABCT) is examined both theoretically and empirically. The ABCT in a nutshell asserts that a boom and bust cycle occurs as the government keeps the interest rate below the natural rate of interest by increasing money supply.

The ABCT and supporting empirical evidence point out that government failures are the cause of the economic crisis. It is also implied from the empirical results that the policies currently implemented will lead to another huge bust in the future.

## Trust and Economic Growth

Research Monograph 09-18

Byoungki Lee

This study offers in-depth analyses on trust as a representative element of social capital in an effort to look into its economic role and its relevance to economic growth. Below is an overview of our research results so far.

First, this study finds statistically significant positive coefficients for trust. Second, how interest groups exemplified by Putnam group and Olson group have an effect on economic growth is examined, and the results suggest that economic growth is hampered by increasing economic participation of the Olson group. Third, according to the analysis of macroeconomic factors contributing to changes in trust, critical factors to enhancing social trust include rooting out corruption, improving the quality of government officials, establishing law and order, protecting property rights, and guaranteeing greater economic freedom. Fourth, the analysis of individual-level determinants of trust indicates that higher levels of social trust tend to be among people with conservative ideology, highly-educated individuals, and Protestants. Fifth, in contrast to that of Nordic countries, Korea's confidence in institutions remains relatively low and even deteriorating as time goes by.

## An Analysis of Trade Patterns and Implications for Economic Integration in East Asia

Research Monograph 09-19

Wongun Song

This study explores the reasons for the limited development of East Asian internal markets by analyzing the internal trade structures and patterns of trade in East Asia. The trends of national and regional proportions of trade in each country are derived and then several characteristics of internal trade in East Asia are identified. First, the proportion of internal trade in East Asia has increased considerably. Second, internal trade is becoming more dependent upon China but the role of Japan in East Asian internal trade is tapering off. Third, China's dependence on internal trade, especially in terms of exports, has decreased recently.

The East Asian economy may be hit hard by the process of rebalancing global imbalances. Thus, in order to expand internal markets and market segmentation, internal trade should be highly liberalized to accelerate internal demand and market integration in East Asia.

## **A Tale of Korea's Two Crises: Distinct Aftermaths of 1997 and 2008 Crises**

Research Monograph 09-20  
Chan\_Guk Huh

Two economic crises that have visited the Korean economy have given rise to more pressing real-time challenges. What happens with respect to the growth trajectory in the post 2008 period is a point of great interest in this regard. In the wake of the 1997 crisis, both economists and policy makers took the view that the pre-crisis period growth trend was not sustainable and deceleration in growth was to be welcomed for a more stable profile of economic performance over time. Despite the distinctly lower growth profile since the late 1990s, Korea's economy ran into difficulties in 2003 due to a domestic cause (credit card burble and bust) and again in 2008 due to a truly large external shock. This suggests that the improvements in the soundness of the Korean economy might have been somewhat limited.

## **Analysis on Recent Trend of Polarization and Inequality: Approach Using Household Demographics**

Research Monograph 09-21  
Youn Seol

This study examines whether polarization has become more serious using 1994-2007 household surveys of Korea based on a recently developed method for assessing polarization. While previous studies indicate that income polarization in Korea reached a serious level using labor income since the 1997 Asian financial crisis, this paper concludes that there is no evidence for increasing polarization of income. This result is robust for empirical analysis using disposable income, including that of those who are self-employed. On the contrary, polarization in consumption expenditure shows a decreasing trend. When households are classified according to the occupation of the household head and the line of business he or she is engaged in, there are no significant differences. However, high school graduates and college graduates have quite different outcomes, implying the existence of polarization in terms of education level. In addition, the polarization of education expenditure has deepened since 2001, calling attention to the need for policy measures to address this.

## Assessment and Implications of the National Target in Reducing Greenhouse Gases

Research Monograph 10-01  
Gyeong Lyeob Cho

This study empirically assesses the national target for reduced greenhouse gas emissions announced by the government. Since the actual amount of greenhouse gases that we need to curtail depends on how far the Korean economy has advanced, two types of scenarios, where the economy achieves low or high growth, are provided to assess the national reduction target. According to our research results, the average annual GDP losses during the period between 2020 and 2050 are projected at 2.76% and 3.35% respectively for the two cases. Therefore, it is recommended to set the 2020 reduction rate at 25%, five percentage points lower than the original national target, and to move to reduction rates higher than the national target by 6~10 percentage points in 2050 (56~60%) based on cost-effectiveness.

## The Impact of Labor “Flexicurity” Policy on Labor Market Performance in OECD Countries

Research Monograph 10-02  
Park Sung-Joon

In this study, the possibility of replicating the Dutch or Danish performance in the labor market is explored in the case of adopting such policy in 22 OECD countries. Our research results show that “flexicurity” policy is likely to bring significant benefits in the labor market, as illustrated by growth in the employment rate, decline in the unemployment rate, and some progress in alleviating poverty. Therefore, policies that promote labor “flexicurity” can have a far-reaching positive effective on labor-market performance, which is not limited to a few countries in Central or Northern Europe. Despite striking differences in inherent conditions, OECD countries can be expected to enjoy favorable outcomes from adopting the same policy as that of their Central or Northern European counterparts.

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