KERI Economic Bulletin

Korea Economic Research Institute

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KERI

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Korea Economic Research Institute

What is KERI?

Korea Economic Research Institute (KERI), a private economic research institute, was founded on April 1, 1981. Its purpose is to contribute to the growth and development of the national economy through "the building of an efficient free-market economy system and the nurturing of healthy corporate growth." Our scholars are conducting integrated research on both the entirety of the Korean economy and the long- and short-term prospects for corporate growth. We are vigorously working towards becoming a world-class think tank. The founding concept and basic philosophy of our research institute is "Free Market, Free Enterprise, Free Competition."

Next year, it is projected to experience some slowdown in economic growth that is caused by worsening foreign environment including economic slowdowns in major countries and global interest rate hikes, and also by rising domestic uncertainties from the presidential election and consequent political turmoil. The recent nuclear test of North Korea will be additional factor in further slowing the nation's economic growth. The degree of negative impacts from the nuclear test will depend on how the incidence further develops in the near future.

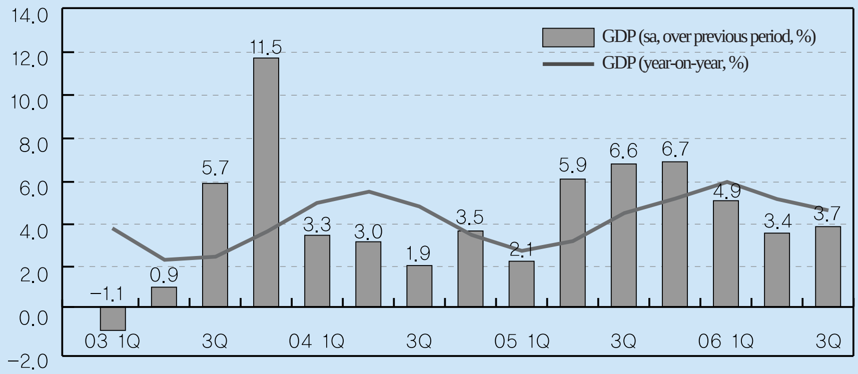
If economic sanctions on North Korea are imposed internationally and consequently disharmony between the South Korean government and other nations regarding the Mt. Keumgang tour project, Kaesung Industrial Complex, PSI engagement, etc. and domestic friction occur, the rate of economic growth next year is expected to be less than 4%, affected by contractions in household consumption and corporate investment sentiment, greater price fluctuations, decline in external confidence, reduction in capital inflows and others.

If North Korea reacts strongly against the economic sanctions and the engagement of PSI with another nuclear test and in turn stronger economic sanctions are imposed and even military tensions are further developed, the growth rate is projected to fall below 2% affected by capital outflows following a sharp fall in national credit rating and limited economic activities in line with the spread of social uncertainty sentiment.

In such case, the government will need to implement a crisis management system for the whole economy, considering it a national crisis situation. It should consider preparing an additional supplementary budget and endeavor to secure a more stable currency value and finance system and should also undertake a temporary suspension of some or all foreign exchange transactions.

Real GDP growth at SAAR(seasonally adjusted annual rates) in the third quarter of this year has slowed at the 3% level, following 3.4% growth in the second quarter. The main factor in stagnated GDP growth is the continuous decline in growth rate of private consumption, from 5.2% in the first quarter to 3.7% and 1.9% in the second and third quarters.

Real GDP



Production at manufacturing sector has been brisk, but the trend of growth in service sector is slowing gradually. Manufacturing production rose 10.9% in the third quarter, maintaining double-digit growth, while the average factory operating rate maintained the 80% level for the quarter. On the other hand, due to continuing contraction in private consumption, growth trend of service activities has declined gradually from 6.1% in the first quarter to 5.3% in the second quarter and 3.2% in the July-August period.

Sales growth in consumer goods, a representative consumption indicator, declined to 2.1% in the third quarter from 5.2% in the first half of the year, and from 5.6% in the second half of last year.

Meanwhile, facility investment growth increased to 4.5% in the first half of this year and 9.8% in the third quarter from last year's 3.3%. Construction investment, which had been sluggish for a while, also grew

6.3% in the third quarter with a sharp increase in public and private construction on general civil projects owing to flood damage restoration activities, and others.

Industrial Output, Consumption and Investment

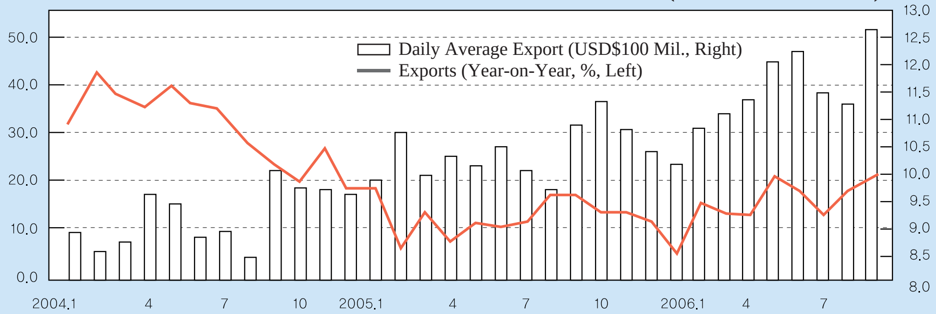
(Unit: Year-on-Year,%)

		2005					2006		
		1/4	2/4	3/4	4/4	Year	1/4	2/4	3/4
Industrial Output	Manufacturing	3.3	3.4	7.3	10.4	6.2	12.6	11.4	10.6
	Services	0.7	2.5	5.4	5.8	3.6	6.1	5.3	4.1
Consumption	Wholesale & Retail sales	-0.8	3.0	4.0	4.5	2.7	3.6	4.1	4.1
	Consumer Goods Sales	1.2	3.4	4.4	6.8	3.9	5.0	5.5	2.1
Investment	Estimate of Facility Investment	3.9	1.5	1.0	7.0	3.3	4.6	4.3	9.8
	Domestic Construction Completed	1.9	9.6	3.8	6.9	5.7	5.9	1.3	6.3

Exports are continuing a brisk trend with 16.6% growth in the third quarter following 16.9% of the second quarter expansion. Exports of semiconductors and automobiles have maintained a favorable tone but exports of computers and wireless communication equipments have continuously experienced slowdowns.

Exports

(Unit: USD100 Million)



The current account balance rebounded to a surplus of USD0.3 billion in the third quarter from a deficit of USD0.4 billion in the first half. Compared with the USD2.7 billion surplus in the third quarter of last year, however, it is off about USD2.3 billion due to a decline in the commodity account surplus and an expanded service account deficit.

Balance of Payments

(Unit: USD1 billion)

	2005					2006		
	2/4	July	3/4	4/4	Year	1/4	2/4	3/4
Current Account	2.6	1.5	2.7	5.4	16.6	-1.1	0.7	0.3
Goods Account	8.6	3.2	7.6	8.1	33.5	5.2	7.4	6.3
Service Account	-3.2	-1.5	-4.3	-2.5	-13.1	-5.0	-3.9	-5.5

The inflation trend is accelerating. The CPI inflation recorded 2.5% in the third quarter, posting an increase of 0.2% point from 2.3% in the first quarter. The PPI inflation also expanded gradually from 1.7% in the first quarter to 2.4% in the second quarter and to 3.1% in the third quarter.

Prices

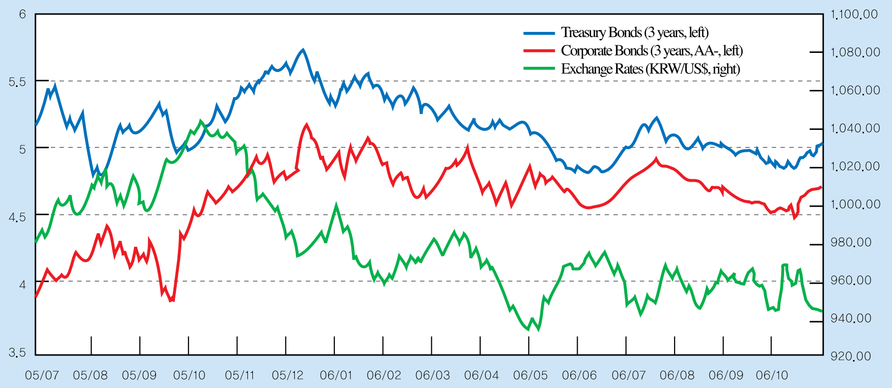
(Unit: Year-on-Year, %)

	2005					2006		
	1/4	2/4	3/4	4/4	Year	1/4	2/4	3/4
Consumer Prices	3.1	3.0	2.4	2.5	2.8	2.4	2.3	2.5
Producer Prices	3.3	2.2	1.7	1.5	2.2	1.7	2.4	3.1

Market interest rates, which had maintained a downward trend since July, rose slightly in October due to higher long-term interest rates and a freeze in the call interest rate target following a favorable turn in U.S. economic indicators.

Entering the second half, won-dollar exchange rates are fluctuating at the 950~960 range. It is attributed to both won appreciation and won depreciation factors: the former(dollar depreciation factor) is due to the freeze in U.S. interest rate increase and expanded current account deficits, and the latter is due to domestic economic stagnation, current account deficits, and net outflows of foreign capital in the stock market.

Interest Rates and Exchange Rates



1. Domestic and External Environments

The global economy is projected to be sluggish, affected by oil price instability and global interest rate hikes. The international oil price (Dubai crude) is expected to remain in the neighborhood of USD60/barrel, influenced by both price-reduction factors such as decline trend of demand growth and increase in crude oil production by non-OPEC countries, and price-push factors such as supply uncertainties in line with geopolitical risks and OPEC's reduced production to cope with oil price declines.

When taking into consideration the progress of the Korea-U.S. FTA negotiations to date, there is a good possibility that the FTA concludes next year. If so, the agreement is expected to have a positive effect on the Korean economy. Meanwhile, as negative impacts related to North Korea's nuclear test and the political situation with regard to the presidential election are expected at the same time, the government is also expected to take active measures to boost the economy, including some deregulation policies and various policies targeting to prevent a sharp decline in economic conditions that may be caused by such negative impacts.

2. Economic Outlook for 2007

Possible Scenarios Following North Korea's Nuclear Test

Scenario A: There is disharmony between the Korean government and other nations regarding a high-degree of PSI engagement, the Mt. Keumgang tour project and business at Kaesung Industrial Complex, and consequently domestic friction deepens. Then, geopolitical risks will become greater and Korea's sovereign credit ratings will fall.

Scenario B: North Korea reacts strongly against the economic sanctions and the engagement of PSI with another nuclear test and, in turn, stronger economic sanctions are imposed and even military tensions are further developed.

Prospects Based on the Scenario A

- GDP growth rate: 4.8% in 2006 → 3.8% in 2007.

With a growth slowdown trend continuing in all segments of the economy, North Korea's nuclear situation further causes contraction of household consumption and corporate investment sentiments, greater fluctuation in major price variables, decline in Korea's national credit rating, and decrease in capital inflows, and these are likely to serve as additional negative factors in the slowdown of economic growth.

- CPI inflation: 2.5% in 2006 → 2.9% in 2007

Increasing geopolitical risks will boost rising domestic prices through increase in the foreign exchange rate.

- Market interest rates(corporate bond, 3-year, AA-): 5.2% in 2006 → 4.7% in 2007

With growing financial market uncertainties due to economic recession and North Korea's nuclear test, expansionary monetary policies are expected.

- Won-Dollar exchange rate: 961 in 2006 → 972 in 2007

Factors causing the exchange rate increase may arise from fundamental aspects such as an economic slowdown and current account deficits. Uncertainties related to North Korea's nuclear test are expected to exacerbate the situation.

- International balance of payments

International balance of payments will be worsen due to decrease in the number of foreign visitors, reduction in capital inflows, and others.

Prospects for Domestic Economy in 2007 (Scenario A)

(Unit: Year-on-Year, %, USD100 Mil.)

	2005	2006					2007
	Year	1/4	2/4	3/4	4/4	Year	Year
GDP	4.0	6.1	5.3	4.6	3.6	4.78	3.8
(SA, Year-on-Year, %)		4.9	3.4	3.7	2.5		
Private Consumption	3.2	4.8	4.4	3.9	3.3	4.1	3.3
Construction Investment	0.4	1.2	-3.9	-1.3	-1.1	-1.5	0.8
Consumer Price	2.8	2.3	2.4	2.5	2.6	2.5	2.9
Current Account Balance (USD100 Mil.)	165.6	-11.2	6.9	3.4	23.1	22.3	-30.6
Commodity Account Balance (USD100 Mil.)	334.7	52.2	74.1	63.0	73.0	262.4	223.9
Exports (USD100 Mil., BOP Basis)	2890.0	758.0	821.3	853.5	884.8	3317.6	3642.7
Growth (%)	12.1	11.4	16.3	18.0	13.5	14.8	9.8
Imports (USD100 Mil., BOP Basis)	2555.2	705.8	747.1	790.6	811.8	3055.2	3418.8
Growth (%)	16.4	19.8	20.5	22.0	16.2	19.6	11.9
Service Account Balance and Others	-169.1	-63.4	-67.2	59.6	-49.9	-240.1	-254.5
Exchange Rates (Won/USD, Average)	1024	976	949	958	960	961	972
Corporate Bond Yield Rates (3 Years, AA-)	4.7	5.4	5.2	5.1	4.9	5.2	4.7

Source: KERI's Quarterly Projection Model

Prospects Based on the Scenario B

- GDP growth rate: 3.8%(Scenario A)→1.9%(Scenario B)

Due to a steep decline in national credit rating, costs for capital supply will increase and capital outflows will accelerate. During the last foreign exchange crisis, Korea's national credit rating dropped dramatically below investment grade (Baa3, Moody's and BBB-, S&P and Fitch).

With the spread of social unrest sentiment, smooth consumption activities will be interrupted. The corporate investment will also be reduced due to sharp increases in prices and interest rates.

- CPI inflation: 2.9%(Scenario A)→5.2%(Scenario B)

As a result of foreign exchange rate hikes, import prices will surge sharply and panic buying may occur for raw materials and daily necessities.

- Market interest rates(corporate bond, 3-year, AA-): 4.7%(Scenario A) →5.6%(Scenario B)

Monetary authorities will likely increase interest rates to curb a sharp rise in foreign exchange rates following a steep drop in the bond prices and rapid outflows of foreign capital.

- Won-Dollar exchange rate: 972(Scenario A)→1,048(Scenario B)

Due to heightened uncertainties, foreign capital outflows will be expected at a rapid pace and panic buying for a stable currency such as U.S. dollars may occur, causing a sharp increase in won-dollar exchange rate.

- International balance of payments

The decline of the national credit rating below investment grade would accelerate rapid outflows of foreign capital and worsen the capital balance. (During the foreign exchange crisis, the capital balance posted a deficit of USD10.8 billion for the two months of November and December 1997.)

Comparison of Economic Prospects for 2007 by Scenario

	2007		
	Scenario A	Scenario B	B - A
GDP (%)	3.8	1.9	-1.9%p
Private Consumption (%)	3.3	0.9	-2.4%p
Construction Investment (%)	0.8	-2.5	-3.3%p
Facilities + Intangible Fixed Assets (%)	5.7	0.1	-5.6%p
Consumer Prices	2.9	5.2	2.3%p
Exports (Int'l Balance of Payments Basis, %)	9.8	5.3	-4.5%p
Imports (Int'l Balance of Payments Basis, %)	11.9	4.1	-7.8%p
Exchange Rates (won/USD, Average)	972	1048	KRW76/USD
Corporate Bond Yield Rate (3 Years, AA-, %)	4.7	5.6	0.9%p

Source: Korea Economic Research Institute (KERI)

Policy Tasks Targeting the Scenario A

Economic policy measures to alleviate the depressed sentiments of economic actors are necessary. In this case, it is desirable that the government pursues microeconomic policies such as deregulation and system improvement at a higher priority on the advance of macroeconomic policies.

For fiscal policy, the government should reallocate welfare budget to the areas with the potentials to expand growth engines and address to economic revitalization through extension of temporary investment tax exemptions, reduction or abolition of special excise taxes, temporary cuts in income and transaction taxes, etc.

For monetary policy, the government should pursue reinforcement of supervision and liquidity supply, and if necessary, it should lower interest rates to prevent financial limitations. In addition, the government must strengthen its monitoring of the foreign exchange market, and if necessary, it will have to intervene the market to seek stabilization through a market smoothing operation.

Policy Tasks Targeting the Scenario B

The government should prepare for a rapid contraction of domestic economic conditions due to a national crisis situation with mobilization of a risk management system for the whole economy.

With regard to fiscal and tax policies, the government should prepare for a supplementary budget and allocate it to public construction investment projects already underway and should also consider temporary expansion of non-taxation, tax exemption, etc.

For monetary policy, the government must make efforts to secure the currency value in the medium- and long-term as well as to stabilize the finance system rather than to prescribe temporary boosting of the economy. With regard to foreign exchange policy, the government should monitor the potential for massive capital outflows closely, and when deemed necessary, it should implement a temporary suspension of some or all foreign exchange transactions in accordance with Article 6 of the Foreign Exchange Transactions Act and Article 11 of the Enforcement Decree of the Act.

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