

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

Contents

Executive Summary	02
Economic Trends and Outlook	03
Recent Developments	
Outlook for 2017	
Policy Issues	



Korea Economic Research Institute

Executive Summary

Korea's growth rate for 2017 expected to be 2.1%, lowered by 0.1%p than the previous forecast

The growth rate is projected to be 2.1% in 2017, lowered by 0.1%p than the previous forecast in September. In accordance with domestic, as well as global factors, the 2017 forecast is adjusted downward by 0.3%p than 2016. While in a domestic sense, the effectiveness of monetary, fiscal and foreign exchange rate policy are all regarded as limited, the heightened uncertainty of world growth also influences the growth rate. The weak global trade is likely to sustain in 2017 owing to the high possibility of epidemic anti-globalization trend, ignited by the US election. French presidential election is to be held in between this April and May, and while for Germany, it's between September and October. To make matters worse, the additional fiscal expenditure is now regarded as obsolete.

Again in 2017, low price, low interest rate & abundant trade surplus will prevail

The overall consumer price is projected to soar marginally by 1.2% in 2017 compared to this year's 1.0%. Amid the restriction of crude oil price increase and the appreciation of KRW, sluggish growth will likely lower the probability of consumer price to rise. The trade surplus is forecast to slide down to US\$93.5 billion in 2017, compared to US\$97.5 billion this year. The huge current account surplus is likely to be on a gradual decline as the good's import loss and service deficit grow. USD/KRW will rise gradually in the 1st half in 2017 owing to the influence of Trump's election and European political uncertainty, which is projected to gradually revert down in the next half to 1,152 won reaching to the year's average. The market interest rate (Corp AA-, 3yr) is expected to rise by small margin as 2.3% in 2017 from 1.9% in 2016 for US tapering shall have a limited effect on the Korean market, growth rate of the Korean economic growth is weakening, and low inflation rate is expected to sustain.

Korea's social conflict index ranked in the 3rd place among OECD member countries; a distinct vision is in an urgent need to alleviate the conflict between genders and generations

The social conflict index, assessing the conflict between genders and generations, as well as conflict management capacity is gauged along with other OECD members. Korea ranked at 3rd for having intensified conflicts between genders and generations, and lacking a government's conflict management capacity. The bright point is that the conflict management skill of government has improved consistently since 2004. Thus, if a long term vision to assuage the conflict between genders and generations were being suggested, Korean society can fully assimilate the ability to manage the social conflicts.

Recent Developments

3Q, the growth rate lowered by 0.2%p to 0.6%

The q/q growth rate of Korean economy is crawling below 1.0% since the 3rd quarter of 2015, for 4 consecutive quarters from the 3rd quarter of 2016. The latest quarterly growth rate recorded only 0.6% as waning effect of certain policy measures becomes more distinct. The over-year-ago basis growth rate plummeted by 0.7%p to 2.6% as well. The government's capacity to hold up the growth rate was not reached to the required level for offsetting the sluggish private consumption, construction and facilities investments.



Source: The Bank of Korea

Gradual drop of the q/q growth, led by weak private consumption and facilities investment

The domestic contribution to GDP growth recorded 1.4%p reflecting increase in government spending and construction investment is weighing on decrease in private consumption and facility investment. Externally, the contribution of net export deteriorated from -0.3%p to -0.8%p owing to the outpaced import on the export contribution.

Contribution to GDP growth by Expenditure

(Unit: %p)

(SA, real)	2014				2016		
	1/4	2/4	3/4	4/4	1/4	2/4	3/4
Final consumption expenditure	0.5	0.1	0.8	0.8	0.1	0.5	0.5
Private consumption	0.4	-0.1	0.6	0.7	-0.1	0.5	0.3
Government expenditure	0.1	0.1	0.2	0.2	0.2	0.0	0.2
Gross capital formation	0.4	0.5	1.1	0.2	-0.3	0.7	0.9
Gross fixed capital formation	0.9	0.3	0.7	-0.3	0.3	0.8	0.6
Construction investment	0.8	0.3	0.5	-0.4	1.0	0.5	0.5
Facilities investment	0.0	0.1	0.2	0.0	-0.6	0.2	0.0
Intellectual property products	0.1	0.0	0.0	0.0	0.0	0.1	0.0
Changes in inventories and acquisition	-0.5	0.2	0.5	0.5	-0.6	-0.1	0.3
Exports of goods and services	0.4	0.0	-0.1	1.0	-0.5	0.5	0.3
Imports of goods and services	0.4	0.2	0.6	1.4	-1.4	0.8	1.1

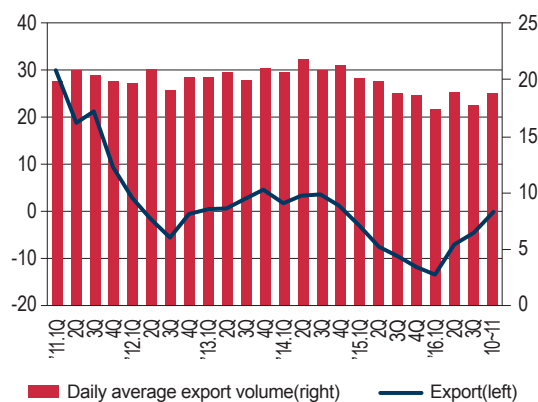
Source: The Bank of Korea

Sustaining the recovery rate on export (on a custom clearance basis) : -13.6%(1Q16) → -6.7%(2Q16) → -5.0%(3Q16) → -0.2%(The monthly average between Oct. and Nov.)

The balance of trade with respect to China has continuously shown auspicious figures, whilst the trade with ASEAN and Japan generated dramatic surplus in between October and November. By product, the export volume of vessels and semiconductor has expanded, while export loss on the auto parts, home appliances and flat panel display has been alleviated. However, the daily average volume of export had fluctuated due to the working days: US\$1.73 billion(1Q16) → US\$1.88 billion(2Q16) → US\$1.78 billion (3Q16) → US\$1.88 billion (the monthly average between Oct and Nov).

Export Growth and the Daily Average Export Volume

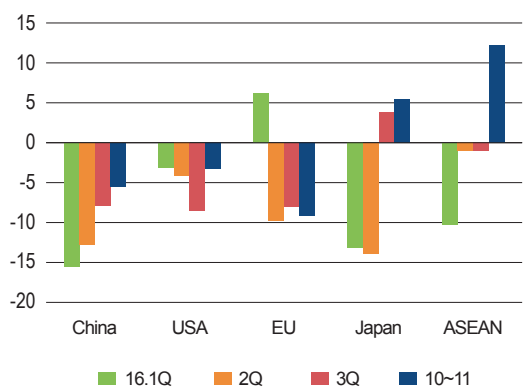
(Unit: left-oya%, right-US\$100mil)



Source: MOTIE, Korea Customs Service

Export Growth by Destination

(Unit: oya%)



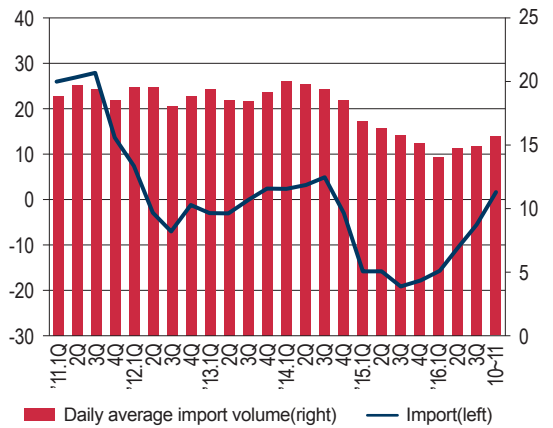
Source: MOTIE

Sustaining the recovery rate on import (on a custom clearance basis) : -16.1%(1Q16) → -10.2%(2Q16) → -5.2%(3Q16) → 2.4%(The monthly average between Oct. and Nov.)

The loss on import for commodities has continuously recovered: -25.3%(1Q16) → -18.8%(2Q16) → -8.5%(3Q16) → -3.8%(the monthly average between Oct and Nov). The daily average import volume has been on the rising trend as well: US\$1.41 billion(1Q16) → US\$1.48 billion(2Q16) → US\$1.49 billion(3Q16) → US\$1.56 billion (the monthly average between Oct 1st and Nov 20th).

Import Growth and the Daily Average Import Volume

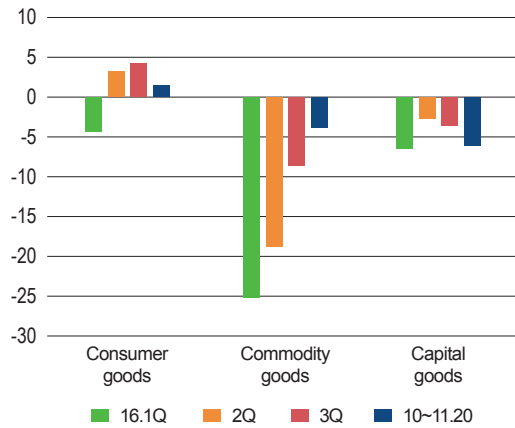
(Unit: left-oya%, right-US\$100mil)



Source: MOTIE, Korea Customs Service

Import Growth by Usage Type

(Unit: oya%)

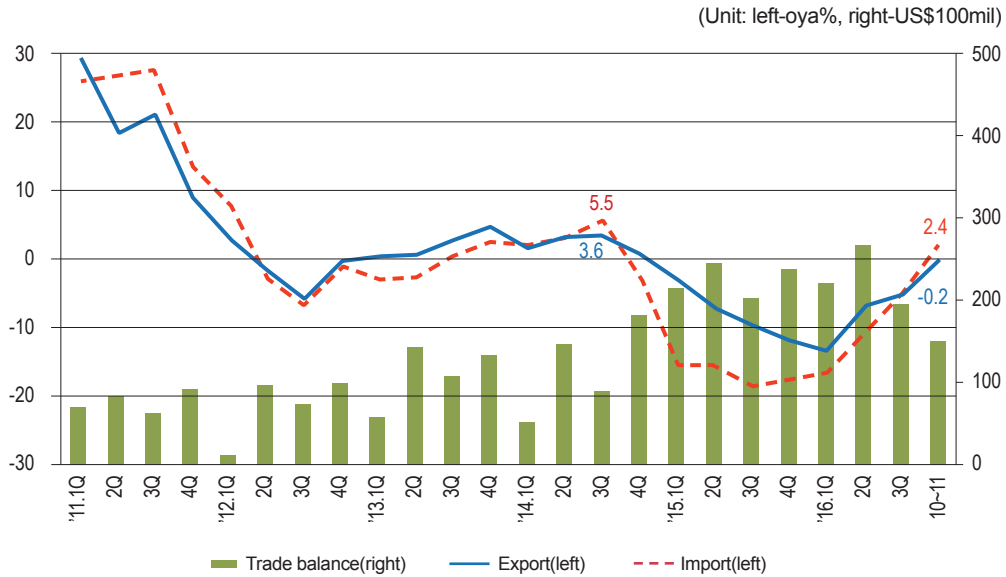


Source: Korea Customs Service

Korea's trade surplus recorded US\$82.7 billion (increased by US\$60 million, -0.7% oya) in between January and November

Trade surplus has declined as the contraction of gap between export and import becomes more distinct while the import loss is still outpacing the export loss. The average import loss was -8.3% between January and November, while that of export was -7.0%.

Trend of Export, Import and Trade Balance



Source: MOTIE

Korea's current account surplus recorded US\$81.9 billion (decreased by US\$6.7 billion, 7.5% oya) in between January and October

The current account surplus declined between January and October compared to the same period of the last year mainly due to the drop in primary income account and the expanded deficits on the service and secondary balance among the sole increase of balance of goods was visible. At the same time, the monthly average Current Account balance has lowered from US\$8.6 billion in 1H16 to US\$7.6 billion in between July and October.

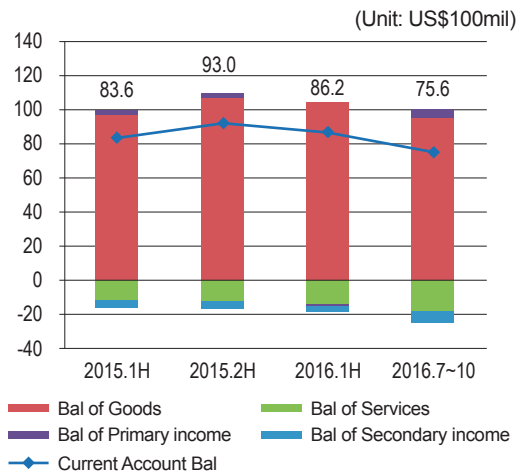
Trend of Current Account Balance

(Unit: US\$100mil)

	2015		2016	
	1H	2H	1H	7~10
Current Account	503.6	555.2	516.9	302.3
Bal of Goods	579.0	624.0	625.0	381.0
Bal of Services	-74.7	-82.1	-78.3	-72.5
Bal of Primary Income	22.7	36.2	-9.2	21.2
Bal of Secondary Income	-23.3	-22.9	-20.6	-27.3

Source: The Bank of Korea

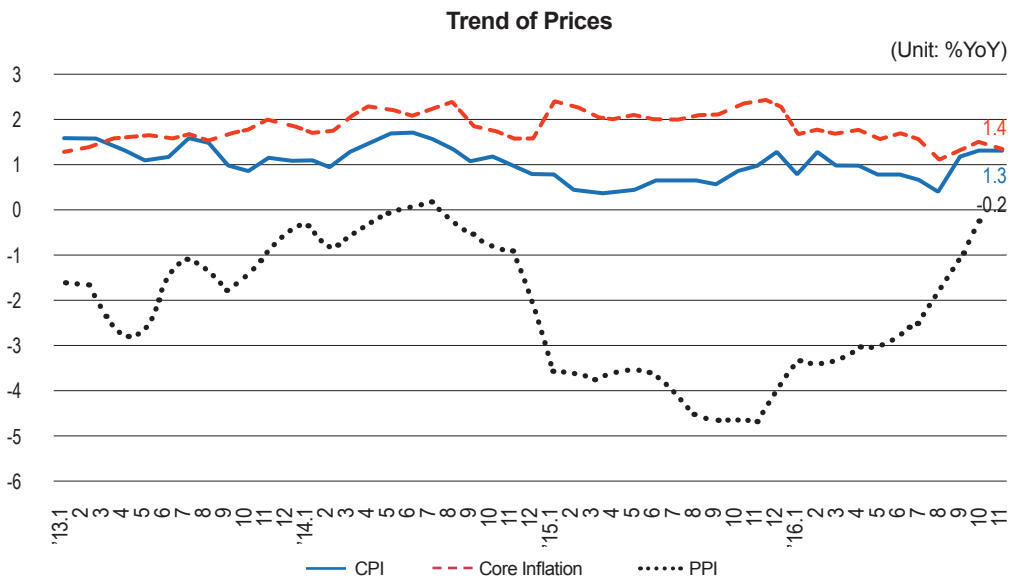
Trend of Quarterly Average Current Account Balance



Source: The Bank of Korea

Consumer price index recorded 1.3% in November, which is plotting 1%-level rise for 3 consecutive months

CPI has soared to the 1% level as the supply-side factors such as the history-recorded high temperature and the price hike of livestock and fishery products, the rebound of crude oil price and the industrial goods price, are offsetting the demand side pressure such as the slowdown of service price hike due to the prolonged low growth projection of Korean economy. The core inflation recorded 1.4% in November and PPI recovered from its declining trend to -0.2% in October.



Source: Korea Customs Service, The Bank of Korea

In October, the number of employment rose than the last month; however yet fell short of the average of 2016

The number of employment growth was 278,000 in October, which was higher than 267,000 in September, but lower than 337,000, which was the average number for 2016. Moreover, there have been some concerns because the employment loss of 30s and the growth of 50s have expanded concurrently, implying the waning of Korean labor market vitality while the employment on manufacturing sector is dwindling for 4 consecutive months. Meanwhile, the unemployment rate has continuously dropped by small margin to 3.4% in October for growth of economic population outpacing the growth of unemployment.

Employment, with Relevant Indicators

(Unit: thousand persons change over year ago, %)

		2014	2015		2016		
		Year	Year	Oct	Aug	Sep	Oct
Changes in employment		533	337	348	387	267	278
By Age	- 15 ~ 29	77	68	101	56	41	31
	- 30 ~ 39	-21	-38	-47	-61	-42	-61
	- 40 ~ 49	38	-14	33	11	-51	-100
	- 50 ~ 59	239	149	125	124	99	133
	- 60 years and older	200	172	136	258	219	275
By Industry	- Agri., Forestry & Hunting	-68	-107	-124	-67	-65	-46
	- Manufacturing	146	156	191	-74	-76	-115
	- Construction	42	27	-27	71	41	59
	- Wholesale & retail trade, hotels & others	259	73	-41	141	88	111
	- Business, personal, public service & others	176	165	265	304	270	259
	- Electricity, transport, communication & finance	-18	22	78	8	5	4
Unemployment rate(%)		3.5	3.6	3.1	3.6	3.6	3.4

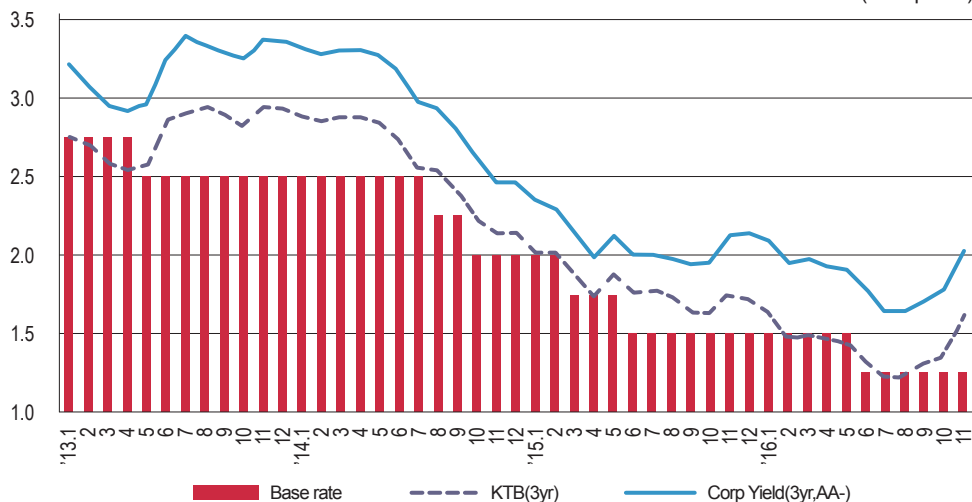
Source: Economically Active Population Survey (Statistics Korea)

Market interest rate, anticipating US Fed base rate hike late in 2016, soared in advance

Korean market interest rate rose remarkably as the US Fed base rate hike became certain. Although the Korean base rate is staying at 1.25% for long, the market interest rates are relatively highly influenced by the condition of the US rates market. The KTB 3-yr yield climbed up from 1.22% in July to 1.61% in November.

Interest Rates

(Unit: p.a %)

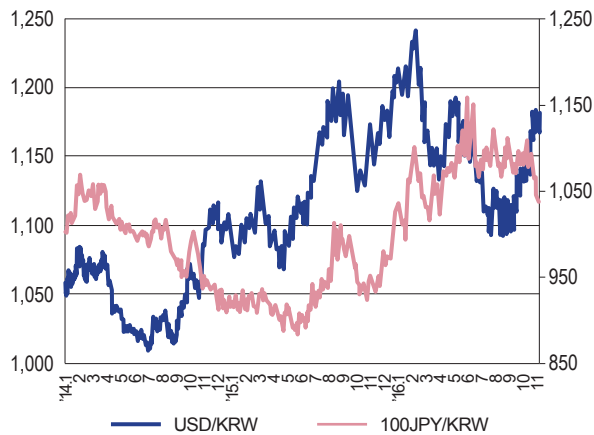


Source: The Bank of Korea

The strong USD/KRW continues expecting US Fed's base rate hike

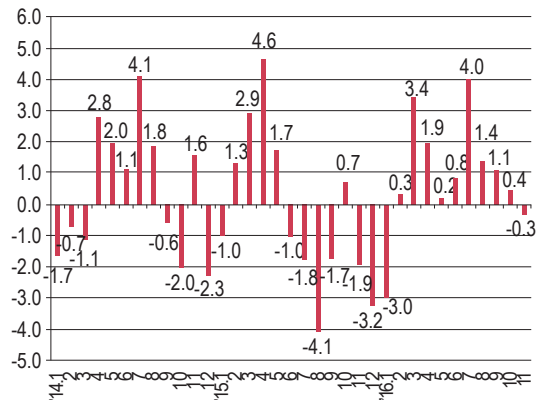
The baseline for strong USD/KRW from October points to the US Fed's definite interest rate hike in December along with the president-elect Donald Trump's support on the tight-money policy while economic data show signs of solid recovery. The USD/KRW soared 1,161.6 won in November from 1,107.5 won in September. The net foreign purchase of Korean equities plummeted in October and even showed net outflow in November as market preference was shifting to the US Equities influencing KRW to depreciate.

Exchange Rate
(Unit: USD/KRW, 100JPY/KRW)



Source: The Bank of Korea

Net Foreign Purchase of Korean Equities
(Unit: Tril won)



Source: The Bank of Korea

Outlook for 2017

1. Global Prospects

(World Economy) While the baseline forecast for the world economy points to a pickup in the growth rates of emerging and developing markets, the projected growth remains modest as underscored by various downside risks. Market interest rate, anticipating US Fed base rate hike late in 2016, soared in advance

(Oil Prices) The overall oil price is forecast to rise, corresponding to the OPEC's agreement on November 30th 2016 to curtail oil production.

(Foreign Exchange Rates) Reflecting Trump administration's new policy scheme and US FED's interest hike decision, appreciation of dollar is forecast to be maintaining, while Japanese Yen, EURO and Chinese Yuan are expected to depreciate modestly.

(United States) In response to the gradual recovery in the labor market and aggressive policy implementation of Trump administration, the growth is forecast to be stronger than 2016.

(China) The economic slowdown is forecast to be mild on the back of the government's aggressive expansionary and new-industries nurturing policy for the new growth industry.

(Eurozone) The growth rate is expected to remain modest as the regional recovery weighs on the Brexit uncertainties.

(Japan) In line with the weakened private consumption and productivity growth, a very gradual growth is projected to continue.

(Supply-Demand) Against the backdrop of excessive supply, the demand increase will exceed the supply increase.

(Speculative & Political Factor) In prospect of political conflicts in the MENA region, including Libya and Nigeria and Terrorism, speculative activity is expected to stay lucrative, possible to envisage the increase of oil price.

(US Dollar) While key economic indices generate auspicious signs, the projected appreciation of dollar crucially hinges on the expectation of interest rate hike, along with Trump administration's "America First" sentiment.

(Eurozone) Euro is projected to remain weak, following QE, adopted in the aftermath of Brexit uncertainties, although regional investment and consumption keep positive values.

(Japanese Yen) Albeit it's regarded as a "safe-haven currency," depreciation seems inevitable, in accordance with QE reflecting sluggish growth of Japanese economy.

(Chinese Yuan) As China's attempt to depreciate weighs on the ramification of Chinese Yuan's official join in the SDR basket, depreciation will last during in 2017.

2. Korea Economic Outlook for 2016~2017

Growth Rate: 2016 2.4% → 2017 2.1%

The lowered growth from 2.4% in 2016 to 2.1% in 2017 reflects increasing uncertainties on the prospect of world economy, weakened effect of domestic expansionary monetary, fiscal and exchange-rate policies. The uncertainty swells along with anti-globalization trend - as Trump's election symbolizes - and diminishing world trade volume and ineffectiveness of existing fiscal policies.

Private Consumption: 2016 2.4% → 2017 1.7%

While the social factors, including house debt and aging society are largely responsible for the low level of APC(Average Propensity to Consume), the growth rate of consumer spending is projected to weaken owing to the job market's exacerbating condition and increased burden on the interest payment as the rate of downshift on loan interest slowed down.

Facility Investment: 2016 -3.6% → 2017 1.7%

The low growth rate of 1% crucially hinges on fluctuations on domestic and international prospects, which often regarded as the premise of recovery, along with exacerbating investment condition as a consequence of market interest rate hike and political unrest.

Construction Investment: 2016 9.9% → 2017 1.0%

Whereas the downturn in a housing market is projected to remain, the growth rate on construction investment is sharply declining as the government budget cut on the SOC.

Export Growth (BOP Basis): 2016 -6.2% → 2017 2.7%

Economic uncertainties of major export nations and the low export competitiveness will have a repercussion on the export recovery. Factors, in terms of the economic uncertainties of major export nations, including China & Japan, developing nations' technological catch-up and fierce competition among nations, have substantive impacts on weakening the export competitiveness.

Import Growth (BOP Basis): 2016 -16.6% → 2017 2.2%

In line with the base effect and the recovery of commodity price such as oil, the import growth will outpace the export growth reverting rather rapidly to the positive growth. On the basis of the base effect- a rebound effect which is induced when the past import growth rate is relatively lower than the rate of export- the import growth rate is forecast to be slightly above the nominal growth rate of export.

Current Account Surplus (US \$Billion): 2016 97.5 → 2017 93.5

Marginal decrease from 97.5 US\$ billion in 2016 to 93.5 US\$ billion in 2017 reflects diminishing commodity trade surplus and trade deficit expansion on the service sector. Trade surplus is expected to shrink from 121.8 US\$ billion in 2016 to 119.7 US\$ billion in 2017 as the import growth exceeds the export growth while the deficit on the service sector is forecast to exacerbate from 18.4 US\$ billion in 2016 to 20.4 US\$ billion in 2016, highly affected by tourism and the diminishing surplus in transport, construction sectors.

Consumer Price: 2016 1.0% → 2017 1.2%

The consumer price is expected to remain low as 1% because oppressing factors from the supply side such as oil price, USD/KRW exchange rate and difficulties on narrowing the deflationary gap are highly influential.

Bond Yield (3yr, AA-): 2016 1.9% → 2017 2.3%

As the slowdown in the domestic economy and low consumer price weigh on the interest rate hike of KRW, influenced by expectations on the US Fed's interest rate hike, the market interest rate (3rs, AA-) growth will be limited. Nevertheless, the forecast of corporate yield has been soared marginally in accordance with elevated possibility on the swift interest rate hike in response to the Trump administration's expansionary fiscal policy.

USD/KRW: 2016 1,159 won → 2017 1,152 won

The rising trend of USD/KRW is projected to sustain until the 1st half of 2017 in the aftermath of Trump administration's aggressive policy, political turmoil in the EU as the strong dollar is expected. For the 2nd half, however, as Trump administration's efforts to improve terms of trade gain its momentum USD/KRW is forecast to depreciate marginally along with debilitating effect on strong dollar.

Outlook for Korean Economy in 2016 ~ 2017

(Unit: YoY(%), US\$100mil(Balance of Payment))

	2016		2017		2015	2016	2017
	1H	2H	1H	2H	Year	Year	Year
GDP	3.0	1.8	1.5	2.6	2.6	2.4	2.1
Private Consumption	2.7	2.0	1.6	1.8	2.2	2.4	1.7
Construction Investment	10.3	9.6	2.0	0.2	3.9	9.9	1.0
Facilities Investment	-3.6	-3.6	1.0	2.4	5.3	-3.6	1.7
Export(Goods & Services)	1.3	2.8	2.1	2.6	0.8	2.0	2.4
Import(Goods & Services)	2.6	4.4	2.7	1.7	3.2	3.5	2.2
Consumer Price	0.9	1.0	1.2	1.2	0.7	1.0	1.2
Producer Price	-3.1	-0.8	0.8	0.9	-4.0	-2.0	0.8
Current Account Bal	516.9	458.4	474.2	461.0	1059.4	975.3	935.1
Bal of Goods	624.9	592.7	590.7	605.9	1222.7	1217.6	1196.5
Export(BOP basis)	2465.6	2626.4	2515.8	2711.5	5428.8	5092.0	5227.2
(growth rate, %)	-9.9	-2.5	2.0	3.2	-11.4	-6.2	2.7
Import(BOP basis)	1840.7	2033.7	1925.1	2105.6	4206.1	3874.4	4030.7
(growth rate, %)	-14.5	-0.9	4.6	3.5	-19.8	-7.9	4.0
Service and other bals*	-108.0	-134.3	-116.5	-144.9	-163.3	-242.3	-261.4
FX rate(USD/KRW, avg)	1182.4	1136.2	1162.0	1142.5	1130.9	1159.3	1152.3
Corp bond yield(3yrs, AA-)	1.9	1.8	2.2	2.4	2.1	1.9	2.3
Unemployment rate(%)	4.1	3.4	4.2	3.5	3.6	3.7	3.9
Changes in number of employed persons	288.0	314.1	271.2	237.2	337.0	301.0	254.2

*Sum of service balance, primary balance, and secondary balance

Policy Issue:

Social Conflict Index and beyond Economic Growth

Social conflict is a common issue for every society, but the most suitable solutions for a democratic society should be to regulate with institutional means and to establish a systematic way for expressing conflicts.

Based on the Rodrik (1999)'s Social Conflict Index, components for social conflicts can be bisected; "conflict factors" and "conflict management"

Above all, among 34 nations, the "conflict factor" is ranked on the top, reflecting conflicts between genders and generations.

While lacking in effective institutional means to subdue, conflicts between political parties and between management and labor, often reached to a substantial extent, frequently inducing physical confrontations. By means of international comparison for gauging the degree of conflicts, it is necessary to recognize the importance of systematic way for alleviating conflicts and of institutional administration for dealing with social conflicts.

Abovementioned Rodrik's Index both reflects various factors of conflict factors and conflict management. The conflict factors were grasped by scrutinizing the entire economic conditions for measuring the degree of conflicts including job market, income distribution, and conflicts between genders and between generations. It also measures the capacity of conflict management, reflecting government's effectiveness to mitigate conflict and generates Social Conflict Index reflecting relative values of conflict factors and conflict management. The formula is as follows:

The Social Conflict Index = Potential Social Conflict Factor Index / Conflict Management Index

Korea ranked 2nd place among OECD 34 member countries in 2014, while it was 4th in 2004. The social conflict factors had increased between 2004 and 2008 and maintained the similar level henceforth. The major source of conflict in 2014 was the conflict between generations and between genders.

For “conflict management,” both the level of quantitative and qualitative management remains low.

In 2004, Korea ranked at 32nd among 34 nations which then lead to the 31st place in 2014. While the increase on the standardized level of conflict management was the 2nd highest among 34 nations, Korea still remained at a low level. For the management capacity, only Chile, Turkey and Mexico ranked below Korea in 2014. Nevertheless, during the period of 2004 and 2014, the index proved that there had been a constant improvement on the conflict management capacity. Specifically, the government’s effectiveness (the integrated evaluation of the constancy of the government’s policy, professionalism of bureaucrats, the quality of regulation and etc) ranked at 20th, marginally below the average meaning the qualitative management level was just about average. The public social spending is ranked at 32th indicating the low competency of the quantitative management.

The comprehensive Social Conflict Index ranks at 3rd among 34 nations.

Of 34 OECD member nations, Korea ranked at 3rd, both for 2004 and 2014. While the average of 34 nations soared from 0.879 in 2004 to 0.904 in 2014, the value for Korea slightly decreased from 1.271 in 2004 to 1.200 in 2014. Nevertheless, Korea’s ranking is still high as 3rd, due to the high conflict level between generations and genders, and the low management capacity of the government.

Continuous efforts to raise the conflict management capacity, for achieving sustainable growth, is an indispensable factor

Based on the 2014 research, the high Social Conflict Index tends to have a strong correlative relationship with a wide fluctuation (standard deviation) of economic growth. In accordance with the heightened possibility of social conflict increment in Korea owing to the political scandals lately, it is essential to enhance the conflict management capacity. Also, the long-term vision, for managing social conflict, must be adopted as social conflict might swell when leave the economic problems unsettled for over-politicization reason. As the management capacity shows improvement rather marginally, but continuously from 2004, it is certain for Korea to be able incubate effective solutions for dealing with current social problems.

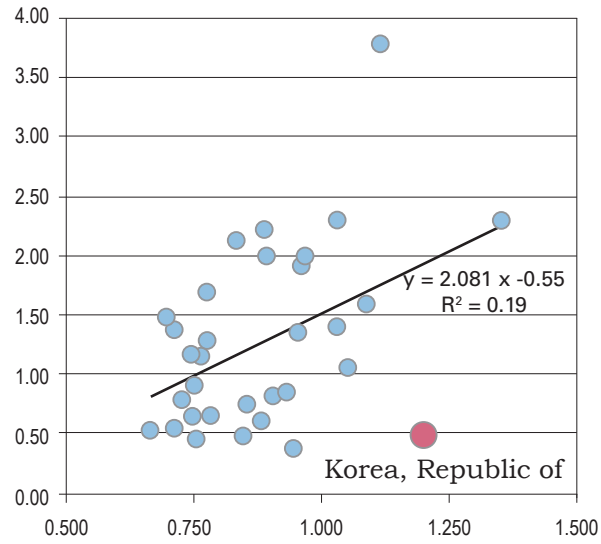
<Table III-3> Social Conflict Index by Nation

(Unit: Standardized Value [1,2])

Ranking	2004		2014	
	1	Turkey	1.412	Mexico
2	Mexico	1.387	Turkey	1.354
3	Korea, Republic of	1.271	Korea, Republic of	1.200
4	Estonia	1.070	Greece	1.119
5	Israel	1.012	Chile	1.088
6	Poland	0.992	Israel	1.053
7	Japan	0.985	Estonia	1.035
8	Chile	0.983	Italy	1.030
9	Greece	0.970	Portugal	0.972
10	Slovakia	0.956	Hungary	0.963
11	Italy	0.932	Poland	0.954
12	Portugal	0.903	USA	0.946
13	Czech	0.901	Slovakia	0.931
14	GBR	0.898	Japan	0.908
15	USA	0.892	Czech	0.892
16	Hungary	0.860	Spain	0.891
17	Spain	0.843	GBR	0.882
18	Ireland	0.837	Canada	0.856
19	Slovenia	0.827	Australia	0.848
20	Canada	0.816	Ireland	0.840
21	Germany	0.798	Slovenia	0.839
22	Norway	0.778	France	0.784
23	Australia	0.777	Luxemburg	0.778
24	Switzerland	0.759	Iceland	0.777
25	Luxemburg	0.747	Germany	0.766
26	Belgium	0.746	Switzerland	0.758
27	Austria	0.729	Austria	0.754
28	Netherland	0.720	Norway	0.751
29	New Zealand	0.718	Netherland	0.750
30	Finland	0.715	Belgium	0.729
31	Iceland	0.704	New Zealand	0.715
32	France	0.704	Finland	0.713
33	Sweden	0.652	Sweden	0.702
34	Denmark	0.589	Denmark	0.666

Source: Author's own calculation

<Figure III-4> Correlation Between Social Conflict Index and Economic Growth



Vertical Axis: Standard Deviation of Economic Growth
 Horizontal Axis: Social Conflict Index

Source: Author's Own Calculation
 (Based on the standard deviation of Economic Growth between 2010-2014 and 2014 Social Conflict Index).

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