

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

## Contents

<b>Executive Summary</b> .....	<b>02</b>
<b>Economic Trends and Outlook</b> .....	<b>03</b>
Recent Developments	
Outlook for 2009~2010	
Policies .....	<b>13</b>
<b>Recent Publications</b> .....	<b>14</b>



# Executive Summary

## **Economic Growth to Improve from -0.8% (2009) to 3.2% (2010)**

The Korean economy is likely to experience a mild decline of -0.8% in 2009. Still, the projection is an improvement compared to last July when the growth rate was forecast to be around -1.9% for the year. The upward revision reflects recent improvements in international financial market conditions and the performances behind economic indicators as fiscal stimulus measures take effect. The recovery trend is going to continue into the next year, but the rebound will be somewhat limited. As a result, the economy is expected to post a modest growth rate of 3.2% in 2010.

The economy will get off to a rather slow start in 2010 as the boost from expansionary fiscal policies disappears. Consequently, the economic growth rate for the first half of 2010 will be 0.5%. However, as the economy gradually returns to its normal growth trend, the rate of growth will accelerate to 2.7% in the second half of the year. The assumptions in this projection are that the won-U.S. dollar exchange rate would appreciate to the 1,100 won level as a result of the national budget for next year being appraised as a de-facto retrenchment, a global trend of dollar weakening, and a current account surplus.

## **Current Account to Post US\$13.1 Bil. Surplus and Consumer Prices to Rise 3.0% in 2010**

Due to rises in international oil prices and the value of the Korean won against the dollar, the current account surplus is expected to decrease to US\$13.1 billion in 2010 from US\$30.4 billion in 2009.

Rising prices of oil and raw materials will fuel the upward pressure on consumer prices. However, due to a lukewarm economic recovery and a stronger won, the consumer price level is expected to rise somewhat gradually and reach 3% for 2010.

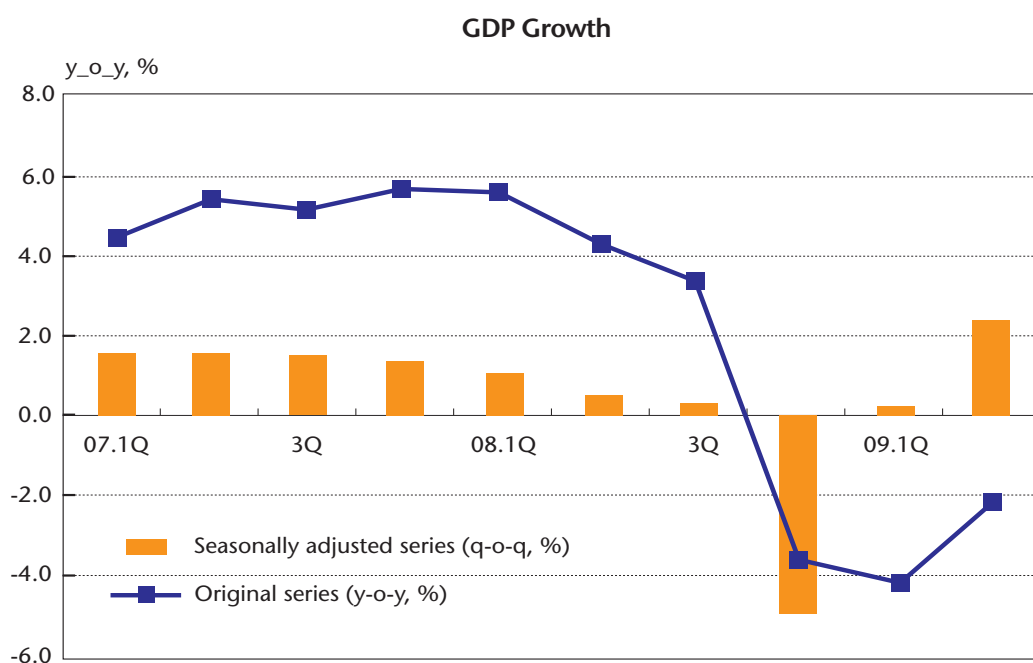
## **Efforts to Enhance Growth Potential Required**

A top policy priority in the aftermath of the recent crisis is to find a way to put the economy back on the pre-crisis growth trend. If a new and lower trend growth rate is accepted as a norm, as happened after the 1997 crisis, the national economy will not be able to escape the US\$20,000 per-capita income trap in the near term.

## Recent Developments

### GDP Growth Showing Signs of Improvement

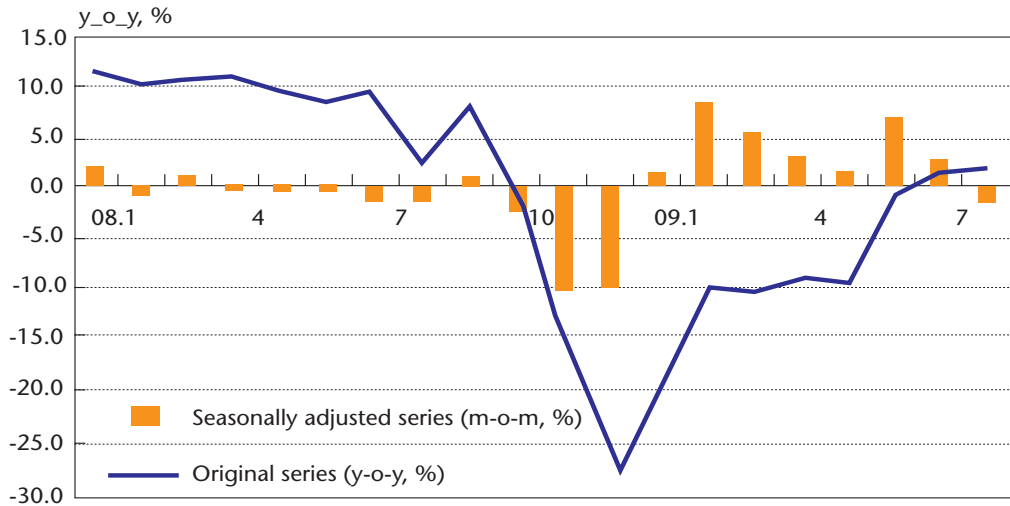
Real GDP in the second quarter of 2009 posted a q-o-q growth of 2.6%. The rate of economic decline in the second quarter slowed a full 2%p on a year-on-year basis, suggesting that things are beginning to improve for the economy. This is attributable to a significant rise in the contribution of net exports to GDP growth owing to decreases in imports, and to alleviation of the decline in the domestic demand sector.



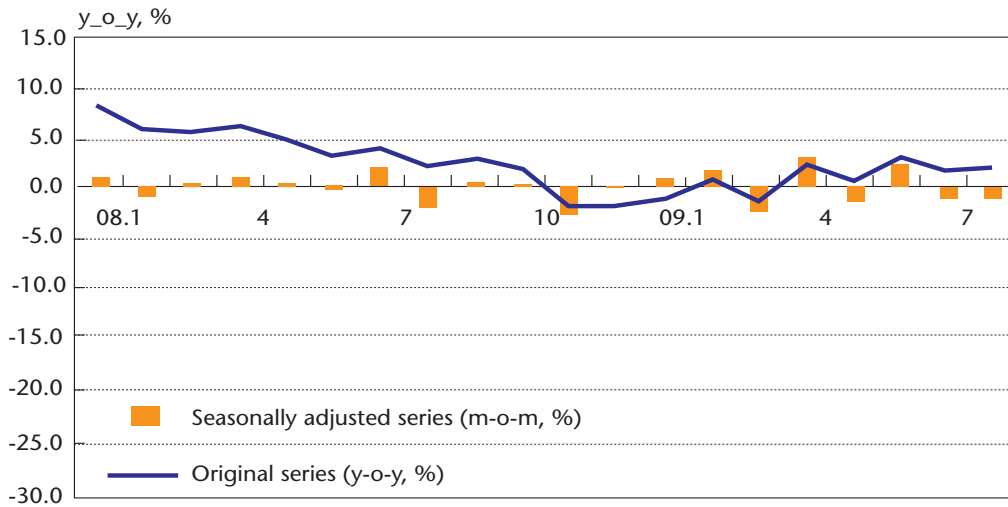
### Production Slowdown in 2nd Half '09

Manufacturing production, which had recorded positive growth for seven consecutive months since January, converted to a downward trend (-1.3%). Service production also decreased for two consecutive months in July and August.

### Manufacturing Output



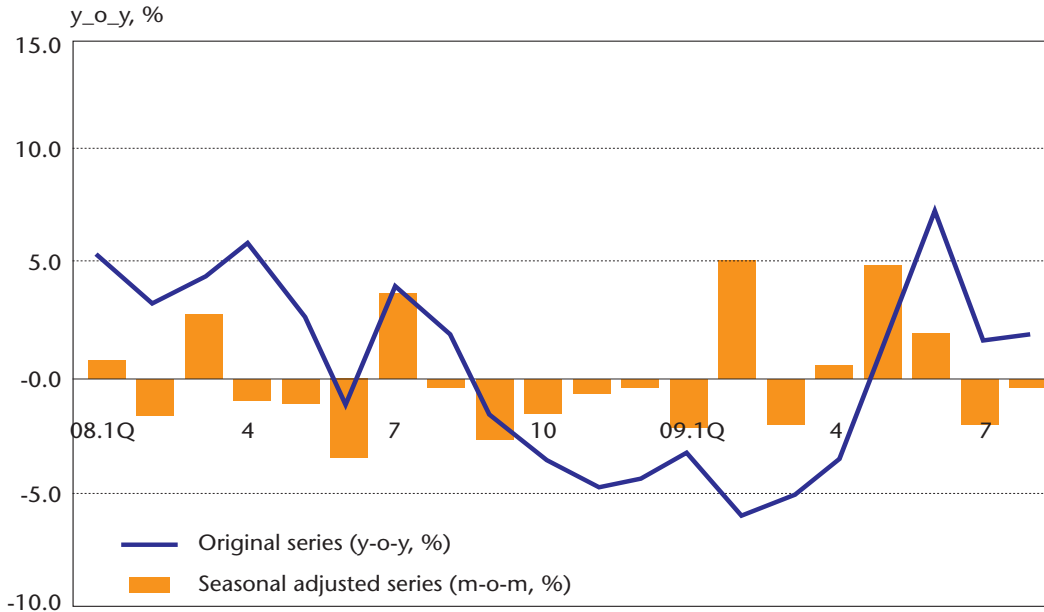
### Service Output



#### Consumer Goods Sales Slowed in July-August

The growth of consumer goods sales sharply slowed to 1.8% and 2.0% in July and August from 7.5% in June on a year-on-year basis. Month on month, consumer goods sales declined for two consecutive months at -1.7% and -0.3% in July and August. This was caused by consumption of durable goods returning to a declining trend as automobile tax incentives came to an end.

### Consumer Goods Sales

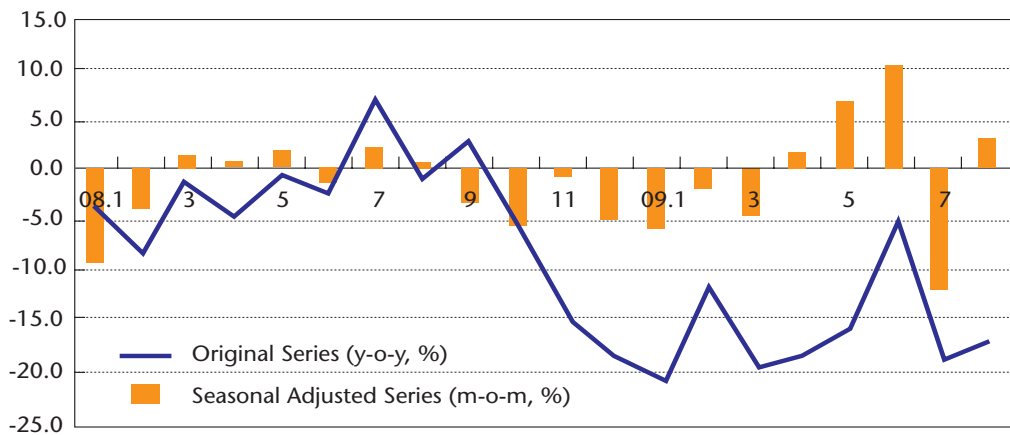


#### Facility Investment Continues Decline

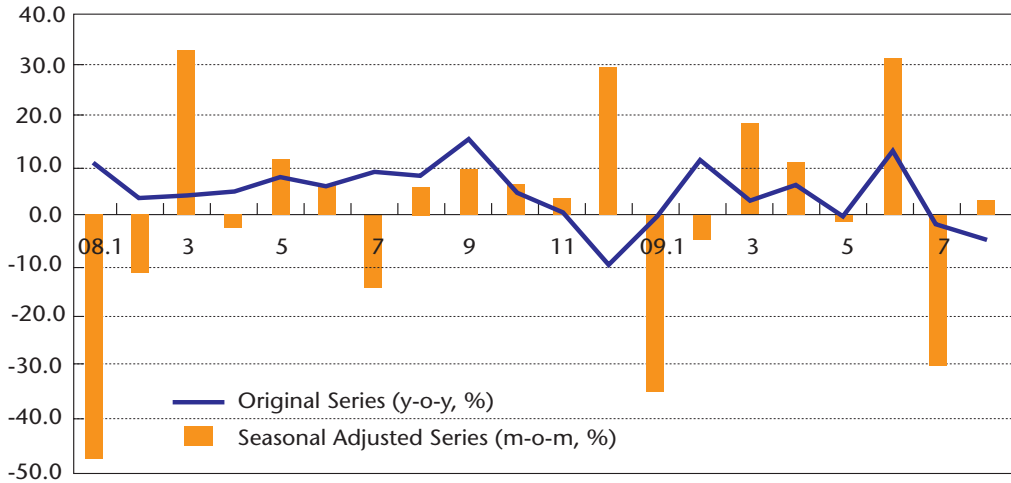
Facility investment decreased 18.8% and 16.6% in July and August, respectively, with investment in transportation equipment slowing again due to the end of the tax incentives for automobile purchases.

Despite growth in public sector construction, construction progress payments decreased 2.3% and 6.8% year-on-year in July and August, respectively, as decline in private sector construction continued to accelerate.

### Equipment Investment



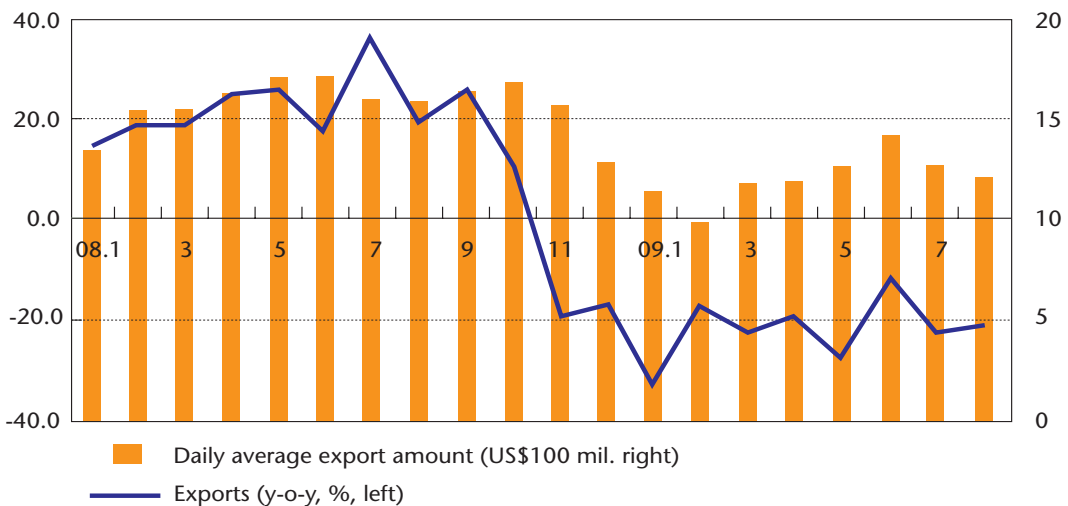
Construction Investment

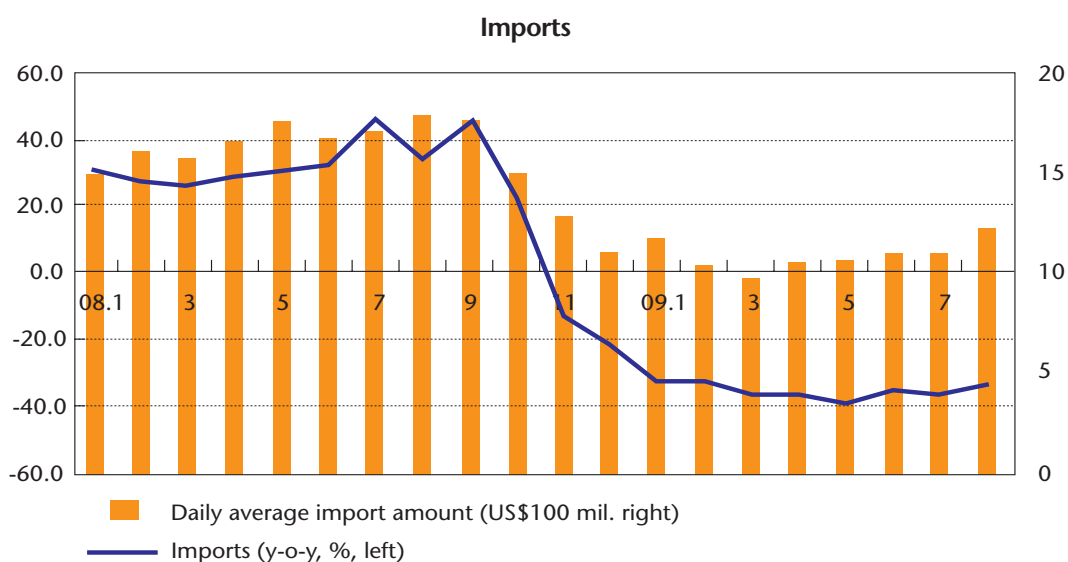


Export Decline Accelerating

Impacted by the foreign exchange rate appreciation, the downward trend in exports accelerated in July-August and the daily average export amount also decreased, dampening any improvement in the flow of exports. Meanwhile, imports are posting a gradual recovery trend due to rises in international oil prices.

Exports





### Current Account Surplus on the Decline

Notwithstanding the decline in exports, the current account balance continues to record a surplus with imports declining more sharply. However, the surplus amount declined from US\$5.43 billion in June to US\$2.04 billion in August.

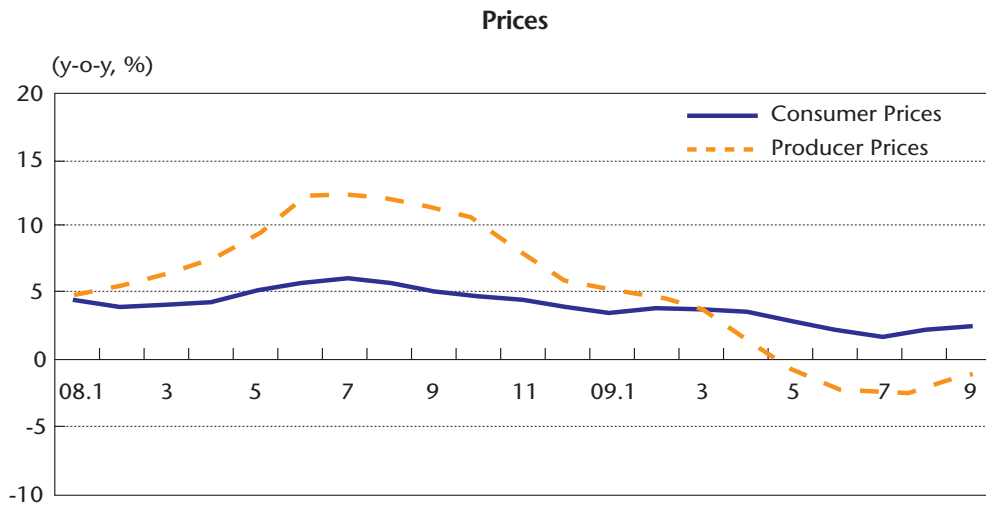
### Current Account Balance

(Unit: USD Bil)

	2008					2009			
	1/4	2/4	7~8	1~8	year	1/4	2/4	7~8	1~8
Current Account Balance	-52.1	-1.3	-72.3	-125.8	-64.1	85.8	131.7	64.0	281.5
Commodity Balance	-12.2	57.2	-25.9	19.2	59.9	83.5	176.3	95.9	355.6
Service Balance	-50.7	-42.7	-44.6	-138.0	-167.3	-18.8	-40.2	-36.9	-95.9
Travel Balance	-30.2	-27.7	-25.9	-83.7	-80.5	5.2	-10.7	-15.5	-21.0
Business Service Balance	-29.1	-29.0	-26.8	-84.9	-145.1	-32.3	-39.9	-24.0	-96.2
Income Balance	16.9	-6.5	-5.6	16.1	51.1	8.3	1.8	10.7	20.8
Current Account Transfer Balance	-6.1	-9.4	-7.5	-23.1	-7.7	12.8	-6.1	-5.7	1.0

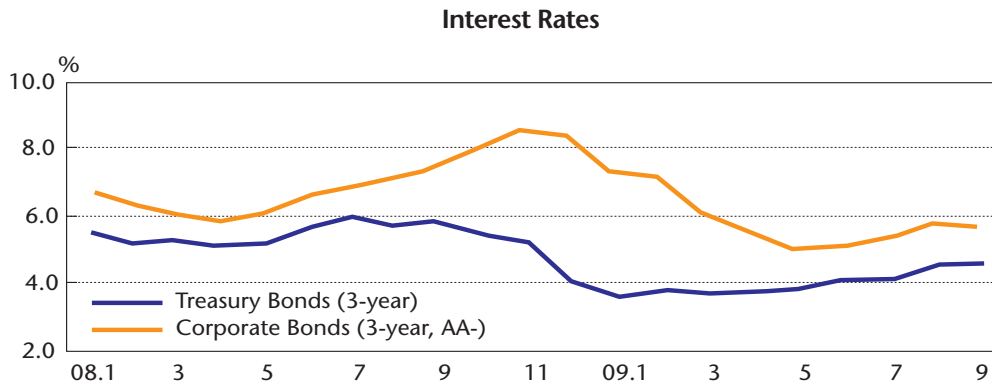
**Inflation on the Rebound since July '09**

Until July this year, inflation had continued a downward trend owing to the base effect and stable oil prices. In August~September, however, both consumer and producer prices rose slightly due to rising expectations for economic recovery.



**Market Interest Rates Continue Mild Upward Trend**

Reflecting expectations of economic recovery and a policy interest rate hike as part of the exit strategy, market interest rates are on an upward trend. The yield rates on treasury bonds (3-year) increased to the 4.4% level in August~September from the 4.0% level in July.

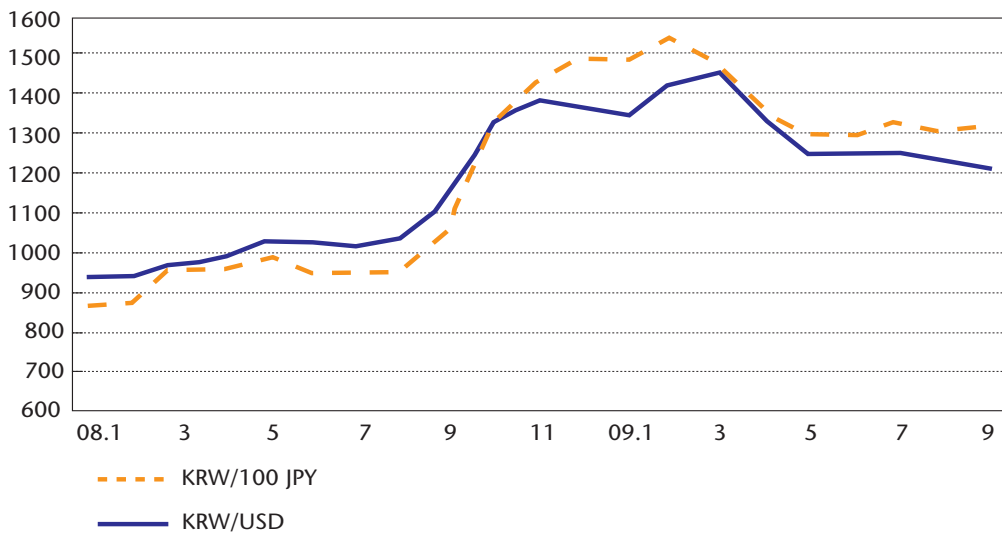




**Korean Won Appreciating Since March**

The Korean won continued a strengthening trend against the U.S. dollar due to such factors as the current account surplus and an increase in foreigners' net purchase of stocks.

Exchange Rates



# Outlook for 2009~2010

## 1. Internal and External Environments

### World Economy to Post 3% Growth in 2010

With the financial crisis apparently receding, the global economy is expected to grow around 3% in 2010. On the other hand, most of the advanced economies are likely to grow at just around 1% as exit strategies are implemented. Also, spread of trade protectionism and delays in consumption recovery caused by poor labor market conditions in advanced economies, including the U.S., are likely obstacles to a robust global economic recovery.

### International Oil Prices to Record Limited Increase

Demand for oil is expected to be stronger in 2010 as the global economy continues its recovery. Nevertheless, the scale of oil price rises will be limited due to the mild growth trend of the global economy and to global easing of the dollar's depreciation trend.

### Korean Won to Continue Mild Appreciation

Also in 2010, the Korean won-U.S. dollar exchange rate may continue to appreciate. But the speed of appreciation is expected to be mild due to reduction in the current account balance surplus and global easing of the dollar's depreciation trend.

### Gov't Budget for 2010 Up 2.6% from 2009

At 291.8 trillion won, the budget for 2010 reflects a lower growth rate than in recent years. Although the 2010 budget is 2.6% higher than the one for 2009, its growth is significantly lower compared with the annual average budget growth rate of 7.9% in 2005~2009.

### Major Assumptions for Projections

Exogenous Variables	Unit	2009	2010
China's Growth	%	8.5	9.0
Japan's Growth	%	-5.4	1.7
U.S. Growth	%	-2.7	1.5
Dubai Oil Price	US\$/bbl.	62.0	75.0
RP Interest Rate (end of year)	%	2.00	3.00
KRW/US\$ Fx-Rate (average)	Won/US\$	1,279	1,145

## 2. Outlook for Korean Economy

**Growth: -0.8% in '09 → 3.25% in '10**

Positive growth of the domestic economy is expected in 2010 owing to the base effect and recovery trend of the world economy. But annual growth is projected to stand at 3.2% with the end of fiscal administration policy effects, etc. In terms of each half of the year, a 'W-shaped' recovery is expected, with second half growth up 2.7% from the first half's 0.5% expansion from the end of '09, as fiscal boosts and foreign exchange rate effects will be much weaker.

**Private Consumption: -0.4% in '09 → 2.9% in '10**

Thanks to improvement in employment and wages, foreign exchange rate appreciation, asset price increases, etc., private consumption is likely to continue the growth trend started in the second half of this year. With higher interest rates and price hikes curbing purchasing power, however, private consumption is expected to post growth that is lower than GDP growth.

**Construction Investment: 3.5% in '09 → 1.3% in '10**

Affected by stagnation of SOC investment and mild construction growth in the private sector, construction investment is projected to record a low 1% level of growth in 2010.

**Facility Investment; -14.5% in '09 → 9.0% in '10**

2010 will be a relatively good year for facility investment as both the global and domestic economies return to their normal trends. Furthermore, government incentives, foreign exchange rate appreciation (making capital goods imports less costly), and rising investment pressure caused by investment slowdowns in 2008 and 2009 are expected to improve the investment environment.

**Current Account Balance Surplus: US\$30.4 Billion in '09 → US\$13.1 Billion in '10**

As imports grow faster than exports, the nation's current account surplus is projected to decrease sharply in 2010 compared to 2009.

**Export Growth: -18.0% in '09 → 9.7% in '10**

Owing to an increase in demand following the mild recovery of the global economy and unit price increases of key export products, exports are expected to grow about 10% in 2010.

## Economic Trends and Outlook

**Import Growth: -26.3% in '09 → 15.7% in '10**

Imports are projected to grow faster than exports at around 16% owing to the recovery of the domestic economy, an increase in the import of intermediate goods, and rising import prices.

**Consumer Price Increase: 2.9% in '09 → 3.0% in '10**

Since the economic recovery is likely to be mild, the upward pressure on the price level from rising demand is expected to be small. Effects of rising prices of imports, including crude oil, will be partially offset by a stronger Won as well. Consequently, consumer prices in 2010 are expected to rise at a stable rate of about 3.0% annually.

**Market Interest Rate: 5.8% in '09 → 6.1% in '10**

Due to a higher policy rate, expectations of economic recovery, and increases in the price level, market interest rates are likely to show a gradual rising trend.

### Outlook for Korean Economy (2009~2010)

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

	2008	2009		2010			
	Year	1st H	2nd H	Year	1st H	2nd H	Year
GDP	2.2	-3.2	1.5	-0.8	3.1	3.2	3.2
(SA, q-o-q, %)		-1.2	2.6		0.5	2.7	
Private Consumption	0.9	-2.6	1.8	-0.4	3.4	2.3	2.9
Construction Investment	-2.1	2.8	4.0	3.5	-0.1	2.5	1.3
Facility Investment	-2.0	-19.5	-9.2	-14.5	8.7	9.2	9.0
Exports (Goods + Service)	5.7	-7.1	1.4	-2.9	8.0	5.4	6.6
Imports (Goods + Service)	3.7	-15.9	-3.6	-9.9	10.0	8.5	9.2
Consumer Prices	4.7	3.4	2.5	2.9	2.8	3.1	3.0
Producer Prices	8.6	1.5	-1.4	0.0	2.8	2.4	2.6
Current Account	-64.1	217.5	86.6	304.1	81.2	49.7	130.9
Commodity	59.9	259.8	141.9	401.7	148.7	103.8	252.5
Exports (BOP Base)	4334.3	1679.5	1872.9	3552.4	1900.6	1997.0	3897.6
Growth (%)	14.4	-24.1	-11.8	-18.0	13.2	6.6	9.7
Imports (BOP Base)	4274.3	1419.7	1730.9	3150.7	1752.0	1893.2	3645.2
Growth (%)	22.3	-34.5	-17.9	-26.3	23.4	9.4	15.7
Service & Others	-124.0	-42.2	-55.3	-97.6	-67.5	-54.1	-121.5
Ex Rate (Avg. KRW/USD)	1099.5	1352.0	1205.0	1278.5	1150.0	1140.0	1145.0
Corp. Bonds Yield (3-year, AA-)	7.1	6.1	5.6	5.8	5.9	6.3	6.1
Unemployment Rate (%)	3.2	3.8	3.7	3.7	3.8	3.5	3.6

# Policies

## More Care Needed to Stabilize Real Estate Prices

Stabilization of real estate prices should be on top of the list of policy priorities. As monetary policy alone has limitations in stabilizing housing prices, a more direct policy intervention is required in addition to interest rates.

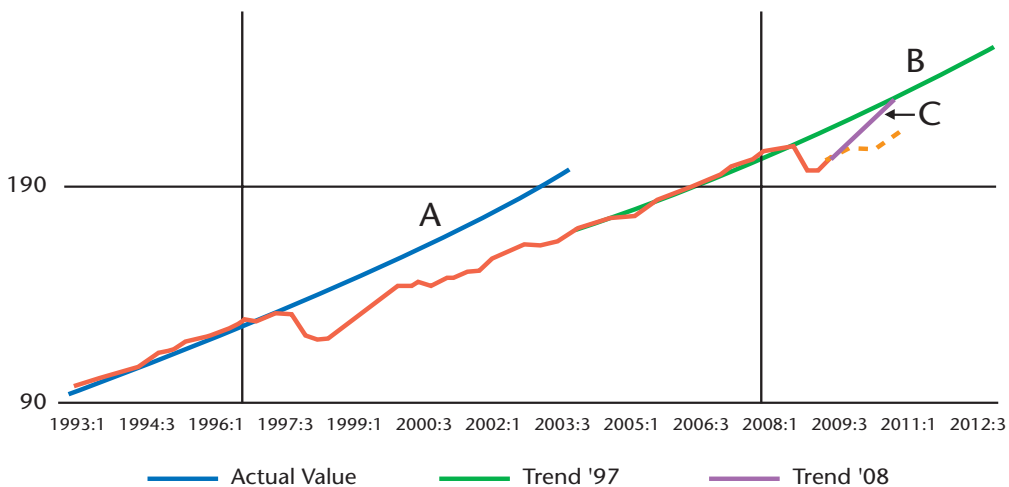
## Excess Liquidity Problem Will Ease Naturally After Completion of Exit Strategy

The level of liquidity sharply increased during the crisis periods in 1998 and 2008. Considering that the increases were due, at least in part, to the government's policy responses, the current excess liquidity problem will ease naturally when the exit strategy is completed.

## Recovering Growth Potential Is Important

The Korean economy's trend growth rate declined significantly after the 1998 foreign exchange crisis. There is no guarantee it will not happen again after the current crisis. With real GDP (thick solid line) failing to return to the 'Trend Curve A' (thin solid line) after the 1998 crisis, the trend growth rate fell from 7.4% (Trend curve A) to 4.7% (Trend curve B). Therefore, our most important policy goal when the current crisis is finally over is to recover the pre-crisis growth potential. Fundamentally, investment and employment need to be expanded by improving the corporate environment through enhanced labor market flexibility and regulatory reform.

Real GDP and Trend Curves



## **The Effects of Financial Development on Corporate Growth - Implications for High-tech Companies' Growth Strategy**

Research Monograph 09-06

Byoungki Lee

This study analyzes which factors induce corporate growth, as well as the role of financial development in corporate growth. In particular, policy implications are explored in shaping growth strategies for high-tech companies. Results from the research suggest how to develop the financial system into one that is more conducive to corporate growth and which direction to take in reorganizing related institutions to support creation of high-tech industries.

First, financial development is a very important factor in bringing about corporate growth. Second, the hypothesis that financial development accelerates the growth of companies can be identically proven both for high-tech industries and traditional industries. Third, high-tech companies owe accelerated growth more to the development of the stock market than to support from banks. Fourth, microeconomic analysis also shows that difference in financial system is not an important factor in the different performances among companies. Fifth, a higher level of financial development cannot be achieved when regulatory enforcement is inefficient, especially due to the considerable time expended on numerous required procedures and excessive bureaucratic red tape. Finally, creditor protection is important for the growth of banks, while investor protection is significant for stock market development.

## **The Effects of China's Exports on Price Levels in Korea**

Research Monograph 09-07

Taekyu Lee

In the past few years, many have argued that China's growing engagement in international trade has played an important role in stabilizing global prices. However, there have been different opinions that do not consider China as a source of downward pressure on prices. In this regard, it is important to evaluate the influence of Korea's fast-growing imports from China on domestic prices. Using macro and micro data, this paper estimates the growing effects of imports from China on Korea's import prices and broader prices. Empirical data shows that the growing imports from China have lowered the growth rate of import prices. However, the relationship between the imports from China and producer prices is inconclusive.

## **An Analysis of the Equity Holding Structures of Korean Business Groups**

Research Monograph 09-08

Chung-Gyu Choi

This paper analyzes equity holding structures of Korean business groups by applying methodologies of social network analysis (SNA). In particular, it analyzes the importance and prestige of affiliated firms in each business group and examines how cohesive and centralized their networks of affiliated firms are.

The main findings are as follows. First, Korean business groups are very heterogeneous in the levels and trends of SNA indices. Second, the annual trends of SNA indices vary substantially according to three methods of measurement. Third, the values of SNA indices, such as centrality, prestige, centralization, and cohesiveness, tend to increase as the asset size of the business group decreases. Fourth, in most business groups, central actors that have the highest values in terms of centrality have ‘persistently’ played a central role in each group’s equity-holding network. Finally, consideration of both direct and indirect equity investments reveals much greater centrality of each group’s controlling shareholder, who is located at the very top of the equity-holding chain.

## **An Economic Analysis on Unfair Attraction of Customers: Focusing on the Effect of Promotional Items in a Two-sided Market**

Research Monograph 09-09

Hyun Jong Kim

We examine how promotional items (offered incentives) affect the profits of economic agents and social welfare in a two-sided market, specifically, the newspaper industry. Though it is well known that promotional items have pro-competitive effects, the offer of incentives in any transaction is considered abnormal in Korea such that it is subject to regulation under Korea’s competition law. We point out that promotional items, which act as price discriminators among types of subscribers, raise the subscription rate and expand the advertisement market. Hence we prove that the regulation on offering promotional items reduces social welfare in a two-sided market. The results of our simulation show that regulation improves the social welfare of the two-sided market, but that it reduces residual welfare, social welfare minus the profits of subscribers and advertisers.

## Job Creation under Differentiated Employment Protection

Research Monograph 09-10

Yanggyu Byun

To evaluate the effect of various measures to ease employment protections in Korea, this paper uses an extension of Mortensen and Pissarides (1994) matching model in which two types of workers, skilled and unskilled workers, come under differentiated employment protection depending on the types of their employment contracts. Simulation of the model, calibrated for the Korean labor market, indicates that relaxing restrictions on the use of temporary employees has a high negative effect on the employment of permanent staff due to a strong substitution effect, thus failing to creating a significant amount of jobs. On the other hand, policies aimed at lowering the employment adjustment cost of permanent workers lead to the creation of a significant amount of jobs by reducing the employment protection gap between temporary and permanent jobs and by increasing the flexibility of the labor market. Under a scenario where the employment adjustment cost of permanent workers is reduced by 50%, more than 166,000 jobs are created, which is roughly equivalent to 55% of average annual job creation in Korea since 2001.

## Measuring the Marginal Effective Corporate Tax Rate and Its Implications

Research Monograph 09-11

Hag-Soo Kim

This research report presents the marginal effective corporate tax rate measured using about 18,500 firms' financial statements over the period of 1991 to 2007. It also presents the results of METR by 30 industry-types and by category of firm size as defined in law. The main findings of the analysis can be summarized as follows:

1. One of the goals of tax reform, "Broader tax base, lower tax rate," has been achieved since 1991, which is implied by the trend of METR and the difference between the 1st quartile and 4th quartile average METRs that decreased slightly from 1991 to 2007 with some moderate fluctuations.
2. Tax reform in the future should target a reduction in the variation in the industrial averages of METR, since the coefficient of variation (standard deviation/average) of industrial averages of METR were two-fold larger in 2007 than in 2000 and this increased cross-sector tax differential hampered the growth of the overall economy, as reported in Lee et al. (2008)
3. According to the results of policy simulation, the decrease in low statutory rate or the increase in the investment tax credit rate will give relatively more benefits to firms with low level METRs.



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

Research Monograph 09-12

Jang-Hee Yoo

This report selects nine service sectors - IT & mobile communications, medical service, cultural content, broadcasting service, Korean food, transportation & logistics, distribution, education, and tourism - and suggests strategies to invigorate their exports.

The idea of developing the service sector 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 industries with growth potential and turning them into export industries. In addition, synergy effects of simultaneously enhancing competitiveness of manufacturing industries are also expected by adding elements from Korea's newly developed service industry to the manufacturing sector where Korea is being closely chased by late developing countries.

## **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 a Korean family survey.

Results from a split sample considering two economic crises confirm the existence of an excessive 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 following the crises between 1999 through 2004. Therefore, unlike an economic boom when similar patterns are observed affecting different risk groups in terms of consumer behavior, Group 1 takes a rational decision in consumption plans during a recession.

Further empirical evidence on the upper income group with lower liquid assets in 1998 does not support liquidity constraints during economic crises. However, consumption of the upper income group does not respond to anticipated income changes, but consumption of the lower income group does.

In conclusion, liquidity constraint is not the main cause of excessive sensitivity of consumption in the Korean case. In an economic recession, the upper income group makes a rational consumption decision to maintain an optimal consumption plan. The empirical evidence casts doubt on the validity of policies that provide support for low liquidity households to mitigate liquidity constraints.

### **Why Should Labor Market Be Flexible? - Lessons from International Comparison of Labor Market Flexibility**

Issue Paper 09-06  
Dong-Woon Park

Based on the result of an international comparison of labor market flexibility, we can learn a lesson - the state of the economies in the United States, U.K., New Zealand and Ireland with flexible labor markets had been good and that of the economies in Germany and Japan without flexible labor markets had not been good until prior to the U.S.-originated financial crisis in 2008.

To revive the economy, it is necessary to increase the flexibility of the labor market. For this, Korea should ease excessive protection of regular workers, rescind the Act on the Protection of Non-Regular Workers, implement an expanded temporary help service system to all occupational categories and abolish the Economic and Social Development Commission (ESDC), where the labor union, employers' association and the government are doing nothing but struggle.

### **Global Financial Crisis and Economic Integration of East Asia**

Issue Paper 09-08  
Won-Gun Song, Tae-Kyu Lee and Pilhyun Kim

The main cause for the East Asian economy to have suffered significant damage in the real economy sector, such as sharp drops in exports and production, from the global financial crisis lies in the economy's high external dependence level.

As long-term development tasks for the East Asian economy, this thesis asserted establishment of, first, an East Asian FTA to stimulate regional demand; second, a Credit Guarantee Investment Mechanism (CGIM) to develop the regional bond market; and third, a new Asian Monetary Fund (AMF) system to promote financial cooperation within the region.

## **Approach to Shareholder Capitalism from the Perspective of Law and Economics - Implications for Korea's Policy for Ownership and Governance Structure -**

Policy Report 09-07

Seuk-Hun Sin

There is a need to re-examine the current restrictions on the corporate governance structure based on traditional shareholder capitalism that shareholders hold own companies.

Therefore, the restrictions to curb concentration of economic power that target a reduction in the disparity of business groups between ownership and governance should be abolished. Dual-class share and Poison Pill systems also should be introduced on the precondition that the principles of 'one share, one vote' and shareholder equality are exceptions.

## **The Current Trend and Projection of Global Economic Recovery**

Policy Report 09-08

Soon-Kwon Ahn

The global economy is expected to hit the low point in the second half of this year. When forecasting the next two years, the possibility is relatively high that after hitting the bottom, the economy may experience a 'W-shaped' recovery.

In this regard, Korea needs to learn good lessons from the United States, which realized a 'W-shaped' recovery in the early 1980s, and from Japan, which experienced an 'L-shaped' recovery in the mid-1990s.

Accordingly, Korea should implement a Keynes-style expansion of fiscal expenditures in the early part of the crisis and induce restructuring later on.

[www.keri.org](http://www.keri.org)

**Publisher:** Young-Yong Kim

**Editor:** Gyeong Lyeob Cho

**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,  
8th Fl., Hana Daetoo Bldg., 27-3, Yeouido-dong,  
Yeongdeungpo-gu, 150-705 Seoul, Korea.  
Tel : (82-2) 3771-0001, FAX : (82-2) 785-0270/1