KERI

Economic Bulletin

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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.”

Executive Summary

Owing to domestic demand recovery, the Korean economy is expected to post 4.9% growth in 2006. This projection is based largely on the expected continued strength in private consumption, which had been the main stumbling block to a strong rebound of the Korean economy until recently.

Influenced by general improvements in consumer sentiment, private consumption is likely to record a growth rate of 4.7%, while facility (including intangible assets) investment is expected to rise by 6.2% on an annual basis thanks to increased investment pressure. In contrast, construction investment is forecast to experience a low growth rate at 1.5% for the whole year under the influence of restrictive real estate policies, as well as a neutral fiscal policy. Exports are expected to maintain double-digit growth thanks to China's continued economic growth.

Consumer prices in 2006 are predicted to post a stable growth rate at 2.9% for the full year, largely helped by the cumulative deflation gap and the won's strength. With contraction in the commodity trade balance surplus and expansion of the service balance deficit, the overall current account balance is projected at a US$6.8 billion surplus, which is significantly lower than the US$16.1 billion surplus of 2005.

Long-term interest rates are likely to maintain a slightly upward trend following increases in policy interest rates and economic recovery. The won-U.S. dollar exchange rates are also expected to experience a mild appreciation.

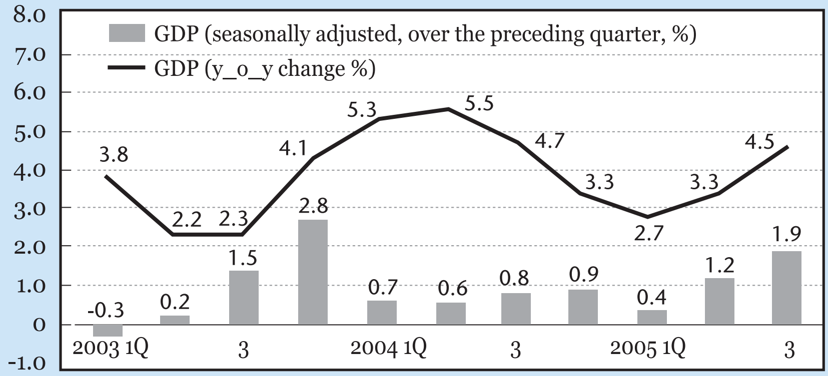
The near 5% economic growth projected for 2006 is seen as somewhat low, considering the output gap that has been building for the past several years. To sustain a 5% economic growth level for an extended period, it is important to stress more efficient utilization of available manpower resources and increased investment.

To enhance growth potential, it is necessary to improve labor market flexibility allowing jobs of diverse conditions and types in the market. This should also make organized economic activity easier for business start-ups, as well as for existing businesses. To stimulate investment, the corporate investment environment has to be improved. A drastic reduction in regulatory hurdles to business activities is needed.

The government also needs to come up with more pro-active measures to boost capital spending including R&D investment, which has remained sluggish since the 1997 financial crisis.

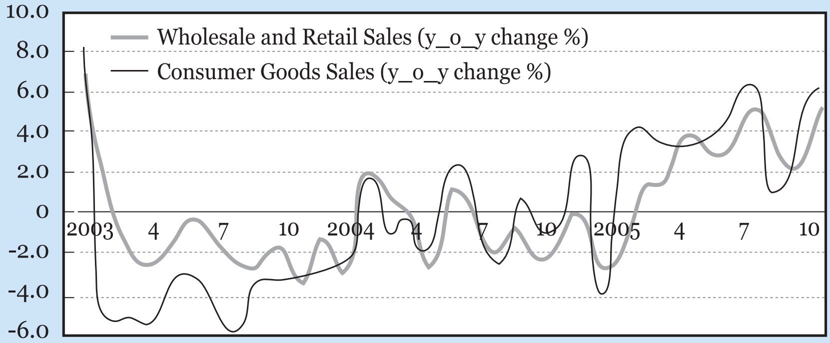
The real GDP growth rate in the third quarter of 2005 rose to 4.5%, which was higher than in the same period of 2004, and up 1.2 percentage point from 3.3% registered in the second quarter. The seasonally adjusted real GDP also expanded to 1.9% from 1.2% in the preceding quarter.

GDP Growth Trends



Consumption appears to be picking up steadily. Wholesale and retail sales have increased gradually since their rebound in March. Consumer goods sales grew 4.8% in the October-November period after registering 3.2% and 3.8% in the second and third quarters, respectively.

Consumption Trends



Entering the fourth quarter of 2005, facility investment had recovered but construction investment had also slowed. Facility investment growth registered 4.3% increase in the Octover-November period, which continued to decline in the second and third quarter. The growth rate in construction investment soared 10.3% in the second quarter, but fell to 4.4% in the third quarter and 7.3% in the October-November period.

Investment Trends

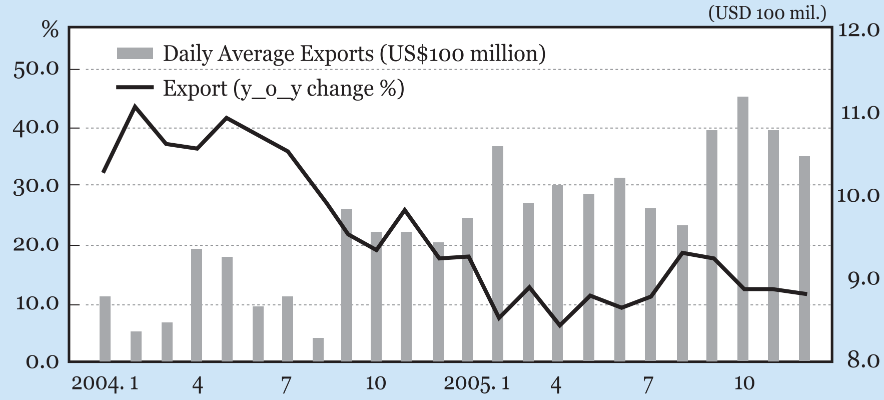
(y_o_y change %)

	2004		2005			
	4/4	Year	1/4	2/4	3/4	Oct.-Nov.
Facility Investment	0.1	1.4	4.0	1.4	0.5	4.3
Domestic Machinery Orders	-0.9	-1.3	-0.4	-1.4	2.2	6.4
Construction Investment	4.4	11.0	2.8	10.3	4.4	7.3
Domestic Construction Orders	26.0	-5.3	27.8	40.5	16.7	-15.6

Source: The National Statistical Office (NSO)

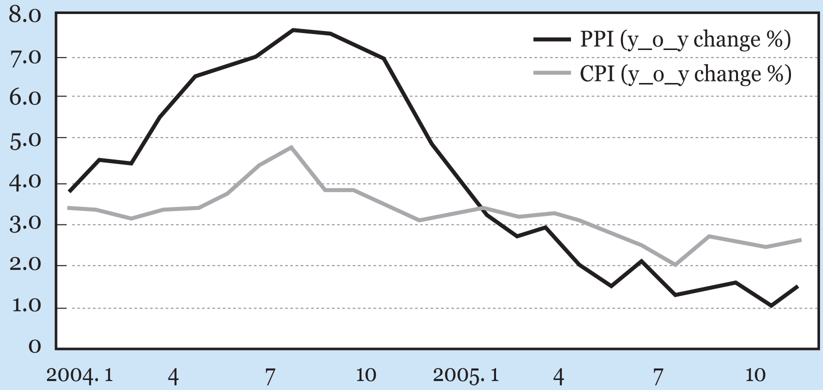
Export growth, which had been on a downward trend since the second quarter of 2004, rebounded in the second half of 2005. On a customs clearance basis, exports slowed to single-digit growth (9.0%) in the second quarter but recovered to double-digit growth rates (15.4%) in the third quarter and 11.8% in the fourth quarter. The daily average export amount has also maintained a level of about US$1.1 billion since August.

Export Trends



Despite the international oil price hikes, prices continued on a stable downward trend thanks to the appreciation of the won's value and stabilization of total demand.

Price Trends



With contraction of the commodity balance surplus and expansion of deficits in the service, income and current transfer balances, the surplus in the current account fell to US$16.13 billion in the January-November 2005 period, down US$9.83 billion from US$25.96 billion in the same period of 2004.

Current Account Balance

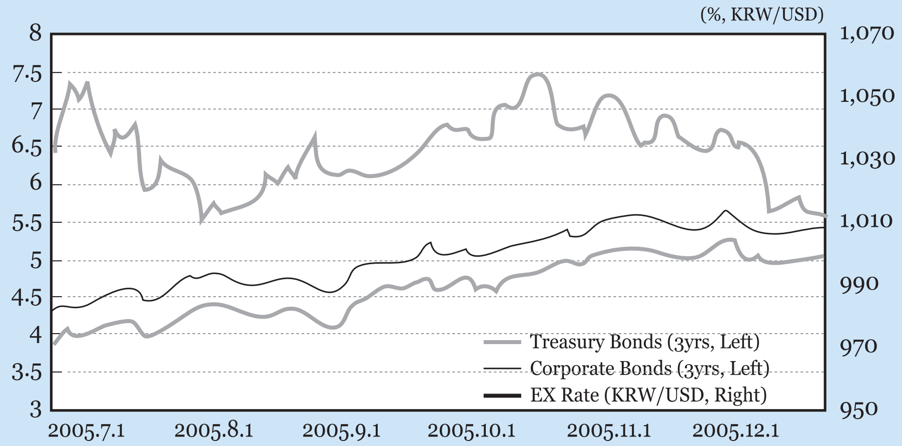
(USD 100 mil.)

	2004		2005				
	Jan.-Nov.	Year	1/4	2/4	3/4	Oct.-Nov.	Jan.-Nov.
Current Account Balance	259.6	276.1	59.5	27.6	25.2	49.0	161.3
Commodity Balance	346.7	381.6	92.9	86.5	75.5	63.3	318.2
Service Balance	-67.8	-87.7	-30.5	-30.8	-44.6	-13.7	-119.6
Income Balance	2.0	7.2	2.4	-21.0	0.4	2.7	-15.6
Current Transfer Balance	-20.9	-25.0	-5.2	-7.2	-6.1	3.2	-21.7

The yield rates on the national treasury and corporate bonds continued on an upward trend owing to policy interest rate increases, expectations for economic recovery, and other factors.

The won-U.S. dollar exchange rate increased to the 1,050 won level at the end of October, but has declined steadily since. Despite the globally strong dollar, there have been simultaneous factors arising from a dollar supply increase and a slowdown in foreigners' stock sales, large-scale selling of dollars by export firms, for example in the shipbuilding sector, as well as inflow of funds from the sale of the Hynix Semiconductor.

Interest Rates and Exchange Rate



The nation's economic growth rate for 2006 is projected at 4.9%, which is higher than the 3.8% growth rate expected in 2005.

While exports should remain a pillar of economic growth, domestic demand weakness of which has been a stumbling block to economic recovery, is forecast to experience a rebound in 2006. Owing to the strengthening competitiveness of non-price factors of the nation's export products and continuation of China's economic growth, exports are likely to continue registering a double-digit growth rate.

In 2006, private consumption is expected to post an annual increase of 4.7% thanks to the settlement of the household debt problem to a certain extent, which has been a structural drag on consumption, along with the influence of improvement in consumer sentiment.

Facility investment, including intangible assets, is projected to record an annual growth rate of 6.2%. The government's permission for construction of large plants in the Seoul metropolitan area will be a one time boost to 2006 capital spending. Affected by the restrictive real estate policy and conversion of fiscal policy to a neutral tone, construction investment is likely to register a low annual growth of 1.5%.

In 2006, consumer prices are expected to rise at 2.9% for the full year. Although high oil prices may continue, total demand pressure, in general, is unlikely to be significant due to the extant deflationary gap. The won's appreciation is also expected to mitigate upward price pressure.

The current account surplus is projected at US$6.8 billion for 2006, which is a sharp drop from the US$16.1 billion surplus of 2005, largely due to the shrinkage of the commodity balance surplus and expansion of the service balance deficit. The commodity balance surplus is expected to decline as import growth outpaces export growth, a result of domestic demand recovery. The service balance deficit is likely to expand steadily under the weak competitiveness of the service sector.

Long-term interest rates are expected to maintain an upward trend in 2006 at the 5% level from the 4% range seen in 2005 due to policy interest rate increases and the economic recovery.

The won-dollar exchange rates are expected to fall to 1,007 won in the first half and 992 won in the second half. There is a possibility that U.S. policy interest rate hikes will end in the first half of 2006 and it is also unlikely that the dollar will continue to maintain its recent strength due to the expansion of the twin U.S. deficits in the national budget and current account. The possibility of appreciation of the Chinese yuan also will serve as a factor to strengthen the won.

Outlook for 2006

(y-o-y change %, USD 100 mil.)

	2004	2005			2006				
	Year	3/4	4/4	Year	1/4	2/4	3/4	4/4	Year
GDP	4.6	4.5	4.7	3.8	5.1	4.7	4.8	5.0	4.9
Private Consumption	-0.5	4.0	4.4	3.1	4.5	4.6	4.9	5.0	4.7
Construction Investment	1.1	0.4	-0.4	-0.1	0.4	1.0	1.8	2.2	1.5
FacilityInvestment	3.1	4.2	4.9	3.8	5.0	5.1	6.8	7.7	6.2
Consumer Prices	3.6	2.3	2.5	2.7	2.6	2.9	3.1	3.2	2.9
Current Account Balance	281.7	25.2	48.2	160.5	35.2	6.4	5.5	20.6	67.7
Exports	2577.1	723.3	784.5	2895.9	759.3	783.6	793.2	850.5	3186.6
y-o-y Change (%)	30.6	14.3	12.9	12.4	11.4	10.9	9.7	8.4	10.0
Imports	2201.4	647.8	704.1	2560.5	680.0	705.9	728.4	784.0	2898.2
y-o-y Change (%)	25.6	21.0	16.7	16.3	15.5	13.9	12.5	11.3	13.2
Exchange Rates (KRW/USD, ave.)	1145.7	1029.2	1036.5	1024.0	1012.1	1002.5	994.5	988.6	994.7
Corporate Bond Yield Rates (ave.)	4.7	4.7	5.5	4.7	5.7	5.7	5.9	5.9	5.8

Source: KERI's Quarterly Projections
* Including Intangible Assets

The 5% growth rate projected for 2006 is judged to be insufficient, when the following points are taken into account.

First, although economic growth in 2006 could reach 5%, the output gap will not be narrowed significantly. Second, the 5% economic growth will not translate into a 5% increase in income due to the adverse terms of trade conditions. Third, 5% growth is insufficient to solve the widening income gap and other economic problems. In view of these issues, the national economy must maintain 5% growth or higher level for an extended period of time, and for this, it is necessary to utilize available manpower resources more efficiently and to increase investment.

For more efficient utilization of available manpower resources, first, labor market flexibility must be improved in order to create new jobs with diverse conditions and of various types. Greater employment of women, youths, and the elderly can be realized only with an increase in the total number of jobs, regardless of whether they are permanent or temporary. Second, steps should be taken to enlarge more organized economic activities to increase the number of business start-ups and expand existing businesses.

To stimulate investment, improvement of the corporate investment environment is required. It is important to establish policies based on economic efficiency, while maintaining a consistent government labor-management policy, finding comprehensive resolutions to various regulations such as the restriction on the location of manufacturing plants in the larger areas, and limitations on the total equity investment ceiling, as well as to expand incentives to induce facility and R&D investments.

The government must focus on areas that could create the most positive effects on the overall economy: opening the services sector, and enhancing labor market flexibility. As for those areas with comparatively limited effects on the national economy, such as corporate governance structure and micro-adjustments to the separation of finance and industry, a more reasoned approach is needed.

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