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Contents

Korea Economic Research Institute

Economic Trends and Outlook

Executive Summary

The Korean economy is projected to grow 2.4% in 2009, which is the lowest level since the 1997 financial crisis. The forecast growth rate has been downgraded from our October projection of 3.8%. A sharp decline in export growth due to the global economic contraction is cited as a main reason for the downgrade. Domestic demand is expected to remain fairly vulnerable as the labor market conditions worsen and the households face declining income amid tight credit conditions. The economy is expected to rebound starting in the second half of 2009 as stimulus packages both domestic and international begin to gradually take effect.

The current account balance for 2009 is expected to record a surplus in the neighborhood of US$16 billion. Sharp declines in import demand and international oil price are cited as major factors. Consumer inflation rate is expected to remain stable at around a low 2% level due to declines in prices of international oil and commodities and domestic demand. On the other hand, the Korean won-U.S. dollar exchange rate is likely to remain at a relatively high level for the time being. However, there is some possibility that the Korean currency would appreciate sharply against the U.S. dollar beginning in the second half of 2009 due to global weakening of the dollar and Korea’s current account surplus. On average, the exchange rate between the two currencies is expected to be around 1,210 won per dollar.

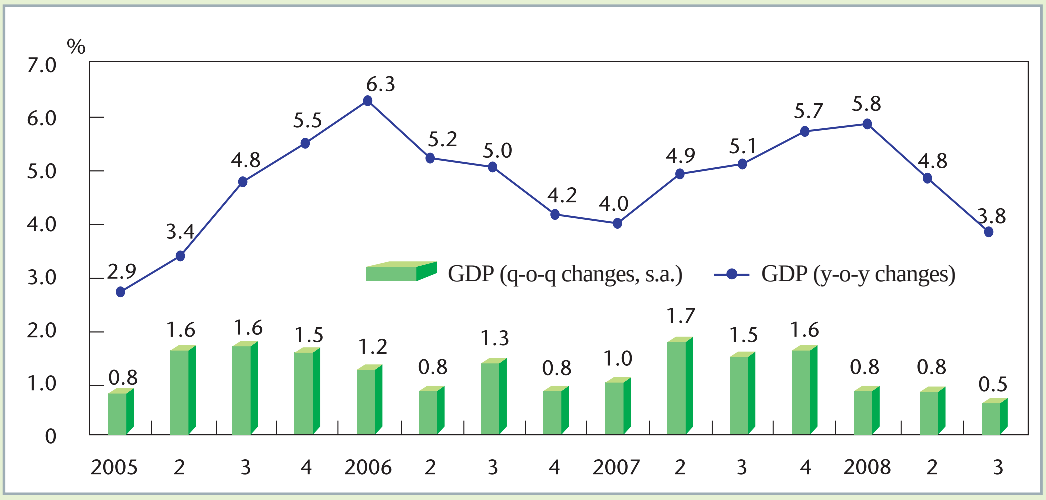
It should be noted that the current projections are based on the assumption that the Chinese economy will make a soft landing with 8.5% growth in 2009. If China's stimulus packages fail to produce desired effects, the Korean economy's growth is likely to fall to a 1% level.

With weaker export markets, reviving domestic demand to jump-start the economy becomes an even more urgent policy task. An important challenge is to create stable job-market conditions so as to prevent further contractions in private consumption. Daunting as it is, structural reforms in key sectors such as construction and shipping industries are needed to improve market conditions and create more favorable conditions for job creation. To this end, the government should ease restrictions on the use of part-time workers, prevent unnecessary layoffs and create additional employment through adjustment of working hours and permission for diverse employment types.

Recent Developments

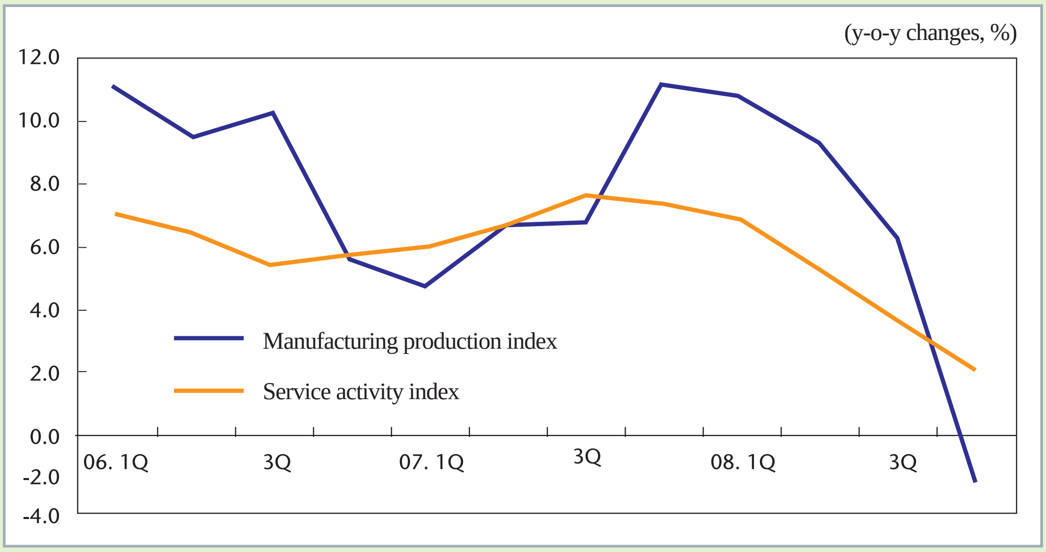
Real GDP growth (s.a.) in the third quarter of 2008 declined to 0.6%, lower than 0.8% of the preceding quarter. It has been the slowest growth rate since the third quarter of 2004.

Quarterly GDP Growth



The economic slowdown was measurable in October. Service output growth significantly declined to 1.0%, falling continuously from 4.6% in the second quarter and 2.7% in the third quarter. Manufacturing output growth, which slowed to 5.6% in the third quarter from 9.8% in the second quarter, posted a 2.8% expansion.

Manufacturing Production Index and Service Activity Index



In the domestic demand sector, consumer goods sales were remarkably stagnant. Sales growth of consumer goods slowed sharply to 1.1% in the third quarter and then posted a decline of -3.7% in October. This is attributed to a sharp contraction of consumption sentiment caused by financial market instability in the midst of worsening labor market conditions. Facility investment increased 6.1% in the third quarter, owing to a base effect from the low 0.7% growth in the third quarter of last year, but decreased significantly to -7.7% in October. The construction orders received has decreased sharply this year despite growth in construction progress payment, showing signs of a possible recession in the construction sector.

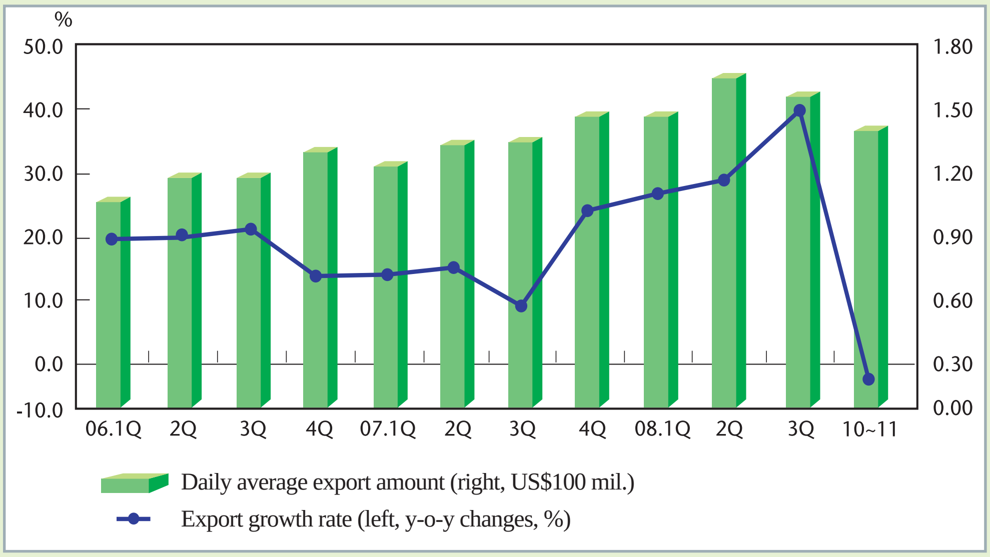
Trends in Domestic Demand

(Unit: y-o-y changes, %)

	consumer goods sales	Facility Investment	Domestic Machinery Order	Construction Completed (nominal)	Constrution Orders Received (nominal)
2006	4.1	8.9	16.2	2.6	9.0
2007	5.3	8.6	21.1	6.6	19.3
06. 1Q	4.7	7.4	10.1	2.9	-8.5
2Q	5.6	9.1	21.9	-1.0	-14.7
3Q	3.1	12.7	18.1	3.8	37.1
4Q	3.0	6.4	15.0	4.8	27.1
07. 1Q	5.7	12.8	18.9	7.9	26.3
2Q	4.2	11.9	7.1	6.0	26.3
3Q	7.0	0.7	19.1	4.4	-5.6
4Q	4.5	9.2	39.3	8.0	29.5
08.1Q	3.9	-0.9	25.2	5.8	-3.9
2Q	2.5	0.1	8.8	6.5	-6.1
3Q	1.1	6.1	-7.6	11.1	-22.8
Oct.	-3.7	-7.7	-36.7	8.0	-23.9

With sluggish overseas economic conditions, export growth decreased dramatically to 5.1% in October-November from 27.1% in the third quarter. The daily average export amount fell to US$1.43 billion in the two-month period from US$1.64 billion in the third quarter.

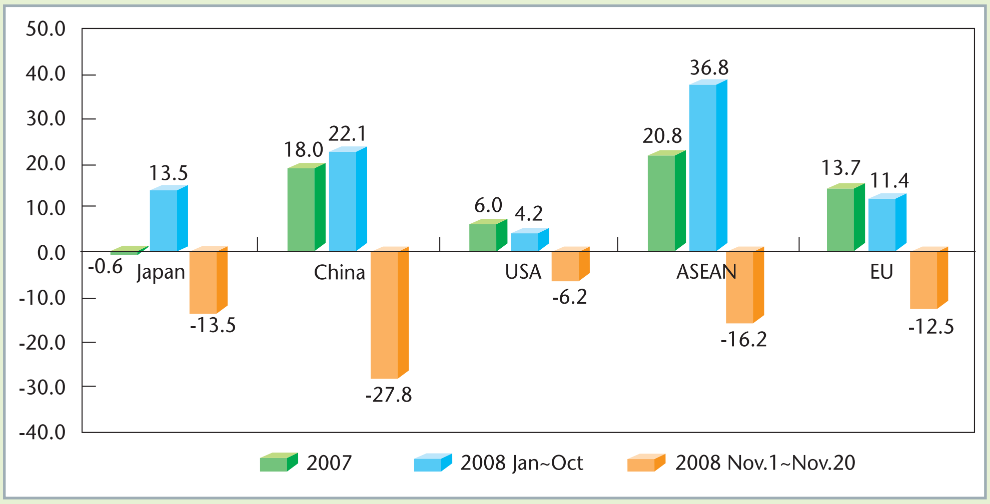
Export Growth Rates & Daily Average Exports



In November this year, exports recorded negative growth in all major export markets including China, ASEAN, Japan, the United States and the EU.

Export Growth Rates by Region

(Unit: y-o-y changes, %)



The current account balance, which recorded a deficit of US$13.9 billion until the third quarter of this year, reverted to a surplus since October as import demand declined rapidly.

Current Account Balance

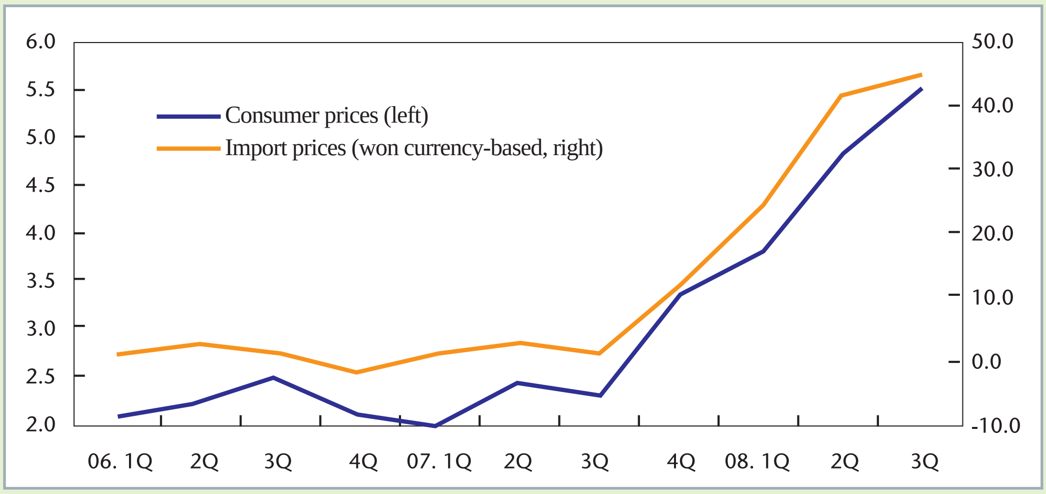
(Unit: US$ bllion)

	Current Account Balance	Goods	Service	Travel	Business Service	Income	Current Transfer
2006	5.4	27.9	-19.0	-13.1	-7.2	0.5	-4.1
2007	6.0	29.4	-20.6	-15.1	-8.4	0.8	-3.6
06. 1Q	-2.0	4.7	-5.1	-3.0	-1.7	-0.5	-1.1
2Q	0.2	7.1	-4.2	-2.9	-1.7	-1.4	-1.3
3Q	1.0	6.2	-5.3	-3.8	-1.8	1.1	-1.0
4Q	6.1	9.9	-4.3	-3.4	-2.0	1.3	-0.7
07. 1Q	-1.7	6.0	-6.2	-3.6	-2.3	-0.7	-0.8
2Q	0.0	7.0	-4.4	-3.7	-1.7	-1.5	-1.0
3Q	4.4	9.7	-5.9	-4.4	-1.9	1.7	-1.0
4Q	3.2	6.7	-4.1	-3.5	-2.5	1.3	-0.8
08.1Q	-5.2	-1.2	-5.1	-3.0	-2.9	1.7	-0.6
2Q	-0.1	5.7	-4.3	-2.8	-2.9	-0.6	-0.9
3Q	-8.6	-3.5	-5.7	-3.0	-4.1	1.4	-0.8
Oct.	4.9	2.8	-0.1	0.5	-1.4	1.4	0.8

The consumer inflation has slowed to a 4% level since October largely due to declines in domestic demand and international oil price. The inflation rate was 4.7% in October-November down 0.8%p from 5.5% in the third quarter.

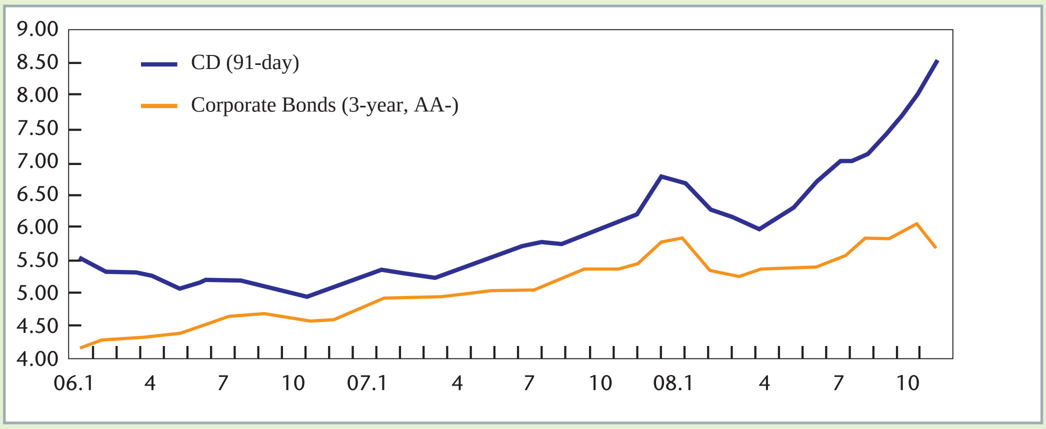
Consumer Prices and Import Prices

(Unit: y-o-y changes, %)



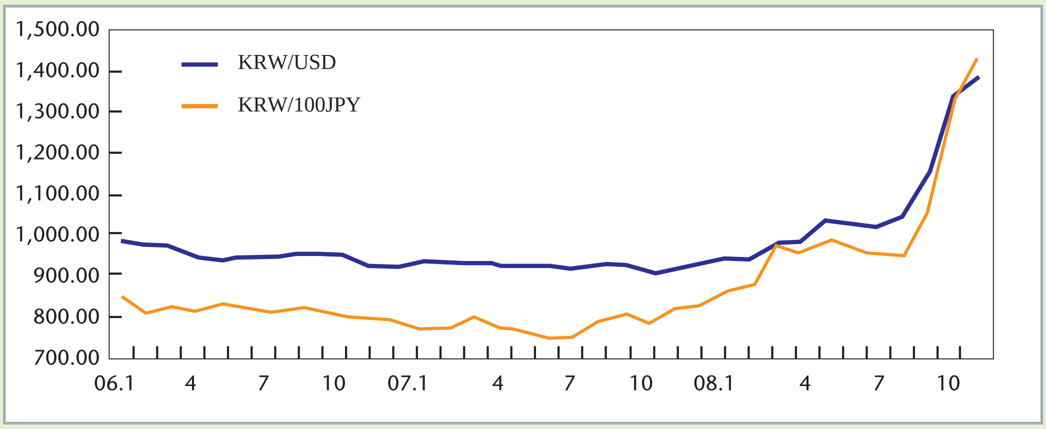
As for market interest rates, yields on safe assets such as treasury bonds are on a declining trend as the Bank of Korea pursues interest rate cuts and the financial market regains some confidence through the curreny swap agreement between Korea and the U.S.. However, yields on higher risk assets such as corporate bonds continue to rise as private companies are under careful scrutiny for possible liquidity failures.

Interest Rates



The Korean won-U.S. dollar exchange rate has been on a gradually increasing trend, from 1,215 won on October 1 to 1,475 won on December 5. However, the Korean won's depreciation against the dollar seems to come under control recently as the U.S. government adopted aggressive policies to sooth market sentiments and the current account balance of Korea has turned to surpluses since October.

Exchange Rates



Outlook for the 2nd Half of 2008

External Environment

Global economic growth is projected to slow significantly as the international credit crunch spreads into the real sectors in 2009. IMF and IBRD are projecting that the world economy will grow 2.2% and 0.9% respectively in 2009.

Due to contraction of international demand, international oil prices are expected to stabilize at around a US$60/barrel level on annual average in 2009. Geopolitical instability in the Middle East and deteriorating supply conditions still exist and remain a risk to stable oil prices. However, contraction in demand for oil due to a global economic stagnation will be an overriding factor in 2009.

The aftereffects of the international financial crisis are likely to persist at least until the second half of 2009. The U.S. housing market recession may continue until next year, and resolving subsequent delinquencies in the related financial market may also require a long period of time. With inflationary pressures gone, the major countries are expected to pursue expansive monetary policies through interest rate cuts.

Internal Environment

The current international financial crisis is expected to have significantly negative effects on the domestic economy for a considerable period. The effects are already being felt in the export sector with recent double digit declines in its growth rate. The major countries are cooperating with each other to cope with the current crisis as soon as possible, but it is more than likely that the recovery is still far away. Until then, contractions of domestic consumption and investment will be unavoidable.

As the inflationary pressures decline, the Bank of Korea is more at liberty to pursue expansive monetary policies through interest rate cuts. Further, international cooperation among major central banks in the world to cut the policy interest rates is nudging the Bank of Korea to adapt a similar policy stance. As a result, further interest rate cuts are expected in 2009.

Economic Prospects for 2009

Korea's economic growth rate for 2009 is projected at 2.4%, the lowest level since the 1997 financial crisis. Affected by the global economic recession, the export growth is expected to decline sharply, and domestic demand is likely to contract as well. The economy is expected to post low growth of 1.8% in the first half of 2009. However the economy is expected to rebound somewhat in the second half and post a growth rate of 3.0% owing to international cooperation to stabilize financial markets and domestic stimulus packages taking effect.

- Private consumption is expected to decrease 0.2% on the annual average due to aggravation of domestic and overseas environments, worsened employment conditions, and increases in household loan burdens.

- Affected by stagnant business conditions and restructuring of the construction industry, construction investment growth is expected to slow further than in 2008 and decrease 1.8% annually.

- Facility investment is likely to record a 0.6% decline due to the economic slowdown and tight credit conditions caused by the international financial market instability.

With import growth decreasing more significantly than export growth due to declines in international oil prices and import demand, the current account balance is forecast to post a surplus of US$16 billion in 2009.

Export growth (based on international balance of payments, U.S. dollar) is expected to fall sharply to 0.4% in 2009 from 18.3% in 2008. With the prolonged credit crunch and the subsequent global economic slowdown becoming more pronounced, significance reduction in overseas demand from most major export markets is likely to be unavoidable.

Consumer prices are expected to stabilize further owing to downward stabilization of international raw material and oil prices and contraction of domestic demand. With the won-dollar exchange rate, one of the important variables in prices, gradually falling next year, consumer prices in 2009 are projected to post 2.5% growth.

Market interest rates are expected to decline gradually due to the Bank of Korea's additional interest rate cuts and gradual improvement in credit market conditions. The corporate bond (3-year, AA-) rate is likely to fall gradually from 8.3% in the fourth quarter of this year to 7.4% in the first half and 6.9% in the second half of next year to record 7.2% on annual average.

The won-dollar exchange rate is expected to show a stable downward trend next year as the global credit condition are likely to ease gradually after the first half and the current account balance is forecast to record a large surplus. The Korean won-U.S. dollar exchange rate is expected to record a 1,210 won level on an annual average in 2009.

Economic Outlook for 2008~2009

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

	2008	2009						
	Year	1Q	2Q	3Q	4Q	1st H	2nd H	Year
GDP	4.1	1.7	1.8	2.4	3.6	1.8	3.0	2.4
(SA, q-o-q, %)		0.4	0.9	1.2	1.1	0.8	2.2	
Private Consumption	1.8	-1.9	-1.9	0.1	2.8	-1.9	1.5	-0.2
Fixed Investment	0.0	-4.2	-3.4	-1.0	2.7	-3.7	1.0	-1.3
Construction Investment	-1.1	-3.3	-3.9	-1.5	0.6	-3.6	-0.4	-1.8
Facilities + Intangible Assets	1.3	-4.9	-2.8	-0.5	5.5	-3.8	2.6	-0.6
Exports (Goods + Service)	8.7	0.4	-0.7	0.7	2.8	-0.2	1.8	0.8
Imports (Goods + Service)	6.0	-5.5	-6.2	-3.6	1.1	-5.8	-1.2	-3.5
Consumer Prices	4.7	3.2	2.6	1.8	2.5	2.9	2.1	2.5
Producer Prices	8.9	7.7	2.1	-0.5	1.3	4.9	0.4	2.6
Current Account	-52.5	22.9	55.5	33.2	48.5	78.4	81.7	160.0
Commodity	85.8	32.0	95.1	62.1	64.3	127.1	126.4	253.5
Exports (BOP Base)	4482.3	1030.2	1157.9	1159.9	1150.5	2188.1	2310.4	4498.5
Growth (%)	18.3	0.1	-2.1	-1.2	4.9	-1.1	1.8	0.4
Imports (BOP Base)	4396.5	998.2	1062.8	1097.8	1086.2	2061.0	2184.0	4245.0
Growth (%)	25.8	-4.1	-5.6	-9.1	6.2	-4.9	-2.1	-3.4
Service & Others	-138.3	-9.1	-39.6	-28.9	-15.8	-48.8	-44.7	-93.5
Ex Rate (Avg. KRW/USD)	1090.3	1320.0	1280.0	1150.0	1090.0	1300.0	1120.0	1210.0
Corp. Bonds Yield (3-year, AA-)	7.0	7.8	7.0	6.8	7.0	7.4	6.9	7.2
Unemployment Rate (%)	3.1	4.0	3.4	3.4	3.4	3.7	3.4	3.5

* Including intangible asset investment

Issue Focus

Understanding the Current Situation and Future Policy Tasks

1. Current Situation

In 2009, with the economies of advanced countries, the U.S., EU, Japan, etc., expecting negative growth, the economic growth of newly industrialized countries such as China and India are also likely to experience a significant slowdown. Therefore, an economic recession of the global economy will be unavoidable. This is a crucial factor that will strike a critical blow to the economy, with the high export dependence level, and stifle the nation's export growth next year at a near zero level.

In the domestic demand sector, as contracted consumption and investment sentiment is unlikely to improve significantly next year, negative growth is expected for both consumption and investment.

Recording the lowest growth rate since the 1997-98 foreign exchange crisis, 2009 is expected to be a painful year. Therefore, preventing the occurrence of a vicious cycle (growth slowdown -> reduction of employment & income -> contraction of consumption & investment) is an urgent task.

2. Policy Tasks

(1) Mitigation of Economic Slowdown with Job Creation through Regulation Reform

The government should reform regulations that aggravate employment reduction to mitigate worsening of the employment situation. Since it is hard to expect creating more jobs through cyclical boost, there is a need to pursue policy alternatives including non-cyclical factors such as reforming regulations. If the economic growth rate drops to 2.4%, employment is expected to increase by only 58,000 persons.

The government must ease restrictions on use of irregular(temporary) workers and prevent unnecessary layoffs following consequently with implementation of the restrictions. The current employment situation is hardly understood to be caused by economic stagnation alone, that is, it can be explained that the regulation mandating conversion of the status from irregular to regular after certain period of time contributes to the additional employment slowdown along with economic stagnation factors. Extending the employment contract period of irregular workers could be one solution. Furthermore, the government should seek to creat additional employment through adjustment of wages and working hours, or even allowing diverse types of employment.

Such employment creation through regulation reform is conducive to the recovery of the economy by increasing consumption. If 200,000 jobs are to be created, which is the government's goal for 2009, private consumption and real GDP growth will increase by 0.34% point and 0.2% point in approximate, respectively.

Employment Increase and Net Consumption Growth by Real GDP Growth

(Unit: 10,000 persons, % point)

	2009 Real GDP Growth by Scenario				
	2.7% (OECD)	2.4% (KERI: Basic Projection)	2.0% (IMF)	1.9% (KERI: Pessimistic Projection)	0.0%
Changes in No. of Employed Persons	10.2	5.8	0.0	-1.4	-29.1
Net Consumption Growth	+0.11	0.00	-0.13	-0.17	-0.82

(2) Economic Policy to Stabilize the Financial and Real Economy

Through activation of substantial liquidity supply, the government should promptly stabilize financial and foreign exchange markets. Despite the government's increased liquidity supply, credit stringency is a remaining problem. The government should help to supply liquidity directly to the real economic sectors by supporting expansion of banks' own capitals through purchasing subordinate securities and examining ways of restricting foreign currency liquidity to the usage only for export and import financing.

Mobilizing all policy measures, such as 'tax reduction,' 'fiscal expansion' and 'interest rate cut,' the government should activate domestic demand. While promoting various suggestions thus far forwarded in due course, the government should establish emergency countermeasures at the same time as well to prepare for the worst situation. It is because according to the deployment aspects of the global financial crisis, we need to prepare for the worst situation derailed from the general economic cycle.

Recent Publications

Research Monograph

Analysis of the Effect of Corporate Restructuring on the Economic Performance Before and After the Financial Crisis

Research Monograph 08-14
Byoung-Ki Lee

This study tries to analyze profit rates and productivity changes of Korean firms before and after the financial crisis. It also empirically analyzes what would be the effects of corporate restructuring on reorganization success. The results can be summarized as follows,

First, the profit rates of Chaebol, large enterprises and high-tech enterprises were improved more distinctly than the ones of non-Chaebol, small and medium-sized firms and traditional corporations. Secondly, debt restructuring, labor restructuring and fixed asset restructuring contributed to improve the profit rates of Korean firms. Thirdly, firms growth potentialities such as the value of intangible assets and increase of cash flow ratio are gaining more power in explaining firms' reorganization. Fourthly, recently, Korean firms show a tendency to increase the investment on intangible assets while decreasing the investment on tangible assets. Fifthly, After financial crisis, high-tech firms in Korea have been displaying a rapid growth, a low debt rate, high cash flow ratio and also showing a lofty investment rate comparing with traditional corporations.

Several policy implications can be drawn, based on these analysis results. First, further deregulation is needed to facilitate the mobility of capital and labor from inefficient sectors to efficient sectors through a natural market selection process.

Second, active restructuring should be continued and substantial institutional reformations are needed for nurturing and growing more high technology firms.

Third, to survive and grow, Koran firms have to continue or expand their R&D investment and institutions should be further improved to form a supporting environment.

Policy Report

FDI Environment and System Improvement Tasks

Policy Report 08-07
Byoung-Ki Lee

Reduction of the corporate tax turns out to be increasing FDI (Foreign Direct Investment). Centering on the EU, European countries are already staging fierce corporate tax cut competitions in need to expand FDI. Active promotion of FTA as a major factor for expansion of FDI is necessary. On the other hand, a high wage increase in the investment-inducing nations was a factor decreasing FDI. Improvement of laws and order was analyzed as a factor giving an positive effect to FDI.

When taking such analysis results into consideration, reduction of the corporate tax, expansion of FTA, stabilization of labor-management relations and wages, stabilization of legalism, politics and economy, and advancing FDI-related systems are necessary.

Review of Unrest Factors at Foreign Exchange Market and Responding Measures

Policy Report 08-08
Soon-Kwon Ahn

Due to shock from the U.S.-originated financial crisis, won currency depreciated about 50% this year. For the next one or two years until resolution of the U.S. financial crisis, instability of the domestic foreign exchange market is expected to continue. Considering trade weights and prices of 20 major countries, the proper won-U.S. dollar exchange rate is 1,040 won to 1 dollar. If Korea's service balance deficit and the recent credit stringency are also taken into account, the proper exchange rate level is estimated at around 1,250. Therefore, it is diagnosed that the present exchange rate of 1,400 won to 1 dollar is due to an excessive 'herd behavior' phenomenon. To stabilize foreign exchange market, it is more of an importance that the government recovers confidence and people cooperate to the policies. Furthermore, the government needs to employ a bold economy-boosting policy through additional interest rate cut and expansion of fiscal expenditures. It should also expand the level of yen-won currency swap so that Japan and Korea would be better off through curbing both strengthening of Japanese yen and weakening of Korean won.

Political Implications from U.S. and Japan's Operation of Poison Pill

Policy Report 08-09
Seuk-Hun Sin

In order to introduce Poison Pill, it is necessary that the corporation law recognizes the variety of share classes and the stock subscription warrant. However, the Poison Pill is misunderstood only as a specific security to protect management rights and hence due to lack of understanding of the basic concept and operating principle of Poison Pill, its introduction to the system is being delayed.

While In the U.S. and Japan, all the legislation, judicial and administrative bodies are agonizing to maximize the positive aspects and minimize the negative aspects of Poison Pill, Korea is hesitating incorporating diversification of share classes and stock subscription warrant into the Corporation Act, judging that there is possibility for Poison Pill to be utilized wrongly only for the interest of management groups.

In order for our enterprises to broaden the radius of activities in the capital market, the government should promote introducing the diversification of share classes and the stock subscription warrant into the Corporation Act.

As for the criteria to judge legality when such a stock system is utilized as Poison Pill to protect management rights, the government should pursue operational techniques of making it gradually through guidelines of the administrative body's guidelines and the judicial body's judgment as in Japan.

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