

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

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Executive Summary

Growth in 2nd Half '11 Projected at 4.1%

Economic growth in the second half of this year is expected to register 4.1%, slightly higher than the 3.8% in the first half, because economic conditions are unlikely to improve significantly as internal and external uncertainties that existed in the first half are continuing in the second half.

Citable as uncertainties are the mood of fiscal retrenchment and normalization of monetary policy at home, financial problems in advanced countries and stronger retrenchment in emerging countries, a decline of real estate transactions, etc.

Accordingly, the annual growth for 2011 is expected to stand at 3.9%, far lower than the 6.2% of last year. Affected by such factors as robust increases in employment and household incomes and eased inflationary pressure, private consumption in the second half of this year will rise about 0.2 percentage point from the 3.0% in the first half.

On the other hand, the slowdown in facility investment will continue in the second half due to base effects and increased uncertainties in the corporate investment environment. Construction investment, which recorded a 20% decline in the first half, is also unlikely to improve, posting a decrease of about 0.6 percentage point.

CPI to Rise 3.9% in 2nd Half '11

With a 3.9% increase in the second half, consumer price inflation may ease compared with the 4.3% in the first half. However, the upside risk is high due to increases in farm product prices, rationalization of public utility rates, rises in home rental costs, etc.

Current Account Surplus to Record US\$6.4 Bil. in 2nd Half '11

The current account balance in the second half is expected to register a surplus of US\$6.4 billion, down from US\$8.4 billion in the first half due to the faster growth rate of imports over exports and expansion of the service balance deficit. The Won-U.S. dollar exchange rate is projected to appreciate, affected by a higher U.S. dollar supply situation and an increase in the base interest rate. Due to the spread of the fiscal administration crisis in Europe and the end of the U.S. second round of Quantitative Easing (QE2) policy, however, exchange rate appreciation is expected to be limited.

Caution Needed in Linking Diverse Social Phenomena with Bipolarization

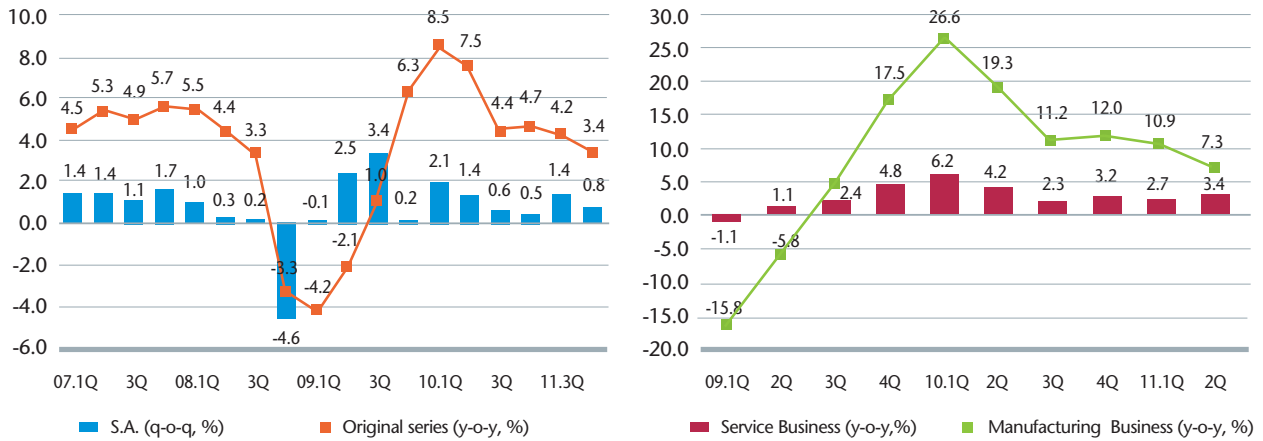
The spread of the social atmosphere that considers even a simple income gap expansion as evidence of bipolarization is a factor that undermines the integration of Korean society. Therefore, equivalent use of the terms income inequality level and bipolarization should be avoided in order to promote social harmony as well as to establish an appropriate economic policy direction.

Recent Developments

GDP Growth in 2nd Quarter '11: 3.4%

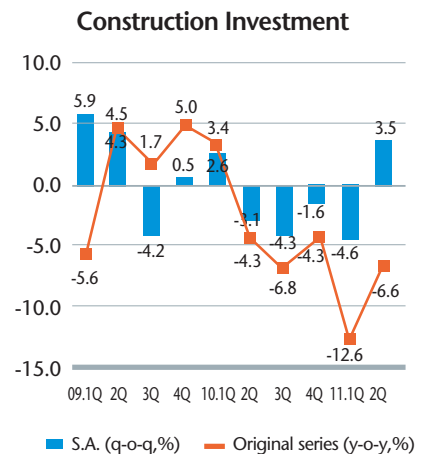
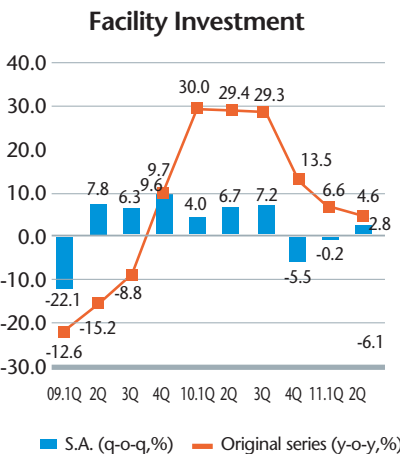
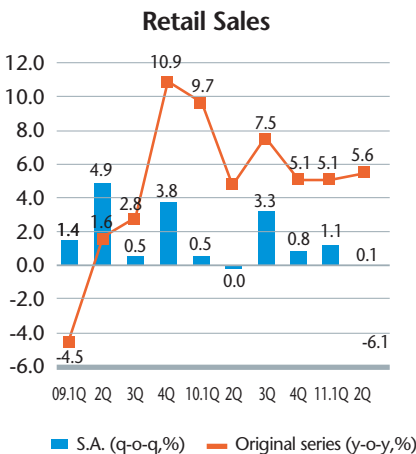
GDP growth continued to slow in the second quarter due to greater uncertainties in internal and external environments, normalization of domestic macroeconomic policy, extinction of base effects, etc. Manufacturing production growth registered 7.3% in the second quarter, a 3.6 percentage point decline from the 10.9% of the first quarter. Service production also continued mild growth of about 3%.

GDP Growth and industrial Production



Consumption Maintains Rebound, Facility & Construction Investment Slow

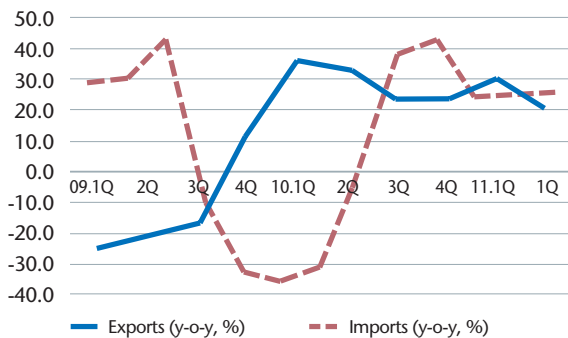
Retail sales (at constant prices) increased 5.6% in the second quarter, maintaining a robust upward trend. Facility investment, however, continued to stagnate, remaining at 4.6% growth, while construction investment growth declined 6.6%, continuing a slowdown.



Growth in Exports & Imports; Current Account Surplus Expands

Exports maintained a high growth rate of 20.0% in the second quarter, albeit a decline from 29.6% in the first quarter. Imports in the second quarter rose 27.2%, recording expanded growth compared with the first quarter. The current account surplus increased, with contraction of the service balance deficit and an increase in the commodity balance surplus.

Exports, Imports and Current Account Balance



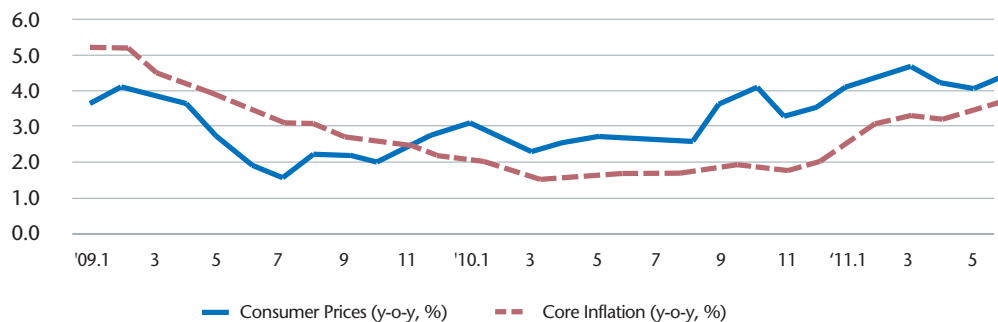
(Unit: US\$100 million)

	2010				2011	
	1/4	2/4	3/4	4/4	1/4	2/4
Current Account	3	89	99	92	26	65
Commodity	48	122	125	123	58	86
Service	-42	-19	-30	-22	-25	-8
Travel	-20	-14	-27	-19	-22	-23
Income	5	-10	13	-1	4	-8
Transfer	-9	-5	-10	-9	-11	-5

Consumer Prices Rose Continuously

The high consumer price trend continued with ripple effects of import price rises in crude oil and raw materials impacting overall prices, notwithstanding the stabilization of prices for farm products.

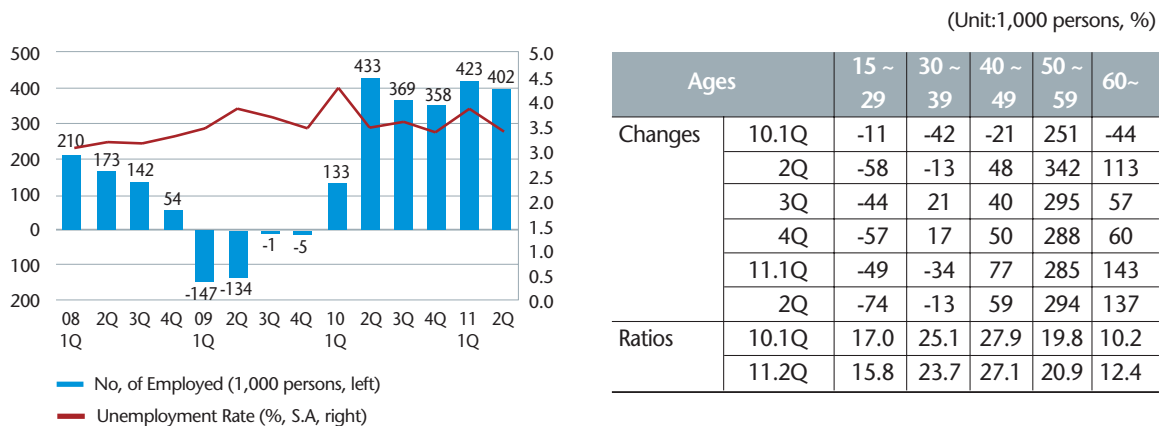
Prices



Employment Recovery Continued; Working Age Increasing

The number of employed persons in the second quarter rose about 400,000 year-on-year and the unemployment rate also improved to 3.4% compared with 4.2% in the first quarter. Nevertheless, a trend in aging workforce, including a decrease in the ratio of youth employment (below 40 years old), strengthened.

Employment



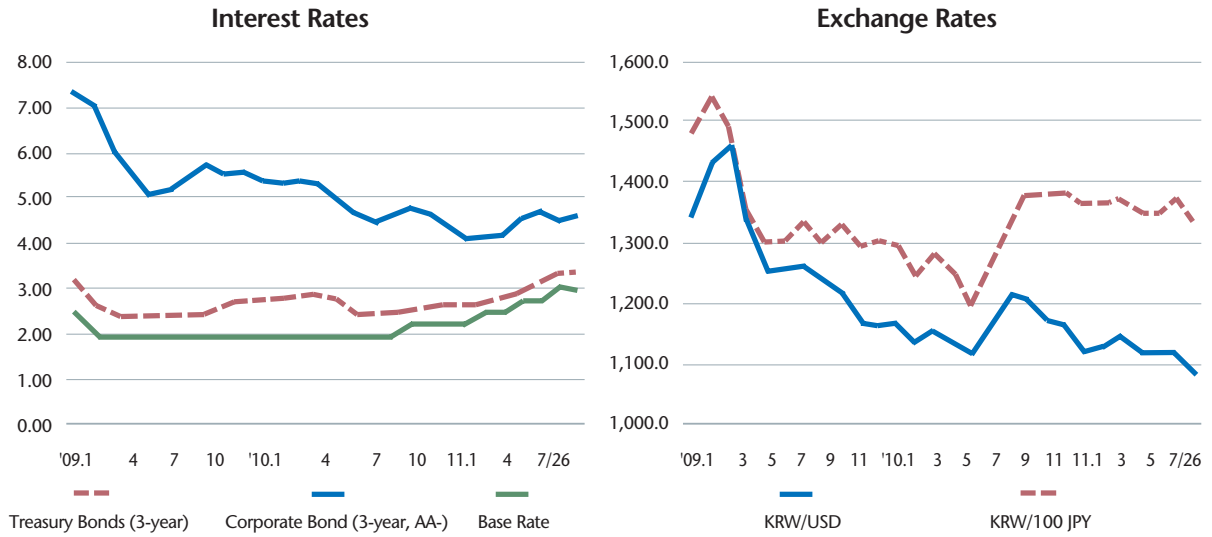
Market Interest Rates Decline Mildly

Despite base interest rate hikes in January, March and June this year and price rises, upward pressure on market interest rates weakened due to expanded foreign investment in domestic bonds and greater uncertainties surrounding the economic recovery.

Won-U.S. Dollar Fx-Rate Continued to Appreciate

The won-U.S. dollar exchange rate appreciated amid the global weakening of the U.S. dollar and continued increases in the supply of the U.S. dollar due to foreign capital inflow, trade surplus, etc.

Economic Trends and Outlook



Outlook for 2nd Half of 2011

1. Internal and External Environments

World Economy Maintaining Robust Recovery, But Uncertainties Growing

The recovery momentum of the U.S. economy weakened due to greater uncertainties associated with termination of the second round of Quantitative Easing (QE2), projections of a downgrade in credit rating, a stubbornly high unemployment rate, and delay in the recovery of housing business conditions, in particular. Meanwhile, recovery of the Japanese economy is expected to be slow, affected by the nuclear power plant accidents in the country and the uncertain economic outlook due to fears over the spread of the fiscal administration crisis in Europe. In China, retrenchment reinforcement may be a factor but the possibility of a hard landing is not high.

International Oil Prices Projected at About US\$105/Barrel

The growth of demand for oil is likely to slow due to uncertain economic projections related to Europe's fiscal administration crisis and the instability of U.S. economic indicators.

Weakening of U.S. Dollar to Yen & Euro to Ease

As comparatively better growth is projected for the U.S. economy than that of Japan or the EU, the U.S. dollar weakening against the Japanese yen and Euro is expected to ease.

Internal Environments: Macroeconomic Direction to Focus on Domestic Demand- Centric Stable Growth

The country's fiscal health will continue to improve, including a 2011 budget that features more total revenues than total expenditures. However, with price pressure gradually rising, increases in the base interest rate are increase likely. But, the tone on momentary policy is expected to be mild due to the re-emergence of the fiscal administration crisis in Europe and the projected soft-landing of household debt and real estate market conditions.

Key Assumptions for Projections

Exogenous Variables	Unit	2010	2011
China's Growth	%	10.3	9.6
Japan's Growth	%	3.9	-0.7
U.S. Growth	%	2.8	2.5
Dubai Oil Price	US\$/bbl.	78.1	105.0
Base Rate (end of year)	%	2.50	3.50

2. Outlook for Korean Economy (2011)

Growth: 3.1% (1st Half) → 4.1% (2nd Half) → 3.9% (Annual)

Following the 'high in the 1st half and low in the second half' pattern of economic growth last year, the Korean economy may grow slightly in the second half this year compared with the first half, but a similar growth pattern is expected year-on-year.

Private Consumption: 3.0% (1st Half) → 3.2% (2nd Half) → 3.1% (Annual)

As the trend in the number of employed persons is steadily increasing and the income growth per household is also improving with the fourth quarter of the last year as the bottom, private consumption may improve slightly in the second half compared with the first half, but the rate itself is likely to be lower than 3.5% due to a continued downward trend in real estate prices.

Construction Investment: -10.0% (1st Half) → -0.6% (2nd Half) → -5.1% (Annual)

Decreases in public construction will be unavoidable, influenced by the early orders for projects in 2009 and a reduction in the SOC budget for 2011, while private construction also is showing sluggishness caused by the delay in the recovery of real estate transactions. Therefore, contraction in construction investment is expected to continue in the second half.

Facility Investment: 9.5% (1st Half) → 6.9% (2nd Half) → 8.1% (Annual)

Facility investment growth is likely to slow due to base effects and greater uncertainties in corporate investment environment compared with 2010. Declines in facility-related indicators, including facility investment pressure and average operation rate, predict a slowdown in facility investment growth in the second half.

Current Account: US\$8.4 Bil. Surplus (1st Half) → US\$6.5 Bil. (2nd Half) → US\$14.9 Bil. (Annual)

The current account surplus in the second half is expected to be less than in the first half due to import growth outpacing export growth. Export growth may slow to the 10% level, caused by demand reduction following fiscal retrenchment and adjustment of household debt in advanced countries, China's economic adjustment and appreciation of the won-U.S. dollar exchange rate. Affected by exchange-rate appreciation and unit price increases, meanwhile, imports are expected to post a higher growth rate than exports.

Economic Trends and Outlook

Consumer Prices: 24.3%
(1st Half) → 3.9% (2nd Half) → 4.1% (Annual)

The increase in consumer prices is projected to be 3.9% in the second half, but it is lower than in the first half due to base effects and a slowdown in international oil price hikes. However, there exists an upward risk for the projection of consumer prices in the second half, since uncertainties over the direction of international oil prices are still persisting.

Market Interest Rates: 4.5%
(1st Half) → 4.7% (2nd Half) → 4.6% (Annual)

Influenced by base interest rate increases and price push pressure, market interest rates are projected to rise on a gradual basis. However, market interest rate hikes are likely to be limited due to ongoing uncertainties caused by external risks and the increasing demand of banks for bonds following the contraction of loan demand.

Won-U.S. Dollar Fx-Rate:
1,102 (1st Half) → 1,040 (2nd Half) → 1,071 (Annual)

The won-U.S. dollar exchange rate is expected to continue appreciating due to continued increases in the supply of U.S dollars and interest rates. But the spread of the fiscal administration crisis in the Eurozone and completion of the U.S. QE2 policy will serve as factors to limit won-U.S. dollar exchange rate appreciation.

Outlook for Korean Economy (2011)

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

	2010	2011						
	Year	1Q	2Q	3Q	4Q	1st H	2nd H	Year
GDP	6.2	4.2	3.4	3.7	4.5	3.8	4.1	3.9
(SA, q-o-q, %)		1.3	0.8	1.0	1.3	2.0	2.1	
Private Consumption	4.1	2.8	3.1	3.0	3.4	3.0	3.2	3.1
Construction Investment	-1.4	-11.9	-8.6	-3.1	1.5	-10.0	-0.6	-5.1
Facilities Investment	25.0	11.7	7.6	6.1	7.7	9.5	6.9	8.1
Exports (Goods & Service)	14.5	16.8	10.2	7.9	7.6	13.3	7.8	10.4
Imports (Goods & Service)	16.9	10.8	7.9	7.8	7.6	9.3	7.7	8.5
Consumer Prices	2.9	4.5	4.2	4.0	3.8	4.3	3.9	4.1
Producer Prices	3.9	6.7	6.4	6.3	5.6	6.5	5.9	6.2
Current Account Balance (US\$100 mil.)	282.1	26.1	57.8	38.3	26.3	83.9	64.6	148.5
Commodity	419.0	58.4	83.5	68.1	63.5	141.9	131.6	273.5
Exports	4642.9	1276.9	1439.2	1369.4	1434.8	2716.2	2804.3	5520.4
Growth (%)	29.6	26.0	22.4	15.8	12.9	24.1	14.3	18.9
Imports	4223.8	1218.5	1355.8	212.0	1371.3	2574.3	2672.7	5246.9
Growth (%)	31.9	26.2	28.7	23.1	19.5	27.5	21.2	24.2
Service & Others	-136.9	-32.3	-25.7	-29.8	-37.2	-58.0	-67.0	-125.0
Ex Rate (Avg. KRW/USD)	1156.5	1120.4	1083.9	1050.0	1030.0	1102.1	1040.0	1071.1
Corp. Bonds Yield (3-year, AA-)	4.7	4.6	4.5	4.6	4.9	4.5	4.7	4.6
Unemployment Rate (%)	3.8	4.2	3.7	3.6	3.5	4.0	3.6	3.8

Policy Issue:

Inequality Level & Bipolarization Trends and Need for Establishment of Appropriate Concepts

Increasing Fears of Bipolarization Stem From Misunderstanding of Conceptual Difference Between Bipolarization and Inequality

Bipolarization, if reviewed in terms of the income inequality index and Gini coefficient, is showing an easing trend recently. Nevertheless, the tendency of linking various social phenomena to bipolarization is strengthening. For example, the concept of bipolarization is being utilized to describe the recent increase in the social insurance burden rate of low income classes. However, this is because low income classes, who had not subscribed to unemployment insurance and health insurance, were integrated into benefit system from the social security system.

Caution Should be Used in Establishment of Bipolarization Concept So As Not to Undermine Social Integration

The spread of a social atmosphere that equates even simple income gap expansion as bipolarization is a factor that is undermining our nation's social integration. Prior to the establishment of any policy to ease inequality and bipolarization, there is a need to distinguish clearly the difference between the two concepts.

Suggestions for DCF method to value unlisted stock in Corporate Law

Research Monograph 11-05

Sin, Seuk Hun

This Article presents a normative analysis of DCF method to value unlisted stock in Corporate Law. It is generally accepted that discounting the firm's free cash flows provides the best measure of value. The value of the stock is calculated to be the pro rata net present value of all future free cash flows. However, one might argue that control value must come out of minority stockholders and law must recognize that there are some premium of value that belong to corporation. This represents an inappropriation of minority stockholders value. However, there is no formal mathematical relationship between a control premium and a minority discount. A controlling stockholder is free within the limits of the law of fiduciary duty to pursue policies that are in the best interest of the controlling stockholder as long as minority stockholders are not harmed. Judicial attention to protect minority stockholders where estimated future cash flows are found to be depressed as a result of fiduciary misconduct, or where such cash flows fail to include elements of value that belong to the corporation being valued, the best way to address the corresponding reduction in the determination of "fair value" is by adjusting those company cash flows upward. The courts must make such adjustments on a case-by-case basis by determining fair value using a DCF analysis. To encourage value-enhancing transactions and discourage value-decreasing transactions, Korean Courts seek for DCF method to value unlisted stock in Corporate Law.

The Economic Effects of the Zombies on Non-Zombie firms' behavior and Boosting the Corporate Restructuring Market in Korea

Research Monograph 11-06

Lee, Byoungki

In this study, the economic effects of the zombies on non-zombie firms' behavior are analyzed through econometric methodology along with policy implications for corporate restructuring. The suggestions made here include the corporate restructuring system which facilitates efficient handling of zombie firms and boosting the corporate restructuring market in Korea. The results from empirical analysis are summarized as follows:

First, the number of zombie firms was the greatest during the period between 1997-1998 when the Korean economy suffered from the financial crisis. Second, when it comes to profitability by size of enterprises, SMEs had lower profitability than that of large companies. Third, the analysis on the entire sample of companies

produces little effect of zombie firms on investment and employment of non-zombie firms. Fourth, for large companies and SMEs, the effects of more productive ones in terms of capital productivity are negatively related to the loan from banks.

Marginal Cost of Tax Revenue and Implications on Fiscal Health: Focusing on Value Added Tax and Income Tax

Research Monograph 11-07

Hwang, Sanghyun

Considering the employment structure consisting of workers and self-employed individuals and the underground economy associated with it, this paper theoretically derives the marginal cost of tax revenue for consumption tax (value added tax) as indirect tax and for income tax as direct tax, respectively. In addition to this, it numerically calculates and analyzes the marginal cost of tax revenue in order to give policy implications for the recovery of fiscal health. According to the results of this study, when the tax authority raises tax revenue, the social cost is ₩1.7140 per the additional tax revenue ₩1 for consumption tax and ₩2.0187 for income tax, respectively. Therefore, in the case of raising consumption or income tax rate for tax revenue, the social cost is relatively larger in Korea, where the self-employed' 31.3% share is quite large compared to other countries. Specially, the recovery of fiscal health by using the income tax causes the social cost at even higher level. Thus, the implications for the recovery of fiscal health is that the government should reduce expenditure rather than raises tax revenue in Korea.

KERI 2010 - Korea's Quarterly Macroeconomic Model

Research Monograph 11-08

Cho, Gyeong Lyeob, Kim, Chang Bae, Jang, Kyoung Ho

The differences between the latest model and KERI 2005 model are summarized as follows. First, the new model reflects the advantages of an error-correction model in the estimate of individual equations in order to resolve spurious regression problems identified in the previous model. Second, it was composed in a way that the GDP gap can be related to real economy sectors, investment function, etc., as the well as the price sector, and also improved the relationship among respective sectors by including the won-U.S. dollar

exchange rate, inventories, export unit prices, etc. that were treated as exogenous variables in the previous model. Third, it segmented endogenous variables that reflect changes in economic environments. Considering increases in the ratio of intangible fixed investments, it separated intangible fixed asset investments, which were included with facility investment in the previous model, and estimated the consumption function after distinguishing between durable goods and non-durable goods. In terms of the export function, the model established separate regions-China and others-to reflect the nation's deepening export dependence on China. Fourth, the model now includes seasonal dummy variables while continuing to use the original series, eliminating possibility of occurrence of errors in the conversion process into seasonal adjustment or original series, and also changed the base year for GDP and various price variables to 2005.

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