KERI

Economic Bulletin

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Contents

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

Key macroeconomic indicators-GDP growth rate, prices and current account balance-are expected to get worsen in 2007 compared with this year.

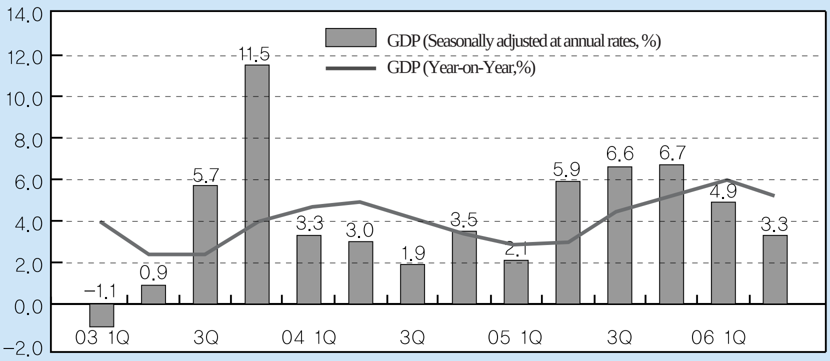
Next year, GDP growth rate is projected to fall to 4.1%, 0.6% point lower than 4.7%, the growth rate forecast of this year. It is mainly due to slower export expansion and sluggish domestic demand. Negative trade conditions attributed to high oil prices and an increase in global interest rates are likely to lower the nation's trade surplus, while the national presidential election and an uncertain domestic environment are expected to negatively impact domestic demand.

The CPI, despite the slowdown in economic growth, is projected to rise to 2.7% in 2007, a 0.2% point increase from this year's 2.5%. The expected increase in inflation is largely attributed to supply side factors, most notably continuing hikes of oil price. Meanwhile, the current account, with import growth outpacing export growth and an expanding service trade deficit, is projected to decline to a US$2.0 billion surplus this year and suffer a US$2.2 billion deficit in 2007.

These conditions will mean deeper stagnation in investment and job creation for the Korean economy, exacerbated by a lack of critical improvements in various regulations and practices, and by the institutional barriers to economic stimulation, not just by changes in the structure of the national economy. In order to stimulate investment and employment expansion, improvements are needed in labor market flexibility, corporate and individual income tax systems, limitations on total equity investment and restrictions related to Seoul metropolitan area.

Real GDP growth at SAAR(seasonally adjusted at annual rates) has slowed continuously since the fourth quarter of 2005 when it peaked at 6.7%, dropping to 4.9% in the first quarter of 2006 and further to 3.3% in the second quarter. It is largely due to a slowdown in private consumption and especially to a fast decline in construction investment (-14.7%, SAAR). Consequently, the contribution of domestic demand to GDP growth declined to 0.5% point (out of 3.3%) in the second quarter following a 2.8% point (out of 4.9%) in the first quarter.

Real GDP



Production activities have also stagnated. Production in the manufacturing sector, which had been registering double-digit growth in the first half of this year, fell to 4.7% in July. Service sector growth has also posted declines, from 6.1% in the first quarter to 5.3% in the second quarter, and to 2.1% in July.

The consumption growth trend has also slowed. The year-on-year growth rate of consumer product sales dropped from 5.6% in the second half of 2005 to 5.2% in the first half of 2006, and fell to -0.5% in July. Wholesale and retail sales growth was also declined in the first half of this year compared with the second half of 2005, while the sales were even stagnated in July.

Facility investment was increased at 7% in the fourth quarter of 2005, but managed to reach only 4.6% in the first quarter of 2006, 4.3% in the second quarter and 4.2% in July. The construction investment growth rate also continuously slowed down and recorded negative in July.

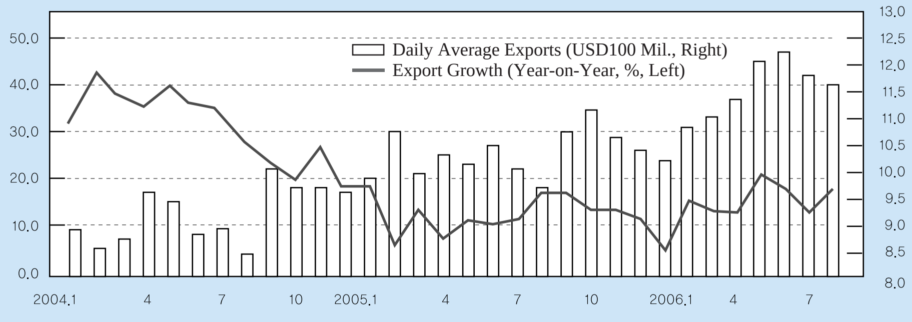
Industrial Output, Consumption and Investment

(Unit: Year-on-Year,%)

		2005					2006		
		1/4	2/4	3/4	4/4	Year	1/4	2/4	July
Industrial Output	Manufacturing	3.3	3.4	7.3	10.4	6.2	12.6	11.4	4.7
	Services	0.7	2.5	5.4	5.8	3.6	6.1	5.3	2.1
Consumption	Wholesale & Retail sales	-0.8	3.0	4.0	4.5	2.7	3.6	4.0	0.7
	Consumer Products Sales	1.2	3.4	4.4	6.8	3.9	5.0	5.4	-0.5
Investment	Estimate of Facility Investment	3.9	1.5	1.0	7.0	3.3	4.6	4.3	4.2
	Domestic Construction Completed	1.9	9.6	3.8	6.9	5.7	5.9	1.3	-0.7

On the other hand, export growth has remained strong. Exports in the July-August period grew 15.4% year-on-year, slightly lower than the 16.9% in the second quarter but higher than the 13.8% for the first six months of 2006. Semiconductors and petrochemical products have achieved brisk performance; however, automobiles, computers and wireless communication devices have weakened.

Exports



The current account balance recorded a deficit of US$210 million in July, adding to a US$430 million deficit in the first half of the year. The setback is due to the dwindling commodity trade surplus and the expanding service trade deficit.

Balance of Payments

(Unit: USD 100 Mil.)

	2005					2006		
	2/4	July	3/4	4/4	Year	1/4	2/4	July
Current Account	26.0	14.5	26.5	54.3	165.6	-11.2	6.9	-2.1
Goods Account	86.4	31.7	75.8	80.9	334.7	52.2	74.1	18.0
Service Account	-32.4	-14.7	-43.6	-24.9	-130.9	-50.0	-38.8	-17.4

The inflation rate has risen gradually. The CPI inflation remained at a mild 2% before shooting up to 2.8% in August. The surge was due to a sharp rise in agriculture, livestock and fishery product prices affected by the hot weather and the long rainy season, and the impact of the sustained high oil prices realized to the price level. The PPI inflation has been getting worsen since the first quarter of this year when it hit the trough at 1.7%.

Prices

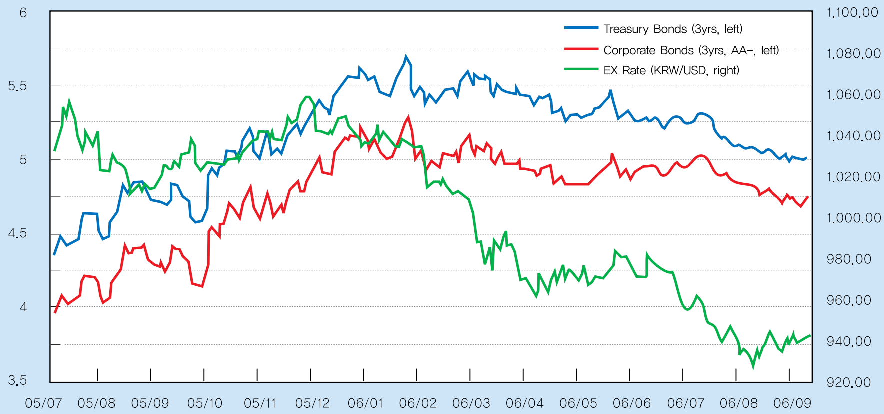
(Unit: Year-on-Year, %)

	2005					2006			
	1/4	2/4	3/4	4/4	Year	1/4	2/4	July	Aug.
Consumer Prices	3.1	3.0	2.4	2.5	2.8	2.4	2.3	2.3	2.9
Producer Prices	3.3	2.2	1.7	1.5	2.2	1.7	2.4	2.8	

Interest rates, which were on the rise in June in line with the target call rate hikes, reversed course in July due to an economic recession, a decline in the yield rate of U.S. treasury bonds and the net purchase of the Korea treasury bonds (KTB) futures by foreigners. The yield rate of treasury bonds rose to the 5.0% level in June, but recently fell back to 4.7%, and that of corporate bonds also recently eased to the 5.0% level which had soared to 5.3% in June.

The won-dollar exchange rates are fluctuating at the 950-960 range for the couple of months. It is attributed to both won appreciation and won depreciation factors: the former (dollar-depreciation factor) is due to the suspension of further U.S. interest rate hikes, and the latter is due to a domestic economic stagnation, the current account deficit and net outflows of foreign capital in the stock market.

Interest Rates and Exchange Rates



1. Domestic and External Environments

The external economic environment is expected to get worsen next year. The global economy is projected to decline, affected by the sustained high oil prices and the trend in interest rate hikes. The international oil price (Dubai crude) is projected to remain in the neighborhood of US$70 per barrel, influenced by supply uncertainties in key oil-producing regions as well as geopolitical risks such as the Iranian nuclear issue and the Israeli-Hezbollah conflict.

Employment instability and falling consumer sentiment are likely to linger due to government policies regulating real estate, protective measures for temporary workers and the dual labor union system.

In addition to these negative trends, domestic and international uncertainties are expected to increase during the presidential election season.

2. Outlook

The GDP growth rate is projected to reach 3.9% in the second half of 2006 and 4.1% in 2007. The high oil prices boosts up the costs for both enterprises and households and a tight monetary policy is feared to retard the recovery of domestic demand. Meanwhile, slowdowns of growth in major countries around the world are expected to curb Korea's export growth to the single-digit range.

With the sustained high oil prices, increase in household tax burden and uncertainty with regard to employment, private consumption growth is projected at 3.8% in the second half of 2006 and 3.8% in 2007. Facility investment is expected to record a low increase rate of 5.1% next year as a result of dampened economic growth and insufficient improvements in the domestic enterprise investment environment. Construction investment is likely to remain weak in the face of demand-restriction real estate policies.

The CPI inflation is projected to rise to 2.7% in 2007 compared with 2.5% expected in 2006, despite the expected slowdown of economic growth next year. Price increase pressure from the supply side appears to be stronger than price decrease pressure from the demand side with the accumulation of a deflation gap.

Affected by the expected slowdown in major economies, commodity exports are projected to be 13.9% in 2006, and gradually to fall to 8.6% in 2007. Commodity imports are also expected to post lower growth during the same period due to weak domestic demand recovery and the slowdown in export growth.

The current account balance is projected to record a US$2.4 billion surplus in 2006 and a US$2.2 billion deficit in 2007 as the import growth rate exceeds the export growth rate and the service trade deficit expands.

The yield rate of corporate bonds (three-year maturity, AA-) is projected to experience a mild depression due to the expected economic slowdown and the lack of improvement in investment sentiment caused by growing uncertainty surrounding the presidential election and geopolitical risks.

The won-dollar exchange rate is expected to end 2006 at 953 and gradually to fall to the 930 level in 2007. Factors that are likely to affect the exchange rate to fall are the suspension of U.S. interest rate hikes, further interest rate increases in Japan and Europe and the revaluation of China's yuan. However, these factors are not strong enough to push the won-dollar rate much lower due to domestic conditions including the projected current account deficit.

Outlook for 2006~2007

(Unit: Year-on-Year%, USD 100 Mil.)

	2005	2006					2007
	Year	1/4	2/4	3/4	4/4	Year	Year
GDP	4.0	6.1	5.3	4.5	3.3	4.7	4.1
(SAAR)		4.9	3.3	2.7	2.8		
Private Consumption	3.2	4.8	4.4	3.9	3.7	4.2	3.8
Construction Investment	0.4	1.2	-4.0	1.3	-1.1	-0.8	0.9
Facility + Intangible Fixed Assets	4.9	6.7	7.4	5.8	5.3	6.3	5.1
Consumer Price	2.8	2.3	2.4	2.5	2.9	2.5	2.7
Current Account Balance	165.6	-11.2	6.9	1.0	23.0	19.7	-22.4
Commodity Balance	334.7	52.2	74.1	53.0	65.0	244.4	216.6
Exports (BOP basis)	2890.0	758.0	821.3	835.0	877.0	3291.3	3574.3
Growth Rate (%)	12.1	11.4	16.3	15.4	12.5	13.9	8.6
Imports (BOP basis)	2555.2	705.8	747.1	782.0	812.0	3046.9	3357.7
Growth Rate (%)	16.4	19.8	20.5	20.7	16.2	19.2	10.2
Service and Other Balances	-169.1	-63.4	-67.2	-52.0	-42.0	-224.6	-239.0
Exchange Rate (KRW/USD, avg.)	1024	976	949	958	950	958	934
Corporate Bond Yield Rate (3 year, AA-)	4.7	5.4	5.2	5.1	5.1	5.2	5.0

Source: KERI's Quarterly Econometric Model

During the 2001-2005 period, real growth rate of facility investment averaged a low 1.2% per year, while the rate of employment increased annually just 1% in average. This situation is attributed not only to change in economic structures but also to insufficient improvements in institutions and practices which remain as obstacles to employment expansion.

Therefore, to stimulate new investment and employment expansion, the following policy changes are suggested:

- Achieve greater labor market flexibility.
- Lower corporate tax rates and revise the income tax systems.
- Relax or repeal policies that retard investment, such as regulation on the total equity investment and restrictions related to Seoul metropolitan area, etc.

1. To achieve greater labor market flexibility

An inflexible labor market is leading to higher labor costs, a major factor in the reluctance of enterprises to expand employment creation. According to the OECD report “Employment Outlook 2004,” the more inflexible a labor market is, based on an evaluation of the degree of employment-protection rules and regulations, the lower the rate of employment gets. This means that the enhancement of labor market flexibility would contribute significantly to employment expansion.

If Korea were able to raise the employment rate of 63.2% (in 2003, among the 15~64 age group) to a higher level of Japan’s 68.6% through achieving greater flexibility in the labor market, the number of employed persons would grow by 1.7 million.

2. To lower corporate tax rates and revise the income tax systems

In order to increase the nation's growth potential and respond more effectively to globalization, it is urgent that the government lowers the corporate tax rate. Other countries are taking measures to prevent capital outflows and to attract the FDIs by lowering corporate tax rates. Moreover, with the potential GDP growth at less than 5%, policy measures to lower corporate tax rates would increase the growth potential. According to recent research studies, lowering the corporate tax rates increases capital earnings and contributes to higher corporate investment and production.

In addition, with the goal of stimulating economic growth, the government should revise of the income tax systems. The general tax base should be broadened by absorbing the self-employed enterprises into the system and lowering the level of minimum taxable income. This is consistent with the principle of a “broad tax base and low tax rate,” the basic objective of any taxation regime. Expanding the tax base will increase the nation’s tax revenue. Consequently, it will enable lower tax rates, which result in desires of taxpayers to work more, which again contribute to greater economic efficiency and GDP growth.

3. To ease restrictive regulations

The government-imposed regulations on total equity investment should be repealed. The basic purpose of equity investment is to advance into new business fields or to expand existing operations. In this context, the regulations only prohibit corporates from expanding normal investment activities. Equity investment is just one of the means used to finance capital resources. According to a recent research, higher facility investment would be generated by allowing more equity investment from the affiliated firms.

The regulations on Seoul metropolitan area, such as total maximum factory load regulation, also need to be eased. Policies that regulate business activities in Seoul metropolitan area aiming to ease population concentration are ineffective. On the other hand, they produce negative side effects. The restrictive regulations are intended to force investment in areas outside Seoul metropolitan area, but they result in investors turning their attention to other countries. According to an analysis, greater investment and higher productivity gained from easing such regulations could increase GDP by 2.7%.

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