

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

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I Economic Trends and Outlook

Executive Summary

The growth of the Korean economy for 2008 (based on real GDP) is projected at 5.1%, higher than 4.8% expected for this year. Despite the global economic slowdown and a stronger won, the export sector is not likely to experience significant difficulties thanks to diversified export markets and enhanced product competitiveness. With a new government in place and reduced risk of North Korean nuclear threat, domestic demand is expected to continue a steady recovery next year.

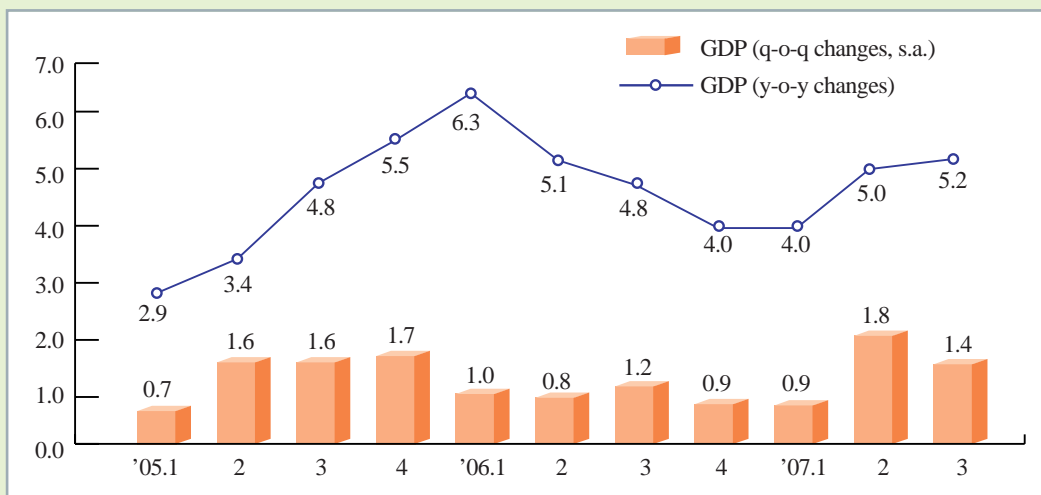
A robust recovery of domestic demand coupled with higher prices of oil and raw materials will fuel the inflationary pressures and raise the consumer prices by 2.6% in 2008, up from 2.3% this year. The current account will post a deficit in 10 years since 1998. It is expected to post US \$2.0 billion deficit in 2008 largely due to the expansion of the service account deficits.

Although the international credit market is not in the clear, the overall macroeconomic conditions are, historically speaking, comparatively favorable for the new government to successfully launch economic stimulus packages. The incoming government should seize this opportunity and pursue well-defined policy objectives to boost the Korean economy. A strong priority should be given to creating more jobs. The government also needs to implement measures to revitalize the domestic demand that has been sagging for some time and to initiate regulatory as well as institutional reforms. They include creating more jobs by enhancing labor market flexibility, downsizing the public sector and reinvigorating the private sector with tax cuts, abolition of the equity investment ceiling system, and easing restrictions on development projects in the capital area.

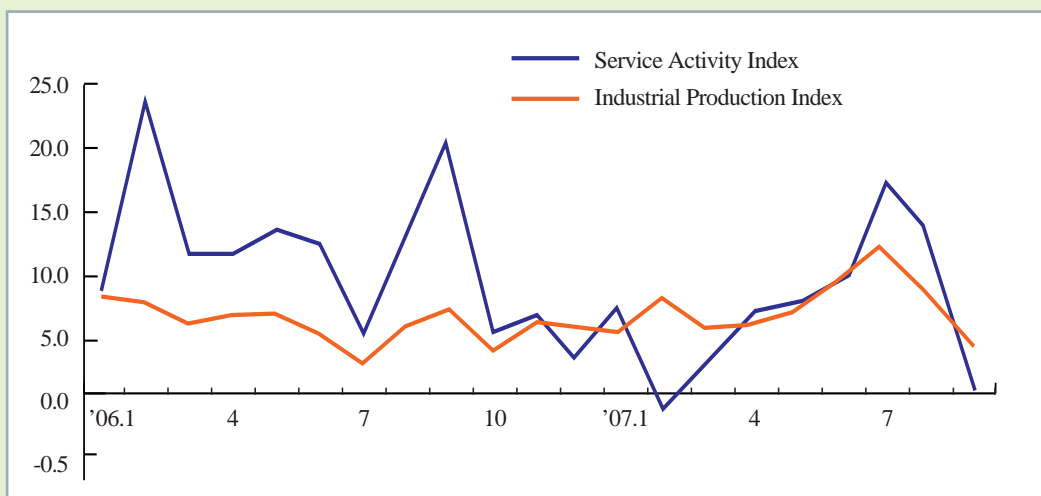
Recent Developments

The growth momentum that started in the first quarter of this year is still continuing. The real GDP has been expanding at a faster rate since it grew at 4.0% in the first quarter. It posted the growth rates of 5.0% and 5.2% in the second and the third quarter, respectively. The manufacturing sector output and the service sector activities also expanded in July and August. However they stagnated somewhat in September as the number of days operated was shortened during the Chuseok season.

Economic Growth Rates by Quarter

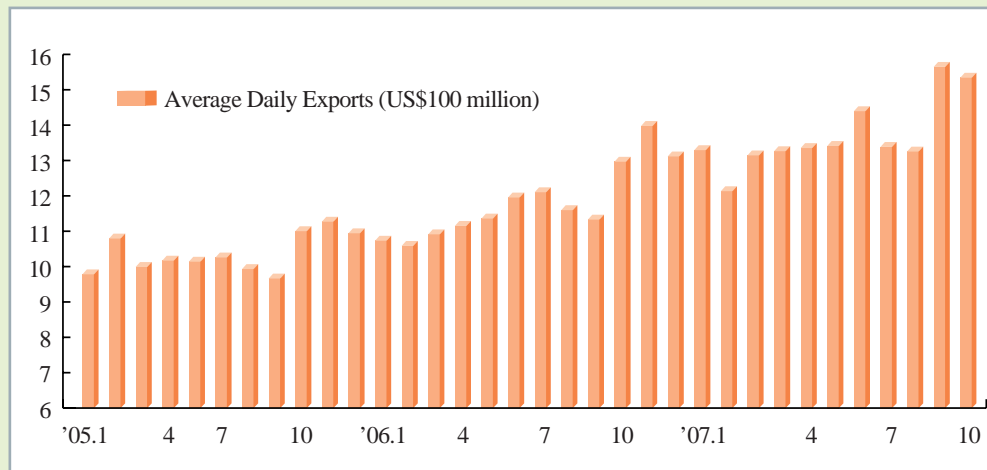


Manufacturing Production Index and Service Activity Index



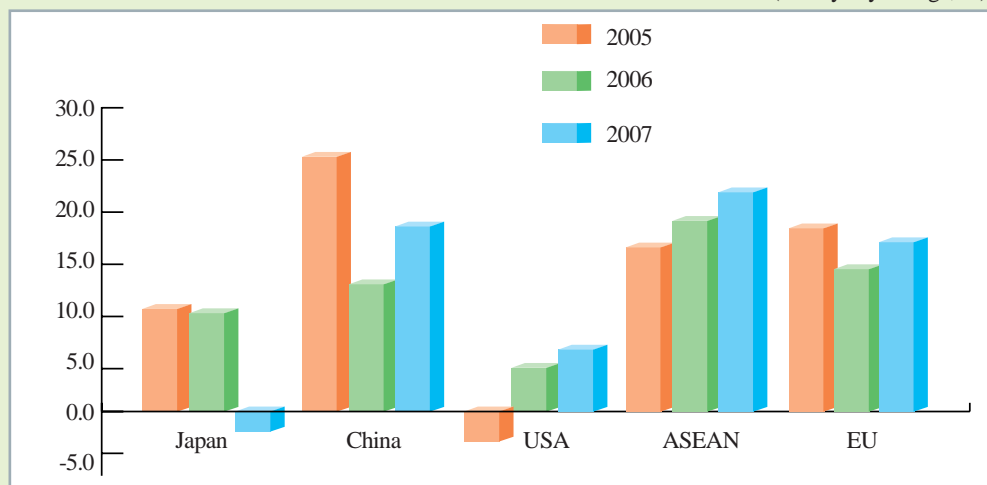
Underlying the economic expansion is the robust export sector since the first half of this year. The amount of the export has exceeded US \$1.3 billion on daily average since March as increasingly more products have been shipped to China, the ASEAN, and the EU. On the contrary, exports to the U.S. and Japan have stagnated.

Daily Average Export Amounts by Month



Export Growth Rates by Region

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



Consumption indicators such as retail sales and consumption goods sales showed a steady recovery in domestic demand in July and August. However, both construction investment and construction orders are showing some signs of trouble. Equipment investment was stagnant during these months as well. However, a rise of 15% in the domestic machinery orders in the third quarter, a leading indicator of equipment investment, signals that the equipment investment is likely to resume its recovery in the future.

Trends of Key Domestic Demand Indicators

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

| | 2006 | | | | 2007 | | |
|---|-------|------|------|------|------|------|------|
| | 2/4 | 3/4 | 4/4 | year | 1/4 | 2/4 | 3/4 |
| Consumer Products Sales | 6.1 | 2.9 | 4.5 | 4.7 | 7.1 | 5.3 | 8.5 |
| Estimate of Equipment Investment (constant) | 6.7 | 11.8 | 5.1 | 7.4 | 11.3 | 12.1 | -2.0 |
| Domestic Machinery Orders (constant) | 24.4 | 21.0 | 16.7 | 18.8 | 15.3 | 7.4 | 14.6 |
| Domestic Construction Completed | -0.3 | 4.8 | 6.0 | 3.7 | 6.5 | 5.2 | 3.6 |
| Construction Orders (current) | -14.7 | 37.1 | 27.1 | 9.0 | 26.3 | 26.3 | 7.3 |

Thanks to the robust export sector, the current account balance reversed to a surplus in the third quarter. With a surplus of US\$4.55 billion in the third quarter, the current account balance improved by about US\$6.2 billion from a deficit of US\$1.63 billion in the first half of this year. It is also an improvement of US\$4.2 billion over US\$370 million deficits in the same period a year ago. The surplus is mainly attributable to the fact that despite the expanding deficit in the services account, the goods account balance improved significantly with export growth outpacing import growth.

Trends of Current Account Balance

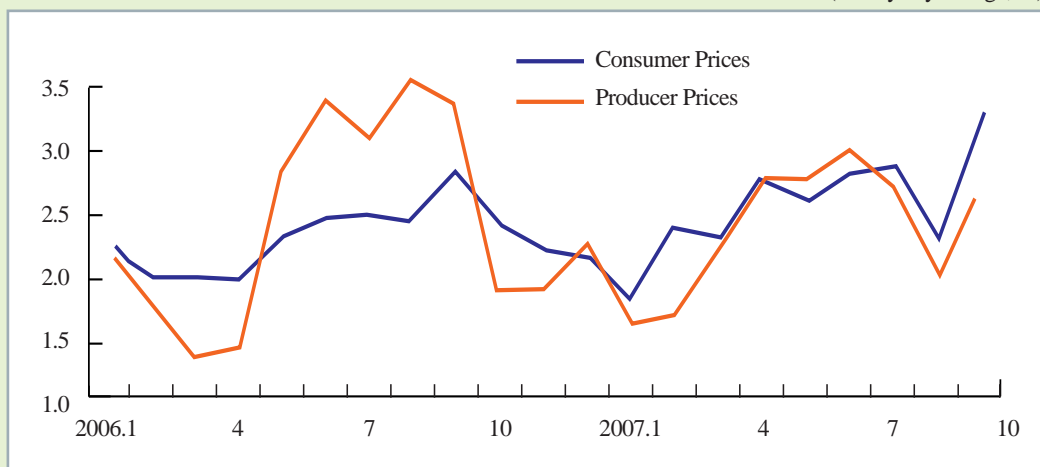
(Unit: US\$100 million)

| | 2006 | | | | | 2007 | | |
|------------------------------------|-------|-------|-------|-------|--------|-------|-------|-------|
| | 1/4 | 2/4 | 3/4 | 4/4 | Year | 1/4 | 2/4 | 3/4 |
| Current Account Balance (=A+B+C+D) | -11.2 | 6.9 | 3.7 | 61.4 | 60.9 | -16.6 | 0.3 | 45.5 |
| A. Goods Account Balance | 52.2 | 74.1 | 62.3 | 103.5 | 292.1 | 60.4 | 69.7 | 97.9 |
| B. Services Account Balance | -50.0 | -38.8 | -53.8 | -45.0 | -187.6 | -61.8 | -44.0 | -58.8 |
| Travel | -29.5 | -28.4 | -37.8 | -33.4 | -129.2 | -36.1 | -36.6 | -43.6 |
| Business Service | -15.1 | -15.1 | -18.5 | -19.6 | -68.3 | -22.6 | -17.1 | -19.1 |
| C. Balance of Income | -4.8 | -16.5 | 6.1 | 9.8 | -5.4 | -6.9 | -15.4 | 16.6 |
| D. Balance of Current Transfers | -8.6 | -11.9 | -10.8 | -6.8 | -39.2 | -8.3 | -10.0 | -10.3 |

Consumer prices are rising at a faster rate. The Consumer Price Index rose 3.0% in October after rising 2.0% and 2.3% in August and September, reflecting hikes in raw material prices.

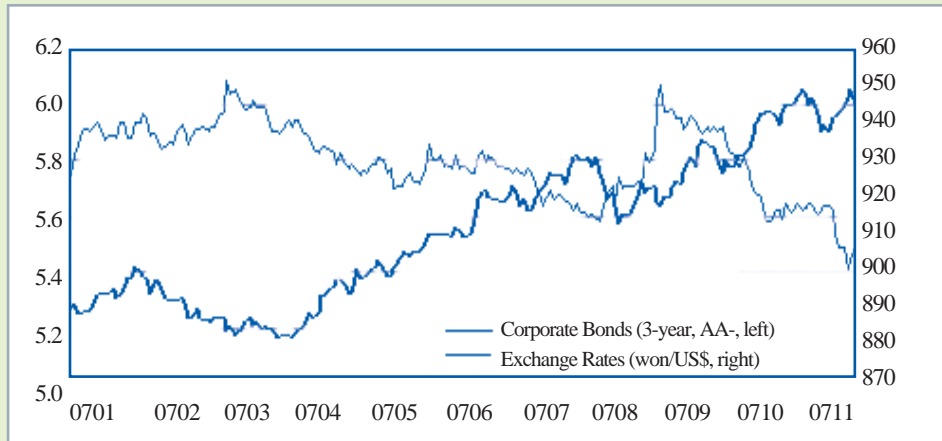
Trends in Consumer Prices and Producer Prices

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



Since the end of August, interest rates have steadily risen as worries over the global credit crunch lessened and expectation of economic recovery gained new grounds. The rate increased in the third quarter by the Bank of Korea also contributed to rises in the market interest rates. The corporate bond yields rose from 5.85% in August to around 6% in October. Korean won has appreciated against the U.S. dollar since August as expectations of economic slowdown in the U.S. grew while aggressive rate cuts by the Fed reduced investors' preferences for safer assets. The exchange rate of the U.S. dollar declined to 908 Korean won in November 5th from 933.8 Korean won in August.

Corporate Bond Yields and Foreign Exchange Rates



Outlook for 2008

External Environment

The global economy is projected to grow at a slower rate of around 4% in 2008 than 5.2% (est.) in 2007. The lower projection is largely based on the economic slowdown of the U.S. and unstable international financial market conditions. The growth rate of the U.S. economy is likely to remain at a 1% level due to the sagging housing market and jittery financial market conditions. Japan and the EU are also likely to experience economic slowdowns because of appreciations of their currencies and declines in export demands. On the other hand, China is expected to maintain the growth rate of around 10 percent despite much likely contractionary policies and a stronger Chinese yuan.

Anticipated Growth Projections for Major Economies

(Unit: %)

| | 2006 | 2007 | | 2008 | |
|-----------|------|------|------|------|------|
| | | IMF | OECD | IMF | OECD |
| The World | 5.4 | 5.2 | | 4.8 | |
| U.S.A. | 2.9 | 1.9 | 2.1 | 1.9 | 2.5 |
| Japan | 2.2 | 2.0 | 2.4 | 1.7 | 2.1 |
| EU | 2.8 | 2.5 | 2.7 | 2.1 | 2.3 |
| China | 11.1 | 11.5 | 10.4 | 10.0 | 10.4 |

Sources: IMF, World Economic Outlook, October 2007
OECD, OECD Economic Outlook, May 2007

International oil prices remain a threat to the world economy. The oil prices are expected to increase further due to geopolitical risks and the weakening of the U.S. dollar next year. However a lower demand for oil due to a global economic slowdown will limit the extent of the price hikes. In sum, we project that an yearly average price of oil (Dubai) will reach \$75 per barrel in 2008.

International Oil Price Projections

(Unit: US\$/bbl)

| Institute (projected date) | Oil Type | 2006 | 2007 | 2008 |
|----------------------------|----------|-------|-------|-------|
| CGES (Sept. 17) | Brent | 65.00 | 69.50 | 81.50 |
| CERA (Sept. 24) | Dubai | 61.46 | 65.80 | 63.50 |
| EIA (Sept. 11) | WTI | 66.02 | 66.97 | 71.17 |
| PIRA (Sept. 27) | WTI | 66.00 | 69.55 | 75.00 |

Note: CGES (Center for Global Energy Studies)
CERA (Cambridge Energy Research Associates)
EIA (Energy Information Administration)
PIRA (Petroleum Industry Research Associates)

The subprime mortgage market remains a key factor in how the international financial markets will fare in 2008. The outlook is not bright particularly because the U.S. housing market that started the whole crisis is showing no signs of any improvement. The sharp drop in the U.S. stock market recently seen on October 19 indicates that the credit crunch is still widespread and very likely to result in a serious economic downturn, should qualities of asset-backed securities deteriorate further.

Internal Environment

Whoever wins the presidential election, it is a safe bet that the new government will implement aggressive economic stimulus packages. As the key issue in the upcoming presidential election is the economy, the new government will have a mandate to revive and put the economy back on a high-growth track.

Then again, the new government will have to walk a pretty fine line in terms of monetary policies. On one hand, it is going to have to deal with ample liquidity in the domestic money market and tame the rising fear of inflation. On the other hand, it will have to be careful so as not to interfere with nascent recovery of domestic demand. Uncertainties surrounding the international financial markets and stronger Korean won further complicate how the Bank of Korea should conduct the monetary policies. Overall, both external and internal environments in 2008 don't leave much wriggle room for the central bank in terms of interest rate policies. Hence, we expect that the Bank of Korea to maintain the current status until the fog clears.

Luckily, there is a good chance that the geopolitical risks of the Korean peninsula will be significantly resolved next year. The agreement at the second-stage meeting of the sixth six-party talks to disable North Korean nuclear facilities within this year and the South-North Korea summit will contribute to reducing the political tension in the region.

Prospects for 2008

The role of the export sector as a growth engine will be less pronounced next year as the global economy slows down. Instead private consumption and equipment investment will pick up the slack and provide impetus for the Korean economy. We expect the Korean economy to post a growth rate of 5.1% next year. Reorganization of the tax system and

improvement of consumer sentiments will provide a boost for the private consumption. However, the boost will be limited by the increase in the burden of household debts as the market interest rates climb up.

A robust recovery of private construction investment will be difficult due to a slump in the housing market. However the government has in line a few mega projects such as constructions of Multifunctional Administrative City, Innovation Cities, and Corporate Cities. With help from the public sector, construction investment is projected to grow by 3.2% in 2008. Equipment investment is expected to maintain the recovery trend of 2007, but will grow by a limited rate of 8.2% due to a slowdown in the export sector.

The external environment for the export sector in 2008 does not look promising. A global economic slowdown, a stronger currency, and rises in raw material prices will make the Korean exporters' lives difficult. An additional threat is that there is now a high possibility that China will implement more stringent monetary policies in its efforts to curb inflation. As China is now a number one destination for Korean made products, an economic contraction on the other side of the Yellow Sea will present another challenge for the Korean exporters. Still, the export sector will be able to grow at a reasonable rate largely because the exporters have been successfully diversifying their target countries while improving the competitiveness of their products.

The current account balance is expected to return to a deficit of about US\$2.0 billion in 2008 after enjoying 11 years of surpluses since 1997. The turnaround is a result of the services account deficit surpassing the goods account surplus. The service sector's lack of competitiveness and a stronger Korean won are cited as fundamental reasons for the change in the country's balance sheet.

Consumer prices are expected to rise 2.6% in 2008, higher than 2.3% of 2007, largely due to rises in raw materials prices and recovering domestic demand.

Market interest rates (based on corporate bond yields) in 2008 will reach 6.1%, 0.5%p higher than in 2007. The rise is mainly contributable to tigher monetary policies and recovery of the domestic demand.

The Korean won is expected to continue its downward march against the U.S. dollar. However, worsening current account balance will provide a cushion and limit the fall to 910 Korean won per dollar.

Projections for Domestic Economy in 2007

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

| | 2006 | 2007 | | | | | | 2008 | |
|------------------------------|--------|-------|-------|--------|-------|-------|--------|--------|--------|
| | Year | 1Q | 2Q | 1st H | 3Q | 4Q | 2nd H | Year | Year |
| GDP | 5.0 | 4.0 | 5.0 | 4.5 | 5.2 | 5.0 | 5.1 | 4.8 | 5.1 |
| (S.A. q_o_q, %) | | 0.9 | 1.7 | 2.2 | 1.4 | 0.8 | 2.0 | | |
| Private consumption | 4.2 | 4.1 | 4.2 | 4.1 | 4.9 | 4.7 | 4.8 | 4.5 | 4.6 |
| Construction Investment | -0.4 | 3.9 | 3.2 | 3.5 | 1.1 | 0.3 | 0.7 | 1.9 | 3.2 |
| Equipment Investment* | 7.8 | 10.1 | 11.0 | 10.5 | 2.6 | 6.5 | 4.6 | 7.5 | 8.2 |
| Consumer Prices | 2.2 | 2.1 | 2.4 | 2.3 | 2.3 | 2.5 | 2.4 | 2.3 | 2.6 |
| Current Account | 60.9 | -16.6 | 0.3 | -16.3 | 45.5 | 35.1 | 80.6 | 64.3 | -19.8 |
| Commodity | 292.1 | 60.4 | 69.7 | 130.1 | 97.9 | 93.5 | 191.4 | 321.5 | 274.2 |
| Exports | 3318.4 | 864.7 | 929.0 | 1793.6 | 939.0 | 988.3 | 1927.3 | 3720.9 | 4078.2 |
| growth(%) | 14.8 | 14.1 | 13.1 | 13.6 | 10.1 | 11.5 | 10.8 | 12.1 | 9.6 |
| Imports | 3026.3 | 804.3 | 859.3 | 1663.6 | 841.0 | 894.9 | 1735.9 | 3399.5 | 3804.0 |
| growth(%) | 18.4 | 14.0 | 15.0 | 14.5 | 6.4 | 14.3 | 10.3 | 12.3 | 11.9 |
| Service & Others) | -231.2 | -77.0 | -69.4 | -146.4 | -52.5 | -58.4 | -110.8 | -257.2 | -294.0 |
| Corp. Bonds Yield(3yrs, AA-) | 5.2 | 5.3 | 5.5 | 5.4 | 5.8 | 5.9 | 5.8 | 5.6 | 6.1 |
| Ex rate(Ave, KRW/USD) | 954.8 | 939.1 | 928.9 | 934.0 | 928.0 | 920.0 | 924.0 | 929.0 | 910.0 |

* Including intangible asset investment

Issue Focus

Policy Recommendations for Incoming Government

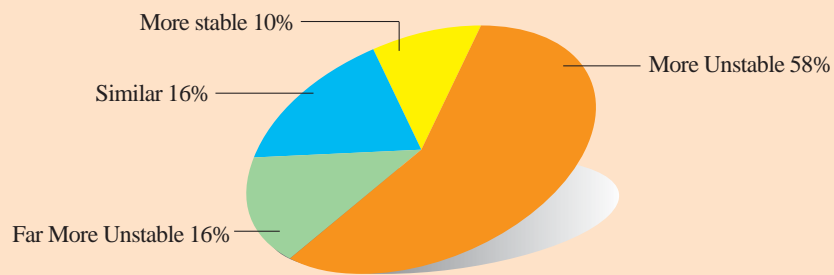
Preconditions

From the first year of the Participatory Government in managing national economy, we can learn lessons. The Participatory Government, which had begun with difficult economic conditions, implemented, in its first year, diverse policies aiming to revive the economy - relaxing restrictions on development in the Capital region such as permitting new construction of LG-Philips' production plants in Paju, extension of promised terms in the temporary tax credit ceiling for investment, financing liquidity of credit card companies, two times of cut in interest rates, allocation of 4.5 trillion won in the supplementary budget for the second half of the year and decision to cut the corporate tax rate by 2% point, and others.

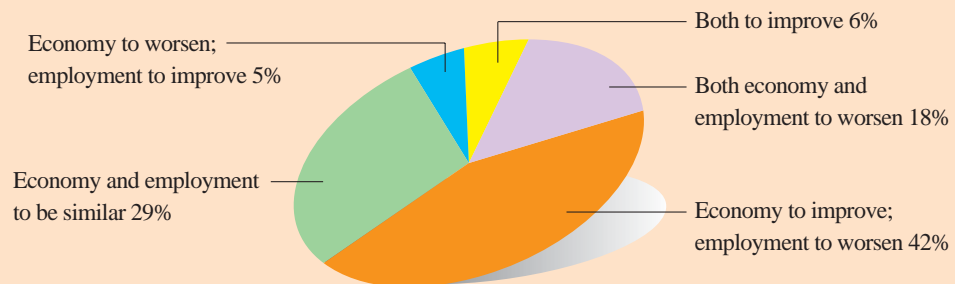
However, the government's efforts bore no fruit only to see continued slowdown in sustained growth rate and domestic economic stagnation. Biggest blame is to be on year-round illegal strikes by labor unions and other interest groups in the country. Started with strike at Doosan Heavy Industries earlier this year, there were another strikes by truck drivers' coalition and subsequent logistics turmoil in May, followed by so-called 'transportation strikes' in June joined by labor union workers of railway and subway, and strikes by Choheung Bank and Hyundai Motors one month afterward.

A bigger problem was that because of these series of strikes, domestic consumption and investment sentiment were severely affected. According to a survey conducted in 2004 by the Korea Employers Federation (KEF), business prospects for labor-management relation, economy and employment were very pessimistic. Asked 'how do you predict labor-management relationship for 2004 compared to 2003?', 58% of respondents answered the relationship for 2004 would be 'more unstable' and 16% of them said it would be a 'far more unstable'. For another question as to 'how would you like to predict the economy and the labor market for 2004?', a majority of them voiced a pessimistic view with 42% replying 'even though the economy improved, employment conditions would remain negatively' and 18% saying 'both the economy and employment conditions would worsen.'

Prospects for 2004 Labor-Management Relation Compared to 2003



Prospects for 2004 Economy and Employment Conditions



Having continued, the labor strikes appear to have, to some extent, a negative impact on the general public's attitude toward labor unions. A survey shows that the percentage of people who think workers' demands in a strike have 'gone too far' increases to 57% in 2007 from 32% in 1989, and 58% of people asked in 2007 say labor unions are 'not conducive to the economy', a surge from 26% in 1989.

○ Results of a Survey on People's Attitude Toward Labor-Management Relation

| | | 1989 | 2007 |
|---|-------------|-------|-------|
| How justifiable Workers' Demands | Justifiable | 67.0% | 41.3% |
| | Excessive | 32.4% | 57.1% |
| How would you describe by management the treatment of workers | Fair | 26.3% | 52.3% |
| | Unfair | 64.5% | 41.3% |
| Labor unions' effects on economy | Good | 53.3% | 16.0% |
| | bad | 26.4% | 57.8% |

The lesson we learned from these experiences is establishment of strict order and security of social stability are the prior conditions to achieve a successful economic management. Without strict restrictions on such interest groups' private interest-pursuing practices and illegal and violent demonstrations that cause social damage, any efforts by the government to activate the economy would fail.

Presentation of Concrete Target of 500,000 Job Creation

Compared to the past two governments which begun with the difficult first years of macroeconomic conditions since inauguration, the new government is expected to embark in a relatively better conditions. The People's Government (1998-2002) experienced decline in growth nearly 7% due to the Asian Financial Crisis that started in full swing in the first year after it launched. The Participatory Government (2003-2007) also suffered serious domestic demand contraction in its first year of inauguration largely because of the aftermath of Credit Crunch.

That is, unlike the previous governments, the next government is somehow in better condition to concentrate full efforts on reviving the economy. To attain the most important policy goal of job creation, we suggest that the upcoming government establish a concrete target like 'creation of 500,000 jobs.'

Despite brisk export performance under the Participatory Government, job creation during the periods was extremely disappointing. The employment growth rate (1.1%) of the Participatory Government was almost similar to that of the People's Government (1.0%) which was affected by the Financial Crisis and was even lower, except in 1998, than 2.7% of its previous government.

○ Major Real Economic Index Change by Governments

(Unit: Increase Rate %)

| President | Period | Rea GDP | Domestic | Demand Exports | Job Growth |
|---------------|-----------|-----------|-----------|----------------|------------|
| Chun Doo-Hwan | 1981-1987 | 8.7 | 8.2 | 14.2 | 2.6 |
| Roh Tae-Woo | 1988-1992 | 8.4 | 10.4 | 7.1 | 3.1 |
| Kim Young-Sam | 1993-1997 | 7.1 | 7.3 | 17.3 | 2.2 |
| Kim Dae-Jung | 1998-2002 | 4.4 (7.2) | 2.7 (7.7) | 11.4 (11.1) | 1.0 (2.7) |
| Roh Moo-Hyun | 2002-2007 | 4.3 | 2.5 | 13.2 | 1.1 |

Note: The figures in the parentheses averaged values of four years excluding the year of 1998.

The poor performance in job creation of the Participatory Government was not unrelated to extremely severe domestic depression. In the 1981-2006 period, the correlation coefficient between employment growth and demand growth in domestic market was 79%, a extremely high figure compared with those of other macroeconomic indicators. This indicated that severe slowdown in domestic demand resulted in worsening situations in labor market. Conversely, activating domestic demand is necessary for creating more jobs.

If 500,000 jobs are created, employment in 2008 will grow 2.1% compared to 2007. According to regression analysis results of employment growth and domestic demand growth, 1% growth in domestic demand increases 0.26% of employment. In order to achieve 2.1% of employment growth in 2008, therefore, domestic demand must grow about 6.5%. Given average domestic demand growth rate of the previous governments, the mid-6% level of domestic demand growth would by no means be an impossible target.

Policy Suggestions

Employment Expansion by Mitigating Labor Market Rigidity

The government policy, which used to focus on protection of job holders, is now required to shift toward the expansion of creating new jobs. Instead of strengthening protection of irregular workers, the government needs to review a system like 'First Employment Contract (CPE: Le Contrat Premiere Embauché)' that was first attempted by France to boost employment of young people. If we raise the nation's employment rate (based on 15-64 years old), which was 63.8% in 2006 to the level of Japan (70%), there will be an employment expansion effect hiring about 2.1 million people.

Downsizing Public Sector through Tax Cut and Activating Private Sector

The expansion of public sector under the Participatory government reached a worrisome

level and tax cut, which is designed to limit governmental expenditures and activate private sector, is believed to be a desirable tool for improvement. Lowering corporate tax increases return on capital (ROC) and it, in turn, will increase corporate investment and production. If tax revenue is increased by revamping income tax system, there will be a room for cutting income tax rate and this will contribute to enhanced productivity giving workers an incentive to work.

Activating Investment through Abolishment of Total Equity Investment Ceiling System and Ease Restrictions on Capital Areas.

Upon investigation, the Federation of Korean Industries (FKI) forecasted if restrictions on total equity investment ceiling system and capital areas was realized in 2006, there would be about 27 trillion won of investment growth effect within the next two years. If 50% of the 27 trillion won (real value of 13.5 trillion won amounts to 11.8 trillion won) had been invested, fixed investment growth would have increased from 3.2% to 8.8% as the investment amount increased to 226.3 trillion won, rather than 214.6. Assuming that without considering multiplier effect, real GDP had grown as much as the amount, the growth rate of the economy in 2006 would have reached 6.6%, not 5.0%.

Recent Publications

Research Monograph

A Legal Study on the Punitive Damages

Research Monograph 07-06

Sam-Hyun Chun

Punitive damages are developed as a way to punish defendants found to have acted maliciously. Punitive damages, therefore, represent a deterrent to future such malicious or otherwise irresponsible and harmful actions. The award of punitive damages has evolved to become an almost routine aspect of the most civil litigation. Perhaps, more troubling is the fact that punitive damages have become so large that they often not only dwarf but also bear little relationship to actual compensatory awards. Larger and larger punitive damages have literally begun to distort the litigation process and negatively impact settlement attempts.

The American Tort Reform Association(ATRA) urges the state governments to rein in punitive damage awards and recommends the following specific reform measures:

- Establishing a liability trigger that reflects the intentional tort origins and quasi-criminal nature of punitive damages awards - actual malice.
- Requiring clear and convincing evidence to establish punitive damages liability.
- Requiring proportionality in punitive damages so that the punishment fits the offense.
- Federal legislation to address the special problem of multiple punitive damages awards; this would protect against unfair overkill, guard against possible due process violations, and help preserve the ability of future claimants to recover basic out-of-pocket expenses and damages for their pain and suffering.

So far, 19 states(Alabama, Alaska, Arkansas, Colorado, Connecticut, Florida, Georgia, Idaho, Indiana, Kansas, Mississippi, Montana, Nevada, New Jersey, North Carolina, North Dakota, Oklahoma, Texas, and Virginia) have enacted punitive damages reform legislation. In 2004, Mississippi(HB 13a) became the latest state to take steps to rein in punitive damages awards.

Until now, Korean courts do not award punitive damages as a matter of public policy, and the Korean laws prohibit the enforcement of punitive damages awards obtained overseas.

Most recently, Korean NGOs and a government commission, “the Presidential Commission on Judicial Reform”, try to make a draft of “Korean Punitive Damages Act” in 2006. But the contents of the draft was very different from the american tort reform.

The Korean government has to try to rule that punitive damages must be reasonable, as determined based on the degree of reprehensibility of the conduct, the ratio of punitive damages to compensatory damages, and any criminal or civil penalties applicable to the conduct.

An Equilibrium Model of Ownership Structure in Business Groups

Research Monograph 07-07

Chung-Gyu Choi

This paper presents an equilibrium model of ownership structure in business groups and investigates that which structures are derived in equilibrium. This paper also analyzes the effects of ownership structure on payoff distribution between a business group founder and external investors. Moreover, this paper examines the impacts on ownership structure of corporate policies such as the ban on cross-shareholdings, shareholder-oriented legislation, and introduction of dual class shares.

We find that seven ownership structures are derived in equilibrium, which include Horizontal Structure (type I), Vertical Structure (type II-1), Vertical Structure with Cross-shareholdings (type II-2), Hybrid Structure without Cross-shareholdings (type III-1, III-2, III-3), and Hybrid Structure with Cross-shareholdings (type IV). We also derive net payoffs of the business group founders, external investors, and the whole society under each ownership structure, and find that the net payoffs are all positive under certain conditions. This implies that, under the conditions, the business group founders have an incentive to build firms and the external investors have an incentive to invest in the firms, and therefore the seven ownership structures are all feasible and socially desirable.

We then compare the net payoffs among the seven structures and find that the net payoffs of the business group founders and the society as a whole are higher under structures II-2, III-3, and IV than under the rest. This result implies that the ban on cross-shareholdings might conflict with the efficiency.

Finally, we find that the structures II-2 and IV are not involved in an equilibrium any more if we allow the business group founders to control the firms by using dual class shares. This suggests that the cross-shareholding is closely related to the founder's control power over the firms and that complex ownership structure among affiliated firms is also closely related to the lack of institutional device such as dual class shares.

The Effect of Exchange Rate Fluctuations on the Korean Firm's Performance and Its Implication for the Strategy to Face Exchange Rate Problems

Research Monograph 07-08

Soon Kwon Ahn

This paper investigates the effect of exchange rate fluctuations on the Korean manufacturing firm's performance in the period of 1989~2006 using total 6,801 firms which include not only the listed firms but the registered and audited firms.

The empirical study shows that the operational performances of manufacturing firms deteriorate as the Korean Won/US dollar exchange rate decreases, but improve as the Japanese Yen/US dollar exchange rate decreases. These results correspond with the theories and the experiences as well as with the results of existing empirical studies that manufacturing firms take advantage of the depreciation of Korean Won and the appreciation of Japanese Yen.

The effects of exchange rate fluctuations on the firm's performance depend on the characteristics of firms as follows. First, the performances of the export oriented firms appear to be more sensitive to the exchange rate fluctuations than those of the domestic market oriented firms. Second, the exchange rate fluctuations have more influences on the small-medium firms than on the large firms. Therefore, it is necessary for the small-medium firms to strengthen the exchange rate management system. Third, the performances of the firms with low productivities appear to be more sensitive to the exchange rate fluctuations than those with high productivities. Therefore, Korean firms are required to continue to reduce costs by means of restructuring and raising the efficiency of the management, as well as by stabilizing the labor-management relations. Finally, the exchange rate fluctuations have more effects on the high R&D ratio firms than on the low R&D ratio firms. Although the rise of R&D ratio may alleviate the exchange rate sensitivity, it is still necessary for the firms to enhance the quality competitiveness of export goods by producing high-technology commodities.

M&A Drive by Chinese Corporations and Its Implications for Korean Corporations

Research Monograph 07-09

Seung Rok Park

This study provides lessons for South Korean corporations on the cross-border M&A drive from the experience of Chinese corporations. Chinese corporations have propelled cross-border M&As recently, and the main reasons are the government's policy change in control of foreign exchange reserves, its strategic consideration for natural resources security, acquisition of advanced technology and famous brand from advanced countries. Despite their longer history than Chinese counterpart, Korean corporations have not actively utilized the worldwide trend of global M&A due to lack of understanding on the M&A as a new momentum for corporation growth. Therefore, South Korean corporations need to enlarge scale of cross-border M&A and increase its weight in the overseas investment.

Policy Study

Policy Responses to Korea-U.S. FTA and Market Opening

Policy Study 07-05

Wongun Song

This report suggests the following policy responses to the Korea-U.S. FTA in order to maximize the possible economic impacts.

- To secure the competitiveness of Seoul as a large international city, the government should replace its balanced regional development policy with metropolitan foothold development policy and also drastically reform the regulation on the development in the Capital region.
- To secure employment flexibility, ease the requirements for redundancy dismissal (layoff) and provide defensive means to enterprises, allowing replacement of strike workers during the labor dispute period, etc.
- Prepare a tax policy in global standard to respond to the market opening era, including reductions of corporate and income tax rates and easing tax imposition on the return on capital.
- As a substantial measure to create an environment to learn English, use Korean and English together in official sectors, reinforce English education for kindergarten and elementary school children and establish ground-wave English broadcasting stations.
- Respect the rights of parents and students to choose schools while stressing the need for liberalistic education to talents required by the global knowledge-based society, expand the bodies to establish and operate schools and open education market.
- As a means to improve medical system, allow establishment of commercial hospitals on a step-by-step basis, activate private medical insurance firms to supplement the National Health Insurance and introduce DRG (Diagnosis Related Group) system to improve medical treatment fee payment system.

Recent Recovery of German Economy and Its Implications

Policy Study 07-06

Soon Kwon Ahn and Pilhyun Kim

The recent recovery of the German economy is mainly due to the strengthened competitiveness of the traditional manufacturing sectors and expansion of new growth engines through M&A strategies in the high-tech fields.

The German government's drastic support to strengthen the growth potentials of small and medium-size enterprises (SMEs) and their innovation capabilities along with expansion of corporate R&D investment have proven effective in reinforcing the quality competitiveness of traditional export goods.

When the SME-oriented industrial policy faced difficulties recently due to profitability decline, structural change of industries forced by drastic technological innovation, and economic vulnerability of the scale, etc., Germany coped efficiently with such problems with M&As among enterprises centering on bio and nano industries.

Korea, like Germany, has high export dependency and a high ratio of manufacturing sectors in its economy. Recently, Korea has been receiving strong check from Japan and intensive challenge from China, India and many other countries in the world market. To maintain a brisk export performance trend amid such situation, the German case implies that efforts to strengthen quality competitiveness, expansion of R&D investment, development of new products, etc. together with proper management of foreign exchange rates are urgently required. For reinforcement of international competitiveness, there is also a need to promote ease of various restrictions related to M&A.

www.keri.org

Publisher: Jong-Seok Kim

Editor: Chan-Guk Huh

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,
FKI Building, 28-1 Yoido-dong, Yeongdungpo-ku,
150-756 Seoul, Korea.

Tel : (82-2)3771-0001, FAX : (82-2)785-0270/1