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Contents

Korea Economic Research Institute

Economic Trends and Outlook

Executive Summary

Our forecast of economic growth for 2008 is unchanged since last June when the projected growth rate was 4.2%. The export sector has been more robust than previously expected and compensated for the weakening domestic demand.

We project that the Korean economy will grow slightly below 4% in 2009. A slowdown in the export sector due to the global financial crisis and the subsequent decline in the world economy is cited as main reasons for Korea's slow growth next year. However, it is expected that the economy will start to rebound in the second half of 2009 as financial market conditions, both domestic and international, stabilize.

The current account is expected to post $5.8 billion in deficit next year following the deficit of $10 billion (est.) for 2008. Consumer inflation is expected to improve next year from 4.9% in 2008 to 3% range in 2009 as the inflationary pressures dissipate. The won-U.S. dollar exchange rate is expected to remain at a relatively high level for the whole of 2009. However, the Korean won is likely to appreciate slowly against the dollar in the latter half with improvements in credit conditions and the Korea's current account balance.

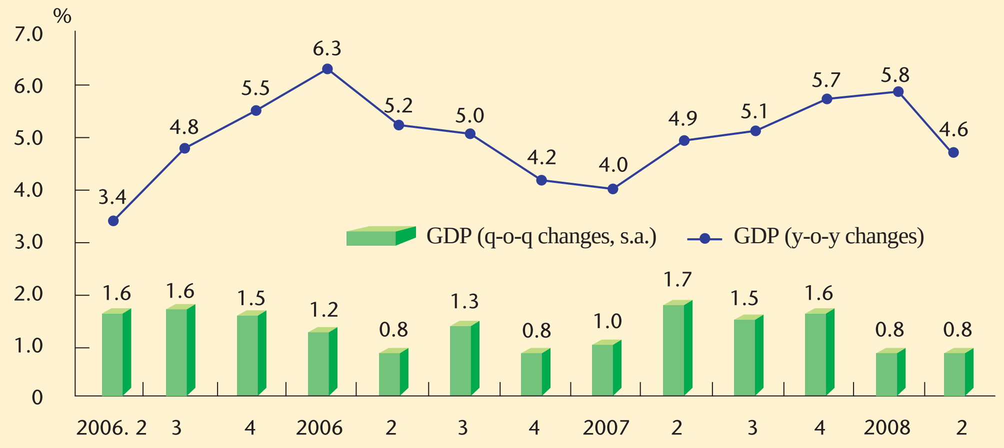
Meanwhile, a tax cut package in the amount of 11.7 trillion won included in '2008 Tax Revision', announced in September, is expected to increase the economy's growth rate by an additional 0.4%p through increases in private consumption and investment.

The current international financial market crisis is expected to have strong negative ripple effects on the export-dependent Korean economy. As such, a stronger policy priority should be placed on supporting domestic demand through improvements in regulatory environment and job market conditions. Specifically, implementation of expansive monetary and fiscal policies such as cuts in taxes and interest rates, boosting SOC projects outside the capital area, easing land-related regulations in the Seoul area, and enhancing the labor market flexibility are essential.

Recent Developments

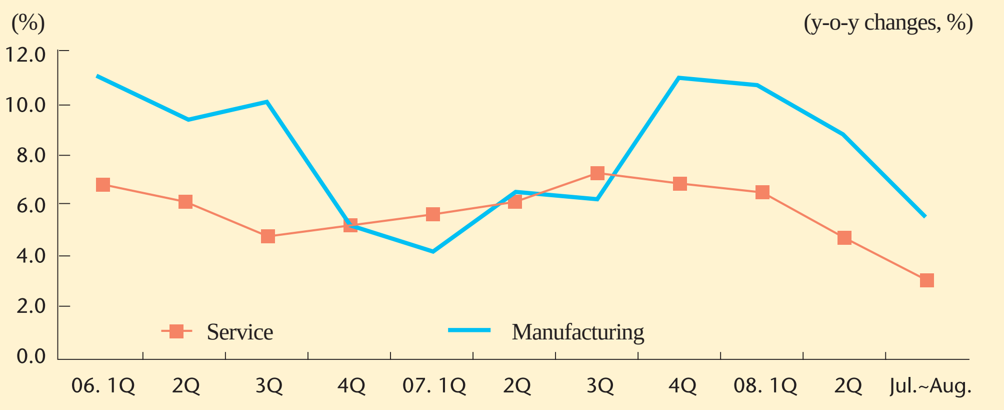
GDP in the second quarter of 2008 grew 0.8% from the preceding quarter. Year-on-year growth was 4.6%, which is 1.2%p lower than in the first quarter. Although the export sector performance has been robust, private consumption and investment remained weak.

GDP Growth



The downturn of economic activities is becoming more severe. The service sector output growth declined to 2.8% in July-August from 6.4% in the first quarter and 4.6% in the second quarter. The manufacturing sector output growth also slowed to 5.3% in the third quarter from 9.0% in the second quarter.

Manufacturing and Service Production



On the domestic demand side, the declining trend in consumer goods sales is becoming alarmingly pronounced posting just a 2% level of growth in July-August after the sluggish second quarter performance. Weaker consumer sentiments, oil price hikes, and financial market instabilities amid worsening labor market conditions are cited as the main causes.

Facility investment growth rose to the 5% level in July-August. However, the bounce appears to be largely due to the base effect from the low growth in the third quarter of last year. Judging from the leading indicators such as construction orders received, a recovery in the construction sector is not likely to occur any time soon.

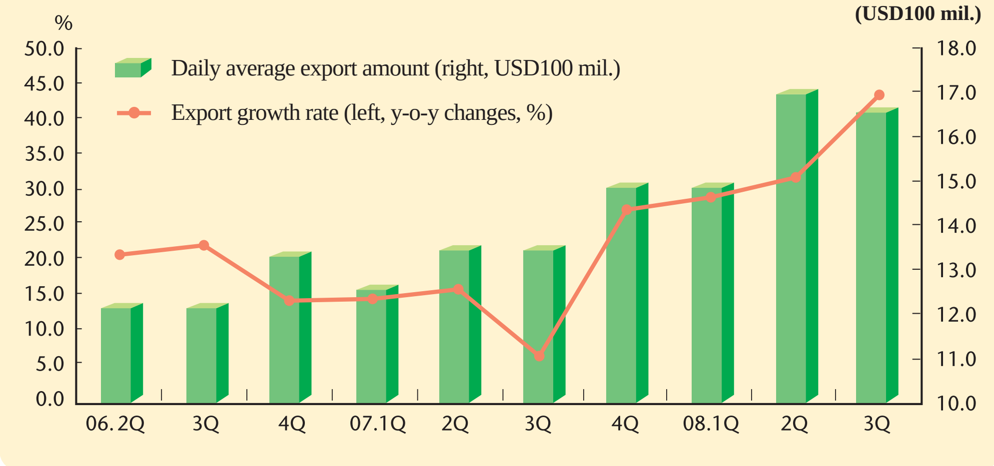
Trends in Domestic Demand

(y_o_y,%)

	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	4.0	-0.9	25.2	5.8	-3.9
2Q	2.5	0.1	8.8	6.5	-6.1
Jul.~Aug.	2.7	5.7	9.9	10.1	-10.2

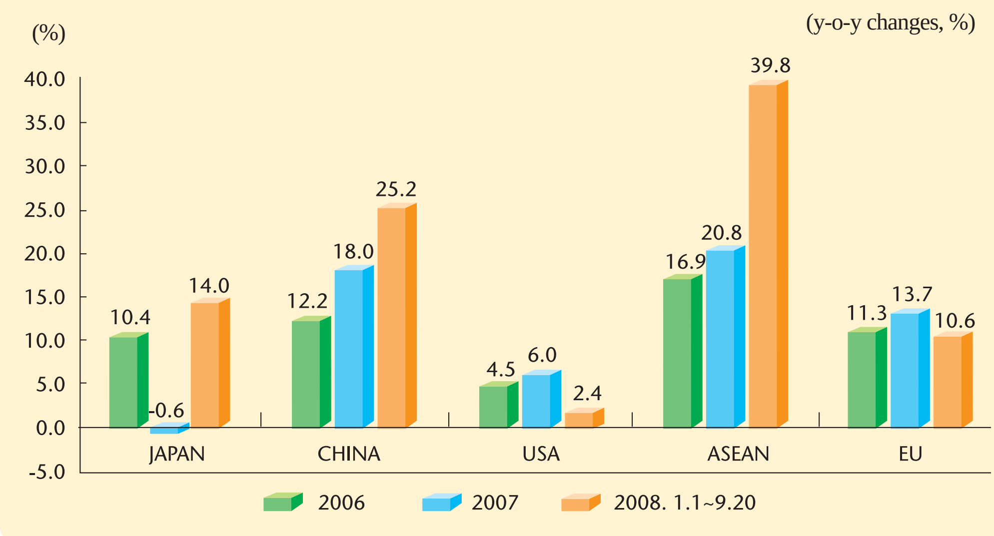
The nation's brisk export performance continued in the third quarter. Thanks to strong performances of key industrial sectors like oil products and wireless communication equipment, the exports grew 27.6% in the third quarter, up from 23.2% in the second quarter. The daily average export amount came in at US$1.65 billion in the third quarter after posting US$1.49 billion in the first quarter and US$1.70 billion in the second quarter.

Exports



During the January-September period, exports to China, ASEAN, and Japan had expanded considerably compared with last year. But exports to the United States had grown at a much slower rate, posting 2.4% growth during the period. Exports to the EU, while somewhat slower compared to last year, posted a robust 10% growth.

Exports by Region



The current account balance has deteriorated due to worsening external environments and recorded a $7.2 billion deficit in July-August period following deficits of $5.2 billion and $100 million in the first and second quarters respectively. A sharp rise in import growth due to hikes in international oil and commodities prices more than offset the gains from the export sector.

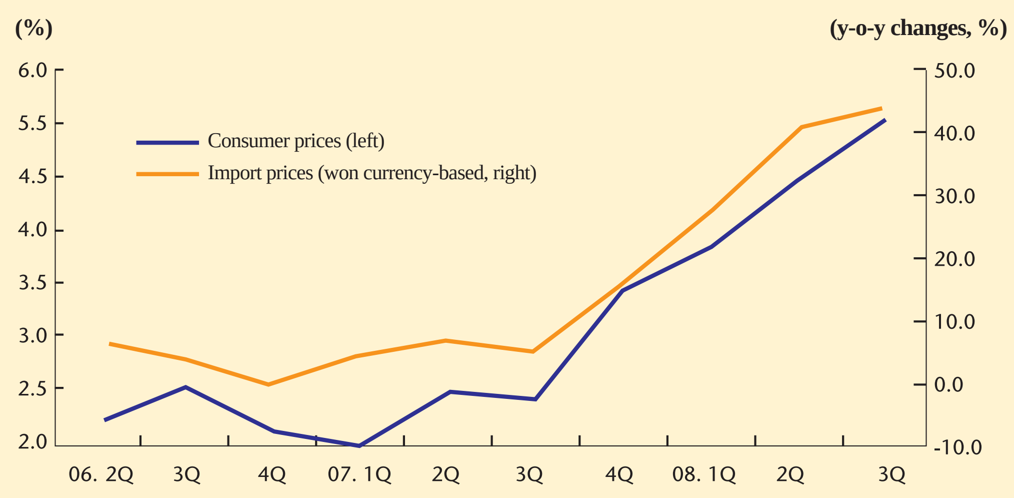
Current Account Balance

(USD Bil.)

	Current Account Balance						
		Goods	Service			Income	Current Transfer
				Travel	Business Service		
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
Jul.~Aug.	-7.2	-2.6	-4.5	-2.6	-2.7	0.6	-0.8

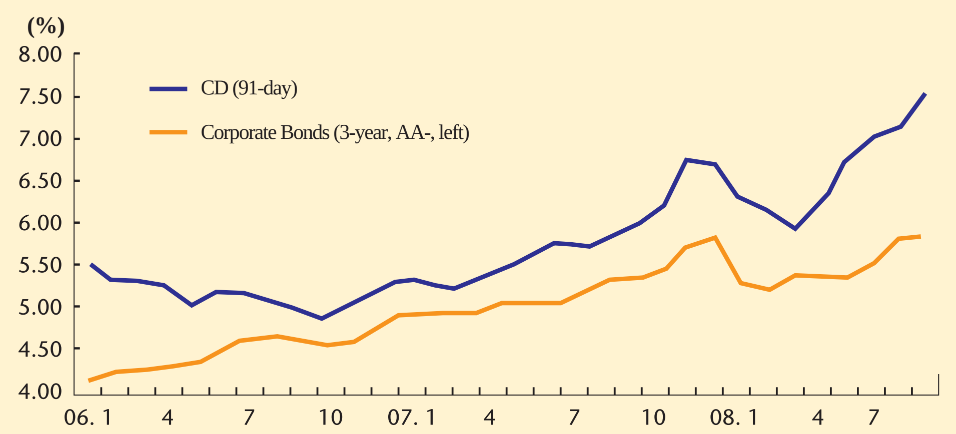
Consumer inflation accelerated in the third quarter to 5.5%. It was 4.8% and 3.8% in the second and first quarters respectively. Currency depreciation against the dollar coupled with rises in oil prices are the main reasons for increasing inflationary pressures. However, with oil prices stabilizing recently, the monthly figures for the third quarter show that inflationary pressures are gradually easing.

Prices

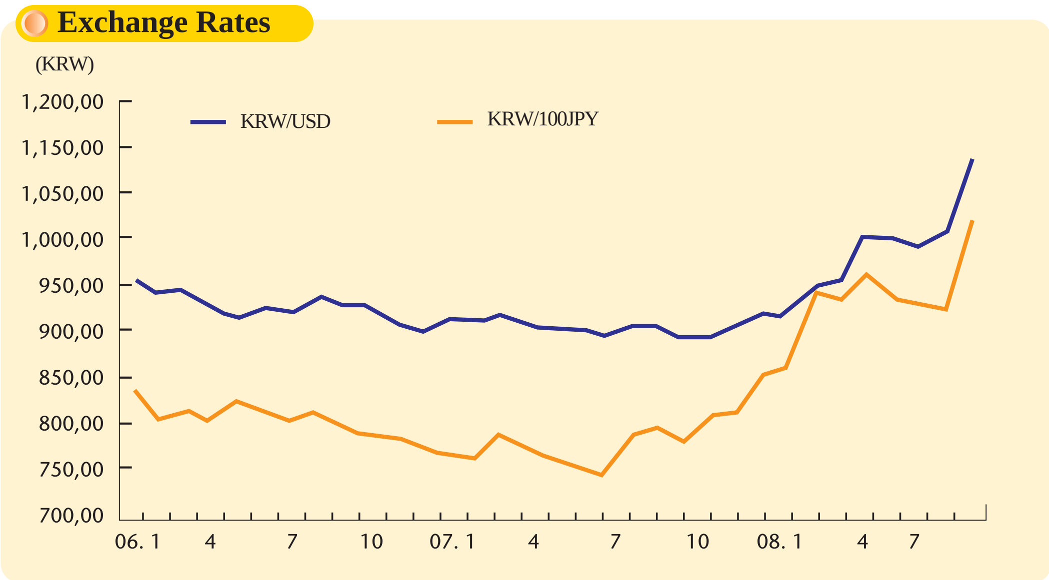


Market interest rates remained on an upward trend since May. Rising inflation expectations subsequently followed by the international credit crunch are the main causes for the ongoing trend.

Interest Rates



The Korean won has depreciated against the dollar due to the international financial crisis and the worsening current account balance.



Outlook for 2008~2009

External Environment

The global economy is expected to slow down as the financial instability spreads over to the real sector in 2009. Accordingly, the IMF adjusted its projections for world economic growth downward to 4.9% for this year and 3.7% for 2009.

International oil price is likely to show a downward trend in 2009. Although supply side risks such as geopolitical instability and disruptions in supply lines continue to exist, contraction in demand resulting from the global economic slowdown is likely to dominate the scene. In this light, the OPEC recently made a downward adjustment in its projection for crude oil demand this year and next year at 120,000 bpd and 140,000 bpd, respectively.

International financial markets will remain unstable and edgy at least until the second half of 2009 as the U.S. housing market is likely to remain depressed well into the next year. In light of the current market conditions, the major central banks are expected to reduce their policy interest rates.

Internal Environment

The aftermath of the U.S. financial market instability is likely to have negative impacts on the domestic real economy for a considerable period. With mounting fears over the dollar shortage, the foreign exchange rate fluctuations may become more severe. In this vein, the domestic stock market is likely to be volatile. With domestic banking institutions tightening lending standards, investment will be sluggish as private enterprises face liquidity problems. Private consumption slowdown will continue as well due to rising repayment burden of principal and interest for household loans.

The '2008 Tax Revsion' will help to stimulate the economy in 2009. The large-scale tax cut package (21.3 trillion won over five years), as yet unprecedented, is expected to stimulate investment and private consumption.

With easing inflationary pressures, the policy interest rate is likely to be lowered in 2009. The Monetary Policy Committee implied in September that it would take into consideration the recovery of growth momentum together with price stabilization in its future monetary policy decisions.

Prospects for 2008

GDP growth in 2008 is projected at 4.2%, 0.8 percentage point lower than 5.0% growth achieved in 2007.

The lower projection was made due to the weakening of growth momentum as the new government's policy initiatives lost traction as a result of political and social disorders on top of the worsened external environment.

In the latest forecast, we maintained the previous projection (June 2008) but adjusted projections for domestic demand and export sectors. A downward adjustment is made for the domestic demand sector to reflect risks following inflation and financial instability. An upward adjustment for growth in the net export sector is made to reflect brisk export performances in the second half.

Adjustment of Growth Rate Projections

(y-o-y changes, %)

	2008		
	3/4	4/4	Year
Growth Rate	3.7 ← (3.7)	2.8 ← (3.0)	4.2 ← (4.2)
Private Consumption	2.3 ← (3.1)	2.1 ← (2.9)	2.5 ← (3.2)
Construction Investment	0.5 ← (0.9)	-0.6 ← (1.9)	-0.6 ← (0.4)
Facility Investment (incl. Intangible Fixed Assets)	1.6 ← (6.5)	1.8 ← (4.9)	1.8 ← (3.4)
Exports (Goods + Services)	11.2 ← (9.6)	9.3 ← (6.6)	11.1 ← (9.8)
Imports (Goods + Services)	9.2 ← (9.4)	7.8 ← (8.3)	8.7 ← (9.1)

* Note: The figures in parentheses are previous projection values (projection time: June 2008).

Prospects for 2009

GDP growth in 2009 is projected at 3.8%, down from 4.2% for 2008

Affected by the international financial market instability and a subsequent global economic recession, the export sector is likely to experience a sharp slowdown in 2009. However, economic growth is expected to recover gradually starting in the second half as the external economic conditions normalize.

- Private consumption growth is expected to stand at the 2% level with worsening consumer sentiment due to poor labor market conditions, increases in the burden of household loans and aftereffects of international financial instability, etc.

- Construction investment will rebound to a positive growth trend in 2009 owing to investment in the public sector. Nevertheless, the recovery is likely to be limited due to a continuing slowdown in overall housing market conditions.

- Regarding facility investment (including intangible fixed assets) growth, the leading indicators such as the receipt of domestic machinery orders are hinting a recovery may lie ahead. However, growth is projected to stand at the 2% level due to a delay in the recovery of investor sentiment, affected by the economic slowdown and tight credit conditions in the aftermath of international financial market instability.

The current account balance is expected to post a deficit in 2009. However, the falling oil prices and the higher exchange rate will serve to limit the deficit's size.

Exports (based on BOP and the U.S. dollar) are expected to slow significantly due to financial instability and subsequent decreases in global demand. Yet, exports are likely to maintain double-digit growth owing to diversification of export markets, comparative advantages in the competitiveness of key products and the rise in the won-U.S. dollar exchange rate.

Consumer inflation is expected to fall to the 3% level in expectation of oil prices stabilizing at less than US$100/barrel next year. However, the won-U.S. dollar exchange rate trend in the wake of international financial instability is likely to become an important factor for future domestic prices.

Based on the corporate bond yield rate, market interest rates are projected to decline next year and reach 6.6% on annual average after posting an average of 7.0% in the fourth quarter of this year. Major factors for the decline are increased likelihood of expansionary monetary policy stance and alleviation of price push pressures.

The won-U.S. dollar exchange rate is likely to remain at a higher level in 2009 than in the past due to upward pressures such as tighter global credit conditions and the export slowdown. However, owing to the mitigation of the global credit situation and improvement in the current account deficit in the second half of next year, the exchange rate is expected to record a gradually downward trend.

Economic Outlook for 2008~2009

(y-o-y changes %, USD100 mil.)

	2007	2008					2009
	Year	1Q	2Q	3Q	4Q	Year	Year
GDP	5.0	5.8	4.8	3.7	2.8	4.2	3.8
(SA, q-o-q, %)		0.8	0.8	0.4	0.7		
Private Consumption	4.5	3.4	2.3	2.3	2.1	2.5	2.4
Construction Investment	1.2	-1.2	-1.0	0.5	-0.6	-0.6	0.4
Facilities + Intangible Fixed Assets	7.4	2.1	1.8	1.6	1.8	1.8	2.9
Exports (goods & services)	12.1	11.7	12.0	11.2	9.3	11.1	7.5
Imports (goods & services)	11.9	9.2	8.9	9.2	7.8	8.7	6.2
Consumer Prices	2.5	3.8	4.8	5.7	5.4	4.9	3.3
Current Account Balance	59.5	-52.1	-1.4	-51.7	5.1	-100.1	-58.0
Commodity Balance	294.1	-12.2	57.2	12.6	61.5	119.1	166.8
Exports (BOP basis)	3789.8	1028.8	1182.9	1165.5	1253.0	4630.2	5224.2
Growth (%)	14.2	19.0	27.3	24.2	18.5	22.2	12.8
Imports (BOP basis)	3495.7	1041.0	1125.7	1152.9	1191.5	4511.1	5057.4
Growth (%)	15.5	29.4	31.0	37.0	20.3	29.0	12.1
Service & Others	-234.6	-39.9	-58.6	-64.3	-56.4	-219.2	-224.8
Ex-Rate (Avg. KRW/USD)	929.2	956.9	1018.0	1062.6	1190.0	1056.9	1170.0
Corp. Bond Yield (3-year, AA-)	5.7	6.4	6.3	7.2	7.0	6.7	6.6
Unemployment Rate (%)	3.2	3.4	3.1	3.1	3.2	3.2	3.3

Prospects from '2008 Tax Revision' Effects

According to the government, '2008 Tax Revision' is estimated to provide tax reliefs in the magnitude of about 11.7 trillion won in 2009. About nine trillion won of them, excluding corporate tax (2.8 trillion won), is likely to return to the consumers' pockets. In addition, the corporate tax rate cut will serve to enhance facility investment.

'2008 Tax Revision' is estimated to boost economic growth by an additional 0.4%p for 2009. The consumer prices will increase by an additional 0.2%p, and the current account balance will worsen by about US$3.6 billion.

Economic Effects of '2008 Tax Revision'

(y-o-y changes, %)

	2009				
	Basic Projections (A)	Tax Revision Effects (B), %p			Projections Reflecting (A)+(B)
		Tax Cuts (9 trillion won)	Corporate Tax Rate Cut (1%p)	Total	
GDP (%)	3.8	+0.2	+0.2	+0.4	4.2
Private Consumption (%)	2.4	+0.7	+0.1	+0.8	3.2
Construction Investment (%)	0.4	+0.1	+1.0	+1.1	1.5
Facilities + Intangible Fixed Assets (%)	2.9	+0.1	+2.9	+3.0	5.9
Consumer Prices (%)	3.3	+0.1	+0.1	+0.2	3.5
Current Account Balance (USD100 mil.)	-58.0	-16.1	-20.1	-36.2	-94.2
No. of Employees (1,000 persons)	23,826	+16	+29	+45	23,871

* Note: We made the projections reflecting 9 trillion won in reduced taxes, excluding corporate tax from the total 11.7 trillion won, in the private consumption function and a 1% corporate tax rate cut effect in the investment function.

Issue Focus

Understanding the Current Situation and Future Policy Tasks

1. Current Situation

It is likely that due to the aftermath of the recent financial crisis around the world, contraction of the global economy will be unavoidable for the next one or two years. Considering Korean economy highly depending on exports, it is expected that this global economic downturn has a negative spillover on the level of export. Therefore, the government should set the top policy priority on maintaining good demand potentials through boosting domestic consumption and creating jobs.

Policy tasks for boosting the domestic demand should be on the government's active tax reduction, interest rate cut, deregulation on the capital sphere in parallel with promotion of SOC projects in non-capital regions, and reform of the labor market, etc.

2. Policy Tasks

First, the government should implement its tax cut policy announced on September 1 as scheduled. The recent estimation of KERI on the possible effect of the policy shows that the tax cut will increase economic growth by about 0.4% point.

To alleviate the risk of economic decline, the government needs to lower the benchmark interest rate in the first half of next year when the inflationary pressure is mitigated. If the global economic recession deepens more than expected due to financial instability, the government's rapid policy response to determine the timing of interest rate cuts will be necessary.

The stabilization of financial and foreign exchange markets must be emphasized. By maintaining consistency in economic policy, the government should recover its policy credibility quickly. However, it must be careful lest the measures of market stabilization encourage moral hazard problems.

It is necessary that the government make strategic decisions which alleviate restrictions on investment in the capital area as well as establish successful regional economic stimulation models by actively supporting SOC projects in non-capital regions like the Saemangeum Project.

Regarding the real estate market, the government should change the existing supply and demand controls over market and pursue stabilization of the housing market. The government should also help expanding supply in downtowns and suburbs where there is always enough demand for housing, and actively consider revision of related tax and loan restriction policies.

More jobs need to be created through reform of the labor market, maintaining a desirable wage increase, easing employment protections and permission of diverse types of employment. High wages are leading to price increases as well as becoming a stumbling block to the creation of new jobs. Diversified types of employment and implementation of flexible working hours will have the effect of enhancing the potential job opportunity for vulnerable classes. Comprehensive revision of existing laws with a goal of increasing the total employment is required.

Recent Publications

Research Monograph

The Nature of the Corporation and Control

Research Monograph 08-11

Seuk Hun Sin

No empirical study has ever shown any strong or consistent price reaction to defense adoption. It is hard to prove that particular governance measures will improve corporate performance, because business firms enjoy a wide range of choice over the governance rules they adopt and work under. Sensibly enough, they choose the rules that work best for their particular business. The prevailing principle on which capital markets should rest is that of freedom of contract, e.g. how companies draft their articles of association should be left to the market.

The modern corporation is the product of an evolutionary process in which entrepreneurs and investors together select governance structures for new firms, which then compete with each other in the markets for products, employees, and capital. So, the authorities should respect that ability rather than imposing its own bureaucratic view of what is good corporate governance.

Financial Integration in East Asia Revisited

Research Monograph 08-12

Pilhyun Kim

As the Asian economy gains a bigger status in the international arena, the possibility and advantages of forming a financially integrated block in Asia are getting stronger as well. However, there seems to be no material progress made to advance the integration of the Asian economies. The main culprits for this lack of progress are believed to be the lack of regional consensus on this issue and differences in underlying financial regulatory system across Asia. This paper suggests that promoting intra-regional capital flows can help to mitigate these problems. Liberalizing capital flows across the region will help to develop the regional financial markets as well as enhance mutual understanding, a key to forming a consensus, by encouraging information sharing and policy cooperations. This paper also has some suggestions as to how to minimize the potential destabilizing effects of free capital flows across the region.

Economic Prosperity and Fundamental Tax Reforms

Research Monograph 08-13

Kwang Choi

This report argues for the fundamental reform of Korean tax system and tax administration. Fundamental changes have to take place in the public awareness and the leaders' philosophy toward the tax system.

A tax system should be simple and clear according to the principles listed below:

- The introduction of dual flat rate income tax, combination of flat rate income tax and dual income tax, has to be considered.
- Corporate income tax should be abolished and integrated into personal income tax.
- It is recommended to abolish inheritance tax and to make capital gains subject to taxation instead.
- Taxation on asset transactions like capital gains tax, acquisition tax, and registration tax should be substantially reduced.
- It is advisable to reinforce taxation on consumption of goods or services.
- More emphasis should be made on the role of local taxes.
- It is of vital importance to create a unified collection system so called 'National Revenue Service.'

Policy Report

Social Cost of the Candle Protest

Policy Report 08-04

Gyeong Lyeob Cho, Wongun Song, Yun Ho Chung and Pilhyun Kim

As the protest over the government decision to import U.S. beef has been prolonged and distorted into an unlawful rally, both direct and indirect social cost is increasing significantly.

Estimating the social cost of the Candle Protest, total damage cost reaches up to 668.5 billion won, which includes the loss of 35.6 billion won of the participants' production loss, 58.5 billion won of public spending and 574.4 billion of third parties, etc. Of the National loss, macroeconomic cost due to social instability was estimated at 1.352 trillion won and cost due to delay of public reforms was estimated at 1.9228 trillion won, which exceeds 0.2% of GDP.

For long-term candle protest will bring vast national losses, both tangible and intangible, that surpass the expected social cost, it is needed that the public change the perception of the protest and the National Assembly and the government re-establish their roles.

A Study on Methods to Improve Regulatory Reform Implementation

Policy Report 08-05

Sung-Han Cho, Jin-wan Seo

This Paper focuses on the problems concerning the contents of the policy, executive authorities and those affected, based on the strategic tasks promoted by the Regulatory Reform Planning Corps of the Participatory Government.

In order to apply the regulatory reform plans properly, suggested by related ministries, cooperation and assistance of local authorities are required. But the story is different in reality. Above all, for the regulation made concerning all the factors realistically to be applied effectively, regulation monitoring system needs to be settled. Desired results cannot be produced, if such a system is simply mandated to the Regulatory Reform Committee or related ministries, but can be successful when cooperative relations among government agencies are established. This report also emphasizes local authorities and the central government should be ruled upon separate systems and individual systems be made for the central government for the different situations accordingly.

Fiscal Spending Analysis and Direction for Improvements

Policy Report 08-06

Gyeong Lyeob Cho, Hag-Soo Kim

This report suggests directions to improve fiscal spending as a structure that can cope with opening the market and aging society in harmony of growth and distribution, pointing out the characteristics and problems of the government's spending over the past five years,

Although the former Roh Moo-Hyun government has increased spending in health&social welfare and balanced development of the national territory in huge extent, problems such as polarization of the economy and income gaps have deepened. This report stresses further policy be made in the ways to recovering the middle class, stimulating investment and national demand, supporting the national growth and increasing employment.

The analysis concludes, if the government cut down the spending on health&social welfare and invest more in R&D, GDP and employment will rise by 0.9% and 0.11% respectively, and Gini's coefficient will be improved by 3.3%.

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