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Contents

Korea Economic Research Institute

Executive Summary

Economic Growth for 2010 Projected at 4.2%

The Korean economy, after recording a rapid recovery in the second half of 2009, is expected to slow down somewhat and mark an annual growth rate of 4.2% in 2010. As the government begins to implement exit strategies, ranging from interest rate rises to expiration of tax benefits, economic growth is expected to lose some momentum. In addition, lower world economic growth and a stronger Korean won will hamper a robust recovery in the export sector, which was a driving engine of economic recovery in 2009.

Current Account to Post US$15 Bil. Surplus and Consumer Prices to Rise 2.9% in 2010

The commodity account surplus is expected to contract sharply due to import growth outpacing export growth in 2010. The service account deficit is also expected to grow again due to foreign exchange rate appreciation and weakness in service sector competitiveness. As a result, the current account surplus in 2010 is expected to be about US$15 billion, significantly lower than the US$41.5 billion in 2009.

Rising prices of raw material imports will threaten price stability in 2010. However, due to weak domestic demand and a stronger Korean won, the consumer price level is expected to post a modest increase of less 3% in 2010.

Caution Required for Interest Rate Increase

It is important to emphasize that the policy interest rate should be raised in step with other countries' monetary policies so as to prevent excessively rapid capital inflows and faster than desired appreciation of the Korean won.

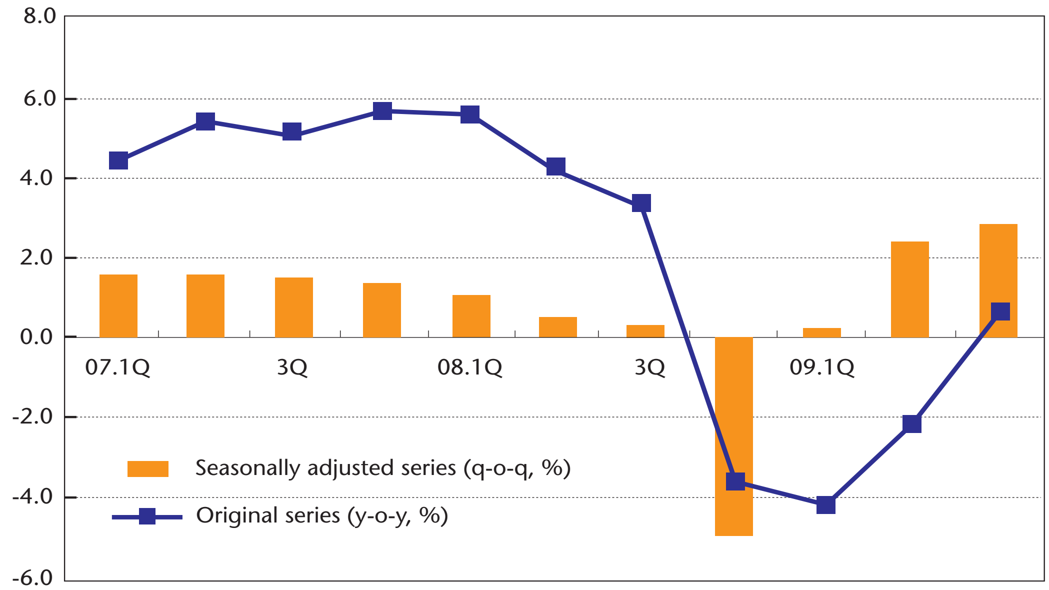
Economic Trends and Outlook

Recent Developments

GDP Growth Expanding

In the third quarter of 2009, real GDP posted a positive growth for the first time in four quarters, since the third quarter of 2008. It grew 0.9% year on year (2.6% quarter-on-quarter).

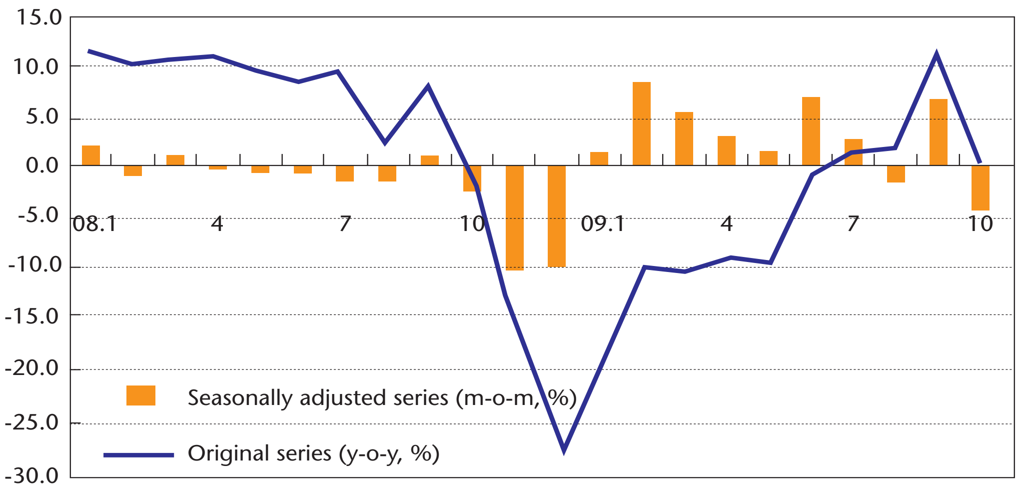
GDP Growth



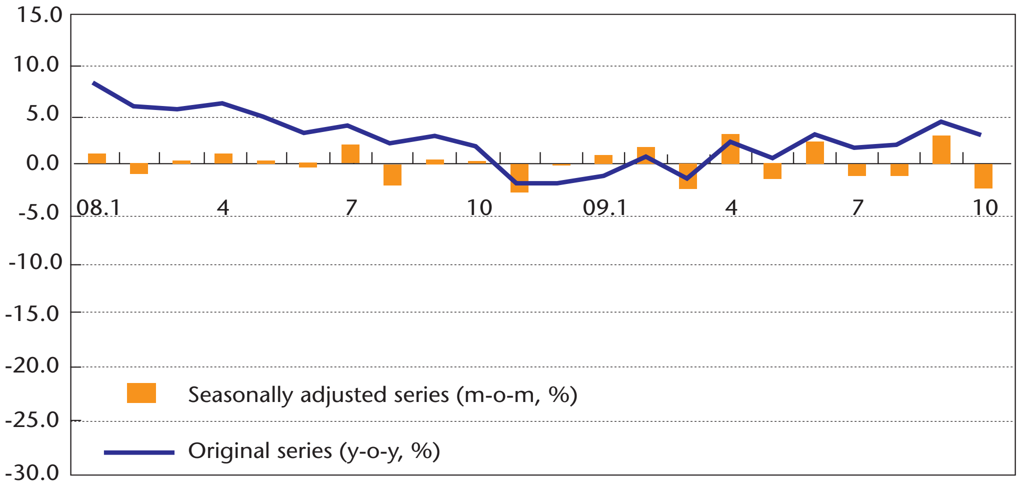
Production Slowdown in Second Half '09

Manufacturing production declined -4.1% month-on-month in October continuing a slide from -1.6% in August 2009. Service production also decreased for three consecutive months from July to September.

Manufacturing Output



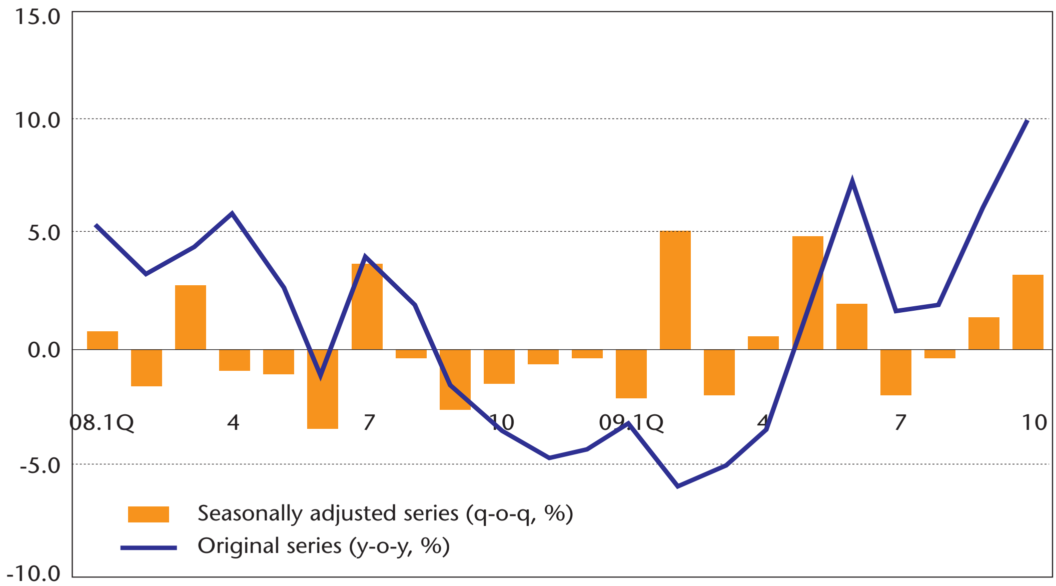
Service Output

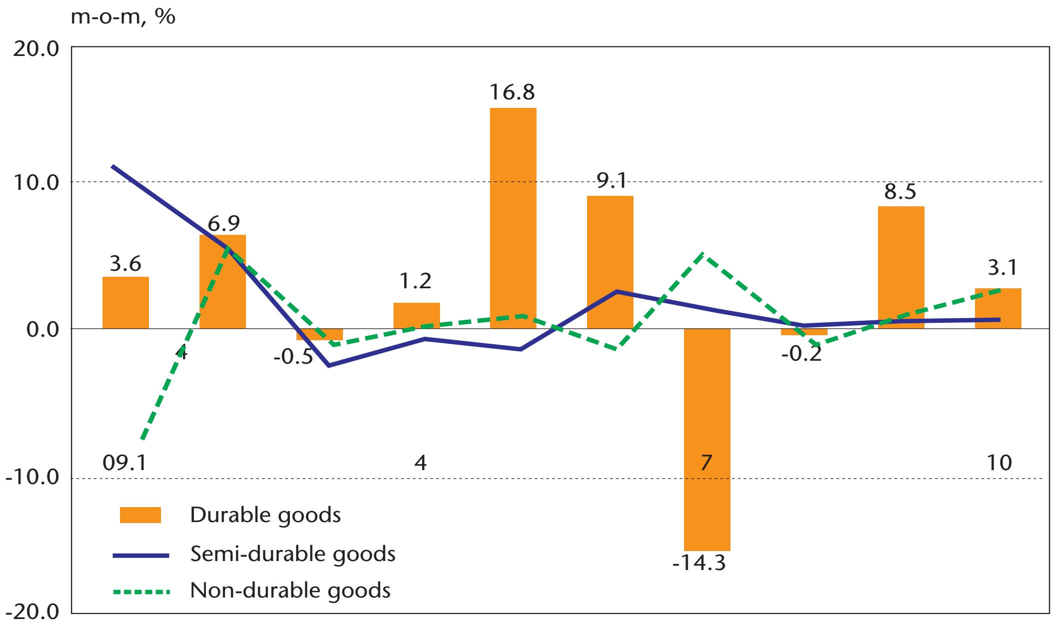


Consumer Goods Sales on the Rise

Consumer goods sales expanded for two consecutive months in September and October, and sales of durable consumer goods such as automobiles also increased sharply.

Consumer Goods Sales



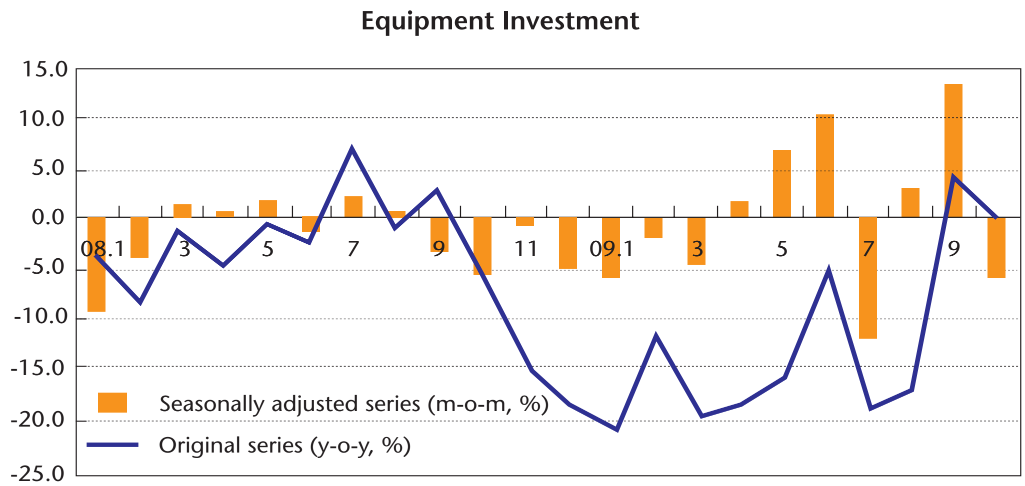


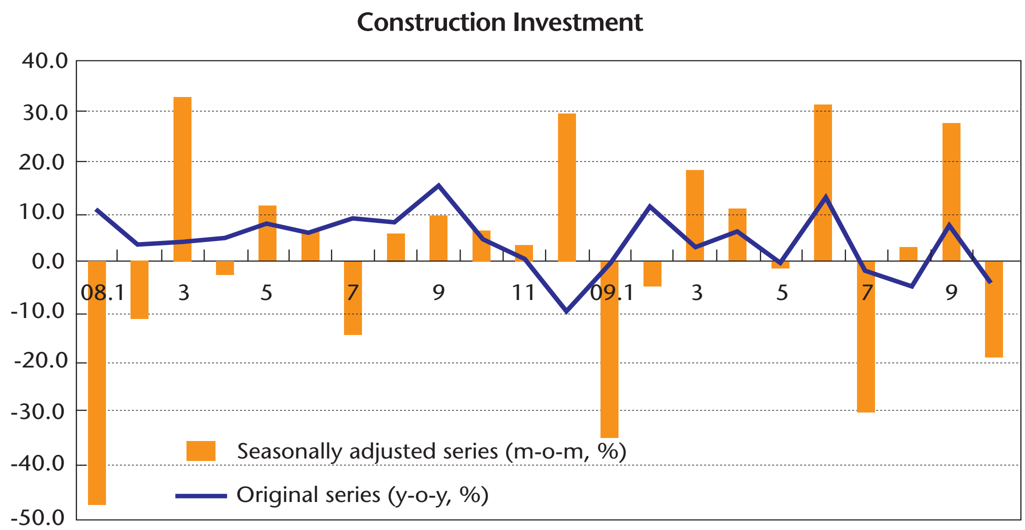
Facility Investment Slowing Down

Due to sluggish investment in transportation equipment, facility investment growth stood at 5.0% and 0.3% year-on-year, respectively, in September and October.

Construction Investment on the Decline

Construction progress payments decreased with stagnation in the public sector amid a continuing slowdown in the private sector.

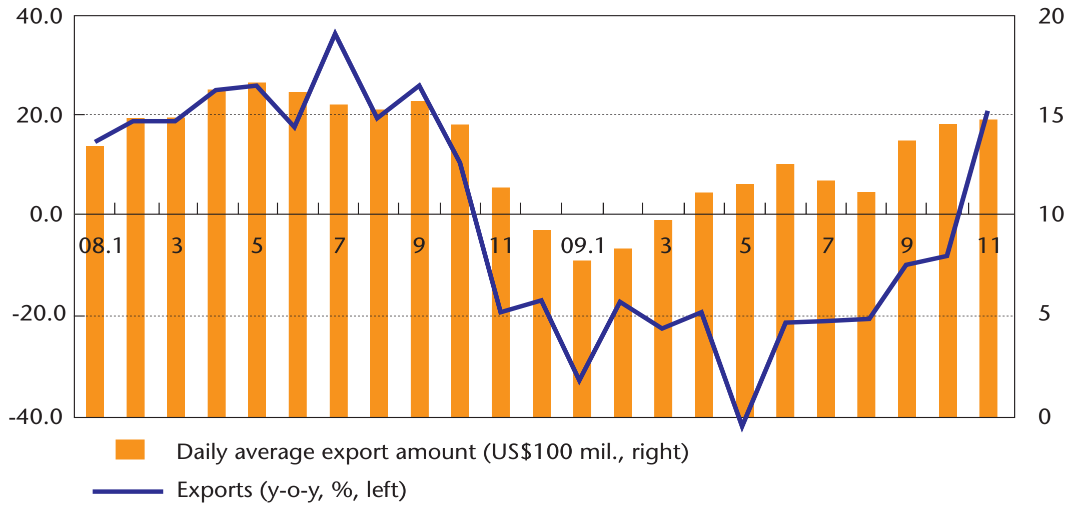




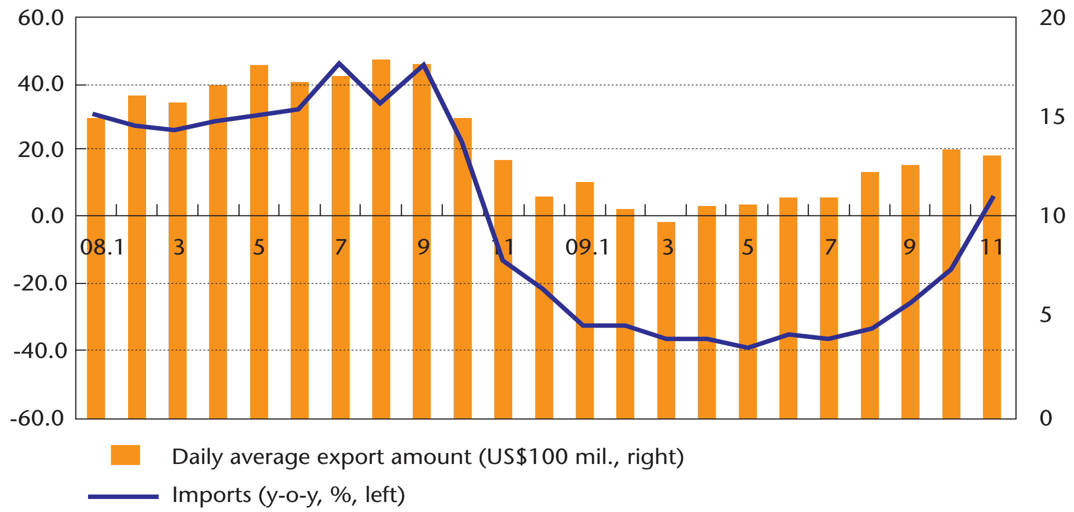
Exports and Imports Recovering

Boosted by improvements in the world economic conditions, exports rebounded to year-on-year growth of 3.4% in October~November. On the other hand, declines in imports slowed to -6.8% in October~November due to exchange rate gains, oil price hikes and increases in domestic demand.

Exports



Imports



Current Account Surplus US$37 Bil. in Jan.~Oct.

Imports declined more sharply than exports in the first ten months of 2009. Consequently, the current account continued to post a surplus. In January~October, the commodity account recorded a surplus of US$46.4 billion, up US$3.7 billion from US$42.8 billion in the same period of 2008, while the service account experienced a deficit of US$12.6 billion.

Current Account Balance

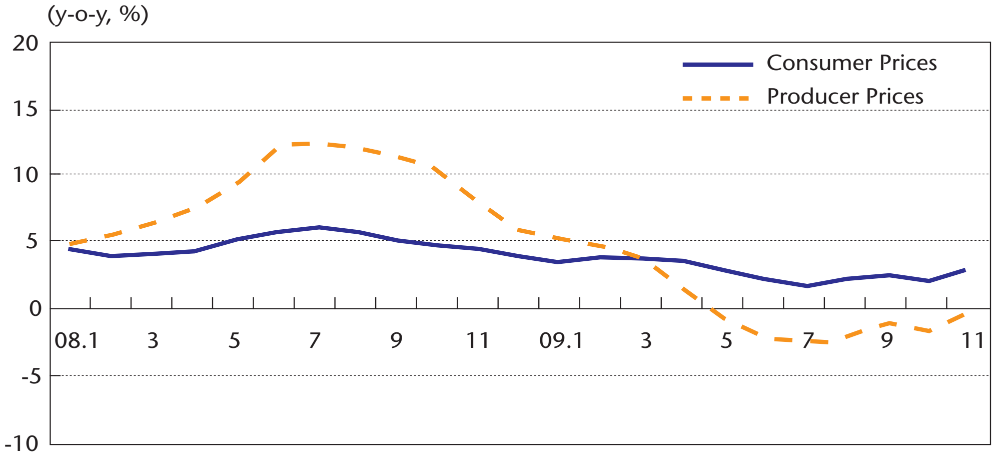
(Unit: USD Bil)

	2008					2009			
	1/4	2/4	3/4	4/4	year	1/4	2/4	3/4	1~10
Current Account Balance	-52.1	-1.3	-85.8	75.2	-64.1	85.8	131.7	103.0	370.0
Commodity Balance	-12.2	57.2	-34.8	49.7	59.9	83.5	176.3	147.4	464.3
Service Balance	-50.7	-42.7	-56.9	-17.0	-167.3	-18.8	-40.2	-53.2	-123.5
Travel Balance	-30.2	-27.7	-29.7	7.1	-80.5	5.2	-10.7	-20.7	-28.6
Business Service Balance	-29.1	-29.0	-40.6	-46.4	-145.1	-32.3	-39.9	-37.5	-124.0
Income Balance	16.9	-6.5	13.6	27.1	51.1	8.3	1.8	16.2	31.7
Current Transfer Balance	-6.1	-9.4	-7.7	15.5	-7.7	12.8	-6.1	-7.3	-2.6

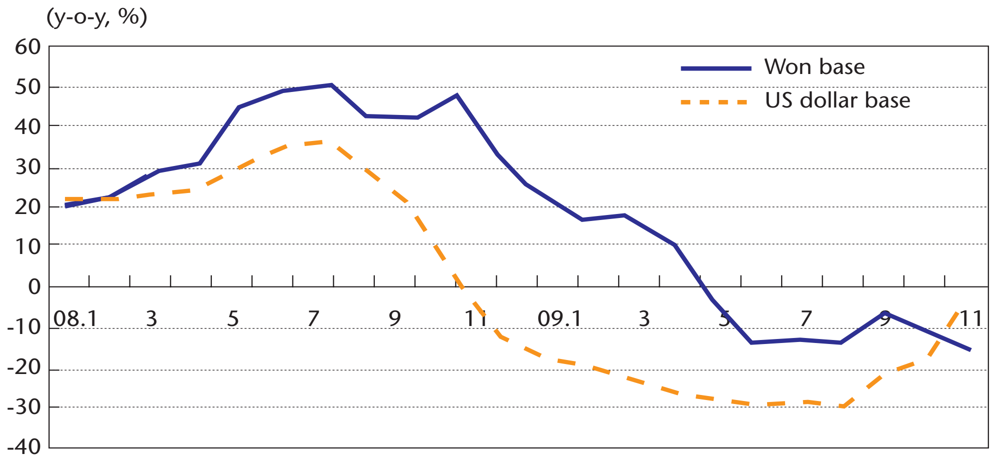
Consumer Prices Remain Stable

In spite of rises in international oil prices, the consumer inflation rate remained stable at a 2% level. Although import prices in U.S. dollar terms rose slightly, the effect on the domestic price level was offset by the stronger Korean won

Prices



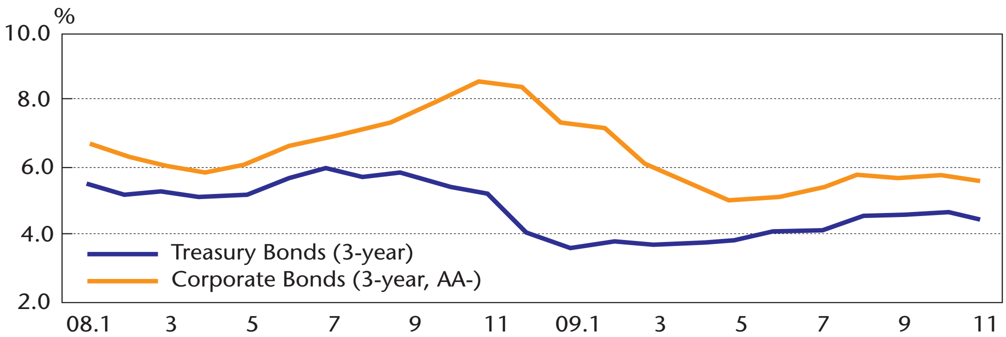
Import Prices



Market Interest Rates Slowed

The trend of rising market interest rates weakened due to the projection of a continued freeze in the policy interest rate and deepening economic uncertainty in the wake of the recent Dubai financial crisis.

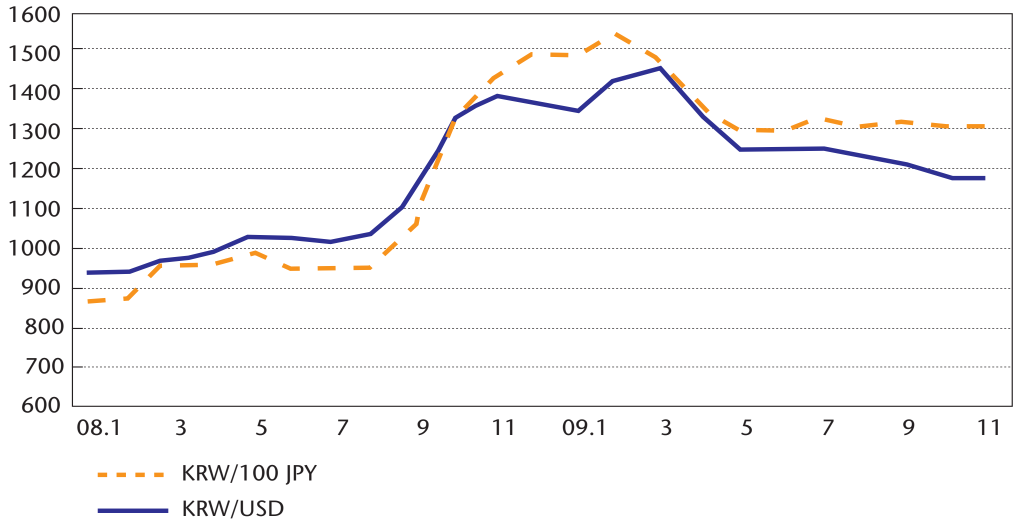
Interest Rates



Won-Dollar Fx-Rates on the Decline

Impacted by global dollar weakening, expansion of the current account surplus, improvement of environments for supply of foreign funds, and foreigner investors' net purchase of Korean stocks, the won-U.S. dollar exchange rate continued to appreciate.

Exchange Rates



Outlook for 2010

1. Internal and External Environments

World Economy to Post About 3% Growth in 2010

With the present recovery tone continuing, the global economy is expected to show positive growth in 2010. However, due to termination of expansionary macroeconomic policies and implementation of exit strategies, the recovery trend is likely to slow in the second half. The spread of protectionist trade policies and aftershocks in international financial markets like the recent Dubai situation may serve as additional risk factors for the world economy.

International Oil Prices to Rise Slowly

Affected by the mild growth pace of the global economy and worsening of the U.S. dollar weakening trend, international oil prices are expected to post a limited rising trend.

Base Interest Rates to Gradually Increase in 2nd Half

Interest rate increases are unlikely in the first half of 2010 due to insufficient recoveries in employment conditions, facility investment, and stabilization of real estate and consumer prices.

Gov't Budget for 2010 Up 2.6% from 2009

At 291.8 trillion won, the budget for 2010 (total expenditure basis) reflects 2.6% growth from 284.5 trillion won for 2009. The average budget growth for the 2005~2009 period was 7.9%.

Major Assumptions for Projections

Exogenous Variables	Unit	2009	2010
China's Growth	%	8.5	10.2
Japan's Growth	%	-5.4	1.7
U.S. Growth	%	-2.7	1.5
Dubai Oil Price	US$/bbl.	62.0	86.0
RP Interest Rate (end of year)	%	2.00	2.75

2. Outlook for Korean Economy

Growth: 0.3% in '09 → 4.2% in '10

Although positive growth is expected owing to the recovery of the global economy, base effects, etc., the domestic economy is likely to weaken gradually from the strong recovery trend recorded in the second half of 2009. With implementation of exit strategies, domestic economic growth may slow.

Private Consumption: 0.4% in '09 → 3.7% in '10

Thanks to improvements in labor market conditions and the stronger Korean won, private consumption is expected to continue a recovery trend. However, the household debt burden, expiration of automobile purchase incentives, and adjustment of asset value increases are likely to serve as factors in slowing consumption.

Construction Investment: 2.8% in '09 → 0.4% in '10

Affected by sluggish recovery in private construction and stagnation in the public sector, construction investment is expected to post lower growth than in 2009.

Facility Investment: -10.8% in '09 → 8.3% in '10

Facility investment is expected to recover significantly in 2010 owing to improvements in internal and external economic conditions and investment-push pressure caused by restrained investment in the past several years. Taking into account raw materials price hikes, interest rate increases and aftereffects of the financial crisis, however, it is difficult to expect double-digit growth.

Current Account Surplus: US$41.5 Bil. in '09 → US$15 Bil. in '10

Due to expansion of imports and the service account deficit, the current account surplus is projected to decrease sharply in 2010 as compared to 2009.

Export Growth: -14.4% in '09 → 10.3% in '10

Impacted by world economic growth that is slower than in recent years, foreign exchange rate appreciation, and delay in the consumption recovery of advanced countries, exports are expected to grow about 10% in 2010.

Import Growth: -25.4% in '09 ⟶ 18.3% in '10

Imports are expected to grow faster than exports owing to the recovery of the domestic economy and unit price increases.

Consumer Price Increase: 2.8% in '09 ⟶2.9% in '10

Considering the deflation gap and the pace of economic recovery, price push factors on the demand side are not significant. Also, prices of imported raw materials including crude oil are projected to increase, but the increases are expected to be limited due to a stronger Korean won.

Market Interest Rate: 5.9% in '09 ⟶6.5% in '10

Market interest rates are expected to rise due to implementation of exit strategies and improved economic outlook. Arrival of the maturity dates for 78 trillion won in corporate bonds and rises in the issuance volume of corporate bonds following increased M&As are likely to become factors for market interest rate hikes.

Won-U.S. Dollar Fx-Rate: 1,279 Won in '09 ⟶1,123 Won in '10

The Korean won will continue to gain ground over the U.S. dollar. However, it will be somewhat modest due to reduction in the current account surplus and alleviation of the global dollar weakening tone.

Outlook for Korean Economy (2009~2010)

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

	2008	2009			2010		
	Year	1st H	2nd H	Year	1st H	2nd H	Year
GDP	2.2	-3.2	3.7	0.3	5.2	3.2	4.2
(SA, q-o-q, %)		-1.2	2.6		0.4	2.8	
Private Consumption	0.9	-2.6	3.4	0.4	4.8	2.6	3.7
Construction Investment	-2.1	2.8	2.7	2.8	-1.2	1.9	0.4
Facility Investment	-2.0	-19.5	-1.6	-10.8	11.3	5.7	8.3
Exports (Goods + Service)	5.7	-7.1	3.0	-2.1	7.6	5.7	6.6
Imports (Goods + Service)	3.7	-15.9	-1.2	-8.7	15.3	13.7	14.5
Consumer Prices	4.6	3.4	2.2	2.8	2.6	3.2	2.9
Producer Prices	8.5	1.5	-2.0	-0.3	1.9	2.6	2.3
Current Account	-64.1	217.5	197.0	414.5	87.9	61.7	149.5
Commodity	59.9	259.8	262.0	521.7	157.5	149.3	306.8
Exports (BOP Base)	4334.3	1679.5	2030.5	3710.0	1893.1	2198.2	4091.3
Growth (%)	14.4	-24.1	-4.3	-14.4	12.7	8.3	10.3
Imports (BOP Base)	4274.3	1419.7	1768.5	3188.2	1735.6	2048.8	3784.4
Growth (%)	22.3	-34.5	-16.1	-25.4	22.2	15.9	18.7
Service & Others	-124.0	-42.2	-64.9	-107.2	-69.6	-87.7	-157.3
Fx Rate (Avg. KRW/USD)	1099.5	1352.0	1205.0	1278.5	1140.0	1105.0	1122.5
Corp. Bonds Yield (3-year, AA-)	7.1	6.1	5.7	5.9	6.3	6.7	6.5
Unemployment Rate (%)	3.2	3.8	3.5	3.7	3.6	3.4	3.5

Policies

Medium & Long-Term Policies: Change Labor Market Paradigm to Increase Employment Rate

1. Activation of Work-Sharing System: The government needs to work to enhance the flexibility of the labor market through adjustment of wages and working hours, create demand and supply of temporary jobs through alleviation of regulations on utilization of regular jobs and improvement of working conditions for part-time jobs, and provide active government support.

2. Implementation of Strong Job Training from a Long-Term Perspective: Creation of jobs in the pubic sector will cause increasing fiscal burdens and cannot bring an employment effect in the long term. Rather than this, if the government implements intensive training for youth and provides wage supports, it can enhance the employment potential for youth with identical fiscal burdens.

3. Revision of Labor-Related Laws, Denunciation of Political Compromise and Observation of Principles: Prohibition of wage payment to full-time labor union officials is a 'no-work no-pay' principle that is required also from the perspective of sharing expenses for improvement of the overall employment situation. In the case of the multiple union issue, unification of windows for negotiation is necessary for the stabilization of labor-management relations.

Short-Term Policies: Base Interest Rate Increase Necessitates Careful Approach in Consideration of Increases in International Capital Inflow, etc.

If large-scale capital inflow continues together with a current account balance surplus, pressure for won currency appreciation can become more intense. And policy interest rate increases will bring expansion of internal and external interest gaps and serve as factors that increase the inflow of funds and appreciate foreign exchange rates. Therefore, it would be desirable for the government to consider decisions on interest rates by major countries comprehensively before deciding on its monetary policy.

AN INTERNATIONAL COMPARISON ON THE DETERMINANTS OF CORPORATE TAX BURDEN AND ITS IMPLICATIONS

Research Monograph 09-10
Hag-Soo Kim

This research report addresses a prevailing phenomenon observed in many OECD countries that their corporate tax burdens, measured as a ratio of corporate tax revenue to nominal GDP, have been increasing while they have been cutting corporate marginal tax rates since 1980. Especially, Korea keeps the corporate tax rate below the OECD average, while Korean firms' corporate tax burden slightly exceeds the OECD average.

In order to explain this phenomenon, we construct an index by country and period using individual firm data for 20 countries, called 'the ratio of corporate tax reduction,' which indicates in percent how the top marginal tax rate in law is reduced by other exemptions and income deductions. The reason that we are use the ratio of corporate tax reduction for international comparison is that the comparison of marginal effective tax rate is no different than the comparison of top marginal tax rate in law since the magnitude and trend of marginal effective tax rates crucially depend on the top marginal tax rate in tax law. This is true no matter how the marginal effective tax rate is estimated.

The estimated results of the ratio of corporate tax reduction show that countries with the lower ratio tend to have a higher corporate tax burden, even if the marginal tax rate in law is relatively low. For Korea, the average top marginal tax rate in law since 2000 is 29%, including local taxes, and it is the 7th lowest among 21 countries included in the analysis. However, the average ratio of corporate tax reduction for Korea is estimated at about 29%, while the OECD average is 35%, which seems to explain why the corporate tax burden for Korea measured as a ratio of corporate tax burden to norminal GDP is relatively high and near the OECD average.

A panel regression analysis is performed to investigate this point more rigorously. According to the regression results over the period of 1986 to 2007, the corporate tax burden increases as the top marginal tax rate in law increases, the ratio of corporate tax reduction decreases, and the share of operating surplus in GDP increases. However, the growth rate of nominal GDP statistically does not have any effect on the corporate tax burden.

In the same analysis with subsample period of 2000~2007, we have basically the same results with the results as using the overall period. One different result is that the coefficient of the growth rate of nominal GDP is now statistically significant, indicating that the corporate tax burden tends to decrease as economic size increases since the corporate tax revenue is inelastic with respect to economic growth.

Legal Economics of Restrictions on Super Supermarkets (SSM)

Policy Report 09-10
Seuk-Hun Sin

This paper raised the following counter-arguments regarding the basis for restrictions on SSM.

First, restrictions on large-scale distribution stores in advanced countries have a strong social element from a city planning perspective. On the other hand, Korea's restrictions on SSM have a strong economic element designed to protect small and medium-sized distribution businesses. Therefore, simple comparisons should be avoided.

Second, Korea's restrictions on SSM also are likely to violate the WTO's General Agreement on Trade in Services (GATS).

Third, when viewed from the experience in advanced countries, restrictions on large-scale distribution stores can bring negative effects to the overall economy by causing employment reduction, price increases, etc.

The Influence of Pandemic New Influenza on the Economy

Policy Report 09-11
Gyeong Lyeob Cho/Won Gun Song

After preparation of diverse scenarios regarding the infection rate of the new influenza, A(H1H1), this paper analyzes the effects of the new influenza on the global economy, including the economies of Japan, the United States, China, Europe, etc., as well as on the Korean economy.

The new influenza brings economic losses due to shocks from the supply side that decrease labor supply caused by absences from work, death, etc. and shocks from the demand side that sharply reduce the demand for travel, tourism, restaurants, etc. following the expansion of social distancing.

This paper's analysis found that the economic shocks caused by demand contraction would be greater than the economic shocks caused by labor supply decrease.

International Comparison of Labor Market Flexibility and Stability - Implications from Comparison of Korean and Japanese Labor Markets

Policy Report 09-12
Yanggyu Byun

The Korean labor market appears to be more rigid than the Japanese labor market, the flexibility of which has been recognized as low due to a lifetime employment system, etc. Such a result is due to Korea's very strict dismissal conditions and complicated dismissal procedures, and stemmed particularly from the different restrictions on the utilization scope and period of dispatched workers between the two countries.

This paper asserts that Korea should strengthen the nation's labor market policies actively in the form of implementing its labor market flexibility policy continuously and expanding investment in the education and training of workers, including unemployed workers, at the same time.

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