

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

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Executive Summary

Korea's 2012 GDP Growth Projected at 3.2%, Consumer Inflation at 3.5%

The Korean national economy for 2012 is expected to grow at 3.2%, down 0.3 percentage point from the 3.5% projected in October 2011. This is attributable to the acceleration of the global economic slowdown following the delay in the resolution of the European financial crisis as well as the international oil price instability related to Iran's nuclear program. Affected by a demand contraction in conjunction with the growth slowdown offsetting a portion of the price-push factors like higher international oil prices, consumer prices are likely to rise 3.5%, a slight upward adjustment of 0.1 percentage point from the previously projected rate.

Current Account Surplus to Record US\$13.6 Billion, Won-USD Fx-Rate to Fall Slightly

The current account balance for 2012 is projected at a surplus of US\$13.6 billion, US\$800 million lower than the earlier projection. The won-US dollar exchange rate is expected to end the year at about 1,093 won, maintaining a high level in the first half due to the preference for safe assets, while posting a declining trend in the second half, influenced by easing of the financial crisis in advanced countries, recovery of the domestic economy, etc.

National Elections and Iran & North Korea-Related Geopolitical Risk Management Important

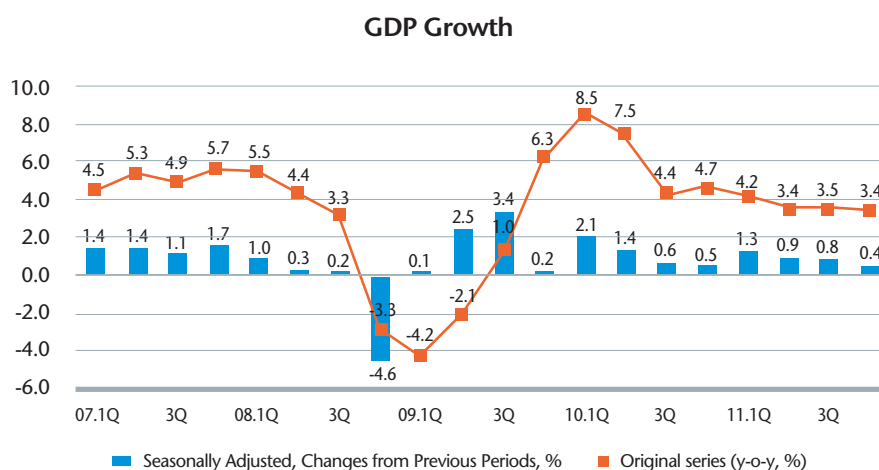
Citable as major downside risks related to the 2012 economic projection are the upward pressure on international oil prices associated with Iran's nuclear program, geopolitical risks associated with the power succession in North Korea and shrinkage in corporate investment related to two national elections. Through a simulation utilizing macroeconomic models, the economic growth of South Korea is projected to decline 0.7 percentage point, 0.9 percentage point and 0.2 percentage point, respectively in following cases; international oil prices rise to US\$150/bbl. in the first half due to the Iran risk; consumer sentiment, KOSPI and overseas demand decline 14%, 22% and 1% respectively; equipment investment contract about 3 percentage points further due to election uncertainties. In order to minimize shocks from the fluctuation of internal and external uncertainties, the government should mitigate excessive psychological impact on economic players, while political circles also will have to refrain from introduction of populist policies that would bring about contraction of corporate investment and worsen the nation's fiscal health.

Recent Developments

GDP Growth Slowed in 4th Qtr. '11

In the fourth quarter of 2011, real GDP grew 3.4% year-on-year and increased 0.4% from the 3rd quarter. The annual real GDP growth stood at 3.6%, a significant decline (2.6 percentage points) from the 6.2% expansion in 2010.

By sector, exports recorded strong growth of 10.0%, but growth slowdowns were witnessed in private consumption (2.2%) and equipment investment (3.8%). Construction investment (-6.5%) dropped due to remarkable slowdowns in the construction sector and equipment investment.



Growth by Final Demand Items & Growth Contribution Rates

(Unit: %, % point)

Contribution Rate (%)		Private Consumption	Equipment Investment	Construction Investment	Exports	Private Consumption	Equipment Investment	Construction Investment	Exports
		(Original Series, y-o-y)				(Seasonally Adjusted Series, q-o-q)			
Growth (%)	2010	4.1	25.0	-1.4	15.4				
	2011	2.2	3.8	-6.5	10.0				
	1/4	2.8	11.7	-11.9	16.8	0.4	-1.1	-6.7	3.3
	2/4	3.0	7.5	-6.8	9.6	0.9	3.9	1.6	1.2
	3/4	2.0	1.0	-4.6	9.6	0.4	-0.8	1.8	2.2
	4/4	1.2	-3.4	-4.0	5.2	-0.4	-5.2	-0.3	-1.5
Contribution Rate (%)	2010	2.2	2.3	-0.3	7.2				
	2011	1.2	0.4	-1.1	5.2				
	1/4	1.5	1.1	-1.8	3.0	0.2	-0.1	-1.1	1.1
	2/4	1.5	0.7	-1.2	1.1	0.5	0.4	0.2	-0.7
	3/4	1.0	0.1	-0.8	2.1	0.2	-0.1	0.3	0.4
	4/4	0.7	-0.3	-0.7	1.7	-0.2	-0.5	0.0	0.8

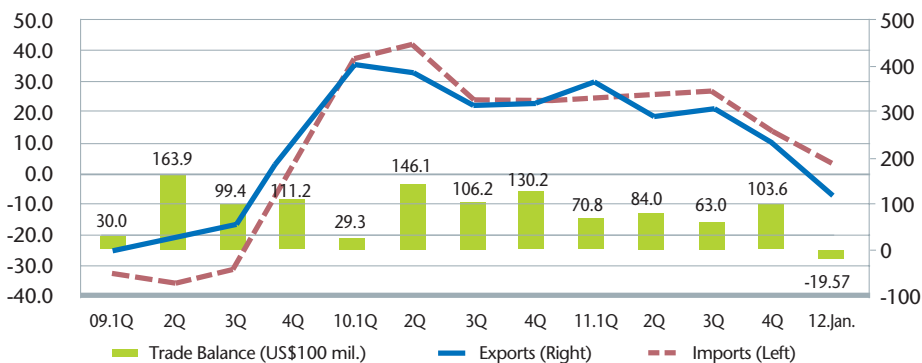
Exports & Imports in Slowdown

Since the 4th quarter of 2011, both exports and imports have shown a sharply declining trend, with import growth outpacing export growth.

Affected primarily by the export growth slowdown, the trade balance in January 2012 reversed course to a deficit, with significant decreases in export and import volumes due to a full-fledged worsening of external environments.

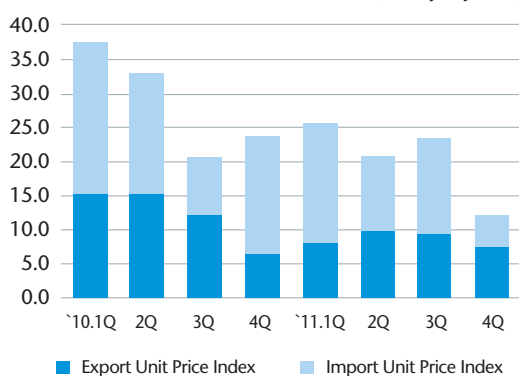
Exports, Imports and Trade Balance

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



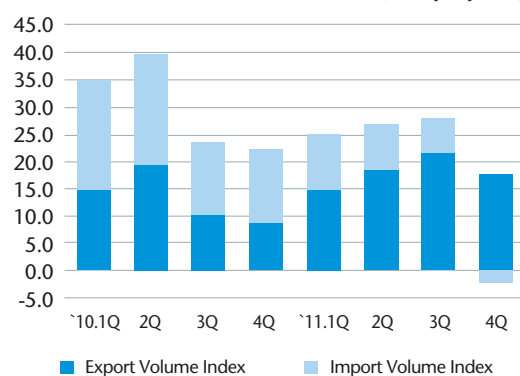
Export Unit Price & Volume

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



Import Unit Price & Volume

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



Current Account Surplus in 2011: US\$27.7 Bil.

Owing to improvements in the balance of service, original income and transfer income, except for the commodity balance, the current account balance recorded a surplus of US\$27.7 billion in 2011, a slight decrease from US\$29.4 billion in the preceding year.

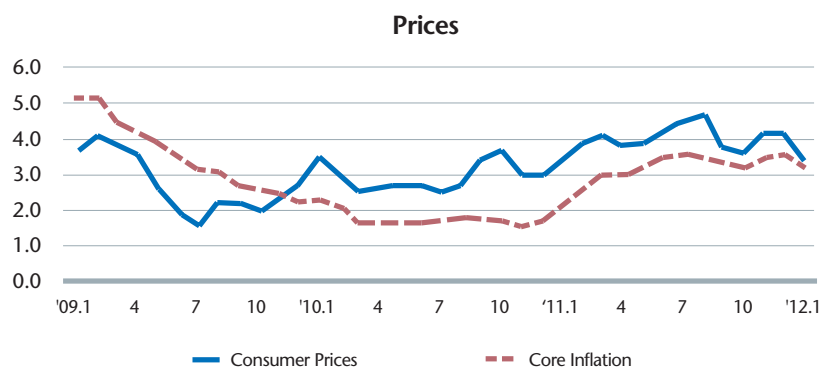
Current Account Balance

(Unit: US\$100 million)

	2010	2011
Current Account Balance	293.94	276.55
Commodity Balance	400.82	321.00
Service Balance	-86.26	-43.77
Original Income Balance	10.16	24.56
Transfer Income Balance	-30.79	-25.23

Consumer Prices Rise 4.0% in 2011

Unfavorable weather, foot and mouth disease (FMD) and international oil price hikes served as price-push factors in the first half of 2011, while increases in public utility charges and foreign exchange rate rises served as factors in rising prices in the second half. As a result, consumer price growth by quarter posted slowdowns since the 3rd quarter.

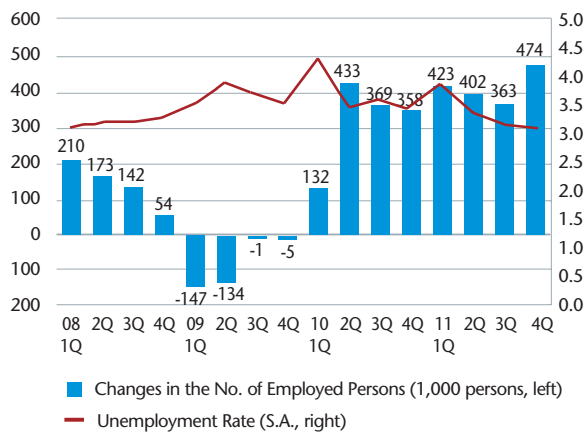


Employment Continuing Quantitative Recovery But Job Quality Low

The number of employed persons was 474,000 in the 4th quarter of 2011, increasing from 402,000 in second quarter and 363,000 in the third quarter. The unemployment rate also decreased to 2.9% in the fourth quarter from 3.3% in the third quarter. Despite the quantitative recovery, aging of the work force is a concern because most of the increase in the number of employed persons was in the over 50 age group.

Employment

(Unit: 1,000 persons)



	Total	15~ 29 Yr.	30~ 39 Yr.	40~ 49 Yr.	50~ 59 Yr.	Over 60 Yr.
10.1Q	132	-12	-42	-21	251	-44
2Q	433	-58	-13	48	342	114
3Q	369	-44	21	40	295	57
4Q	358	-57	17	50	288	60
11.1Q	423	-49	-34	77	286	143
2Q	402	-74	-13	59	294	137
3Q	363	-1	-83	46	270	131
4Q	474	-18	-56	47	315	185

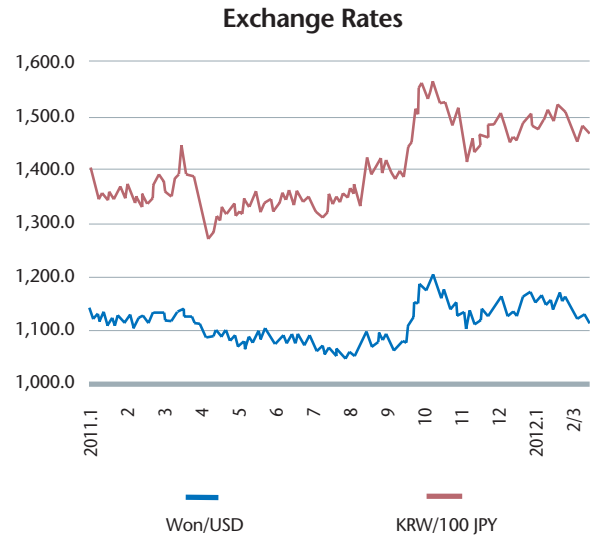
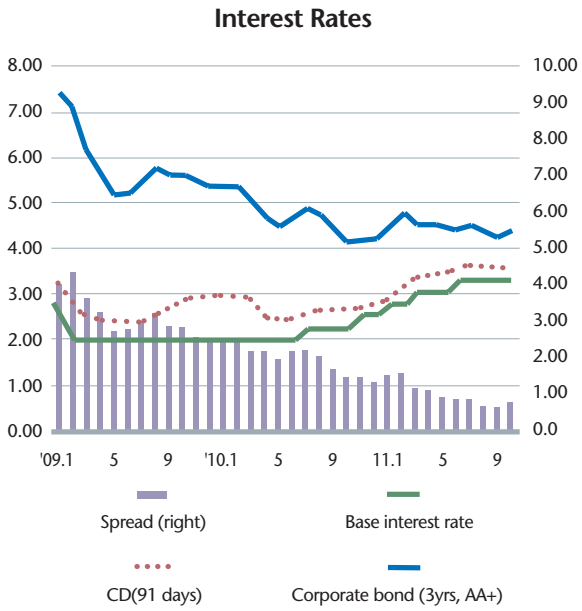
Short-Term Interest Rate Up: Long-Term Interest Down Affected by Base Rate Hikes

Long-term interest rates declined due to the continued inflow of foreign investment capital. Led by increased demand for domestic bonds due to a preference for safe assets following the increase in financial market fluctuations, the short-term and long-term interest rate spread fell to the lowest level since 2007.

Won-USD Fx-Rate Up Since August But Down from October

The won-U.S. dollar exchange rate in 2011 slid to 1,108 won in 2011 from 1,156 won in 2010. But the exchange rate rebounded in August with the preference for safe assets in the wake of the instability in external environments. However, starting in October, the exchange rate stabilized on a downward trend due to the continuation of the current account surplus, increases in the inflow of foreign capital, and easing of the U.S. dollar's strength.

Economic Trends and Outlook



Outlook for 2012

1. Internal and External Environments

Weakening of Global Economic Growth

Despite signs of employment recovery, slow economic growth is projected for the United States due to persisting stagnation in the housing market, fiscal retrenchment to reduce the national debt and other factors. In Japan, the nation's economic growth may improve owing to base effects, etc. after moving beyond its earthquake's aftermath. However, growth is likely to record about a mere 1.7%, caused by the nation's financial deficit, yen's appreciation, etc.

Since aggressive fiscal retrenchment will be unavoidable despite resolution of liquidity crises, the eurozone is expected to experience negative growth. In China, the possibility of a hard landing following its fiscal retrenchment declined with a slowdown in prices but growth is expected to remain at the 8% level due to negative factors, including an export slowdown.

International Oil Price Projected at US\$106/bbl.

Although price reduction factors, such as a global economic slowdown, have been expected to prevail, the direction of oil prices is more or less uncertain due to the risks related to Iran's nuclear program. Considering the military power gap between the United States and Iran, however, the possibility of a military conflict is not expected to be high. Therefore, the increase in international oil prices, if any, is likely to be small.

USD to Weaken, JPY and Euro to Strengthen

The U.S. dollar may strengthen temporarily due to instability in international financial markets, but it will likely maintain a weakening trend, influenced by low U.S. economic growth and a decline in confidence in the U.S. dollar. The Japanese yen is expected to remain strong amid the nation's expected growth recovery in the wake of the major earthquake and with the sentiment that the yen is a safe asset continuing. The Euro is likely to rebound on expectation of a resolution to the eurozone crises, but the recovery may be relatively small considering the slowdown in the eurozone economy.

Major Assumptions for Projections Revised in Consideration of Changes in Internal and External Environments

The forecast for global economic growth was adjusted downward to 3.3% from the earlier projection of 4.0%, while an upward adjustment was made for international oil prices to an annual average of US\$106/bbl. from US\$100/bbl.

2. Outlook for Korean Economy (2011 → 2012)

Growth:

3.6% (2011) → 3.2% (2012)

The Korean economic growth is expected to contract to 3.2% in 2012 amid an anticipated export slowdown following the uncertainty in external environments and due to weakened growth support potential of the domestic environment. In the second half of the year, when uncertainties in external environments may ease more or less, however, growth is likely to gain strength to a certain extent.

Private Consumption:

2.2% (2011) → 1.8% (2012)

Taking into account the post-cyclical characteristic of employment with regard to economic conditions, the number of employed persons is expected to decline, while wage increases will be low for industries on the whole. Increases in household debt burden due to maturing real estate mortgage loans, credit crunch due to banks' restrictions on loans, a tightening criteria for new loans, etc. are expected to serve as factors in lowering consumption growth.

Equipment Investment:

3.8% (2011) → 2.6% (2012)

The export slowdown caused by the worldwide economic recession is expected to lead to contraction of investment by industries. Due to the possibility for interest rate hikes following the expansion of fluctuations in financial markets and uncertainty related to national elections, policy confusion and investment delays are expected.

Construction Investment:

-6.5% (2011) → 2.0% (2012)

Construction investment in 2012 is projected to improve compared with 2011 owing to base effects, etc. following a long-term stagnation. Although limited, construction investment is showing signs of recovery, with declines in real estate business being alleviated and the decreasing trend in construction orders stabilizing. Nevertheless, a rapid recovery in construction investment is likely to be difficult, affected by the national SOC budget cut for 2012, worsening of financial conditions at public enterprises, including Korea Land & Housing Corp., completion of the four major rivers restoration projects, etc.

Current Account Surplus:

US\$27.7 Bil. (2011) →
US\$13.6 Bil. (2012)

The current account surplus is expected to decline in 2012 from 2011 due to a reduction in the commodity balance surplus and increase in the service balance deficit caused by lower overseas service consumption following the Korean currency appreciation and low productivity.

Economic Trends and Outlook

Consumer Prices: 4.0% (2011) → 3.5% (2012)

Consumer prices are expected to grow 3.5% in 2012, lower than in 2011, due to weakening of international raw materials prices, won currency appreciation, base effects, and other factors. The won-U.S. dollar exchange rate decline, weakening of the U.S. dollar, continuation of current account surplus, etc. also are expected to serve as factors in lowering consumer prices slightly. However, the consumer price slowdown is likely to be limited due to rises in public utility charges and housing rental prices.

Market Interest Rates: 4.4% (2011) → 4.6% (2012)

Considering the very low long-term interest spread and possibility of economic recovery in the second half of 2012, market interest rates are expected to rise gradually. However, by considering a possibility that a preference for safe assets continues and a low possibility that the base interest rate increases in the first half, market interest rate hikes are not likely to be high.

Won-U.S. Dollar Fx Rate: KRW1,108 (2011) → KRW1,093 (2012)

The won-U.S. dollar exchange rate is expected to decline mildly in 2012 due to the weakening of confidence in the U.S. dollar, worsened projection for U.S. economic growth, current account surplus, and other factors. Affected by a preference for safe assets, the exchange rate may maintain a high level in the first half, but it is likely to decline at a faster pace in the second half due to stabilization of the global financial crisis and recovery of the domestic economy.

Outlook for Korean Economy (2012)

(Unit: y-o-y, %, US\$100 million (Int'l Balance of Payments))

	2011	2012								
	Year	1Q	2Q	3Q	4Q	1st Half	2nd Half	Year (A)	Previous Projection (B)	Difference (A)-(B)
GDP	3.6	2.8	2.9	3.3	3.8	2.8	3.6	3.2	3.5	-0.3
(SA, q-o-q, %)		0.7	1.0	1.2	0.9	1.4	2.1		3.5	-3.5
Private Consumption	2.2	1.3	1.4	1.6	2.7	1.3	2.2	1.8	2.6	-0.8
Construction Investment	-6.5	2.7	1.6	1.4	2.5	2.1	2.0	2.0	1.9	0.1
Equipment Investment	3.8	-2.2	1.6	3.2	7.8	-0.2	5.5	2.6	4	-1.4
Exports (Goods & Service)	10.0	3.9	5.2	5.9	8.8	4.6	7.4	6.0	8.1	-2.1
Imports (Goods & Service)	6.6	1.6	2.4	3.3	7.2	2.0	5.3	3.7	7.1	-3.4
Consumer Prices	4.0	3.8	3.6	3.3	3.5	3.7	3.4	3.5	3.4	0.1
Producer Prices	6.1	4.6	4.1	4.1	4.2	4.3	4.2	4.2	3.8	0.4
Current Account Balance (US\$100 mil.)	277	19	16	44	58	35	102	136	144	-8
Commodity	321	47	37	51	71	84	123	206	228	-22
Exports	5565	1394	1516	1506	1533	2910	3039	5949	6178	-229
Growth (%)	19.3	9.2	6.2	6.5	9.1	7.6	7.8	7.7	10.2	-2.5
Imports	5244	1348	1479	1455	1462	2827	2917	5743	5950	-207
Growth (%)	23.3	10.6	9.5	8.4	11.8	10.0	10.1	10.1	12.2	-2.1
Service & Others	-45	-28	-21	-7	-14	-49	-21	-70	-85	15
Ex Rate (Avg. KRW/USD)	1108	1125	1110	1080	1055	1118	1068	1093	1083	10
Corp. Bonds Yield (3-year, AA-)	4.4	4.3	4.5	4.7	4.9	4.4	4.8	4.6	4.7	-0.1
Unemployment Rate (%)	3.4	3.9	3.6	3.5	3.2	3.8	3.4	3.6	3.7	-0.1

Policy Issue:

Analysis of Major Risks' Economic Effects for 2012 and Policy Recommendations

Suspicious on Iran's Nuclear Program-Related Oil Price Hike Risk

Tensions are mounting at the Hormuz Strait due to suspicions associated with Iran's nuclear program. Considering the military power gap, realization of containment and subsequent outbreak of a war are unlikely. Nevertheless, Iran's political and economic situation is a unpredictable variable. If tensions grow and a military conflict appears more likely at the Hormuz Strait, international oil prices are expected to rise to about US\$150/bbl. in the first half of 2012.

Should international oil prices jump to US\$150/bbl. due to the Iran risk, the growth rate of the Korean economy in 2012 is projected to decline about 0.7 percentage point. Furthermore, consumer prices may rise about 0.5 percentage point and the current account surplus also is likely to weaken by about US\$16.2 billion and may possibly reverse course to a deficit in 2012.

Geopolitical Risk Related to Uncertainty of Power Transition in North Korea

Taking into account North Korean leader Kim Jung-Un's young age and lack of experience, there is always a possibility that power succession-related risks may materialize. Considering the existing internal & external environments that have become very unfavorable, if the North Korean risk materializes, severe damage to the Korean economy would be unavoidable.

If a similar situation to the 1996~1997 tension between South and North Korea, which continued for a long time, occurs, the growth rate of the Korean economy is expected to decline about 0.9 percentage point, led by contraction of domestic demand, including consumption and investment.

Corporate Investment Shrinkage Risk Associated with Elections in 2012

It is possible to experience a rapid change in the management environment and investment slowdown due to increased uncertainty ahead of the general and presidential elections in 2012. Due to populist reform measures targeting conglomerates, including reinstatement of the total equity investment restriction and introduction of a chaebol tax, there may also be negative side effects, such as investment slowdown and reduction in employment.

Considering that equipment investment growth was about 3 percentage points lower during past presidential elections than in years without elections, the overall economic growth decline due to uncertainty related to elections is estimated at 0.2 percentage point.

Policy Tasks

In preparation for geopolitical risks in the Middle East region, efforts should be strengthened to avoid inflation expectation sentiment, curb public utility charges increases, diversify import sources for crude oil, expand oil stockpiling volume and secure alternate transportation routes.

To cope with the risk associated with power succession in North Korea, fiscal expenditure structure should be oriented towards expanding growth engines, and corporate tax and income tax need to be lowered in the preparation for contraction of investment and consumption.

To minimize negative aspects of election, political circles must refrain from excessive populist policy pledges and the government should implement the national budget as planned so as to secure fiscal health from a long-term perspective.

North Korea's Military Power and Military Strategy

Research Monograph 11-10

ChoonKun Lee

Since the end of the cold war era, North Korea has turned to full-scale development of nuclear weapons with the single objective to maintain a comparatively advantageous military position against South Korea. If North Korea's nuclear program develops a practical weapons system capability, South Korea will not be able to deter the North's military provocations with its existing military strategy alone. There are possible countermeasures, such as re-entry of U.S. tactical nuclear weapons and consideration of South Korea's nuclear armament.

Based on a 2011 analysis, North Korea's military power was threatening to surpass South Korea's. But North Korea is expected to pursue an advantageous war strategy that it can win without an all-out attack on South Korea. The recent provocations by North Korea that occurred on the five islands in the West Sea and the reality of North Korea's 200,000-strong special warfare units imply that the types of military provocations being prepared by North Korea include surprise attacks or unconventional warfare.

This report contains detailed data regarding North Korea's military power at several crucial times from the establishment of its government to today. The data is expected to play an important role in better understanding the North's military power pattern.

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