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KERI ECONOMIC BULLETIN

Contents

Korea Economic Research Institute

Executive Summary

Korea's 2013 economic growth likely to close at 2.4%, 2014 GDP projected at 3.4%

The Korean national economy for 2013 is expected to reach at 2.4% despite positive effect of policy measures of supplementary budget and interest rate cut. This is a result of exports being forecast to remain around 3% range in the second half of 2013 due to the US fiscal impasse and the following market uncertainties of the surrounding emerging economies, as well as the weak.

Recovery rate in 2014 projected to be higher with gradual improvement in domestic and global conditions, but is expected to fall below the level of potential growth (approx. 3.5%). The slow recovery is attributed to uncertainties relating to the decision regarding the US Fed's exit strategy and domestic issues such as on-going household "deleveraging" (debt reduction), and legislation related to economic democratization all of which have dampened private spending and investment sentiment.

Consumer price grows at 2.6%, current account surplus records US$49.5 billion and USD/KRW to mark 1,074

Consumer prices in 2014 are projected to slightly increase comparable to the average rate at 1.4% in 2013 due to the upward pressure of public utility charges and base effect. However, the increase is expected to be slowing around the 3% range, owing to gentle but steady recovery, the fall of USD/KRW and the stabilizing trend of the international prices of raw materials. Current account surplus is expected to reach a record high at US$61.8 billion in 2013, followed by a short fall at around US$50 billion in the following year due to rise in import amount and the reversal of services account into deficit. USD/KRW is expected to show an ascending trend around 1,074 in 2014, from this year's average of 1,100.

Need to prepare for exit strategy of advanced economies, maintain current account surpluses, emphasize the use of macroeconomic stabilizing policy and pursue interest rate rise with prudence

Owing to the advanced economies decision to slow down on quantitative easing, financial markets of the emerging economies may show signs of instability. With estimated net accumulated foreign capital inflow to the stock and bond markets of Korea at 8.7% of GDP since 2009, Korea has higher than the average ratio of foreign capital/GDP among 10 other emerging markets.

The capital freeze index of the emerging markets, the index to calculate the risk of an abrupt end to capital inflows, demonstrates that the vulnerability of Korean financial market is higher than average for risks associated with capital outflow. Therefore in order to minimize volatility of the financial market prompted by exit strategies of the major economies the following are necessary: 1) maintain current account surpluses, 2) emphasize the use of macroeconomic stabilizing measures, and 3) be cautious in interest rate increase.

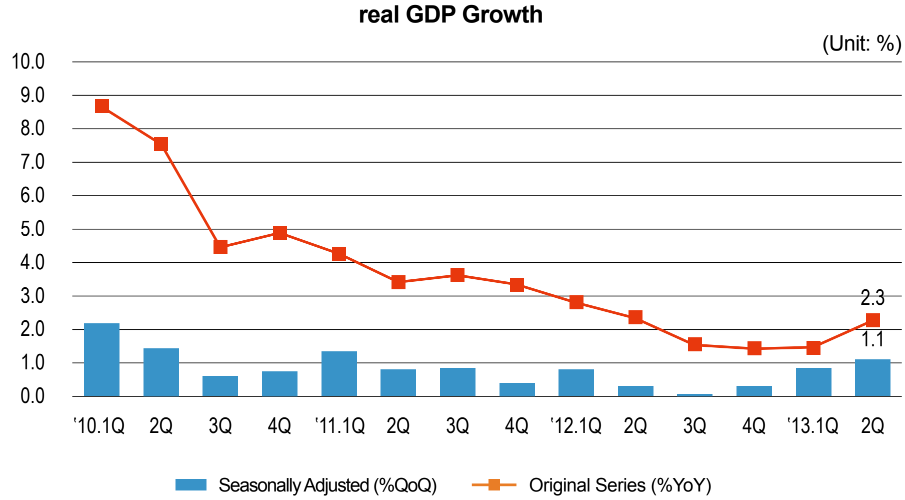
Economic Trends and Outlook

Recent Developments

GDP Growth in 2Q increased by 1.1% (QoQ) and 2.3% (YoY)

Economic growth turned around to record the 1% range (QoQ) after the nine consecutive quarters of low growth since 2Q 2011; Year-on-Year growth rebounded after seven consecutive quarters since 3Q 2011 (at 3.6%).

real GDP Growth



Public finances, such as government expenditure and construction investment, led growth in 2Q 2013.

Public expenditure recorded 0.4%p higher contribution ratio comparable to the private spending of 0.2%p. While contribution from facility investment and export sector diminished, construction investment was able to maintain higher than average contribution ratio, due to the expansion of SOC and early execution of planned budget in the first half of 2013.

Contribution to GDP by expenditure

(Unit: %p)

	2012				2013	
	1/4	2/4	3/4	4/4	1/4	2/4
Final consumption expenditure	0.9	0.2	0.5	0.3	0.0	0.7
Private consumption	0.4	0.2	0.4	0.4	-0.2	0.3
Government consumption	0.5	0.0	0.1	-0.1	0.2	0.4
Gross fixed capital formation	0.8	-1.0	-0.4	-0.4	1.0	0.5
Construction	-0.2	-0.2	0.1	-0.2	0.6	0.5
Facilities	1.0	-0.8	-0.5	-0.2	0.2	-0.1
Exports of goods and services	2.2	-0.2	1.1	-0.6	1.7	0.9
Imports of goods and services	2.2	-1.0	1.0	-0.4	1.3	0.6
GDP expenditure	0.8	0.3	0.0	0.3	0.8	1.1

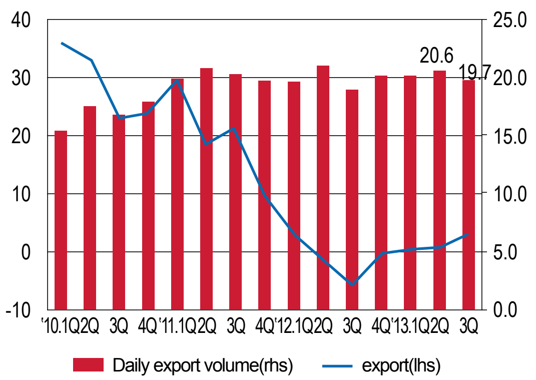
Source: Bank of Korea

Exports (on a custom clearance basis) recorded slow recovery at 0.6% in the first half of 2013 but rebounded at 2.9% in the 3Q

Daily average of exports in 3Q 2013 increased at 3.7% YoY or US$1.97 billion. By region, exports to EU and Japan struggled while exports to China and the US continued to pick up.

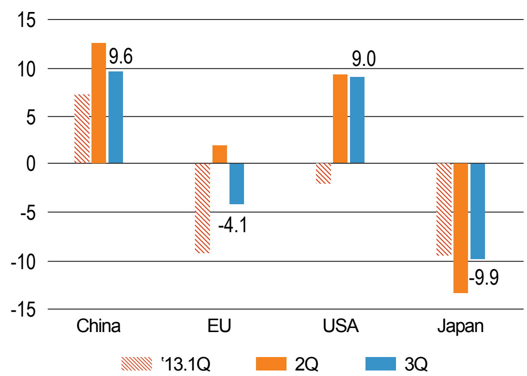
Export growth and daily average export volume

(Unit: US$100mil , %YoY)



Export growth by destination

(Unit: %YoY)

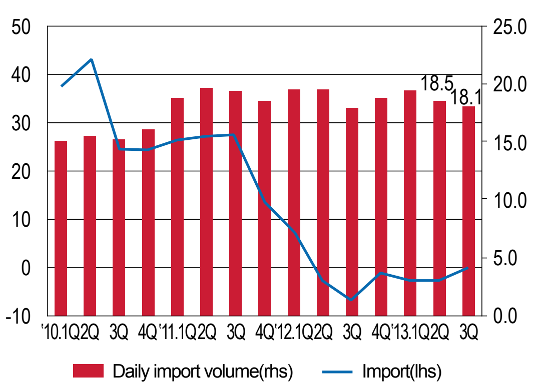


Imports (on a custom clearance basis) fell 2.9% in the first half of 2013 but rebounded to increase 0.2% in the 3Q

Daily average of imports in the 3Q increased to US$1.81, or 1.0% increase (YoY). By sector, raw material imports, the largest share of imports (63.2%, 2012 basis) continued to decrease while imports of capital goods and consumer goods expanded its increase since 2Q.

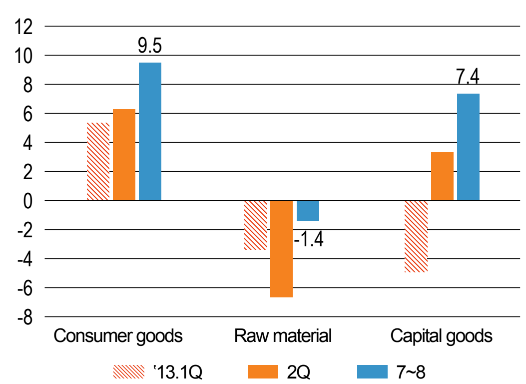
Import growth and daily average import volume

(Unit: US$100mil , %YoY)



Import growth by use

(Unit: %YoY)

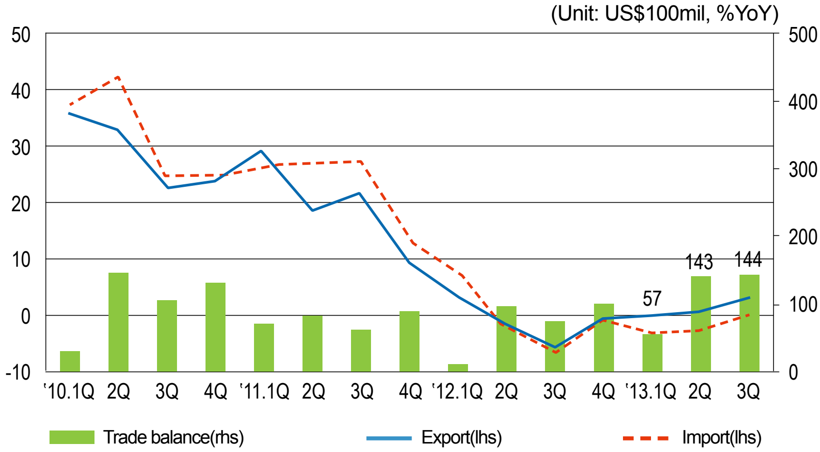


Trade account records surplus of US$31 billion in the periods between January and September, 2013 (improved by US$12.7 billion YoY)

Trade account surplus, despite moderate export increase is attributed to the negative growth of imports. Exports increased 1.3% in the periods between January and September while imports decreased by 1.9%.

Export/Import Trade balance

(Unit: US$100mil, %YoY)



Current account records surplus for the 19th consecutive month, with accumulated surplus of US$42.28 billion in the periods between January and August of 2013.

Total current account surplus surged by US$19.9 billion (YoY, from US$2.24 billion during Jan to Aug. 2012). The upward trend of monthly average surplus is maintained in the second half of this year. Monthly current account surplus surged to US$4.96billion during the periods of January and June, comparable to US$6.25 billion between July and August.

Current Account trend

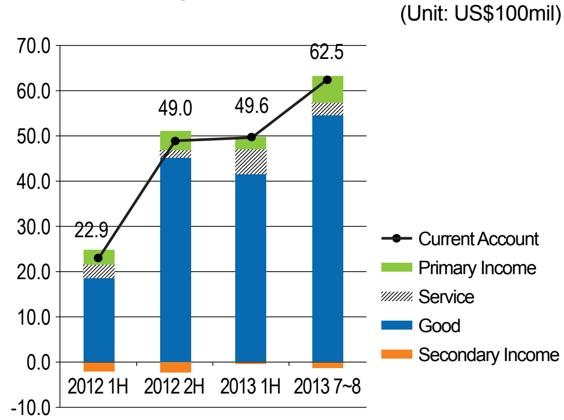
(Unit: US$100mil)

	2012		2013	
	1H	2H	1H	7~8
Current Account	137.5	293.9	297.7	125.0
Goods	111.3	272.0	251.8	110.1
Services	16.6	10.1	32.8	4.6
Primary Income	23.1	25.8	14.4	12.5
Secondary Income	-13.6	-14.0	-1.2	-2.1

Source: Bank of Korea

Monthly trend of Current Account

(Unit: US$100mil)

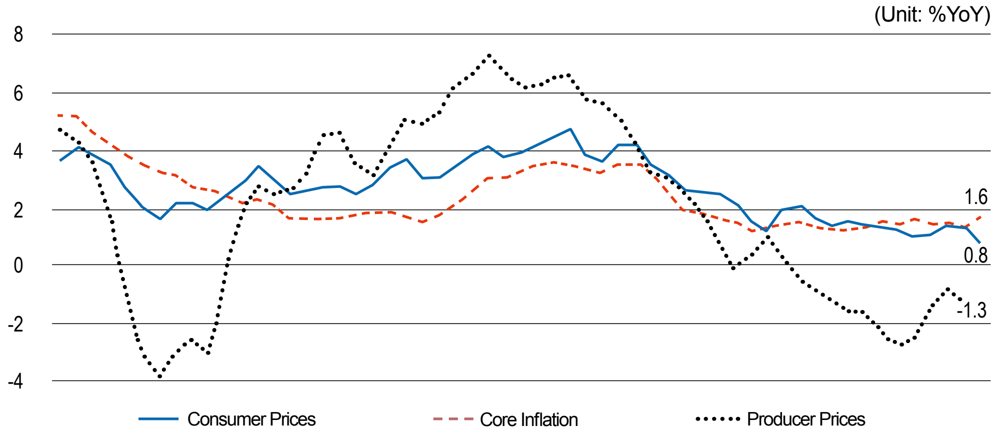


Source: Bank of Korea

Consumer prices maintain a low 1% range for the 10th consecutive months since November 2012

Consumer prices stability is mostly attributed to the diminishing upward pressure of the supply side, such as raw material prices including international oil prices and stabilization of prices of agricultural, livestock and fishery products. Overall slump in the demand side also contributes to a price stabilization trend. Government supports on welfare service such as free high school education and expansion of free school meals has also shown to decrease consumer price by 0.3% annually.

Trend of Increase of Prices



Employment continues quantitative growth among the elderly

The total number of employed persons is on the rising trend: 257,000 in 1Q, 324,000 in 2Q, 367,000 in 3Q and 432,000 in August of 2013. However, youth employment rate continues to decline (QoQ), while the elderly job seekers of over age 50 increased to 377,000 in 1Q, 410,000 in 2Q, 410,000 in July and 469,000 in August this year, respectively.

Employment related Indicators

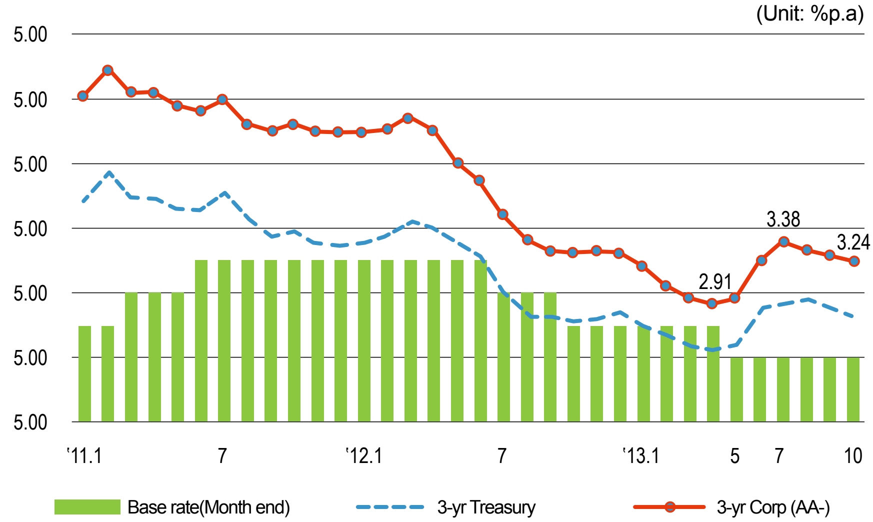
(Unit: 1,000 persons, %)

		2012	2013			
		Year	1Q	2Q	July	Aug
Changes in number of employed persons (1,000 persons)		437	257	324	367	432
Age	- 15 ~ 29	-36	-117	-88	-101	-60
	- 30 ~ 39	-30	-15	7	-49	-22
	- 40 ~ 49	11	12	-6	31	45
	- 50 ~ 59	270	196	254	284	287
	- 60 years and older	222	181	156	202	182
Unemployment rate (%)		3.2	3.6	3.1	3.1	3.0

Market interest rate reversed to decline since August 2013

With the US QE tapering forecasted to be delayed, owing to several factors including the US recent budget standoff, the ascending interest rate trend reversed its course. The corporate bond yield rate increased to 3.38% in July, but turned around and started to fall, recording at 3.28% as of October 4, 2013.

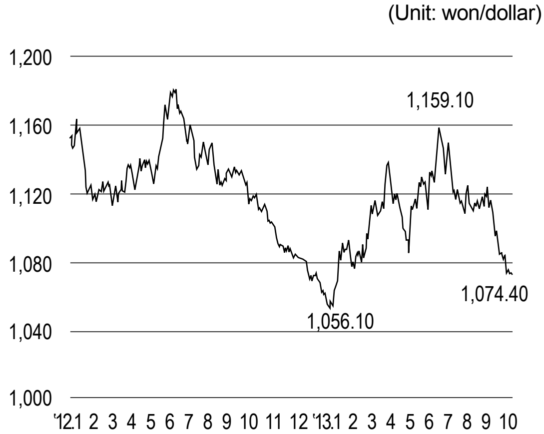
Interest Rates



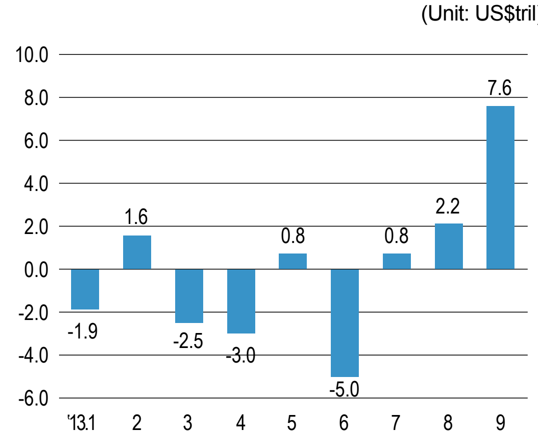
USD/KRW on a falling trend since June 2013

With increase of the current account surplus in the second half of this year, net foreign purchase of equities also expanded, pushing USD/KRW down. Foreigners net sold Korean equities during the periods of January and July with the size of 10 trillion one while they reversed their position and net purchased 10.6 trillion one between July and September.

Exchange rate trend of Korean Won



Net foreign purchase of Korean equities



Outlook for 2013

1. Internal and External Environments

(World Economy) Despite relatively slow economic recovery among the emerging economies following decisions regarding QE tapering, overall economic growth is expected to continue, anchored by accelerating economic recovery in the developed economies led by the United States

(United States) The U.S. economy is predicted to quickly rebound as political risks alleviate in 2014. But the extent of this recovery in the second half could be understated due to political impasse on issues of budget and debt limit, as well as uncertainties surrounding QE tapering.
(Europe) The Eurozone economy is expected to have positive growth, buoyed by gradual improvement of household and business sentiments despite lingering issues such as insolvent banking sector, credit crunch and high unemployment rate.
(Japan) Weakening of recovery factors following increase in consumption tax is expected to hinder economic growth of Japan in 2014.
(China) China is expected to show a moderate economic growth rate in the upper half of 7% amid recent structural reform in the Chinese economy centered on domestic demand and the service sector.

(Oil Price) Although demand is expected to grow following global economic recovery in 2014, the supply side is also expected to keep pace, causing only a slight fall in oil prices

(Demand) With the global economic recovery accelerating, global demand for crude oil is expected to increase, mainly due to developed nations like the United States and Europe. But speculative demand, following a global strong dollar trend, is expected to show a slight decline.
(Supply) Rise in Non-OPEC supply capability and removal of the "Middle East Risk Premium" in oil prices will bring about recovery of supply in 2014.

(Foreign Exchange Rate) Influenced by the strong dollar, the euro will continue to weaken; weakened yen expected to fluctuate within a small range, while the yuan will continue steady appreciation.

(U.S. dollar) U.S. dollar will continue to strengthen in 2014 with relatively favorable outlooks in the U.S. real estate and employment markets, despite existing uncertainties in policy direction. (Euro) The prospect of recovery in the Eurozone is relatively obscure when compared to other developed nations in the second half, and so the euro is expected to stay weak. (Japanese yen) Although the weakening of yen is expected to continue, its value will fluctuate within a small range due to lack of viable growth strategy and increase in consumption tax. (Chinese yuan) The yuan's exchange rate will maintain its moderate upward trend this year.

2. Outlook for Korean Economy in 2013 – 2014

Growth: 2.4% in 2013 (1.9% in 1st half, 2.9% in 2nd half), 3.4% in 2014

(2nd half of 2013) The Korean economy's growth rate in the second half is expected to hit the ceiling at 2.9%, owing to fiscal issues in the United States and uncertainties in the emerging foreign financial markets.

(Year of 2014) Although recovery is expected to continue with improved conditions at home and abroad, current domestic conditions such as debt "de-leveraging" and reduction in corporate investment will act as major barriers to a rebound in domestic consumption, halting the potential growth rate at around 3.4%. Economic growth trend in both the 1st and 2nd half of 2014 is expected to show a similar pattern of growth led by exports rather than domestic consumption.

Private consumption: 1.8% in 2013 (1.6% in 1st half, 1.9% in 2nd half), 2.5% in 2014

(2nd half of 2013) Boosted by continued price stability and improved real purchasing power caused by fall in the USD/KRW exchange rate, private consumption for the second half of 2013 is expected to increase mildly.

(Year of 2014) However, the uplift in consumer sentiment is expected to be limited by downward factors such as debt "de-leveraging" and worsening conditions of the real estate market including price hikes of lease deposit, all of which will act as factors that weigh down on the growth rate of private consumption in 2014.

Facility investment: -3.0% in 2013 (-8.2% in 1st half, 2.6% in 2nd half), 5.6% in 2014

(2nd half of 2013) In the second half, facility investment is expected to shift to a rising trend due to the base effect, recovery in exports and fall of import price of capital goods due to the ascending KRW value.

(Year of 2014) In 2014, the recovery trend will continue but negative factors will cap the growth rate at around 5% next year.

- Lag in recovery of conditions at home and abroad and rise in international interest rates will result in higher purchasing cost.
- Delay in recovery of domestic consumption and policy implication due to economic democratization will discourage investment sentiments.

Construction investment: 3.7% in 2013 (5.2% in 1st half, 2.4% in 2nd half), 2.4% in 2014

(2nd half of 2013) Despite the lag in private construction sector, SOC budget increase and the consequent recovery in public construction sector is expected to drive continuous growth in construction investment.
(Year of 2014) Amidst the mid- to long-term structural reform in the real estate market, an SOC budget cut for 2014 will dampen the rate of increase in construction investment in 2014 compared to 2013. In particular, delay in recovery of domestic consumption and policy implication due to economic democratization will discourage investment sentiments.

Export growth (BOP basis): 3.3% in 2013(2.3% in 1st half, 4.2% in 2nd half), 5.1% in 2014

(2nd half of 2013) A slightly higher rate of increase in export of 4.2% is expected, compared to 2.3% in the first half.
(Year of 2014) Gradual recovery in the U.S. economy and other advanced economies will be a positive factor for the growth of export in Korea, but its effect will be mitigated by negative factors such as QE tapering and the consequent uncertainties in the emerging economies, shift in growth strategy policy of China and the weak yen, capping the growth rate at around 5% in 2014.

Import growth (nominal, in USD): 0.0% in 2013 (-2.9% in 1st half, 3.1% in 2nd half), 6.7% in 2014

With a lag in consumption at home and abroad, import growth rate in 2013 is predicted to stagnate at 0%. However, an outlook for 2014 looks more promising, as gradual recovery in domestic and external consumption and the base effect is expected to produce an import growth rate of mid-6%.

Current account surplus: US$61.8 billion (US$29.8 billion in 1st half, US$32.0billion in 2nd half), US$49.5billion in 2014

(2nd half of 2013) With the current account surplus of $29.8 billion in the first half, the total current account surplus in 2013 is predicted to set a record-high of $61.8 billion.

(Year of 2014) With expectation of downsizing of goods balance surplus and downward trend of services balance, current account surplus is predicted to be slightly smaller than that of 2013, at around $49.5 billion.

- Growing demands in both domestic and foreign markets, added with the base effect, may cause import growth rate to outpace export growth rate, causing a downsizing of the goods balance surplus.
- Boosted by a surge in foreign tourists in 2012- 2013 and surplus in the construction service sector, services balance has finally taken a positive turn to record a surplus for the first time since 14 years ago. However this upward trend may be short-lived, taking into account negative factors such as low productivity in the service industry and the falling exchange rate.

Consumer prices: 1.4% in 2013 (1.3% in 1st half, 1.6% in 2nd half), 2.6% in 2014

(2nd half of 2013) While a slight increase relative to the 1st half is expected, the generally low price pressure is likely to limit the increase in consumer prices.

(Year of 2014) Gradual economic recovery will prompt an upward trend in prices of goods in 2014, but this trend is expected to be dampened by the negative outlook on the GDP gap in 2014.

- However, taking into account the fact that expected inflation is hovering near 3%, strengthening the economic growth momentum will play a key role in inflation.

Corporate bond yield (3 years, AA-): 3.2% in 2013 (3.1% in 1st half, 3.3% in 2nd half), 3.6% in 2014

(2nd half of 2013) Market interest rates are expected to register an upswing expansion in the second half due to the amplification of financial market volatility. However, recent interest rate freeze and difficulties in carrying out QE tapering is expected to limit this uplifting pressure.

(Year of 2014) With the US Fed's efforts to implement QE tapering shifting to high gear next year, domestic growth rate and upward trend of inflation rate will affect a gradual yet steady increase in corporate bond yield. In addition, forecast of normalization of base rate by next year is another positive factor that will keep interest rates afloat.

USD/KRW: 1,100 won in 2013 (1,103won in 1st half, 1,096 in 2nd half), 1,074won in 2014

(2nd half of 2013) With a balance between strengthening and weakening factors, the dollar exchange rate is expected to fluctuate around KRW 1,090 in the second half of 2013.

(Year of 2014) The extent of U.S. Fed's QE tapering is a decisive factor in determining the exchange rate in the future. However, Korean market's relatively low vulnerability to dramatic outflow of capital is expected to contribute to a moderate devaluation of the won in 2014.

Outlook for Korean Economy in 2013 ~ 2014

(Unit: %YoY, US$100mil(Balance of Payment))

	2012	2013			2014
	Year	1H	2H	Year	Year
GDP	2.0	1.9	2.9	2.4	3.4
(SA, QoQ%)		1.5	1.3		
Private consumption	1.7	1.6	1.9	1.8	2.5
Construction investment	-2.2	5.2	2.4	3.7	2.4
Facilities investment	-1.9	-8.2	2.6	-3.0	5.6
Consumer prices	2.2	1.3	1.6	1.4	2.6
Current Account Balance	431.4	297.7	319.9	617.6	495.1
Goods Balance	383.4	251.8	313.5	565.3	512.5
Export(BOP base)	5,525.7	2,797.3	2,910.0	5,707.3	6,000.7
Growth rate%	0.1	2.3	4.2	3.3	5.1
Import(BOP base)	5,142.3	2,545.5	2,596.6	5,142.1	5,488.2
Growth rate%	-1.1	-2.9	3.1	0.0	6.7
Service and Other balances*	48.0	46.0	6.4	52.4	-17.4
FX rate(avg. won/dollar)	1,126.9	1,103.5	1,096.0	1,099.8	1,073.8
Corp. bond yield (3-yr, AA-)	3.8	3.1	3.3	3.2	3.6
Unemployment rate(%)	3.2	3.4	3.1	3.2	3.1
Employment level changes(000)	436.8	290.0	263.9	277.0	318.6

* Sum of service balance, primary balance, and secondary balance

Policy Issue:

A review of capital flight possibility after QE Tapering embarks

(Study Background) Fed's QE tapering is likely to start after next March as its exit strategy shall embark in stages. Consequently, the rising volatility of capital markets in emerging countries is worrisome.

Since financial crisis took place in America, Fed poured liquidity into the market over 3 trillion dollars by three times of quantitative easing. From 2009, more than 500 billion dollars flew into emerging markets, and 300 billion dollars, which is about 60% of total, flew into Asian emerging markets.

Emerging market's private capital inflow

(Unit: US$100mil)

	2008	QE Period				
		2009	2010	2011	2012	2013
Emerging markets	-861	1,333	1,481	50	1,250	890
Asia	-554	984	818	80	810	460
Europe	-147	90	62	-70	140	100
Latin America	-24	573	435	70	240	210
Middle East	-146	-224	166	-30	60	120

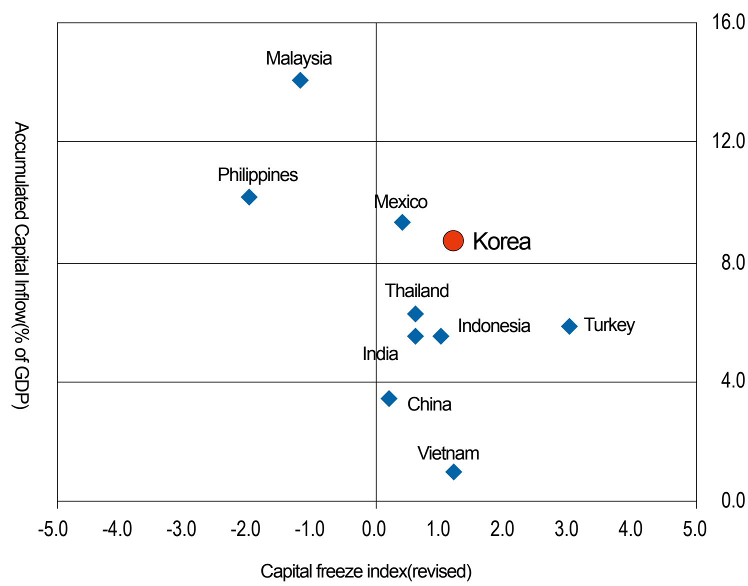
Source: Institute of International Finance, "A review of emerging market's crisis possibility (2013)" by Heungki Back

(Result of Analysis) The vulnerability of Korean financial market, assessed by the volume of capital inflow and capital freeze index, would be higher than that of emerging countries in average if Korean economy doesn't ride sustainable growth trajectory.

Net foreign capital inflow after 2009 in Korea is about 8.7% of GDP, which is fairly over than the average of 10 countries, 7.0%.

Also, the capital freeze index of Korea is 1.2, which is the second highest among 10 nations same ranking with Vietnam after Turkey topping the chart having the figure of 3.0.

International comparison of capital inflow and capital freeze index



Source: International Monetary Fund, International Financial Statistics, World Bank, the Bank of Korea, Economist, "A New Measure of Financial Openness" by Menzie Chinn and Hiro Ito

(Policy Implications) It is recommended that Korean government maintain current account surplus with applying policies buoying macro soundness efficiently rather than raising base rate.

First, consistent current account surplus will successfully alleviate negative shocks as experiences of Korea and other countries who have undergone financial crisis tell and considering recent size of speculative hot money.
Second, without the guarantee of stable macroeconomic growth, minor level enhancement of base rate would reluctantly shield capital outflow and should give more burden to households as they already hold tremendous debts.
Third, considering high openness of Korea, policies augmenting macro soundness should be applied and monitoring must be strengthened since speculative money ran out from emerging markets is possible to flow into the Korean market.

Recent Publications

A Fundamental Review of Welfare Polices in Korea

Research Monograph 13-01
Kwang Choi, Young-Hwan Lee and Sung-Kyu Lee

Debates on sustainability of welfare state and financing of social expenditures have been heated, as social expenditures are expected to increase further. Demographic changes resulting from ageing population and low fertility are major factors for social expenditure growth, as pension and health expenditures for the old are to grow faster now on. In addition to the demographic changes, Korean society faces transitional stage in terms of welfare states. After experiencing fast economic development, the demand for welfare state and social integration has been expanded. The social want and demand substantiate electoral campaign pledges such as expansion of child care subsidy into all income classes.

Also, the paper examines the problem of tax-welfare churning and provides a potential way to reduce it. In modern welfare state, tax-welfare churning is perhaps one of the largest anomalies. Tax-welfare churning is said to occur when the government extracts taxes from people on one hand but then gives in it back to the same person in the form of transfer or welfare payments on the other hand. The case for removing tax-welfare churning is quite strong and thus it should be an obvious candidate for reform to achieve smaller government.

The paper proposes several suggestions to make better welfare policies, including setting up of ‘Committee on National Strategy’ and “Committee on Budget and Welfare Policy” in the legislative body, consolidation of budgetary ‘bags’(general and special accounts, funds, tax expenditures, and debt of public enterprises), introduction of Chief Performance Officer, ex post evaluation of major projects, and introduction of fiscal rules in the Constitution.

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