

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

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Executive Summary

Korea's 2012 GDP Growth Projected at 2.9% in 1st Half and 3.4% in 2nd Half

The national economy for 2012 is expected to achieve 3.4% growth in the second half after expanding 2.9% in the first half, reflecting a phenomenon of 'low in the first half as well as low in the second half.' Due to the re-emergence of the European financial crisis, the unstable recovery of the U.S. economy and China's economic slowdown, expectations for a global economic recovery have been weakening again recently. Therefore, Korea's economic growth is not likely to find it easy to improve. Affected by the easing of international oil prices, won-U.S. dollar exchange rate appreciation, base effects, etc., consumer price growth in the first half is projected to fall slightly.

Current Account Balance: US\$5.3 Bil. in 1st Half and US\$10.6 Bil. in 2nd Half

Exports are projected at single-digit growth due to the slow pace of the global economic recovery, competition with Japan and exchange rate appreciation. Owing to expansion of domestic demand in newly emerging countries and the Korea-U.S. FTA, however, exports are expected to improve more in the second half than in the first half. Accordingly, the current account balance is projected to increase to US\$10.6 billion in the second half from US\$5.3 billion in the first half. Influenced by the preference for safe assets, meanwhile, the won-U.S. dollar exchange rate will maintain at a high level in the first half, but is expected to decline to the 1,099 won level in the second half, caused by a weakening dollar trend and expansion of the surplus in the current account balance.

Need to Respond to Weakening of Japanese Yen

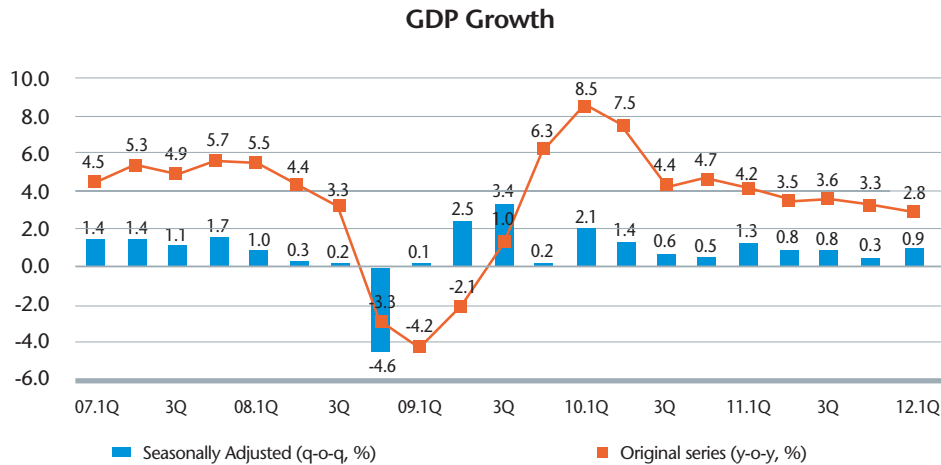
When considering a decline in the exchange rate pass-through (ERPT) on export prices in the wake of won-yen exchange rate fluctuations and a high export competition level between Korea and Japan, an analysis found that the 'weak yen' phenomenon expected in the future would have a significant impact on Korea's exports. As a result of simulations utilizing a macroeconomic model, if the yen-U.S. dollar exchange rate depreciates 10%, Korea's exports and economic growth are likely to fall about 3.2% and 0.35 percentage point, respectively. Therefore, Korea should work to overcome a 'weak yen' through enhancement of non-price competitiveness, including quality improvement, in the long term. In the short term, however, Korea also needs strategies to minimize adverse side effects of the weak yen by making the best use of the Korean economy's comparative advantages, such as Korea-U.S. and Korea-EU FTAs.

Recent Developments

GDP Growth Records 2.8% in 1st Qtr. '12

The Korean economy posted year-on-year growth of 2.8% in the first quarter of this year, the lowest rate since the 3rd quarter of 2009. This poor growth is attributed to a slowdown in exports that offset improvements in domestic demand, including consumption and facility investment. Private consumption expanded 1.1% in the first quarter compared with the preceding quarter owing to an increase in the number of employed persons and slowing consumer inflation. Affected by expectations of a global economic recovery in the early part of the year and base effects, facility investment grew 9.0% year-on-year.

Construction investment rebounded to a positive year-on-year growth of 2.1% in the first quarter, but fell 0.7 percentage point quarter-on-quarter, influenced by continuing stagnation in the housing market. Due to import growth expanding faster than export growth, export growth slowed to 0.4% from 2.8% in the preceding quarter.



Growth by Final Demand Items & Growth Contribution Rates

(Unit: %, % point)

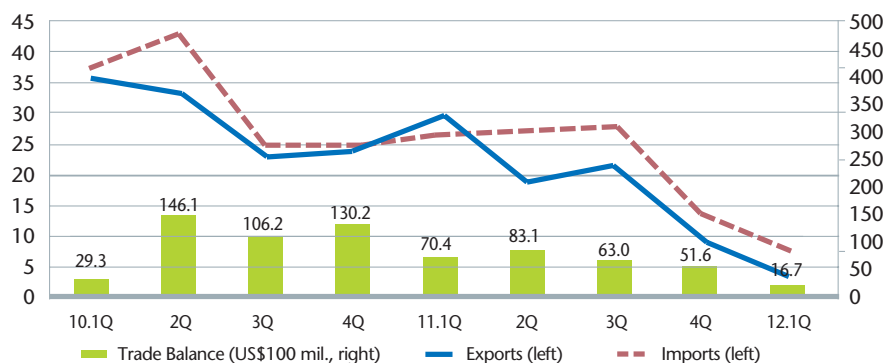
Contribution Rate (%)		Private Consumption	Equipment Investment	Construction Investment	Net Exports	Private Consumption	Equipment Investment	Construction Investment	Net Exports
		(Original Series, y-o-y)				(Seasonally Adjusted Series, q-o-q)			
Growth (%)	2011 1/4	2.9	10.3	-11	6.2	0.6	-1.6	-4.4	1.4
	2/4	3	7.7	-4.2	0.6	0.8	4.7	3.5	-1.1
	3/4	2.1	1.2	-4	3.4	0.2	-1.8	-0.5	1.8
	4/4	1.1	-3.3	-2.1	2.8	-0.4	-4.3	0.1	0.7
	2012 1/4	1.6	9.1	2.1	0.4	1	10.8	-0.7	-1.1
Contribution Rate (% p)	2011 1/4	1.6	1	-1.6	3	0.3	-0.2	-0.7	0.8
	2/4	1.5	0.8	-0.7	0.6	0.4	0.5	0.5	-0.6
	3/4	1.1	0.1	-0.7	2	0.1	-0.2	-0.1	1
	4/4	0.6	-0.3	-0.4	1.5	-0.2	-0.4	0	0.3
	2012 1/4	1	0.9	0.1	0.1	0.5	1	-0.1	-0.4

Sharp Declines in Exports & Imports

Both exports and imports recorded negative growth in March and April this year. The trade growth slowdown is a concern even considering a decrease in operating days and the base effects from high growth in the previous year. The trade balance continued a surplus since February due to the simultaneous decline in the growth of both exports and imports.

Exports, Imports and Trade Balance

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



Current Account Surplus in 1st Qtr. '12: US\$2.63 Bil.

The current account recorded a surplus of US\$2.63 billion in the first quarter, a level similar to the US\$2.61 billion in the first quarter of 2011, thanks to a contraction in the commodity balance surplus offsetting a reduction in the service balance deficit.

Current Account Balance

(Unit: US\$100 million)

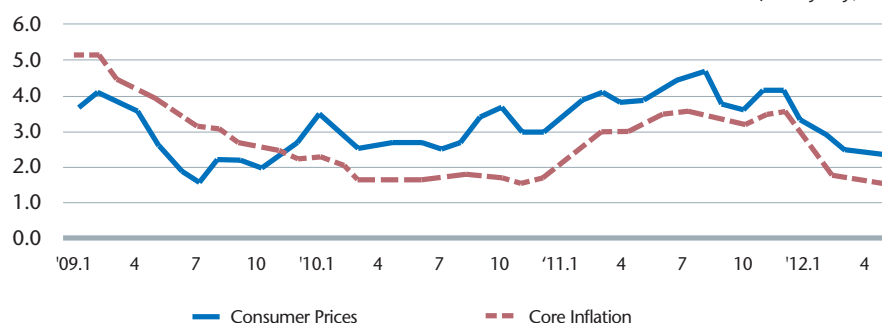
	2010	2011	2012 1/4
Current Account Balance	293.9	276.6	26.3
Commodity Balance	400.8	321.0	26.9
Service Balance	-86.3	-43.8	-6.5
Original Income Balance	10.1	24.6	14.9
Transfer Income Balance	-30.8	-25.2	-8.9

Consumer Prices Rise 3.0% in 1st Qtr. '12

Consumer price growth by quarter has been on a decline since the third quarter of last year. The reason for the sharp decline in price growth is that certain expense items have been impacted by recently implemented government policies, such as free nursery services, free school meals and decreases in university tuition fees.

Prices

(Unit: y-o-y, %)

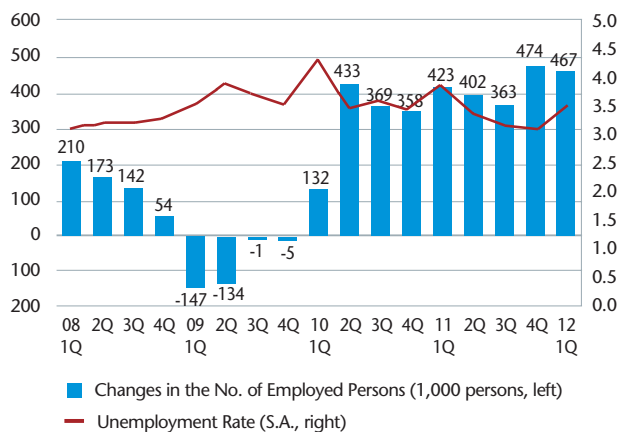


Employment Continuing Quantitative Growth But Job Quality Low

A quantitative recovery trend in employment continued in the first quarter, with the number of employed persons increasing 467,000 year-on-year. The unemployment rate also decreased to 3.8% from 4.2% in the first quarter of 2011. Nevertheless, the number of employed persons in all age groups, except for the over 50 category, decreased and aging of the work force continued.

Employment

(Unit: 1,000 persons)



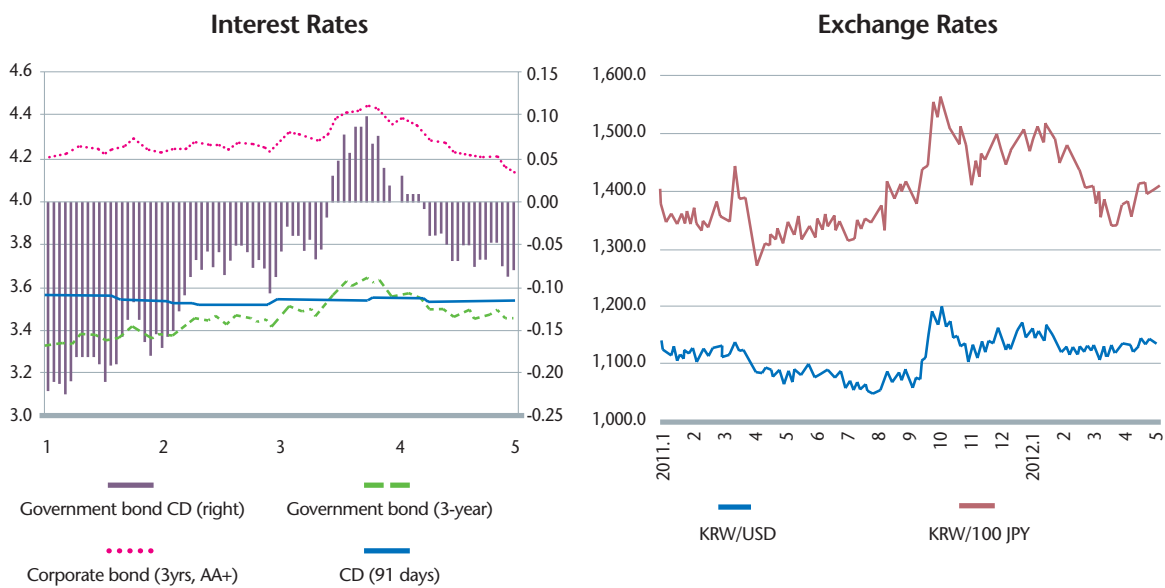
	Total	15~ 29 Yr.	30~ 39 Yr.	40~ 49 Yr.	50~ 59 Yr.	Over 60 Yr.
11.1Q	423	-49	-34	77	286	143
2Q	402	-74	-13	59	294	137
3Q	363	-1	-83	46	270	131
4Q	474	-18	-56	47	315	185
12.1Q	467	1	-65	28	326	178

Market Interest Rate Fell Again from End March

With expectations of a global economic recovery weakening, the market interest rate declined again at the end of March, but the short-term CD interest rate has not moved significantly since June last year, affected by the base rate freeze. Accordingly, short & long-term interest spreads are expanding further since the end of March when they returned to negative levels.

Won-USD Fx-Rate on Rising Trend

The won-U.S. dollar exchange rate has been on the rise due to the maintenance of a strong dollar following the preference for safe assets stemming from concerns about the global economic slowdown since March, spread of the eurozone's crisis, China's downward adjustment of its growth target, recurrence of sluggishness in U.S. employment recovery and continuation of the Iran crisis. The possibility of a third North Korean nuclear test being raised since the failure of its April missile launch is also serving as a factor in the increase of the won-U.S. dollar exchange rate.



Outlook for 2012

1. Internal and External Environments

Global Economic Growth in 2nd Half '12 Still Uncertain

In the Euro region, market uncertainty is expanding due to election risks in European countries. Europe's financial crisis is re-emerging, caused by economic recession as an aftereffect of the region's retrenchment policy. The United States is facing an unstable recovery due to lack of improvement in the employment index and continuation of the housing market slump. China is expected to experience a growth slowdown, influenced by export stagnation, real estate price instability, unemployment growth and downward adjustment of growth targets. Owing to overcoming damage from major earthquakes and a weak yen, there is a possibility that the Japanese economy may improve in the second half.

International Oil to Continue at High Price Level

International oil price instability linked to the Iran risk may ease gradually. Due to insufficient price stabilization functions by world oil reserves, political unrest in the MENA (Middle East and North Africa) region and supply capability expansion issues, including reduction in OPEC's spare production capacity, however, oil prices are expected to maintain a high level for the time being.

European Financial Crisis to Serve as a Variable

If the international financial market instability is eased with resolution of the eurozone's liquidity crisis, the U.S. dollar will weaken as the preference for safe assets loses strength. The Japanese yen is likely to turn to a weakening trend in and after the second half when international financial market instability eases, with the perception of "yen = safe asset" weakened. There is a possibility that the Euro may gain strength slightly due to a technical rebound following an excessive fall and in expectation of a resolution to the eurozone crisis. Appreciation of the Chinese yuan is expected to be faster in the second half, with the currency's fluctuation expanding to 1% from the previous 0.5%.

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

The forecast for global economic growth was adjusted upward to 3.5% from the earlier projection of 3.3%. An upward adjustment also was made for international oil prices to an annual average of US\$115/bbl. from US\$106/bbl.

2. Outlook for Korean Economy (2nd Half of 2012)

Growth:

2.9% (1st Half) → 3.4% (2nd Half), 3.2% (Annual)

With the global economic uncertainty easing more or less in the second half, the contribution rate of exports to growth is expected to increase and the GDP growth rate is likely to improve slightly. Due to single-digit export growth and slow domestic demand recovery following the weakening of growth potential, however, economic growth is projected to stand at less than 3.4%.

Private Consumption:

1.7% (1st Half) → 2.6% (2nd Half), 2.2% (Annual)

As purchasing power will improve due to the slowdown in consumer price growth and a decline in the foreign exchange rate, private consumption growth is expected to be slightly higher than in the first half. For the whole year, nevertheless, private consumption is projected to stand at a low level of 2.2%, with household debt, etc. restricting the private consumption recovery.

Facility Investment:

6.4% (1st Half) → 5.6% (2nd Half), 6.0% (Annual)

Due to shrinkage of corporate investment sentiment and slowdown in leading indicators, facility investment in the second half will slow, with the facility investment projection of the Bank of Korea's BSI remaining below 100. Facility investment adjustment pressure has maintained the 1% level since the third quarter of 2011, while the average operating rate of manufacturing businesses declined and receipt of domestic machinery orders also decreased 26.0% in March. For the whole year, facility investment growth is expected to be 6% due to worsened investment environments, including export slowdown, interest rate hikes and general elections.

Construction Investment:

1.8% (1st Half) → 2.2% (2nd Half), 2.0% (Annual)

Reception of construction orders, a leading indicator, has continued a recovery trend since the end of last year. Affected by more favorable real estate policies after the April general election, construction investment is expected to improve slightly in the second half. Annual construction investment is likely to grow 2% due to a reduction of roles in the public sector.

Current Account Surplus:
US\$5.3 Bil. (1st Half) →
US\$10.6 Bil. (2nd Half),
US\$15.9 Bil. (Annual)

The current account surplus is expected to increase in the second half thanks to improvement in the commodity balance affected by the narrowing the gap between export and import growth, despite growth in the service balance deficit. The service balance is likely to expand due to an increase in overseas services caused by foreign exchange rate falls.

Consumer Prices:
3.1% (1st Half) → 3.0% (2nd
Half), 3.1% (Annual)

Influenced by the weakening of international raw material price hikes, won currency appreciation, base effects, etc., consumer price growth is expected to slow slightly. International oil prices are likely to be slightly lower due to the easing of the Iran risk and other factors. The Won-U.S. dollar exchange rate will decline due to slowdown of dollar's rising trend and expansion of the current account surplus. Affected by base effects of the growth in 2011, a low (3.9%) in the first half and higher (4.1%) in the second half, consumer prices in 2012 are expected to record 3.1% in the first six months and 3.0% in the second half to result in an annual expansion of 3.1%.

Market Interest Rates:
4.3% (1st Half) → 4.6% (2nd
Half), 4.5% (Annual)

Considering a very low short-term and long-term interest spread and a reduced scale of foreigners' purchase of bonds, market interest rates in the second half are projected to rise gradually. Since March, the phenomenon that short-term interest rates exceed long-term interest rates will serve as a factor pressuring interest rate hikes. Foreigners' trend of bond purchases is likely to contract due to the authority's action to stabilize capital inflow and outflow.

Won-USD Fx-Rate:
KRW1,126 (1st Half) →
KRW1,099 (2nd Half),
KRW1,112 (Annual)

As long as the European financial crisis does not reach a stage that shocks domestic and overseas financial markets, the won-U.S. dollar exchange rate will decline gradually. Risks such as Iran's nuclear development, China's growth slowdown, North Korea's potential nuclear test, which served as additional factors in the decline of won-U.S. dollar exchange rates, are expected to ease. With these risks easing, other factors like the weakening of confidence in U.S. dollar, continuation of Korea's current account surplus, etc. will emerge in the second half to lower the won-U.S. dollar exchange rate.

Outlook for Korean Economy (2012)

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

	2011			2012						
	1st H	2nd H	Year	1Q	2Q	3Q	4Q	1st H	2nd H	Year
GDP	3.8	3.4	3.6	2.8	3	3.3	3.6	2.9	3.4	3.2
(SA, q-o-q, %)	2.1	1.4		0.9	0.9	1.2	0.6	1.5	1.9	
Private Consumption	2.9	1.6	2.3	1.6	1.8	2.3	2.9	1.7	2.6	2.2
Construction Investment	-7.1	-3	-5	2.1	1.6	2.1	2.2	1.8	2.2	2
Equipment Investment	8.9	-1.1	3.7	9.1	4.1	4.6	6.7	6.4	5.6	6
Exports (Goods & Service)	12.5	6.9	9.5	5	5.8	5.9	7.1	5.4	6.5	6
Imports (Goods & Service)	9.3	3.8	6.5	4.6	4.9	5.2	5.9	4.8	5.6	5.2
Consumer Prices	3.9	4.1	4	3	3.2	2.8	3.2	3.1	3	3.1
Producer Prices	6.5	5.6	6.1	3.2	2.8	2.9	3.1	3	3	3
Current Account Balance (US\$100 mil.)	81	159	240	26.3	26.9	46.1	59.6	53.2	105.6	158.8
Commodity	135	174.5	309.5	26.9	47.3	52.1	87.9	74.2	140	214.2
Exports	2704.1	2821.5	5525.7	1346.6	1510	1498.8	1511.7	2856.6	3010.5	5867.2
Growth (%)	23.5	15	19	5.5	5.8	6	7.4	5.6	6.7	6.2
Imports	2569.1	2647	5216.2	1319.8	1462.7	1446.6	1423.8	2782.5	2870.5	5653
Growth (%)	27.2	20.1	23.5	8.3	8.3	7.8	9.1	8.3	8.4	8.4
Service & Others	-54	-15.5	-69.5	-12.5	-20.4	-6.1	-28.3	-33	-34.4	-67.3
Ex Rate (Avg. KRW/USD)	1102.2	1113.9	1108	1131.5	1120	1106	1091	1125.8	1098.5	1112.1
Corp. Bonds Yield (3-year, AA-)	4.6	4.3	4.4	4.3	4.3	4.5	4.7	4.3	4.6	4.5
Unemployment Rate (%)	3.8	3	3.4	3.8	3.4	3.2	3.2	3.6	3.2	3.4

Policy Issue:

Recent Weak Yen Phenomenon's Impacts on Korea's Exports

Need for Response Strategies to the Continuation of Weak Yen Trend

The weak yen phenomenon is expected to give negative impacts on the export competitiveness of Korea's key businesses, which are in export similarity relations with Japan. Therefore, it is necessary to review the exchange rate pass-through (ERPT) on export price and trends of the export similarity index and analyze the impacts of the weak yen phenomenon on the Korean economy.

ERPT on Export Price Worsened Since the Financial Crisis

Falls in the exchange rate pass-through (ERPT) on export price are interpreted as price adjustment difficulties following the competitions with Japanese products were reflected, in addition to an affirmative aspect - quality competitiveness enhancement of Korean products. This implies that if the ERPT on export price weakens, the weak yen's negative effects can become greater for those industries whose similarity relations with Japan are more intensive.

Export Similarity Index between Korean and Japanese Products in Manufacturing Business on the Rise Since 2002

The Korea-Japan export similarity index in such business types as automobiles & automotive parts, semiconductors, computers and other transport equipment (ships) is, at over 0.7, being feared to weaken Korea's export competitiveness due to the weakening of yen. As these business types, in particular, account for 31.8% and 36.8% of Korea's total exports and manufacturing business exports, respectively, their influence on the overall Korean economy is huge.

Since the export similarity index is on the rise, if the won-yen exchange rate drops, it is projected to have negative impacts on the Korea's exports and economy.

Simulation Results Show That a 10% Rise in Yen-USD Ex-Rate Will Reduce Korea's Annual Exports by About 3.17 %

Due to an export decrease following the weak yen phenomenon, Korea's economic growth may decrease 0.35 percentage point and trade balance will worsen by US\$5.9 billion.

Enhancement of Non-Price Competitiveness in the Short Term and Utilization of Korea-U.S. and Korea-EU FTAs in the Long Term Required

As a result of reviewing the ERPT on export price and export similarity index, it is judged that securing corporate profitability with focus on price competitiveness in response to the weak yen trend will be difficult.

In the medium and long term, there is the need to concentrate on the enhancement of non-price competitiveness, including quality improvement of export products, expand particularly Korea-Japan industrial cooperation and induce investment and technology transfer.

In the short term, it is necessary to pursue ways of actively utilizing FTAs - the comparative advantage of the Korean economy.

Study of Historical Factors Influencing the Ownership & Governance Structure of Korean Business Conglomerates and Implications

Research Monograph 12-02

Hyun Jong Kim

The formation process of business conglomerates in the 1960s began in a situation without any agency problem between minority and large shareholders. With subsidiaries going public and debt ratio raised in the 1970s, the high growth period, due to the Public Corporation Inducement Law, discussions on the corporate governance structure started. Also, the cause for the expansion of business conglomerates' financing structure was related to the business diversification launched starting in the 1970s.

It can be said that the controlling shareholders of business conglomerates have assessed the influencing power on corporate value from the investor's position and decided on corporate management direction. Business diversification, investment expansion and export growth among the policies suggested by the government, which had been the substantial second stakeholder, coincided with interest relations of business conglomerates as enhancing corporate value. Therefore, business conglomerates duly accommodated the policies and responded in the policy direction.

With the influence of the capital market increasing since the foreign exchange crisis, the governance structure of business conglomerates are moving in the direction of enhancing corporate value. However, the government policy that can undermine the demand for corporate social responsibility or corporate value would rather have negative impacts on the governance structure of business conglomerates. Therefore, social demand or restriction reinforcement policies for business conglomerates are feared to weaken the controlling power of the capital market and change the governance structure of business conglomerates in the direction of rather worsening the agency problem between minority and majority shareholders.

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