July 2015 No.80

KERI ECONOMIC BULLETIN

Contents

Korea Economic Research Institute

Executive Summary

Korea's growth outlook downgraded from 3.4% to 2.7%

As global growth forecast was revised downward and exports showed deepening doldrums, the growth estimate for this year was cut by 0.7%p, from a revised 3.4% in three months earlier. Significant reasons for the downward revision are that global growth projection for 2015 has been marked down roughly 0.4%p, Chinese economy shows a continuing slowdown, the weakening of Japanese yen and economic uncertainties in emerging markets increase. If the impact of MERS lingers until the end of July, it may bring the growth outlook down to 2.0%.

Consumer prices growth revised down to 1.0% from 1.4%

Consumer prices are expected to show a modest rebound, mainly attributable to an increase in utility prices such as gas, electricity and water in the latter half of the year. However, falling international oil prices and tepid domestic demand limit the size of the rebound, implying that annual consumer prices growth is forecast to be 1%, lowered than last year (1.3%).

Current account surplus expected to reach a record US$105 billion; USD/KRW projected at 1,101won for 2015

Despite a decline in export volume current account surplus for 2015 is forecast to reach a record US$105.4 billion boosted by minus import growth, resulting from a drop in unit price. USD/KRW is expected to a gradual depreciation at a yearly average of 1,101won, as the ascending pressure from strong-dollar remains.

Stimulating overseas investment and offering customized supports in order to alleviate relative upward pressure on Korean won

Some industries in Japan, which have been retaining unit export price to maximize their profits since the phenomenon of weakening Yen began, are expected to implement offensive price cutting strategy with the purpose of increasing market share. So as to ease upward pressure on Korean won against the Japanese yen, the regulations on overseas investment reporting system and scales of overseas investment should be revised so that businesses are not obligated to report to the government in advance. Additionally, overseas investment stimulus plan such as a separate taxation on overseas investment incomes and vitalization of the National pension's overseas investment need to be implemented. Furthermore, it is inevitable to offer specifically designed export strategies for ASEAN markets where Japanese government actively increases their contributions. Domestic businesses first of all need to put their all efforts to reduce cost and enhance non-price competiveness and develop global business competency in the long run.

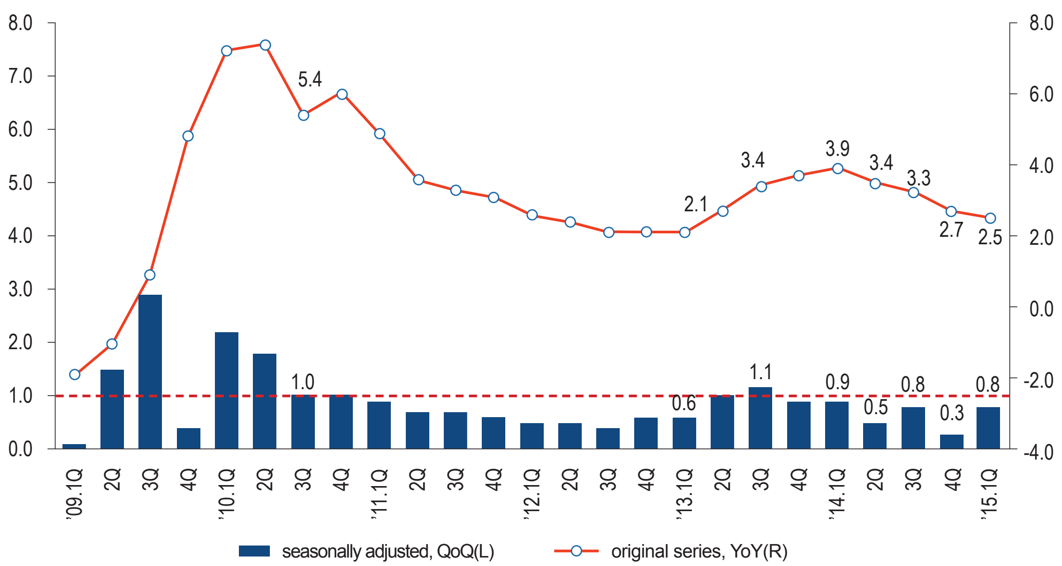
Recent Developments

Korea GDP growth marginally rise to 0.8% (QoQ) in 1Q 2015, compared with 0.3% in 4Q 2014

As increases in construction investment, mainly residential premises by private sector, private consumption and investment in knowledge industries offset the degree of declines in facility investment and exports, growth rate shows a slight upturn. Yet, the growth has been fallen below 1% for 6 consecutive quarters since 3Q 2013. Growth over the same period in the last year also consecutively dropped, 2.4% in 1Q 2015 since the growth rate of 3.9% seemed in Q1 2014.

Real GDP Growth

(Unit: %)



Source: The Bank of Korea

Contribution from domestic demand to GDP improved, largely driven by an upsurge of construction investment and increases in private consumption and investment in knowledge industries

Due to global uncertainties, contribution from net exports to GDP shows a marginal growth, 0.2%p, whereas contribution from domestic demand to GDP posted a large jump to 1.0%, compared to 0.4%p in 1Q 2015. It's mainly attributable to that contribution from construction investment to GDP enlarged to 1.0%p, from -1.2%p in the previous quarter, and contributions from both private consumption and investment in knowledge industries to GDP increased by 0.1%p. On the other hand, contribution from facility investment to GDP dropped to 0.4%p from 0.0%p in 1Q 2015.

Contribution to GDP by expenditure

(Unit: %p)

	2013				2014				2015
	1/4	2/4	3/4	4/4	1/4	2/4	3/4	4/4	1/4
Final consumption expenditure	0.1	0.5	0.6	0.4	0.2	-0.1	0.7	0.3	0.3
Private	0.0	0.2	0.5	0.3	0.2	-0.2	0.4	0.2	0.3
Government	0.2	0.3	0.1	0.1	0.0	0.1	0.3	0.0	0.0
Gross capital formation	0.8	0.0	0.7	1.3	-0.6	0.4	0.7	0.1	0.7
Gross fixed capital formation	1.2	0.8	0.2	-0.2	0.7	0.2	0.1	-0.8	1.2
Construction	0.8	0.7	-0.1	-0.7	0.8	0.1	0.1	-1.2	1.0
Facilities investment	0.2	0.1	0.3	0.4	-0.1	0.1	0.0	0.4	0.0
Intellectual property products	0.2	0.0	0.0	0.2	0.1	0.0	0.0	0.0	0.1
Changes in inventories and acquisition	-0.4	-0.8	0.5	1.5	-1.3	0.2	0.5	0.9	-0.5
Exports of goods and services	0.1	1.3	-0.4	0.7	0.7	0.7	-0.9	0.2	0.0
Imports of goods and services	0.4	0.8	0.0	1.5	-0.6	0.6	-0.3	0.3	0.2

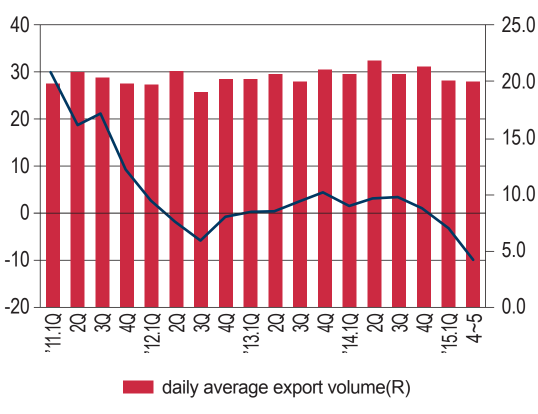
Source: The Bank of Korea

Exports growth (on a custom clearance basis) posts a large decrease to monthly average of -9.4% between April and May 2015, from -3.0% in 1Q

The daily volume of exports decreased to a monthly average of US$1.99 billion between April and May 2015 from US$2.01 billion in 1Q 2015. By the region, exports to EU and Japan declined as well as exports to China, the U.S., EU and Japan all turned to a decrease.

Export Growth and Daily Average Export Volume

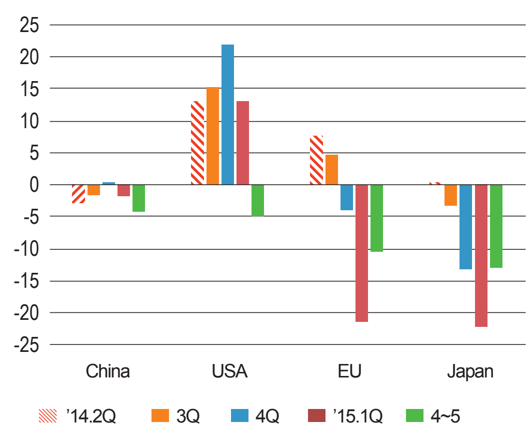
(Unit: left – oya%, right – US$100mil)



Source: MOTIE, Korea Customs Service

Export Growth by Destination

(Unit: oya%)



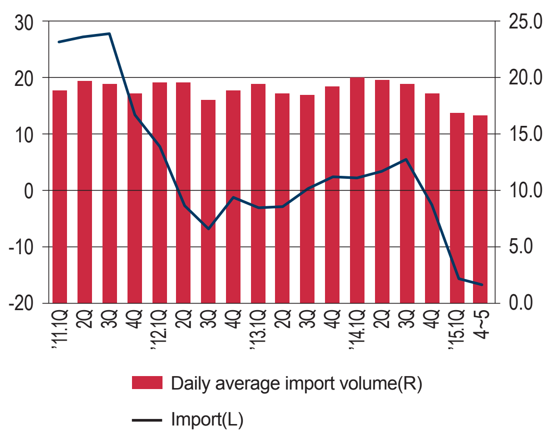
Source: Korea Customs Service

Imports growth (on a custom clearance basis) decreases further as it records a monthly average of -16.6% between April and May 2015 from -15.5% in 1Q 2015

The daily volume of imports between April and May 2015 reduced to US$1.66 billion, from US$1.68 billion in 1Q 2015. This appears to be largely driven by slashing raw material imports which constitutes largest share of total imports, following a continuing downturn in oil prices.

Import Growth and Daily Average Import Volume

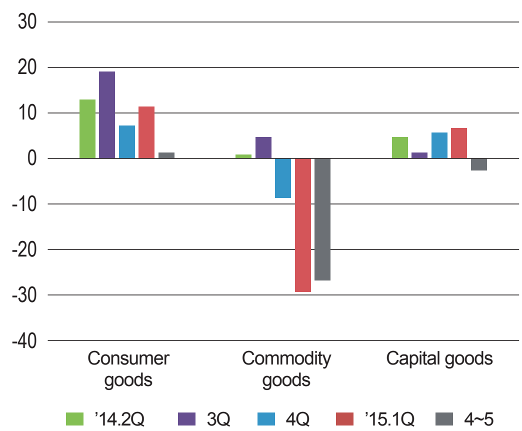
(Unit: left – oya%, right – US$100mil)



Source: MOTIE, Korea Customs Service

Import Growth by Use

(Unit: oya%)



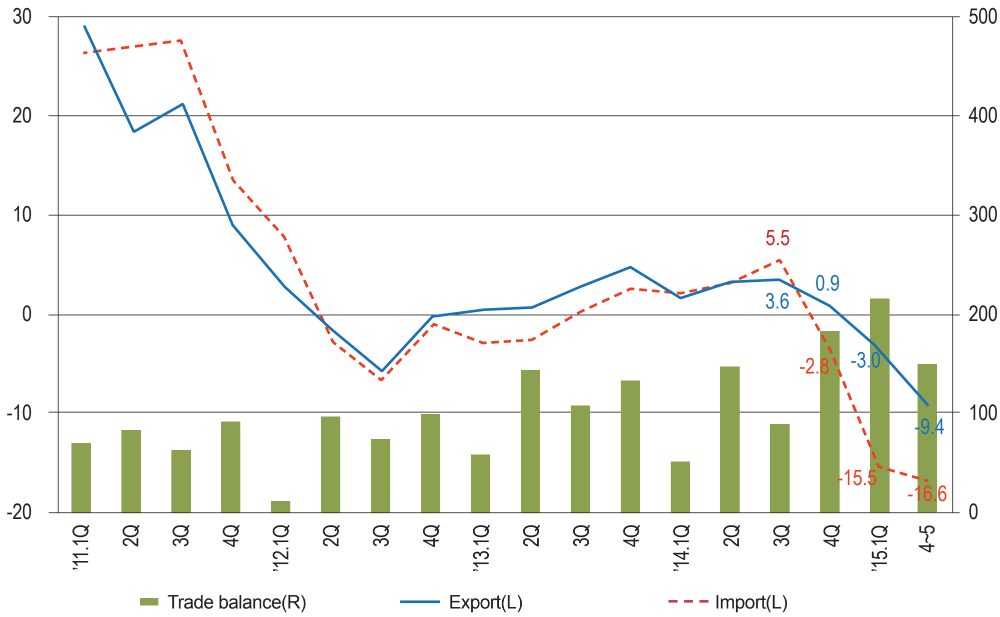
Source: Korea Customs Service

Korea's trade balance records a US$36.5 billion surplus between January and May 2015 (a US$ 22.0 billion, 151% increased, oya)

The declining magnitude of import growth led by the plummeting oil prices outpaced that of export growth owed by weak yen and strong dollar. In fact, monthly average export between January and May 2015 was -5.7% while import growth marked way lower figure of -16.0% over the same period.

Trend of Export, Import and Trade Balance

(Unit: left – oya%, right – US$100mil)



Source: MOTIE

Korea's current account surplus archived US$31.59 billion between January and April 2015

Korea's current account surplus increased 41.1%, by US$9.25 billion year-over-year. The surplus on balances of goods and primary income increased whereas the deficit on balances of transfer and services declined. The monthly average current account was US$7.9 billion, a modest drop from US$8.3 billion in 2H 2014.

Trend of Current Account

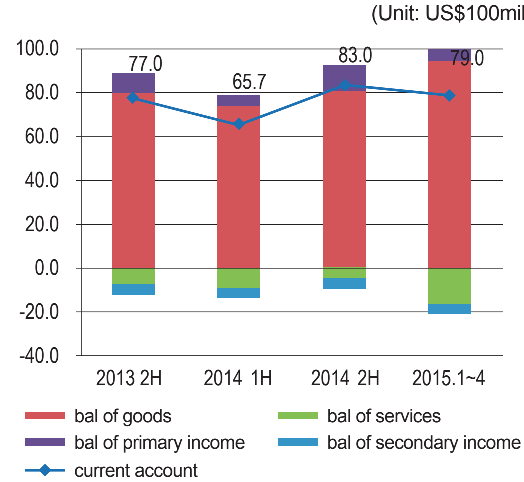
(Unit: US$100mil)

	2013	2014			2015
	2H	1~4	1H	2H	1~4
Current Account	461.9	223.4	394.3	498.0	315.9
Bal of Goods	479.0	283.9	441.8	485.2	378.2
Bal of Services	-44.8	-45.0	-53.4	-28.2	-65.4
Bal of Primary Income	55.9	2.8	32.4	69.6	19.9
Bal of Secondary Income	-28.1	-18.2	-26.4	-28.6	-16.8

Source: The Bank of Korea

Trend of Average Current Account

(Unit: US$100mil)



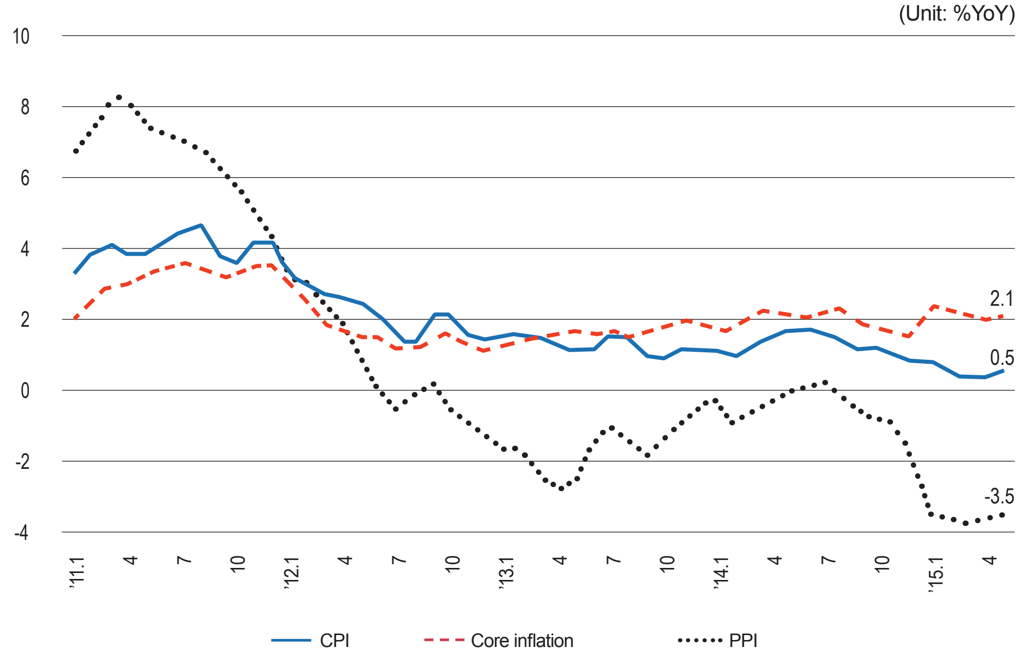
Source: The Bank of Korea

Consumer prices trimmed to 0.5% in May 2015; tumbling below 1% for 6 consecutive months

On demand side, weak international crude oil prices contributed to weak prices gains. Korea's core inflation, excludes volatile oil and food prices, was 2.1% and inflation expectation stood at 2.5% in May 2015. Meanwhile, producer prices has held steady with figures of -3.6%, showing no significant changes from January 2015. It has fallen into negative territory since August 2014.

Trend of Prices

(Unit: %YoY)



Source: Korea Customs Service, The Bank of Korea

The overall job growth shows a slower pace than 2014

The number of employed persons rose by 379,000 in May 2015 indicating a slowdown in quantitative expansion momentum compared to 533,000, the average number of employed persons in 2014. By age group, employed person among young people increased to 114,000 in May from 85,000 in April, and 32,000 in 1Q 2015. This demonstrates a moderate improvement from the last year; the average number of employed persons among young people was 77,000. On the other hand, the number of employed persons in electric, transportation, communication and finance sectors turned to an increase after 13 months' tumbling since May 2014.

Employment-related Indicators

(Unit: thousand persons change over year ago, %)

		2014			2015		
		Year	1/4	4/4	1/4	Apr	May
Changes in number of employed persons		533	729	422	354	216	379
By Age	- 15 ~ 29	77	97	56	32	85	114
	- 30 ~ 39	-21	-6	-29	-1	-68	-44
	- 40 ~ 49	38	99	4	-47	-26	-7
	- 50 ~ 59	239	323	190	177	112	147
	- 60 year and older	200	218	201	192	114	167
By Industry	- Agri.,Forestry & Hunting	-68	12	-109	-87	-135	-123
	- Manufacturing	146	123	129	139	167	140
	- Construction	42	27	72	72	63	42
	- Wholesale & retail trade, hotels & others	259	303	241	147	69	178
	- Business, personal, public service & others	176	209	134	113	67	141
	- Electricity, transport, communication & finance	-18	56	-39	-26	-13	4
Unemployment rate (%)		3.5	4.0	3.2	4.1	3.9	3.8

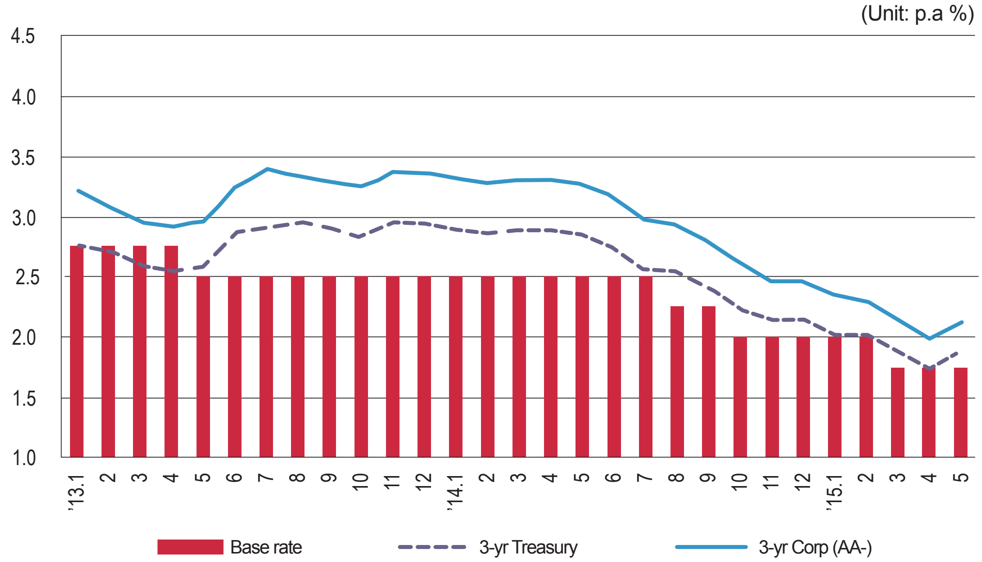
Source: Economically Active Population Survey (Statistics Korea)

Market interest rate dropped in line with BOK's decision to cut its benchmark base rate and MERS shock in June

In addition to weak yen and reduced exports and imports growths due to shrinkage in demand, the MERS outbreak dampened overall economic activities since the first case was reported in the middle of May. In order to counter the negative economic effect, the Bank of Korea revised the benchmark interest rate to 1.5% from 1.75%. Market interest rates slipped in sympathy with the benchmark interest rate.

Interest rates

(Unit: p.a %)



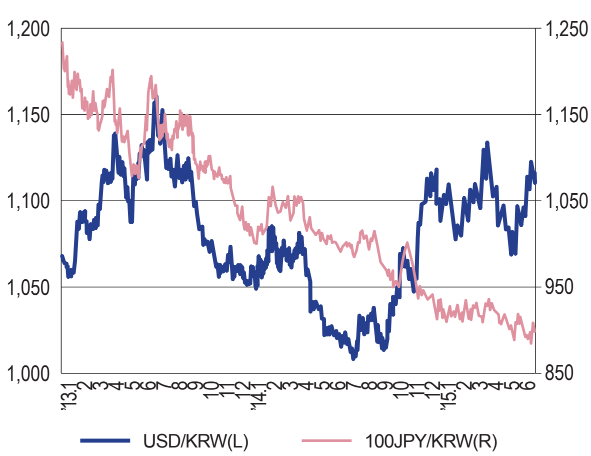
Source: The Bank of Korea

USD/KRW continues its upward trend since the end of April while JPY/KRW remains weak

The dollar has pulled back in recent weeks due to slower recovery of the US economy and delayed the benchmark interest rate hike. After Federal Reserve Chair Janet Yellen reaffirmed expectations of an interest rate hike by year-end, the upward trend of the US dollar continues.

Exchange rate trend

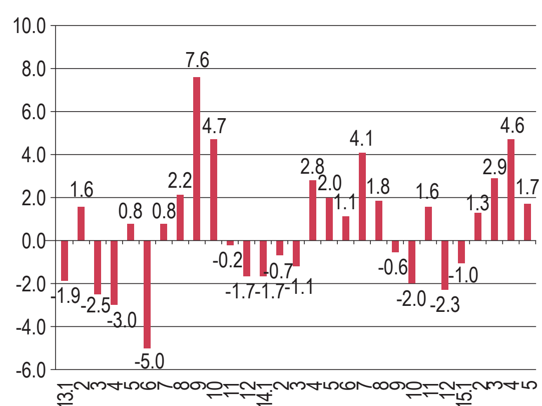
(Unit: USD/KRW, 100JPY/KRW)



Source: The Bank of Korea

Net Foreign Purchase of Korean Equities

(Unit: Tril Won)



Source: The Bank of Korea

Outlook for 2015

1. External Environments

(World Economy) It projected a slower pace of growth for global economy compared to 2014 because slower growth is expected in emerging market countries which outpace positive forecast for advanced countries.

(United States) After resolving temporary issues, the U.S. job market shows a continued improvement. Nonetheless, the U.S. economy is forecast to recover at a slower pace.

(Eurozone) The Eurozone is expected to demonstrate a moderate increase, supported by improvement in private consumption and investment which was placed for encouraging growth in all sectors in Q1 2015.

(Japan) Japan's private consumption and exports enhanced, resulting from improvement in working conditions, increases in wages and the weakening yen, which all push the economy into the recovery phase.

(China) The Chinese economy is expected to be deemed at remain weak, though positive effect from new growth engine gained via the embarked comprehensive reform measure.

(Oil Prices) The price of oil is expected to continue a downturn trend, mainly attributable to negative effects from weakening speculative sentiment, strong dollar and high risk of Greek debt default, amid continuing over supply of crude oil, which counterbalances positive effects such as summer peak-season.

(Factors contributing to rise) Factors pushing the oil prices upward are increased demand in major countries, China's economic stimulus plan and a slowdown in oil production in the U.S

(Factors contributing to fall) Factors putting downward pressure on the oil prices are improved technology and efficiency of Shale gas companies in the States, which swells amount of crude oil production, strong dollar, high risk of Greek debt default and damped speculative sentiment.

(Foreign Exchange rates) By the end of the year, the US dollar is projected to remain strong with small fluctuation, and Euro and Japanese yen are expected to continue a downward trend.

(Euro) Bearish factors such as ECB's quantitative easing program and rise of the US interest rate are prevail but mitigated concern over deflation and rally of German long-term bonds dampen the weakening Euro.

(Japan) As BOJ embarked quantitative easing program, investment by Japanese major investors were augmented, Japanese yen shows signs of weakening whereas the U.S. interest rate was revised upward which increases volatility of Japanese yen.

(Yuan) China Renmin Bank reduces the volatility, expected to keep the rate as seen in the previous period although the factors that influence exchange rates such as a numerous expansionary exchange rate policies and SDR transfer by IMF in October were applied.

2. Outlook for Korean Economy in 2015

Growth: 3.3% in 2014 → 2.7% in 2015

The growth rate for 2015 was revised down by 0.7%p, to 2.7% from 3.4%, estimated in March 2015, largely influenced by poor global economic outlook and contraction in exports in 1H. First of all, recovery in the domestic demand is sluggish even though the domestic expansionary policies adopted. A weak and slow global economic recovery, a slowdown in growth of Chinese economy, weak Japanese yen and vulnerable emerging market countries attribute to minus growth of exports. Negative effects caused by MERS outbreak will bring the growth rate down further to 2.0% if MERS lingers until the end of July.

Private consumption: 1.8% in 2014 → 2.0% in 2015

Private consumption is expected to show a modest rebound in 2015, supported by rise of asset price, increases in purchasing power, resulting from falling prices of crude oil. The size of growth is expected to trivial as low growth of wage rate, increased burden on households' debt, preparation for retirement pull down average propensity to consume.

Facility investment: 5.8% in 2014 → 4.8% in 2015

In consideration of corporates' investment expansion plan and government's investment activation measures, facility investment is projected to show a continuing growth as seen in the last year. Nevertheless, the investment conditions are worsened due to dampened investors' sentiment, contraction in capacity of investment and the incremental cost of borrowing. Accordingly, the growth of facility investment is projected to be lower than the last year.

Construction investment: 1.0% in 2014 → 2.7% in 2015

Construction investment is expected to show a higher annual growth of 2.7%, compared to 1.0% in 2014. The government's property market stimulus measures and expansion of SOC budget for 2015 act as positive factors which push construction investment upward.

Export growth (BOP basis): 0.5% in 2014 → -5.7% in 2015

Annual export growth is projected to show minus growth of 5.74% for the first time since 2009, mainly led by contraction in global growth, changes in Chinese economy and incessant yen's falling trend which all worsen the export conditions. Yet, export growth is expected to improve marginally in 2H as a downward trend of export unit price is expected to alleviate.

Import growth (BOP basis): -1.3% in 2014 → -8.9% in 2015

An annual import growth is projected to post a large decrease with continuing slowdown in domestic demand. This appears to be largely driven by a steep drop in import unit price caused by falling oil and raw material prices.

Current account surplus: \$89.2 billion in 2014 → \$105.3 billion in 2015

Despite a negative growth of service balance, the total current account surplus is expected to reach a record in 2015, supported by a goods balance surplus surge. In contrast, the total service balance deficit is projected to increase as travel account deficit widens and surpluses from construction and transportation sectors decrease.

Consumer prices: 1.3% in 2014 → 1.0% in 2015

An annual growth rate of consumer prices is forecast to 1% as a steep drop in oil prices and sluggish domestic demand put downward pressure on both supply and demand. The growth rate is projected to turn to an increase owing to a hike in cost of utilities services, appreciation of Korean won against the US dollar.

Corporate bond yield (3yr, AA-): 3.0% in 2014 → 2.3% in 2015

Global interest rates continued a downward trend, mainly influenced by a two-steps cut of the benchmark interest rate by the Bank of Korea and a drop in the U.S. Treasury yield in 1H. However, the global interest rates are expected to rally by a small margin in 2H with a rise of US Treasury yield, which hampers further drop in the domestic benchmark interest rate before the end of the year.

USD/KRW: 1,053 won/ dollar in 2014 → 1,101 won/ dollar in 2015

As the strong dollar effect is superior to appreciating factors such as the upswing in Korea's current account surplus, Korean Won to US Dollar exchange rate is expected to rise over the previous year.

Outlook for Korean Economy in 2015

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

	2014	2015						
	Year	1Q	2Q	3Q	4Q	1st Half	2nd Half	Year
GDP	3.3	2.5	2.4	2.6	3.1	2.5	2.8	2.7
(sa, QoQ%)		0.8	0.4	1.1	0.7			
Private Consumption	1.8	1.5	2.2	2.0	2.3	1.9	2.2	2.0
Construction Investment	1.0	0.6	2.1	2.5	5.1	1.5	3.8	2.7
Facilities Investment	5.8	5.8	4.7	4.9	3.9	5.2	4.4	4.8
Export(Goods & Services)	2.8	0.1	0.3	2.5	3.9	0.2	3.2	1.7
Import(Goods & Services)	2.1	1.9	1.1	3.4	4.6	1.5	4.0	2.8
Consumer Price	1.3	0.6	0.6	0.9	1.8	0.6	1.3	1.0
Producer Price	-0.5	-3.6	-3.4	-3.0	-1.0	-3.5	-2.2	-2.9
Current Account Bal	892.2	234.5	276.9	264.6	277.3	511.4	541.9	1053.3
Bal of Goods	926.9	252.6	288.1	273.5	277.6	540.7	551.1	1091.8
Export(BOP basis)	6213.0	1354.8	1432.9	1488.8	1580.8	2787.7	3069.6	5857.2
(growth rate, %)	0.5	-11.3	-10.1	-3.0	1.5	-10.7	-0.7	-5.7
Import(BOP basis)	5286.1	1102.2	1144.8	1215.3	1303.2	2247.0	2518.5	4765.5
(growth rate, %)	-1.3	-18.3	-13.9	-7.8	1.1	-16.1	-3.4	-9.8
Service and other balances*	-34.7	-18.0	-11.3	-8.9	-0.3	-29.3	-9.2	-38.5
FX rate(USK/KRS, avg)	1053.0	1100.3	1096.5	1095.0	1112.0	1098.4	1103.5	1101.0
Corp bond yield(3yrs, AA-)	3.0	2.3	2.0	2.3	2.5	2.2	2.4	2.3
Unemployment rate (%)	3.6	4.1	3.8	3.4	3.3	4.0	3.4	3.7

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

Policy Issue:

Yen depreciation process and its implication for Korean enterprises

(Background) To overcome the relative Korean Won strengthening to Yen depreciation, the Yen depreciation process and its implication should be examined

Amid the weak Yen particularly prevailing since the mid – 2012, Japanese corporate's strategy altered quite a bit riding the Yen sliding. As JPY depreciation projected to prolong further, the amended strategy must be analyzed and Korean companies' export strategy should be designed corresponding to it.

(Current Status) As weak – Yen capturing the hill, Japanese companies allegedly lowered unit export price from time to time in order to enhance their operating profit; indeed each industry shows different feature

Industries of which competitive power declined such as electric and electronics, or which needs price competitiveness such as metals have lowered their unit export price continuously. At any rate, industries already maintaining the lead such as general machinery, transportation equipment have not curtailed their unit export price but rather are focusing on profit growth. In reality, the unit export prices of general machinery, transportation equipment, and textiles have not lowered until late 2014.

(Forecast) Industries sustaining current unit export price and focusing on profit growth forecasted to join the curtail herd as well cutting their unit export price affirmatively expecting the enlargement of their market share

The industries which have not cut their unit export price are projected to follow below trajectory. First, they would invest on research and development, equipment, or promote merger and acquisition using their accumulated profit. In reality, the Japanese retained earnings are thought to be 328 trillion Yen which is the historical peak. Second, more companies are forecasted to curtail their unit export price dramatically in order to expand their market share in the globe. Wrapping all up, even if the Yen depreciation ends, the augmentation of Japanese R&D investment and market share would hit the Korean market irreversibly.

(Suggestions for government) Customized export policies needed in order to limit remarkable Won appreciation, and alleviate the negative shock of Yen depreciation

First, government may modify regulations upon foreign investment, and provide tax exempt for foreign portfolio investment in order to alleviate Won appreciation. To be specific, the foreign investment should better be a report ex-post rather than ex-ante. Also, there shouldn't be a certain limitation for the magnitude of foreign investment. Moreover, foreign investment of market player and national pension fund should be promoted by the development of tax and regulation. Second, government would also prepare support plans for companies focusing on export to ASEAN as negative strike of weak yen thought most severe in ASEAN territory. In reality, Korea's export to ASEAN plummeted by 18.3% from January to April this year, while Japan's export to same place climbed by 13.8% from January to March 2015.

(Suggestions for companies) Export companies should conduct strong cost savings effort in the short run, and enhance non-price competitive edge and global business skills in the long run preparing for Japanese export invasion done by unit export price cut

Export companies should conduct strong cost savings effort in the short run. To be specific, firms should improve labor productivity through working system development and unnecessary overtime work curtail. In addition, excessive wage growth should be restricted. In the long run, the firms would enhance their non-price competitive edge and global business skills. Developing high value products through technology innovation, acquiring foreign blue chip company using pivotal domestic dollar supply, and foreign investment are suggested to be performed.

www.keri.org

Publisher: Tae-shin Kwon
Editor: Chang-Bae Kim, Soya Kwon, Alexese Yoonjin Kim

KERI Economic Bulletin

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