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Contents

Korea Economic Research Institute

Executive Summary

Korea's GDP growth projected at 2.9% in the 2nd half, Korea's 2013 annual economic growth likely to close at 2.3%

The Korean economy for 2013 is expected to grow by 2.3%, down 0.6 percentage point from 2.9% projected in March 2013. This downward adjustment is due to uncertainties of external conditions for the global economic recovery, owing to US Fed's downsizing of QE, China's shift toward "quality growth" and unintended side effects of Japan's 'Abenomics.' Recovery in the domestic demand is also limited due to households "deleveraging", housing market slowdown, and excessive discussion on the so-called "economic democratization."

▷In the second half, private consumption growth will stop its rise at 2.0% (1.7% per annum), affected by risk factors such as increasing household debt burdens, worsening quality of job growth, and readjustment of house prices and rent level.

▷Equipment investment is expected to escape negative growth by a narrow margin attributable to base effect. But the rate at which it is growing is expected to slow down at around the 4% range (-2.0% per annum) due to dampened investment sentiment owing to slow export growth and impact of economic democratization.

▷Construction investment expects to have slow recovery despite SOC budget increase and base effect, offset by the prolonged stagnation in the housing business conditions.

Consumer price growth remains low at 2.4%, KRW/USD to mark 1,086

Consumer prices are projected to remain low at 2.4% (1.8% per annum) for the second half of 2013, influenced by decline in the prices of raw materials and KRW/USD in addition to existing low pressure on the demand side.

Despite the slow recovery in exports, current account surpluses will be maintained at US$20 billion. This is attributable to delayed domestic economic recovery, which slow down the pace of the import increase outstripping that of exports.

KRW/USD is predicted to show a descending trend based on a current account surplus and sound Korean capital market conditions. However the downbeat of KRW/USD shall be confined following the downsizing of QE in the U.S., resulting KRW/USD hovering around 1,086 in average for the second half of 2013.

Need to minimize FX volatility and improve non-price competitiveness

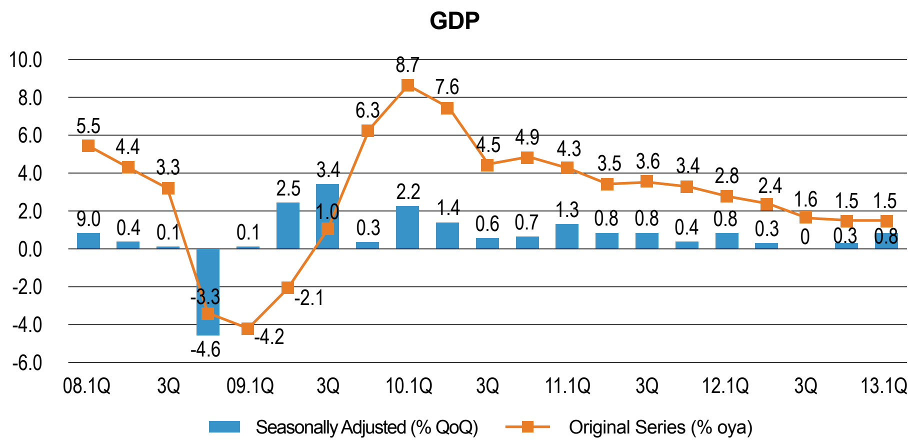
A slump in key exports such as steel, automobile, semiconductors and shipbuilding is alarming. Amid the prolonged global economic recession, a recent weakening of the yen is one of the key downside risks associated with such impacts. In order to minimize shocks, the government should focus on stabilizing foreign exchange market and seek for ways to invigorate market functions by different sectors and sizes, while industries make greater efforts to strengthen non-price competiveness.

Economic Trends and Outlook

Recent Developments

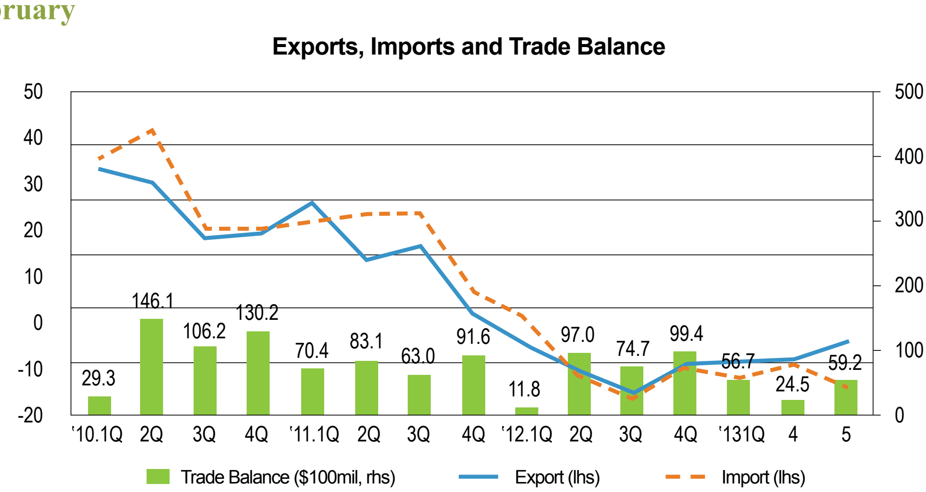
GDP Growth in 1Q 2013 records only 0.8%p higher than the previous quarter

The Korean economy posted growth of under the 1% range for the eighth consecutive quarters since 2Q 2012. Mid-term risk factors associated with the slow growth are the lagging external and internal economic recovery following the euro-zone crisis. In the short-term, escalating US fiscal risks at the start of the year and the North Korean nuclear risks have been attributed to an economic slowdown. In terms of final demand, equipment investment continues to struggle while private consumption is turning to a receding trend. While construction investment rebounded to a positive growth, its lasting effect is expected to be minimal.



Exports managed to rebound since March but exports in overall records stagnation in the first half of 2013. Imports maintains a negative growth since February

Exports rebounded to be positive at 0.9% (oya) during the periods of January and May. Imports recorded an average of -2.8% (oya) in the same period. With the fall of imports exceeding the fall of exports, it displays a recession-type trade surplus since the 2Q 2012.



Current account surplus records a huge increase in 1Q 2013

Total current account surplus surged to US$13.9 billion in the period between January and April, comparable to US$4.3 billion over year ago. The whopping current account surplus increase is attributed to the increased commodity balance surplus and the conversion of service balance into a surplus.

Current Account Balance

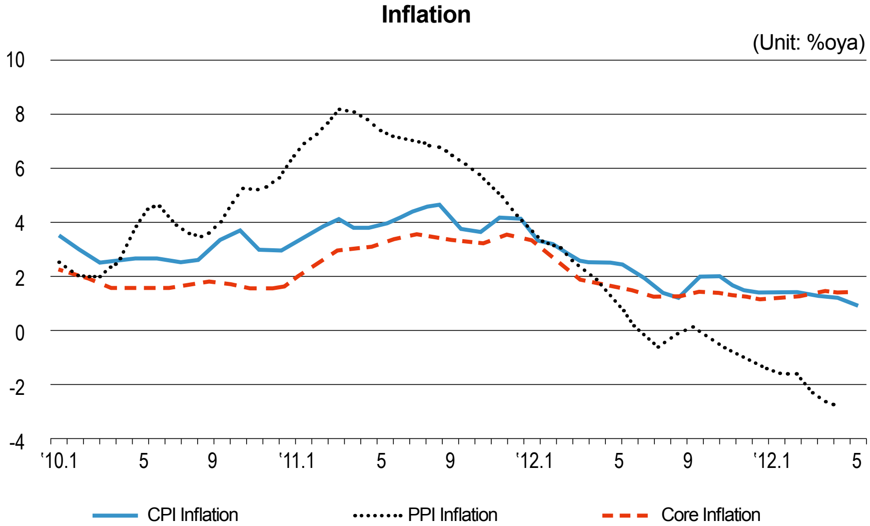
(Unit: US$100 mil.)

	2011	2012					2013	
	Year	1/4	2/4	3/4	4/4	Year	1/4	April
Current Account Balance	260.7	25.6	111.9	145.6	148.3	431.4	100.2	39.7
Goods	316.6	26.1	85.2	133.4	138.6	383.4	93.9	35.9
Services	-58.5	-6.5	23.1	6.5	3.6	26.8	-4.8	14.5
Primary Income	28.9	14.9	8.2	10.4	15.4	48.9	13.8	-10.9
Secondary Income	-26.3	-8.9	-4.7	-4.8	-9.3	-27.6	-2.6	0.2

Consumer prices record 1% range, producer prices continues a negative growth

CPI Inflation set on a downward stabilization since 1.5%(oya) in January this year to 1%(oya) last May. PPI Inflation recorded -2.1% between January and April, making it a negative growth for the seven consecutive months since October 2012.

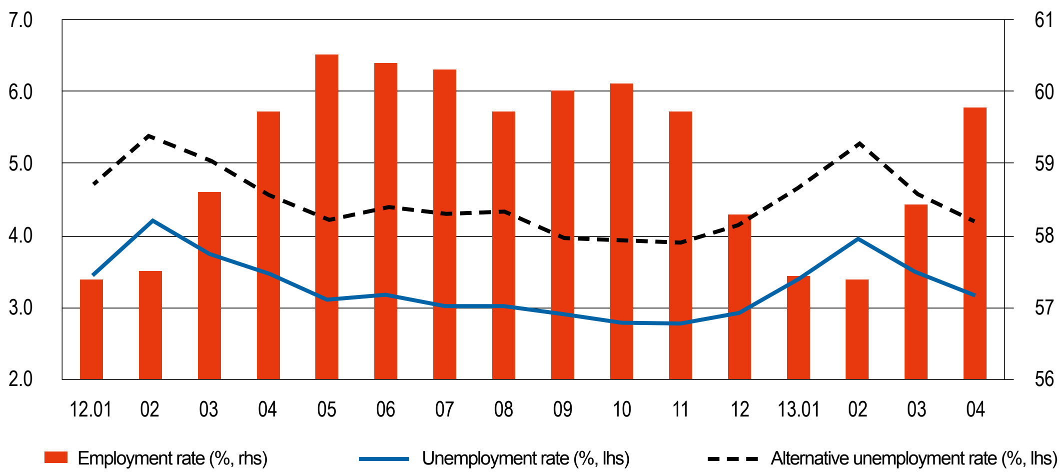
Inflation



Employment continues quantitative growth but quality remains low

The number of employed persons is on the rise in 1Q with employment rate of 59.8% in April 2013. The unemployment rate in February showed a downward trend from 4% to a bit fallen 3.2% last April. The rate of decline for youth employees continues to worsen since 2Q 2012 but the growth rate of employed persons in the age group of 50 increased since 1Q 2012.

Employment



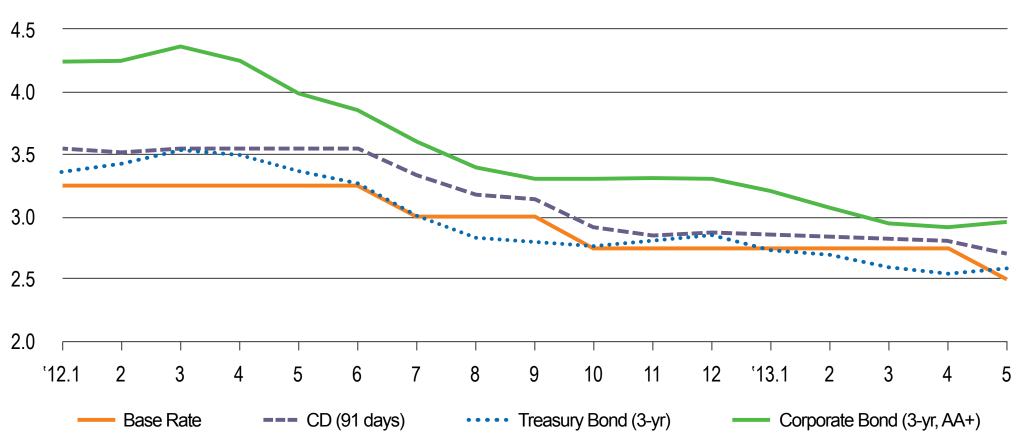
■ Unemployment rate = Unemployed workers / Total labor force

■ Alternative unemployment rate = (Unemployed workers + Discouraged workers + Marginally attached workers) / Total labor force

Market interest rate rises despite the base rate cut (May 9, -25bp)

The corporate bond yield rate (3-yr, AA-) recorded an increase at 3.13% in June 18 from 2.99% in February 28. Despite the recent base rate fall, long-term interest rate increased, affected by weakening expectation of additional interest rate cut, and downsizing of QE in the U.S.

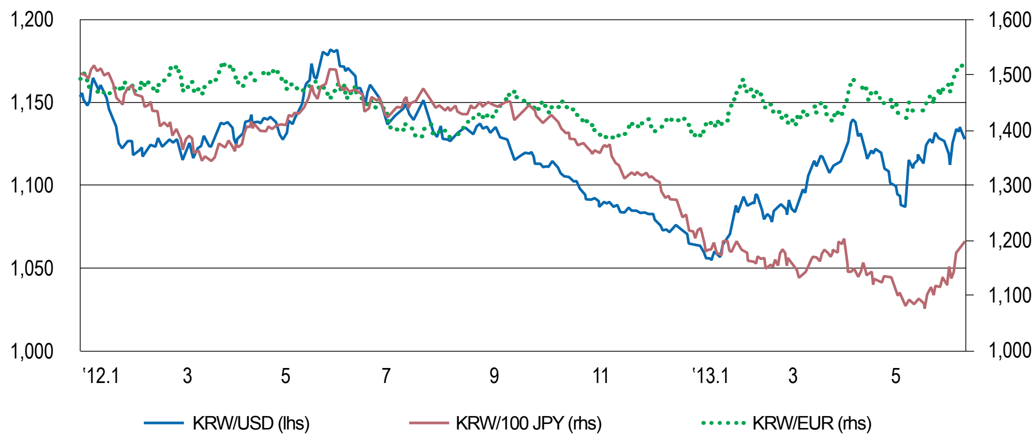
Interest Rates



KRW/USD on rising trend amid a current account increase between January and April

Mitigation of geopolitical risks associated with North Korean nuclear program since mid-April led to a temporary fall of KRW/USD. The appreciation of won was short-lived as KRW/USD rebounded to hit 1,128.3-level (May 31), showing the weaker won trend against the dollar.

Exchange Rates



Outlook for 2013

1. Internal and External Environments

Slower global economic recovery in the second half is expected

Despite vigorous pro-growth measures, the Eurozone economy forecasts to maintain a negative growth in the second half of this year. This is due to downside risks including instability in the banking sector, credit crunch and contraction in investment and consumption, which have interacted to play a negative feedback on Eurozone growth. In the U.S., uncertainties associated with the impact of sequestration and downsizing of QE may weaken the pace of economic recovery in the second half. Japan's 'Abenomics' is expected to buoy the economy but the upward momentum may slow down as 'side effects' associated with the excessive weakness in the yen (increased financial strain following the interest rate rise and slowdown of real economy) is lurking. China is forecast to show a more moderate economic growth after a recent policy shift that centers on the domestic demand and service sector.

Amid weak demand, increased non-OECD production, weakening of geopolitical risk and speculative demand are factors associated with downward pressure on oil prices.

With global economic recovery slower than expected in the second half, global demand for crude oil is estimated to be moderate. In addition, higher supply capability, removal of 'Iran risk premium' in oil prices and decrease of speculative demand are downward pressure factors on oil prices.

Midst the strong dollar, the yen and euro are weakening while the Chinese yuan continues a gentle appreciation.

Relatively favorable U.S. economy and confirmation for downsizing quantitative easing are factors associated with a strengthening dollar in the second half. Although yen riding on continuous weakening trajectory, its volatility surges as Abenomics loses its luster and Japanese stocks tumble. Perspective on a possible Eurozone recovery is obscure in the second half and the euro is expected to stay weakened. The Chinese yuan will maintain its moderate upward trend this year.

2. Outlook for Korean Economy in 2013

Growth: 1.7% (1st half) → 2.9% (2nd half), 2.3% (year)

The Korean economy in the second half is expected to have sluggish growth under 3% (oya) despite government's reflationary measures, including the supplementary budget. This is because expectation global economic recovery was dampened further by a slower than expected recovery process in addition to the current domestic situation in which conditions for improvement is obscure. This is attributed to factors such as a recent remark about US downsizing of QE, uncertainty regarding China's stimulative measures and the consequences of the Abenomics. The IMF continues to trim its economic growth forecast, whose latest forecast of 3.3% in April is almost as close to the last year's 3.2% growth rate.

Private consumption: 1.5% (1st half) → 2.0% (2nd half), 1.7% (year)

With evidence of consumer sentiment index (CSI) slightly improved, private consumption for the second half of 2013 is expected to increase mildly. However the uplift consumer sentiment is limited by downward factors such as readjusted household debt, fall of housing prices, and worsening of employment quality, all of which bring down the private consumption level to be 2.0% in the year's second half.

Facility investment: -7.8% (1st half) → 4.3(2nd half), -2.0% (year)

In the second half, facility investment is forecast to turn around to a rising trend due to base effect. However, slump in export growth and nation-wide discussion on "economic democratization" are the limiting factors to investment sentiment that cap the growth at around 4.3% in the second half of the year, which will lead to an annual average growth of -2.0%.

Construction investment: 2.8% (1st half) → 2.0% (2nd half), 2.3% (year)

Boosted by a SOC budget increase, public construction in the year's second half continues to improve; however recovery in private construction is expected to delay further due to a low demand, making overall construction investment a low 2.0% increase in the second half and 2.3% annually.

Export growth (nominal, USD): 3.0% (1st half) → 4.6% (1st half), 3.8% (year)

External risk factors in the overseas markets, such as downsizing of quantitative easing in the U.S., the lurking possibility of the failure of Abenomics, and political uncertainty of the eurozone economy that center around Germany and Italy, place cap on gradual export growth at 6.4% in the second half (annual average of 3.8%).

Current account surplus: US$22.3 billion (1st half) → US$20.8 billion (2nd half), US$43.1 billion (year)

The total current account surplus in the second half is expected to maintain a similar size as the surplus for the first half. Limited import growth together with low export growth will maintain a large-scale goods balance surplus.

Consumer prices: 1.3% (1st half) → 2.4% (2nd half), 1.8%(year)

Consumer prices are expected to continue a stabilizing trend with the growth rate at 2.4% in the second half, and annual average hovering on the upper 1% range. However, taking into consideration a fall in expected inflation and deflation gap, the upward pricing pressure is unimposing as spillover effects of the price increase of public service fee and food will be limited while global prices for raw materials will move toward downward stabilization.

Corporate bond yield (3-yr, AA-): 3.0% (1st half) → 3.3% (2nd half), 3.2% (year)

The market interest rates are expected to register an upswing expansion in the second half at 3.3%, a 0.3%p increase since the first half. Amid possibility of additional cut of base interest rate diminishing, possibility of downsizing of U.S. quantitative easing turned into reality; and a fall in domestic bond prices and upward pressure on interest rate will be expected.

KRW/USD: 1,100.4 won (1st half) → 1,086.0 (2nd half), 1,093.2 (year)

Favorable conditions such as current account surplus and relatively sound conditions of the bond market are major factors attributed to the appreciation of the won. The strong dollar following the debate related to the downsizing of QE and exchange rate policy of the Korean government will slow down the pace at which the rate is dipping.

Outlook for Korean Economy in 2013

Unit: %oya, US$100 million (Int'l Balance of Payments)

	2012			2013			2014
	1st half	2nd half	Year	1st half	2nd half	Year	Year
GDP	2.6	1.5	2.0	1.7	2.9	2.3	3.4
(SA, %chg from previous half)	1.2	0.3		1.4	1.5		
Private Consumption	1.2	2.2	1.7	1.5	2.0	1.7	2.5
Construction Investment	-1.9	-2.4	-2.2	2.8	2.0	2.3	2.4
Equipment Investment	2.3	-6.1	-1.9	-7.8	4.3	-2.0	5.6
Consumer Prices	2.7	1.7	2.2	1.3	2.4	1.8	2.7
Current Account Balance	137.5	293.9	431.4	222.8	207.9	430.7	342.3
Goods Balance	111.3	272.0	383.4	205.4	232.7	438.1	359.9
Exports (US$100 million, BOP base)	2734.1	2791.5	5525.7	2814.9	2918.7	5733.6	6123.6
Growth (%)	1.4	-1.1	0.1	3.0	4.6	3.8	6.8
Imports (US$100 million, BOP base)	2622.8	2519.5	5142.3	2609.5	2686.0	5295.5	5763.7
Growth (%)	2.3	-4.5	-1.1	-0.5	6.6	3.0	8.8
Services & Other balance	26.2	21.9	48.0	17.4	-24.8	-7.4	-17.6
Ex Rate (Avg. KRW/USD)	1141.7	1112.2	1126.9	1100.4	1086.0	1093.2	1045.0
Corp. bonds yield (3-yr, AA-)	4.2	3.4	3.8	3.0	3.3	3.2	3.9
Unemployment rate (%)	3.6	2.9	3.2	3.4	3.1	3.3	3.1
Changes in the number of employed persons (1,000 persons)	449.5	424.0	436.8	279.8	263.9	271.9	318.5

Policy Issue:

An overview of major risk factors by exports and its policy implications

Current status and outlook of the key export sectors

There is a growing concern over worsening export environments for the key export sectors of Korea. In the case of the automobile and trailer-manufacturing sector, the growth rate of export shipment index plummeted by 23.6% points as from July 2012, when the depreciation of the yen accelerated. Other transportation equipments manufacturers, including shipbuilders, continue to record less that 3% of growth.

Large-scale export sectors that have recently grown sluggish are steel, shipbuilding, electric and electronics (semiconductors, communications, home appliances, etc), automobile, petrochemical and machinery industries. Aggregate exports of these sectors take up of 69.9% of Korea's total exports as of May 2013. These sectors, with an exception of the semiconductors, have shown downward trends in production output, shipment and export level with no visible prospect of improvement in the near future.

Analysis of the impact of the global economic growth and the weak yen on the Korean export sectors

Korea and Japan have high export similarity in sectors of automobile, electric and electronics and shipbuilding, among others. The latest sector that joins the ranks is the computer industry. In order to assess the risk factors associated with export fluctuations of these sectors, we have used an export model, including variables such as global slowdown and the weak yen, allegedly the two key causes of the recent deterioration of these industries.

The analysis shows an overall positive correlation between export and global GDP growth. In regard to the weak yen, however, the direction of correlation differs greatly by sectors. In general, the weak yen has greater impacts on sectors that have a high export similarity index, though sectors that are relatively less affected by the weak yen despite their high export similarity scores do exist.

Implications

Businesses that are relatively susceptible to the depreciation of the yen should find means to improve their non-price competitiveness. Short-term and long-term efforts of, for example, product improvement and increase in R&D investment should be made to minimize the impacts against price fluctuation of other competitors.

The government should seek ways to minimize the impact of financial market volatility on industries with an emphasis on supporting businesses in improving non-price competitiveness. In addition, the government should focus on creating a market-friendly environment in which smooth operations of market functions are guaranteed, taking into consideration distinctiveness of characteristics by sectors and sizes.

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